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Foreword

The Eurofi Financial Forum took place in Prague on the eve of the informal Ecofin meeting and was organised in association with the Czech EU Council Presidency. The 46 sessions of this Forum involved 250 speakers from the EU public authorities and the financial industry and were followed by more than 1000 participants from the public and private sectors.

The main regulatory and supervisory developments in the financial sector at the European and global levels and the challenges from the Russia-Ukraine war were discussed during this Forum, as well as the main vulnerabilities in the financial sector and the EU policy initiatives aiming to support the digitalisation of financial services and the development of sustainable finance.

In the following pages you will find the summaries of all the panel discussions and speeches that took place during this international Forum, which provide a comprehensive account of the latest thinking on trends and issues affecting the financial sector and the policy actions needed to address them. We hope you enjoy reading this summary.

This report, as well as the different publications published on the occasion of this Forum (Regulatory Update, Monetary and Macroeconomic Scoreboards and the September 2022 edition of the Eurofi Views Magazine) are available on our website www.eurofi.net.

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I

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

Russia-Ukraine War: inflation and growth impacts

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 – major 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.

Several highlights emerged from the discussion:

- The shocks unleashed by the war are setting the EU economy on a path of lower growth and higher inflation;
- Central Banks need to move quickly to tackle record inflation in the eurozone;
- The fiscal stimulus, amplified by the pandemic has led to a considerable deterioration in the euro area's public finances: enhancing the EU fiscal rules is therefore essential to make them more effective, reduce the growing heterogeneity in terms of budget and debt across EU Member States and prevent debt distress; and
- The successful implementation of the Recovery and Resilience Facility (RRF) is key to foster growth across the EU.

1. Russia's invasion of Ukraine is severely setting back the global recovery and European economies are experiencing the greatest shockwaves of the conflict amid advanced economies

The Chair introduced the session by stating that these are very challenging times, as there is the double shock of Covid and the war in Ukraine. That has tremendous repercussions on the EU economic outlook, creates a great deal of uncertainty and risks to lead the international economy working with a higher degree of fragmentation. The war in Ukraine has disrupted Europe's strong economic recovery from the Covid shock while adding to inflationary pressures. The pandemic and the war in Ukraine have widened the gap between the EU and its main global competitors.

This opening session underlined that Ukraine requires support to its real economy for a protracted period of time to weather the storm, and the war in Ukraine is slowing economic activity and elevating inflation. The energy crisis is taking centre stage in Europe. The gas shutoff by Russia will have significant economic impacts in Europe and increase the cost of living for EU households. Despite sizable debt currently outstanding across many sectors, the balance sheets are generally in reasonable shape compared to prior periods.

1.1 Ukraine needs to rely on external support

An official stated that Ukraine has managed the war economy well in the last six months, as it has maintained a market mechanism and has been able to maintain macroeconomic stability during the war. The Ukrainian government has ensured that macro stability has been maintained, hyperinflation has not occurred, an exchange-rate devaluation has not happened, and savings have not been eliminated. This will allow a restart of the economy as soon as the territory is freed up. Significant external support has also been provided. The war will take longer than expected, but the principal parameters remain the same. Ukraine will need to rely on external support, and the Ukrainian authorities will need to continue to be agile in order to adjust to the demands of a war economy and to keep its objectives of managing through this war with its economy intact.

1.2 Economic activity is slowing, and the risks of stagflation are increasing in the EU

An official agreed that there has been a big shock to the global economy. The Organisation for Economic Co-operation and Development (OECD's) projection for world GDP growth in December 2021 was 4.5% for 2022, and in June the OECD cut that to 3%. The OECD weekly tracker is showing activities starting to fall off in Europe. On an EU 2022 average, purchasing managers indices (PMIs) are down into contraction territory in Europe, the United States and China. In December 2021 the OECD was projecting 2.7% inflation in 2022 for the euro area, and in June it forecasted 7%. Energy prices continued to surge over the summer, which is going to hold inflation higher and for longer. Europe has also had idiosyncratic issues, such as a severe drought, nuclear plants out for maintenance, and a large fire at a major US liquefied natural gas (LNG) facility.

An official added that Europe is having one significant shock after the next. Europe had a good exit from the pandemic, based on good policy settings, with one issue to struggle and fight with which was inflation. Russia then invaded Ukraine, which drastically changed the outlook. The IMF revised the outlook down for 2023 already in the July forecast and will do so again in October.

A policy-maker stated that the European Commission shares the economic outlook and the risks that have been mentioned. The expectation for the European Commission's autumn forecast is that it will substantially revise downwards its growth and inflation estimates for 2023. The baseline is that, in the medium-

term, growth will recover and inflation will return to the target of the European Central Bank (ECB). Stagflation is a risk and will depend upon policy responses in three key areas, one of which is energy policy. Discussions are ongoing with energy ministers in terms of an emergency intervention to try to alleviate some of the immediate impacts.

1.3 The energy crisis is taking centre stage in Europe

A policy-maker noted that surging energy prices have worsened the terms of trade in Europe and are expected to increase the cost of living for households. Country policies to soften the impact of high energy prices have varied, with price-suppressing measures being widespread. Energy measures need to be targeted at the most vulnerable, and high energy prices should be passed onto consumers to help price signalling and promote energy efficiency.

A public representative observed that if Eurofi had taken place two months earlier the main topic would probably have been inflation, implications for economic growth, and a proper reaction to the decline in real income. Two months have passed, and it is obvious that Europe is facing a huge energy crisis. He stated that Europe did very well in securing supplies, but it is now struggling with extreme prices. Before the crisis, Czech businesses and households only paid for electricity and gas energy, without taxes or distribution costs, calculated at around 3% of GDP. At the current prices it would be potentially 10% more, so the situation is very serious. It is important to work out how to make economies, countries, and the European Union more resilient to such crises.

A policy-maker observed that a policy issue to watch is on the fiscal side. Important fiscal interventions have and will support the most vulnerable in Europe, and also to support companies in order to get through the energy shock. A price signal needs to be maintained to keep encouraging savings on the energy side. Deficits of high debt have risen as a result of Covid. When the European Commission looked at the direct measures on energy in May it estimated that on average for the EU it was 0.6% of GDP. That figure is now probably closer to 1% of GDP. The European Commission has also been monitoring whether these measures are ones that act on the price side and have an impact on the marginal cost of energy, or whether they are operating on the income side. In May around 60% of the measures had been acting on the price side, but the percentage of that has probably gone up in recent months.

An official noted that support to households and firms is very important. Targeting is ideal, but there are advantages to the blanket support that has been provided, such as administrative simplicity.

1.4 The gas shutoff by Russia would have significant economic impacts in Europe and increase the cost of living for EU households

An official stated that two risks are currently on everybody's mind. One is the gas shutoff by Russia. An IMF study showed that if gas had been shut off in June or July it would have meant a shortfall of supplies in some central European countries over the winter months of between 15% and 40%. The IMF estimated that for these countries over a 12-month period the impact on GDP would be a drop of between 2.5% and 4% of GDP. The IMF believes Europe is currently on a knife edge where, if Russian gas is cut off completely, Europe would not need to go into a rationing scenario for these countries, and the price mechanism could deal with moving energy to where it is needed most. This is because policymakers took action, looked at alternative supply in order to bring those online, and dealt with infrastructure bottlenecks in order to deal with those.

An official added that a second issue is the cost-of-living crisis, related to the gas issue. The IMF estimated in July that the cost of living of average European consumers had increased by 7%, which is a huge increase in terms of cost of living. When looking at Estonia and the UK, the impact on the lowest-income versus highest-income quintile of this energy crisis is double. This calls for allowing prices to pass through to end consumers, because a demand response is needed in order to cut back on energy consumption in order to make it through. It also calls for targeted subsidies in order to protect the most vulnerable in society, because this is going to be expensive. The IMF estimated that, if the lowest quintile is made whole for the cost-of-living rises, it would cost an average of 0.4% of GDP in Europe for 2022. That was before the last increase in gas prices. If the lowest 40% of consumers in terms of income are bailed out, it would cost 0.9% of GDP. It is vital to ensure that targeted subsidies are part of the mix in order to protect the poorest, and that prices are passed through in terms of getting a demand response on the energy side.

1.5 Despite sizable debt currently outstanding across many sectors, the balance sheets are generally in reasonable shape compared to prior periods

An industry representative stated that, despite sizable debt currently outstanding across many sectors, the balance sheets are, in general, in reasonable shape compared to prior periods. Overall default rates and transition rates are relatively low at the moment and are below the 10-year average still at this time but rising. However, the current Moody's forecast at the moment is for 2023 growth rates dropping to 0.3% for the euro area. That forecast came out just days before Nord Stream 1, recognising that there are other pipelines for oil. When Moody's look at the different risks across the sectors, there is the short-term risk that has been discussed regarding dealing with inflation and the need to find different transmission mechanisms across the energy sector. Moody's has identified multiple ways that can curtail the impact and the pressures from energy across societies, and they can fall into the supply side or the demand side.

An industry representative added that there are different exposures when thinking about the sovereign space, the banking space and the non-financial corporate space. There are still a number of countries across Europe that are exposed to a stagflation scenario due to the wage-setting mechanism and indexation. There is an expectation that throughout this next three to-five-year period there will be a weakening of debt affordability as

a result of rising rates and policy responses. Moody's estimate that only about 20% of its non-financial corporate portfolio would be in severe stress, should there be a full curtailment of Russian gas, because of the measures that many of those companies have taken in the short term.

2. Normalising monetary policy to tackle record inflation in the eurozone

2.1 Central banks have an exclusive responsibility to keep inflation under control

A public representative stated that the EU economic framework still contains shortfalls, such as central banking. Central banks have lost part of their credibility in recent months because people are losing the value of their savings. Central bank should go back and focus on price stability, which should be the goal. Central banks must be run by professionals, and political influence should be kept low and be strongly resisted by those professionals.

2.2 No current sign of a wage price spiral

A policy-maker noted that an important policy area to watch for is in terms of wages and the avoidance of a wage-inflation spiral. There has been an uptick in terms of nominal wage settlements in recent months, but they still remain substantially below projected inflation rates. Structural changes in the labour market have taken place, indexation of wages is much less prevalent than in the past, and wage negotiators have been prioritising job security over wages.

2.3 Real interest rates remain very negative, and central banks have to continue to move

An industry representative stated that 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. In addition, the energy situation passed through into wages and other prices, so the central banks cannot ignore what is happening.

Central Banks have to act. The arguments about inflation being transitory were illusory. The Fed has begun to move. The divergence of US and eurozone monetary policies has resulted in much wider interest rate differentials. Consequently, there has been a depreciation of the euro down to parity and which traded at its lowest levels in two decades is being seen. This favours European exporters, but Europe is paying more for energy because of that depreciation. It is difficult to know whether the Fed will 'overdo it', but the current inflation rate in the US is in the high single digits while the Fed funds rate is at about 2.5%. What is priced into the futures curve may not be enough.

3. Enhance EU fiscal rules to make them more effective and prevent debt distress

3.1 This is not the time to relax fiscal rules in Europe

A public representative stated that fiscal policy is a big issue that EU countries will be confronted with in the years and months to come. Sustainable fiscal policy in all parts of the EU is needed. EU member states must have a fiscal policy that does not rely on zero interest rates. It must be economically sound, transparent and must work in the short term.

An industry representative noted that while the policy coordination that takes place during the European Semester and the Stability and Growth Pact (SGP) have the potential to address this vulnerability, a lack of policy tools is not the barrier to reducing the significant differences in credit quality among member states. Adhering to the existing EU rules will be a key driver to de-risking sovereigns' credit profiles. 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.

3.2 The limits of current EU fiscal rules

An official noted that the IMF recently brought out a paper on its proposal for a reform of the European fiscal rules. Existing fiscal rules did not prevent deficits and debts ratios that have threatened the stability of the monetary union in the past and continue to create vulnerabilities today. The fiscal rules in place did not deliver on one key principle: when times are good, fiscal buffers need to be created for bad times. The existing EU fiscal framework also did not also support EU-wide macro-stabilisation.

3.3 IMF proposals to strengthen the EU fiscal framework

An official noted that the IMF's proposal is to enhance the whole system, not to scrap the 60% debt limit under Maastricht or the 3% budget deficit limit. The first pillar of that enhancement is to have the speed and the ambition of any adjustment under the fiscal rules determined by the fiscal risks coming from a country. The IMF proposal is for a high-risk country to have a fiscal-adjustment target specified country by country, but to adjust the overall fiscal balance over a period of three to five years towards zero or positive. Countries need to be more ambitious the further they are away from the 60% target.

An official explained that the second pillar of the IMF proposal is to have a greater number of stronger national institutions in place. Multi year expenditure caps need to be in place on an annual basis, so that policymakers have clarity on what the targets are, and that the targets are tangible and visible to the population. The third pillar deals with the macro stabilisation part and the issue of common goods. Macro fiscal stabilisation should be part of the new fiscal rules. Central fiscal capacity should be enhanced through a climate fund to deal with climate issues and energy security. It also needs to examine common public-good issues where it makes sense to operate across the European Union.

3.4 Keeping the 3% of GDP deficit rule is a reasonable option while the 60% of GDP debt rule would be personalised on a case-by-case basis, depending on available margins and debt sustainability

An industry representative agreed with focusing on the 3% deficit target, but the 60% debt level is more problematic. Most European countries are currently far above the 60% debt level. France is at about 112%. EU government debt to GDP is at about 95% overall. To go toward 60% would be trouble economically, because it implies a big deflationary impact.

An official asked whether the specific fiscal targets should be set at the international or supranational level, and whether it should be a more principles-based fiscal framework where sustainability is a principle. The exact targets should potentially be set at the national level because a key component is political commitment.

3.5 The Commission's proposals on the reform of the Stability Pact are expected in the fall of 2022

A policy-maker stated that the intention of the European Commission is to come forward with proposals and suggestions in the autumn, ideally well in advance of member states submitting draft budget plans which are due at the end of October. The intention is to move ahead. It is very important that consensus on the medium-term fiscal framework is agreed as soon as possible because the general escape clause applies in 2023. There is a great deal of consensus on the objectives. Public investment is well below the levels that will be needed to meet the digital and climate transition. The fiscal rules need to be supportive of that. A critical issue will be ownership. In building ownership, it will be important to build upon the positive experience of the Recovery and Resilience Plan (RRP), where Europe seems to have found a better approach to getting engagement on a quasi-contractual basis, where difficult structural reforms and important investments are committed in response to financial support coming from the EU.

A public representative stated that the EU should have a good market infrastructure with good policies, resilient systems and different support measures. Europe has not progressed the European Deposit Insurance Scheme (EDIS). The impact of the energy crisis on society and businesses is enormous, and it is very difficult to address it with non-targeted measures. The hope is that there will soon be a discussion about taking some market-consistent measures that will cut the peaks of the electricity price.

4. The successful implementation of the Recovery and Resilience Facility (RRF) is key to foster growth across the EU

A policy-maker stated that the implementation of the RRF is key. The RFP was legally adopted 18 months ago and became operational 12 months ago. 25 national recovery and resilience plans have been adopted, with the Netherlands soon to be the 26th. The European Commission has already received 13 payment requests. Seven payments have already been made, for a total of €112 billion. €112 billion dispersed in one year is probably equal to or more than what the European Commission disbursed last year for all of its structural funds and agricultural funds combined. For the countries that have submitted payment requests, the European Commission has seen the most progress in euro area countries with high deficits and high debt. In Italy the European Commission is putting hundreds of millions of euros into the operational capacity of the justice system to recruit 20,000 legal assistants to support the judges, and to modernise the IT system and the justice system.

A policy-maker added that the European Commission is expecting 25 payment requests by the end of 2022. Countries have made commitments in terms of difficult reforms, and now is the time to deliver. €113 billion has been disbursed, but there is still €550 billion available, of which 40% has gone into climate objectives. €250 billion has gone into the area of the green transition. 30% of that is directly related to energy efficiency, 15% to renewable energies, and 30% to sustainable transport. This funding is already available to tackle the immediate crisis around the transition that needs to be accelerate in the face of the current crisis.

An industry representative observed that that the NextGenerationEU (NGEU) economic recovery programme offers an opportunity for some of the EU's most indebted countries to improve their credit fundamentals. It is a once-in-a-generation opportunity that has to be recognised for the changes that need to be made by the recipient countries. Simplicity and transparency are vital.

An official stated that the NGEU approach is working. The link between reforms and money is important, and that is helping in terms of productivity increases. Most of the money goes to those countries most affected, and they are the most engaged.

An official stated that the EU programme is going in the right direction. It is putting money into digitalisation, which is an area where Europe is clearly behind the United States. The United States has around 70% of digi tech firms in the top 100 by market capitalisation and Europe has 6%. OECD research shows that those top 100 firms are the ones that drive productivity growth.

Europe had a vaccine that came much faster than any scientist said would come. Policy makers decided to keep the economy supported for a vaccine that they thought would not be coming for a long time, so they overstimulated. Inflationary pressures then came out of the pandemic. Russia then illegally invaded Ukraine. More surprises would come.

A public representative stated that bad politics or bad policy can cause huge harm, even in the short term. There is no space to make huge mistakes, because recovering from mistakes takes time. The level of unity shown by western countries in response to Russia's invasion of Ukraine has been excellent, but people now doubt whether there will be solidarity in Europe over gas or electricity. Success is not a given, and the challenge can be failed if Member States do not reach a functional compromise. However, the track record is not bad. Big issues with a social dimension can only be solved at the EU level. Member States are complementing each other strongly.

Monetary policy and stagflation challenges

1. Persistent inflation and its causes

1.1 Two approaches to address monetary policy challenges

An expert remarked that there are two attitudes for looking at the macroeconomic monetary problem of Europe. One is to try to be reassured, because energy prices should decelerate, and inflationary expectations should peak before the end of this year and will gently decline in 2023 to reach the sacrosanct 2% target in 2024. In addition, there are no significant increases in wages. With this view it is only possible to 'normalise' monetary policy in a gradual way, pushing nominal interest rates towards neutrality. This view is present in Europe, but not in the United States, because of a belief that inflation is exclusively a supply-side problem.

However, while oil prices will probably stabilise, long-term considerations like the ecological transition imply energy prices should continue to rise. Secondly, wages in Europe have not yet reacted much to inflation, but they are starting to be revised upwards. The trend towards systematic indexation that many European countries showed in the 1970s should not be forgotten. The assumptions of the European Central Bank (ECB) for a wage increase of 4% in 2022 is optimistic. The depreciation of the euro/dollar exchange rate, as well as the current very expansionary fiscal policies, are fuelling additional inflationary risks in Europe. Lastly, on the convergence of inflation expectations towards 2% in 2023, claiming that monetary policy will reach neutrality if nominal rates reach the 2-2.5% range is circular reasoning. After the increase of 75 percentage points, it seems a bit far reaching to consider that monetary policy is moving towards neutrality when nominal rates of 0,75% can be compared to 10% inflation. Given the uncertainties, procrastination carries financial stability risks that a central bank dedicated to monetary stability cannot take.

1.2 Inflation is driven both by negative supply shocks and positive demand shocks

1.2.1 Monetary policy in the face of the pandemic and energy shocks hitting the euro area economy

A Central Bank official pointed out that the euro area is seeing inflation driven by the two unprecedented shocks of the pandemic and the war in Ukraine. When inflation is driven by supply-side pressures, an undue tightening of monetary policy would aggravate the negative output effects of the supply-side shocks. The energy crisis is equivalent to an energy tax, because Europe is a very large net energy importer. Europe is different from the United States, which is a neutral or a large energy exporter. 75% of the disruption in consumer prices and output comes from natural gas, which, due to Europe's electricity marginal cost pricing rules, affects the electricity price one-to-one.

Models and estimations suggest that between 2022 and 2023 the gas price will go up by 40%, and so the same holds for electricity. This is what keeps average inflation at 5.8% next year compared to 8.1% this year according to the ECB baseline scenario.

The issue is not wage growth. On average wage growth in Europe is 3.5%. Subtracting productivity growth, it is very close to the 2% target. It is not inflationary expectations, either from surveys or from the five-year/five-year swaps, which are also close to 2%. It is not a positive output gap.

1.2.2 An unprecedented energy crisis

An industry representative remarked that the source and clear trigger for the inflation was the surge in energy prices. Between 2015 and 2019, the EU imparted roughly €400 billion of oil and gas, at $55 per barrel of oil and €20 per megawatt of gas. The jump in energy prices amounts to a new permanent tax. We can make various assumptions on prices and reduction in consumption, but it will be not far from €400 billion and €500 billion. . That is a meaningful and permanent shock. It was of paramount importance for the Governing Council to raise the three key ECB interest rates by 75 basis points. A Central Bank official warned that the very high energy prices have to be accommodated as soon as possible. The ECB wants to be more proactive and to have strong increases in rates as a result.

1.2.3 Inflation as both a supply and demand shock

A Central Bank official explained that as to inflation, the risks are on the upside. First, multiple supply-side shocks came in over the past year. Most likely more supply shocks will be seen in terms of energy or food supplies. However, it is not only supply; the demand side is also kicking in. Monetary policy has to do its job, which is price stability. The ECB has raised rates twice already and expects to do so at the next several meetings as well. Uncertainty is extremely high, so providing detailed forward guidance would be a mistake, but the direction is very clear. The inflation differentials across the euro area countries are natural because different sets of economies have different fundamentals (e.g., weight of energy in consumption, domestic demand growth...). However, if inflationary differentials build up that is an issue.

1.3 Avoiding recession will be very difficult

A Central Bank official suggested the risks to growth are to the downside. With the current high inflation for the European economy to pull through without recession would be a massive success story but quite unlikely. With high inflation, avoiding recession as such will be

very difficult. A Central Bank official stated that the question is whether there should be patience or whether there should be a somewhat more aggressive monetary approach because the upside risk for inflation is higher than the downside risk. The issue is not only monetary policy but also accommodative fiscal policy. There is the question of whether inflation expectations have been destabilised. There are strong signs of inflationary expectations being unanchored, so there is a need to be very careful.

1.4 While wage growth appears limited in Europe monetary policy cannot remain expansionary

A Central Bank official emphasised that one of the aims of monetary policy is to anchor expectations. Another Central Bank official noted it should be asked whether the pandemic is temporary or not. The same holds for the war and energy supply. It should be ensured that trust is built that expectations will be anchored where the target lies.

A Central Bank official remarked that when policymakers take decisions, they should always think on acting at the margins. There should be humility in the present moment of high uncertainty in which Europe is at war. Recognized that the ECB's decision that had taken place the previous day sent a very clear signal that the ECB is taking action and will continue to act. This message is also very clear to the labour markets. There are no signs of second-round effects in European labour markets, and the workings of Europe's labour market proved to be much more efficient in the reaction to the Covid crisis and the current challenges.

Europeans always feel that the speed of adjustment and efficiency typically seen in the US labour market does not translate to Europe, but this is wrong. In Europe, the numbers show the same Beveridge curve as before the crisis. In the context of a huge shock to the economies, Europe's labour markets kept going, even when the government support faded away. Contrary to that, the US showed a significant outwards shift in the Beveridge curve, meaning that for the US to fill a vacancy a much higher unemployment rate is needed, or, putting it differently, there is a huge number of vacancies compared to the number of unemployed people in the US.

The ECB's decision is a signal to the labour market that there is a need to continue in this way. It is not a call for wage restraint, but for the labour markets to continue working as they currently are. When the Beveridge curve is moved outwards, something has to give, which means wages. There is a need to be patient and to act at the margin. While times are very challenging for Europe, they are not yet difficult. Monetary policy aims at bringing inflation back to target.

The Chair agreed that this applied to Central Eastern Europe. On aggregate in the eurozone, wage pressures have not been high so far, but Central Eastern Europe looks to be between Western Europe and the US in terms of the labour market. It is a more flexible labour market, with higher wage pressures and a tighter labour market than in Western Europe. He noted that, looking at the current statistics across Central and Eastern Europe, wages are growing much more quickly in the private sector than union-negotiated wages under collective bargaining. They are a small share of overall wages, so the pressure in the labour market is higher and inflation rates are higher in Central and Eastern Europe.

2. Calibrating the policy responses to rising inflation

2.1 The strong price increase is hitting society

The Chair highlighted that Europe is suffering a large terms-of-trade shock. In a terms-of-trade shock of this size, somebody has to pay. An industry representative observed that there will be further elevated public debt after the crisis. It is unlikely, in the medium term, there will be lower debt rates. Talk of monetary and fiscal policy is always very strategic and high-level but the numbers on the ground give a sense of how people feel. The spill-over into consumption is taking place because inflation has already eaten away significantly into what people put aside. The German savings banks association issued statistics highlighting a net deposit inflow of only €600 million in the first half of the year. That compares to €25 billion in the previous half year, which is a drop of 97%. The average European saver who has a small, conservative portfolio of investments, with lots of bonds and a little equity, was down 7-9% in the first half of the year. That is a significant negative wealth effect. People are suffering, and that needs to be acknowledged.

2.2 Weapons to tame inflation

A Central Bank official pointed out that the inflation problem can be compared to the three-headed Hydra from Greek mythology. There are three heads, so he suggested three weapons are needed. Monetary policy is one of the weapons, but it should not be the only one as that will be very costly in terms of output and employment. The other two weapons are fiscal and energy policies. Energy policy is needed to disentangle, temporarily at least, the electricity price from the natural gas price and to retain incentives for energy conservation and green energy investment. Fiscal policy has to retain a stance which should not be in conflict with monetary policy, while using targeted rather than horizontal measures to support the most vulnerable. Tax subsidy instruments are also needed.

A Central Bank official added that national fiscal, structural and macroprudential policies are extremely important to establish a healthy and effective policy mix. Even if national policies can contribute to addressing inflation challenges, there is a lack of broad common policies, especially in terms of common fiscal policy, for the euro area.

2.3 Drawing the line between warranted and unwarranted interventions is a major challenge for monetary policy

A Central Bank official suggested the bigger picture presents an economy that did not suffer coming out of the pandemic because of the fiscal help and monetary easing. It is still strong, and that can be seen on the

labour-supply side as well, which is different from across the Atlantic. There is also financial stability with a strong banking sector post-financial crisis.

On the negative side, there is a war. Governments today have successfully helped households and industry because it was said the pandemic would be short-term and the desire was to hit the ground running. In a way that did happen, given the enormous pumping of money. Although energy prices are a price signal, and there is a need to economise, but current governments will not allow it. They have been used to solving problems and helping households by spending and currently there are no regulations in place at the European level. Government attitudes have changed. At the same time there is globalisation. With sanctions and bad relations with China it is really moving, which will affect efficiency. Then there are climate risks.

Central banks cannot afford to make mistakes. However, the limitations of their instruments have to be understood. They are demand-oriented, but the response is to a supply shock. While the ECB's commitment to stable prices applies over the medium term, to account for the supply side dislocations behind the current spike in the price level, an annual rate of increase of consumer prices above 8% warrants a normalisation of the supportive monetary policy stance of the Euro system. A too slow withdrawal of accommodation risks entrenching a high inflation regime and prompting second-round effects on wages. At the same, the necessary normalisation of the policy stance must be implemented given the uncertainty in the global economy.

2.4 Normalising effectively monetary policy

2.4.1 Monetary policy has become even more accommodative in the eurozone

An expert reminded the audience that people think very low interest rates are going to create more productive investment, but they are mistaken. The charts calculated by the International Monetary Fund (IMF) show that over the last 20 years of real negative interest rates global productive investment has fallen significantly. Negative interest rates are not good for investment. They are the cause of the liquidity trap that Keynes described so well, and which makes people place savings into very short-term liquid instruments instead of long-term projects that carry risks. When risks are not remunerated but taxed there is not much appetite for long-term investment.

An expert remarked that there have been 15 years with very low inflation around 1% per year and nominal interest rates from central banks of effectively zero. So, there was an environment of -1% in real terms. The current situation is much worse than during the last 20 years because instead of doing the arithmetic with negative interest rates of -1%, it is now -8,75% (considering the current annual inflation rate of 10% and the ECB fixed rate of 1,25%). With interest rates of -8,75% the conclusion is that, in real interest-rate terms, there has been a move towards immense accommodation of monetary-policy conditions.

There are complaints because interest rates have been "boldly" increased by 0.75% at the September ECB meeting, but, at the same time, the monetary conditions have been enormously relaxed. This is very important, if the fight against inflation is considered, real interest rates must be considered. If real interest rates are so advantageous for the borrower, the monetary causes of the past inflation will continue because some are saying that it is a supply-side shock. It is a supply-side shock, but it is in a monetary environment of strong monetary creation. If no attention is paid to this, a very dangerous track will be followed.

2.4.2 Inflation cannot be broken with high negative interest rates

An expert pointed out that normally, central banks should tighten when inflation threatens. Instead, we see the opposite: a significant de facto loosening monetary policy conditions. Before saying there is monetary neutrality, nominal interest rates have to be brought to a point that they offset. They should offset the basic guess that anyone in the street would make, which is that inflation is going to be around 4-5%. When Volcker made his break of inflation, inflation continued at 5%. Supposing there is 5% inflation, the European 0.75% increased rate can be looked at. That is not up to it; it will have to be increased further. That is disagreeable to hear, but people are not in these roles to be agreeable. They are present to look at reality. The question whether it is truly believed that inflation will be broken with significantly higher negative interest rates. Waiting too long in the euro area for effectively normalised monetary policy will not make life easier.

A Central Bank official noted central banks cannot determine the real rate of interest in the medium to long term. They can only determine nominal magnitudes. Before the pandemic there was secular stagnation. Despite huge quantitative easing (QE), inflation was almost negative and interest rates very low. Productivity growth and the natural interest rate were decreasing. That is what drove the developments.

The real interest rate should be the difference between the expected interest rate and expected inflation, and according to that real interest rates have been going up since normalisation was started in both the US and Europe. Bond yields are 2.5% because people expect that inflation will decrease, because it is supply-side issue in Europe. Monetary policy normalisation has started. Huge losses on output and employment could be imposed, so there has to be caution.

A Central Bank official pointed out that supply shocks are quick to pass through to prices and inflation jumps up quickly. In contrast, monetary policy has significant lags. The full impact of the monetary policy will come in about a year and a half. That is why it is extremely important to ensure that expectations remain anchored at about 2%. Another factor is core inflation, which has been trending up and increases the risk of inflation becoming entrenched. This is why the ECB will not stop at the September rate raise by 75 basis points.

A Central Bank official noted that the monetary-policy strategy was revised also because inflation was previously anchored on the downside. There is now symmetry in the

rules. It is introduced to grant more leeway for the ECB.

A Central Bank official referred to the fall in the equilibrium rate over the last 40 years. The full answer for what has driven that is not known, but productivity has played a role. The second issue is population and an ageing demography. The third issue is the accumulation of excess savings in the north EU countries. The task is to consider this not as an exogenous variable, but as one that that can be influenced by policies. If and when it is possible to make the green transition with the creation of high productivity, that will allow for this but also get rid of some of the excess savings. There is a major role for policies that needs to be discussed.

2.5 Building more structural resilience

2.5.1 Fiscal measures must be targeted for the households that need them most

The Chair asked about the loss of purchase power and the effect of inflation on households. Inflation has a compound effect whereby with 6% or so for three years in a row almost a quarter of a person's wealth is gone if their income does not increase. A Central Bank official understood that the major problem is a political one in terms of messaging, because if there is a terms-of-trade shock it cannot be compensated for. Only the most vulnerable can be compensated. The result of trying to compensate everybody is hyperinflation. What can be done is an attempt to reverse the terms-of-trade shock through specific measures, and here the problem is Europe is caught in an unfortunate investment, which is its full dependency on gas. Looking at the broader worldwide picture, things have already changed. The shock that happened last year, before the war, was a demand change in Asia. The situation has changed again, and liquefied gas can be bought very cheaply in Asia, but it does not come to Europe.

An industry representative noted monetary policy is playing its part. Fiscal agents are also playing their part, but handouts cannot be the solution. That is a short-term fix, and, in many instances, it is important that support fiscal measures are targeted at the right level. However, there is another avenue not being discussed enough which is around the regulatory and fundamental finance framework within Europe.

2.5.2 Further integration of banking and capital markets would strengthen the capability of Europe to address asymmetric shocks

A Central Bank official noted that, from the macro perspective, Europe's capital market does not yet exist, so it is always inclined to use fiscal policy to compensate for asymmetric shocks. In the US, at least half of the shock is absorbed by the capital market. At the micro level, there is a lack of equity in small and medium-sized enterprises (SMEs). In most countries, the legal effects are often not there.

2.5.3 Accelerating the green transition

An industry representative emphasised that the energy transition needs to be accelerated. On top of the monetary response, conditions to reduce the impact of energy on the economies must be created. The right incentives to adapt consumption of oil and gas are needed, all the while protecting citizens and especially low-income households. Governments need to put in place a massive increase in both public and private investment to prepare a better energy mix. At the same time, dependencies need to be reduced for the sake of European Sovereignty.

An industry representative remarked that the energy-transition conversation should not be limited just to investment in renewables. Four-fifths of the European commercial buildings there are not fit for purpose and need massive investment to reach the energy targets. When thinking about big policy measures, there should not just be quick fixes. The long-term impacts should be considered.

A Central Bank official noted changes in the setting of energy prices are possible; there is a need for Europe to be more differentiated in how it gets energy. There has to be clarity and greater strength on the green transition. While it is important to think the energy crisis can be aided by putting windmills on mountains, using a great deal of hydrogen and putting photovoltaics into fields will help, that will not solve the problem. For sustainable and renewable energy, the thinking has to go beyond what is currently on the table, and this is something that will occupy people in the future.

2.5.4 Private investors should play a role in public policy transformation

An industry representative referred to the lack of diversification of savings assets across Europe. There are not enough real assets in these portfolios because they are a key element to protect purchasing power for the long run. Real assets are not very difficult to combine. There is a significant demand out there, as Europe is hopefully transitioning to energy independence. This is a longer-term problem and the shift to energy independence will be crucial. One way of doing it is investment in renewables.

In the first half of the year, Europe saw €44 billion of private money raised for infrastructure projects, mainly in renewables. There is significant demand, not just in Europe but also in the US and Asia, for investments to come into Europe and for what will be a generational shift in terms of energy policy and energy investment opportunities. There should be much more strategic public-private partnerships to tackle these elements. They will help with inflation, the shift to renewables, a longer-term prosperity picture and much more stability in Europe.

The Chair noted people from the energy sector usually comment that there is plenty of money. The problem is that they cannot get the permits or plan projects because there is always somebody complaining, often the same people who insist on having renewable energy and on fighting climate change.

2.5.5 Banking industry solutions to address negative consequences of inflation on households

An industry representative reminded the audience that 70% of European financing is currently coming from banks. Monetary policy has therefore a more pronounced impact than it does in the US, where 75% of

the economy is market-financed. In France, we do not witness a deterioration in the creditworthiness of clients, either retail or corporate. The level of bankruptcy is still below 2019 levels, and the same is true for households. There is a social and governmental demand for coordinated action by banks, and that is what the industry is doing in Europe. This ranges from a freeze on fees and commissions, to bespoke, proactive actions to help clients, such as specific repayment holidays from bills, raising very technical issues. A default must not be triggered according to European Banking Authority (EBA) regulations. In this context, the industry is striving to find solutions.

2.6 Thinking in general equilibrium terms and being more optimistic about EU responses to the crisis

A Central Bank official recommended considering the most difficult period experienced, starting from March 2020. Workers were told to stay away from their jobs, so supply was very depressed. Nonetheless, there was deflation in 2020. The fiscal stimulus in the US between 2020 and 2022 was 18 percentage points of GDP larger than Europe. Nevertheless, Europe is panicking about fiscal policy today. That does not make sense. There should be more consideration in general equilibrium terms. European sovereignty is feared, but with that there will always be difficulties moving ahead in a global world.

In 2019, 14 out of the 19-euro area Member States were at their medium-term objectives for fiscal policy. That was the first time there was a period without excessive deficit procedures in any country in the euro area. It is a very difficult task for a country to be at its medium-term objectives according to the treaties. But that was the position and there was to be even further convergence in the coming years had it not been for the Covid crisis. Fragmentation is an issue in Europe, but Europe is doing its job. No one else will do it for the region. Europeans must believe themselves. There are very strong institutions, they have been improved but they have to be improved. The CMU and on Banking Union will need to be achieved.

A Central Bank official agreed about the need for certain optimism. For fiscal policy, support for the vulnerable groups must be provided in a targeted way without fuelling inflation further. High inflation is a problem, and the longer it stays high the stronger the second-round effects will be, and so the more monetary policy action will be needed. There should be a healthy policy mix that includes monetary, fiscal, macroprudential and structural policies. Fragmentation is monitored very closely by the ECB. Ultimately there is one monetary policy for the whole of the EU and it has to be ensured that is transmitted throughout the euro area. There is a very powerful backstop in the Transmission Protection Instrument (TPI) to address issues of unwarranted and disorderly market dynamics when things go wrong.

A Central Bank official suggested if policymakers are not optimists, then depression is transmitted to the private sector, households and companies. There should be anti-fragmentation instruments in the Euro area because it is not a perfect Economic and Monetary Union. It does not have a fiscal union or a Banking Union. There is no Capital Markets Union (CMU). This is why, with the first signals of instability, the classical division between north and south comes to the surface, irrespective of the fiscal situation of countries.

The European south is now solvent. The debt-to-GDP ratio of Greece, for instance, is high but falling rapidly. The old-fashioned procyclical fiscal policies have been abandoned, and now the snowball effect is favourable. (This is the difference between the growth rate and the average interest rate of public debt). These are the kinds of policies needed. Anti-fragmentation instruments are needed at the central bank, because the other part of the Economic and Monetary Union (EMU) is not perfect yet so the burden falls on the monetary side.

A Central Bank official remarked that fragmentation is a problem due to a lack of unity. Markets would respect a common front and would not pick up on and attack individual countries. There is a question of a moral hazard at the bottom of the CMU, Banking Union and depository guarantees being incomplete. Strong countries would not contribute if they saw weaker or vulnerable currencies not doing their job. They would say they want to be disciplined and need reforms. By voluntarily undertaking those reforms and showing seriousness about them, unity will come.

In various Council, Parliament and ECB discussions this moral hazard is not discussed, but it can be seen. With unity, there is no need for any instrument because the flaws are made up for. It is a political union because it is willed, and whatever is necessary will be done. The moral hazard has to be addressed. The stronger countries need to be generous, but, at the same time, they need the assurance that the weaker ones will pick themselves up and stand up.

A Central Bank official added risk reduction measures should take place at the same time with risk sharing measures, and that will solve the moral hazard problem. A Central Bank official suggested NextGenerationEU is an experiment in this respect. More than €750 billion has been distributed asymmetrically, with the hope that this will help to reduce some of the economic differences, allowing Banking Union to be proceeded with, and for there to be more fiscal public investments.

Fostering investment in the current EU macroeconomic and geopolitical context

1. Mobilising private resources and achieving synergies with public investments in the green transition

1.1 The green and digital transitions involve a great deal of money

How to find €650 billion per year until 2030 to spend on something considered politically important? An official opened the panel by reminding the audience that the green and digital transitions involve a great deal of money. The sources of that money are public money, or private money, or a combination of the two. It is probably going to be a combination of the two.

An official noted that, although the green and digital transitions are desirable, the net present values are not positive, so it is not beneficial to invest for the private sector. The public sector needs to provide public goods, where there is not necessarily a lot of money to be made. The public sector provides infrastructure, but European rules can be seen as an obstacle. There is the question of the allocation of savings in Europe and the most efficient way of mobilising the resources needed. A large amount of cash is available. There is the economic environment. The energy crisis favours investment in sustainable energies in order to become less dependent on Russia and on fossil fuels. Producers of hydroelectric energy are making large profits at the moment and taxing them more is being considered. This is normally the signal to invest more in a particular type of technology. The big question is whether there is something wrong with the framework for the financial market.

1.2 The transition cannot be financed by public or private money alone

A public representative noted that private households are normally long-term investors. Long-term investment is needed to finance the transition towards a carbon-neutral society. Whether banks are the right investors could be questioned because their business model is for short and mid-term investments. Even more of a mixture than only public/private has to be created. What is private has to be identified, whether it is only the huge pension funds or insurance companies. How to attract normal people must be considered. The best solution is a combination of everything. The public can take some risks, as with the European Fund for Strategic Investment (EFSI). Above this risk-taking from the public, private investment can take place.

1.3 Making full use of available public resources and addressing possible supply side bottlenecks to move fast with green transition and reduce the reliance on imported energy

An official noted that Lithuania has engaged in a very ambitious green transition programme in the public sector. The current rate of inflation in Lithuania is more than 20%.

An official stated that two-thirds of inflation in Lithuania results from energy, increasing the profitability of businesses investing in energy projects. However, the projects for the public sector are becoming more expensive. Lithuania alone will need 14 billion euros of investments until 2030 for the green transition. Previously, Lithuania used the subsidy side of the Recovery and Resilience Facility - the key instrument at the heart of NextGenerationEU -, but now Lithuania is planning to also use its loan side. In Lithuania, the focus is also on energy security.

Investing more into the green energy and acting faster might lead to more freedom and security in the coming years. The electricity price for businesses in Lithuania is one of the highest in Europe. Not investing in electricity from renewables is no longer a choice, but the banks are not providing enough funds to do that for private firms. There are also bottlenecks on the supply side, for example in relation to solar panels. If too much public funding is provided, the price of solar panels will increase, so we need a balanced solution. To maintain the country's competitiveness, it is necessary to consider the green element in taxation decisions, utilize public funds and attract private resources. Investing in renewables will increase Europe's energy security and competitiveness.

1.4 Climate remains a key driver of investment in Europe despite macroeconomic context

An industry representative confirmed that green projects are profitable and generate enough yields for investors. According to Morningstar data for the first half of 2022, there were inflows into sustainable investing of around 100 billion and outflows from conventional funds of about 1.5 times that. There is currently abundant capital in Europe because of the low-for-long interest rates. Because of the macroeconomic backdrop, some asset owners are investing more in investment grade and high yield. In addition, as an inflation hedge, there is an acceleration of an existing trend of investing in real assets. Real assets are fundamental to the transition. All the largest clients of the industry representative's organisation in Europe have signed up to the Net Zero Asset Owner initiative, which is committing to net zero by 2050.

The energy crisis has led to huge dislocations in energy prices, while asset owners still have to pay out to their beneficiaries. High-carbon companies have outperformed clean energy. Some asset owners are now also investing in high carbon-intensive companies with credible transition plans or those that are supplying materials and supplies to the transition. This can help with energy security in the short term. Public/private investments

are essential. The demand side must be considered. Capex in the traditional energy sector has fallen by 40% in recent years without a compensating investment in renewables. At the same time, demand has increased. Giving a price signal should be considered when discussing windfall taxes and price caps. Rising interest rates and higher inflation are favouring green investments in terms of debt investing and projects, but not equity investments.

1.5 The green way is the only way forward, but normal business also has to be financed

An official stated that, prior to Russia's invasion of Ukraine, the green transition was seen as restrictive, especially by some sectors. The green transition is now perceived as a way to be energy-independent from Russia and less dependent on price swings in international energy markets. Lithuania, for example, is not buying any energy resources from Russia, but prices are set at the international level. In this context, businesses perceive the green transition as an opportunity rather than a restriction.

A public representative commented that there is a concern that new bubbles will be created if all the money is invested in one aspect. There should be a mixture on a balance sheet. If everything is put into green, there will be no investments for those who have to become green and a great deal of normal business will not be covered. A baker who currently uses gas will need to buy a new oven. Money is needed to make this investment, which is not taxonomy compatible but is climate neutral.

2. Challenges and regulatory constraints for fostering green investments

2.1 Long-term investments are riskier, which creates challenges for banks

A public representative underlined that, after 2009, there was a change to a risk-based approach to regulation. The European Union never had a Lehman case, so the actions taken were effective. Even the Covid pandemic was perceived as an economic problem, not a financial world one, demonstrating that the financial systems are stable.

An official noted that it had been stated that banks are not the right institutions for engaging in long-term investment and that banks are not providing enough money for necessary investments. How banks can be encouraged to play their part in the transition should be considered.

A Central Bank official commented that these investments might be riskier than traditional corporate business as they often involve new technology and business models. Entrepreneurs often do not desire a bank loan, but rather an equity type of instrument, which is not yet provided by banks. Banks would need to take more risks. However, longer-term investments are usually not covered by the risk appetite of banks. Representatives of banks might state that supervisors stand in the way of taking higher risks. However, the risk-orientated approach to supervision provides an important safety net also for the green and digital transitions. It would be wrong to lower the standards for risk management or credit risk to enable certain investments even though they might be politically desirable.

An official commented that there used to be a way of providing money for projects and isolating the risks, either moving it outside the balance sheet or limiting it: project finance. This is one of the contentious areas in Basel III when it comes to capital provision.

A Central Bank official stated that there are various ways to offload the risks from the balance sheet, such as securitisation. The issue of project finance is a very technical one. The Basel Accord does not put general obstacles in the way of project finance. Certain corporate constructions are not covered. There is no objection in principle to banks financing projects, but they have to do it in a way that does not weigh too much on their capital.

2.2 Banking and capital markets are too fragmented in Europe to support a sustainable investment momentum

A market expert reported that an optimal economic and financial environment has not been stabilised for supporting a sustainable investment momentum. Improving the Banking Union and the Capital Markets Union (CMU) has been discussed for many years, but the banking sector is still fragmented. There is even possibly a move backwards as national governments and national authorities have tended to ringfence their banking sectors more.

Member States with excess savings (Germany and Netherlands in particular) do not finance projects in lower per-capita- capital countries (Spain Portugal, Greece...) due to the limited financial flows in the euro area and the interest rate differential between the US and Europe. These limited cross- border capital flows in the Eurozone reflect as the lack of a genuine Banking union and integrated financial markets as well as persistent doubts of some investors in Northern Europe and bout the solvency of states and companies in other countries.

In such a context, progress should be made on the recognition of the transnational banking group at the consolidated level by the EU prudential and crisis management frameworks. To this end, EU legislation should directly empower European authorities to require banks to maintain an appropriate level of capital, eligible loss-absorbing liabilities, and liquidity also at the level of each subsidiary and rely on recovery and resolution plans to make sure that losses can be properly distributed across the group and liquidity can flow where needed at times of stress.

Moreover, the power of markets should be harnessed by improving transparency and overcoming asymmetries, so investments in long-term sustainable projects can be made with confidence.

2.3 Europe benefits from a large pool of savings, which could contribute to finance these investments, provided such savings are taxed in Europe, due to lasting negative real interest rates

A Central Bank official stated that the finance needs and the cash are there but who the intermediary should be is uncertain. The capital markets will play a major role for riskier long-term investments.

A public representative noted that there are always times when major investments are needed. Especially on the European level, there is sometimes the impression that only public money is the solution. However, if money is released from the insurances, the relevant authorities are displeased because that is private money. Private investors must be encouraged to put their savings somewhere that could return higher revenues than a classic savings account.

A market expert added that most of the savings in Europe are liquid. An appropriate system to transform these savings is lacking. The Ukraine crisis and the rise of inflation has aggravated the situation, but inflation existed prior to the Ukraine and Covid crises.

There are three reasons why it is not possible to transform illiquid savings. The first is a prudential one: while there has been some progress in the Solvency II framework to recognise an infrastructure investment as an asset class, it has not gone far enough. Secondly, the risk of investing these savings is not remunerated at the correct level in Europe compared to what it exists in the US, due to the differential in interest rates. The appropriate monetary environment to encourage long-term investment is not present. The third problem is that there is still too much fragmentation in the banking sector and a lack of confidence between the savers and the states. Therefore, the review of the Stability and Growth Pact in Europe should not be delayed too much.

2.4 The interest rate differential between the US and Europe encourages savings to leave the EU and finance the rest of the world, in particular the United States

A market expert commented that a rise in interest rates will increase investing costs for states. Some states that are highly indebted will have financial difficulties. However, there must be a demonstration to the public that there is a move in this direction, even if the rates are not increased immediately to the necessary level. Such a differential poses enormous risks for the future of Europe. An attempt should also be made to attract savings from outside Europe. This would require more confidence in solidity and the sovereignty of some states and in the harmonisation of some parts of the sector. The standardisation of information and the rating of companies should be promoted further. 80% of corporates in Europe are still not rated.

A Central Bank official added that investors who seek riskier investments are going to the US. There has been a dramatic shift in Germany, where net capital exports increased tremendously from €43 billion in 2020 to €255 billion in 2021. Financial intermediation does not really work in Europe, but it works in the US. There is no strong need to go to the US to get more returns, but it is much easier, because Europe suffers from a fragmentation and a lack of transparency.

2.5 The data challenge is huge

An industry representative reported that a recent trader survey in the equity space highlighted that the major concerns are inflation, geopolitical risks and the vulnerability of global supply chains. Environmental, social, and governance (ESG) is therefore less of a priority. The three different areas of ESG have very different levels of maturity. The most difficult area is the 'S'. Oversight of supply chains in another jurisdiction is difficult. Capital flows need to be directed towards ESG purposes, not just government spending or bank loans. ESG factors have to be included in the investment process. There is a perception that investing in ESG is for risk mitigation rather than returns. This is also why impact investment is only discussed in terms of ESG. That needs to change. To be successful, ESG needs to offer market returns in order to draw additional capital.

The first step is for all stakeholders to start using the same data. This is essential. Currently, especially in Europe, there is an ESG data jungle. It is a challenge for everyone. Companies want to report on their ESG status or progress, but smaller and mid-cap companies sometimes do not have the resources to do this. Some of the different ESG ratings methodologies diametrically oppose each other. A common standard here might help.

An official noted that green and sustainable is a political concept, not a scientific one. Depending on an individual's concept of green, different data is relevant. A political compromise is needed to solve the data problem, even though there are very few providers at the moment, so there is also a statistical problem. There is hardly any quantifiable data for the 'S'. There is the question of whether the 'S' should be excluded.

An industry representative commented that the 'S' should not be excluded, but prioritisation is a possibility. The 'E' has the dynamic and the measures currently, so should be the focus. Overall, the same data should be used. More people will then start making similar investment decisions, E investments will start to show market returns and then, potentially, the same dynamic will develop in the 'S' area.

3. Improving the framework for a sustainable financial market: the way forward

3.1 The successful implementation of NextGeneration EU, REPowerEU and Fit for 55 are essential support to long-terms

An industry representative stated that NextGenerationEU (NGEU), REPowerEU and Fit for 55 are fundamental in terms of the scale of the investment and of the signal that they give to investors of the European intent and the cohesion of policymakers. Companies and investors require certainty about in

order to price risk. If NGEU is successful, the most important aspect will be increasing the pipeline of opportunities. There is no lack of capital. There is an undersupply of projects. Canadian pension funds are investing in Europe, but there are not enough opportunities. There is currently some competition between NGEU money and national sovereign green bond issuance for the same projects. An overall policy and business environment that clearly demonstrates Europe's direction is essential.

An official emphasised that environmental regulation directly affects the yield of sustainable investments.

An industry representative added that approval mechanisms should be faster. The lack of projects is partly due to the speed of identifying them and the time before they are investable and approved.

3.2 Strengthening the CMU is fundamental to fostering investment in the green transition

An industry representative commented that CMU is still fundamental. The European Long Term Investment Fund (ELTIF) could be a game-changer in terms of pooling institutional and retail money and investing in private assets. The investment guidelines should be relatively simple and the retail distribution rules should ensure that the potential can be unlocked.

A public representative commented that, independent of the specifics of the projects being financed, effective financial markets are needed to finance a flagship project such as the twin transitions. In that context, completing the CMU and ensuring easier access to financial markets becomes even more important. Legislative initiatives in the pipeline that could boost long-term investments include the revision of the regulation governing ELTIF and the European Single Access Point (ESAP). Insurance companies are the perfect long-term investors. The ongoing Solvency II review is therefore a golden opportunity to strengthen insurance undertakings' capacity to invest long-term. Securitisation needs to be relaunched, focusing not just on simple, transparent and standardised but also on attractive.

3.3 Bring certain production lines back to Europe

A public representative noted that there is no problem with getting investments for electricity production, but the challenge for the coming winter will be heating. There is a need to go to private households. It is not huge investment in one place, but in a lot of places. Possibilities for large investors to address that have not yet been identified. More production of the whole value chain for photovoltaics should be brought back to Europe. Something like the Carbon Border Adjustment Mechanism (CBAM) is needed, otherwise the investments will not be there. There will be no private investor for the hydrogen transition in European steel production because it is not competitive. Even in the long term, there will be no revenues if the steel company goes bankrupt. If the environment is not organised, investors from within or outside Europe will not be attracted to invest in Europe any longer.

3.4 National promotional banks and institutions (NBPIs) need to be treated separately from a regulatory perspective

An industry representative commented that three issues have not been discussed. The first is the expectation that yields in the future will be the same as they have been in recent years. The second is that company benefits, and dividends have never been so high and what people in the street think of such high benefits and dividends. The third is inequalities. The rise of populism in Europe is fuelled by inequality. Inequality is so high that it is putting society and European model at risk. Green (and digital) transition will only be achieved if we reduce and not increase, inequalities between winners and losers whether they are countries, regions or individuals.

Long- term investment in Europe is cruelly insufficient. This means investment with positive externalities and investments where the people in the street understand that results are for them, not only the dividends and the benefits. This is about infrastructure assets and energy. The coming winter may be difficult for some people and long term investment in energy is needed. The green transition is more needed in Europe than ever, but uncertainties are raising. Some actors are doing their job. The national promotional banks and institutions (NPBIs) are transforming savings into long term investment and should be treated differently than others regulatory wide as they are doing a different job. Inflation will be, and is, the main difficulty, but when there is a high level of inflation it is better to invest in tangible assets.

An official queried how a regulation that favours tangible assets could be written.

An industry representative replied that a previous successful although not perfect approach was infrastructure as an asset class. The example set by the Juncker plan was positive due to cooperation between public and private. InvestEU is a positive outcome of the Juncker plan, even though the global level of InvestEU is not as high as could have been expected some years ago. Regulation should also treat the actors differently based on whether they are acting for the long term due to their nature. There are differences between Kreditanstalt für Wiederaufbau (KfW) and a pure private investor. It is difficult to regulate by actor, but it is a necessity.

Growth challenges in the Central and Eastern Europe region

1. Challenges facing the CEE region in the current geopolitical and macro-economic environment

An IFI representative stated that this is a crucial point in time for central and eastern Europe (CEE). The CEE region is facing short and longer term challenges. In the short term, the region is particularly exposed to the shock induced by the war in Ukraine, with the energy shock, high inflation, and related economic, political and social consequences. CEE firms are confronted with the challenges of high energy costs with 87% of them considering this to be an impediment to their investment capacity. The CEE region has nevertheless shown its ability to adapt to shocks in the past, notably during the Covid crisis. There was strong policy support, but the CEE economies adapted with an acceleration of their digital transformation and a diversification of their trade partners. There is now a need for additional changes to adapt to new energy and security needs, while not compromising the green transition. These challenges also exist in the rest of Europe but are more prevalent in the CEE region.

In the longer term the CEE region needs to structurally transform its growth model and adapt to the digital and green transitions. The transformation is particularly demanding in some of the sectors that are at the centre of the current growth model of the region, like the automotive industry. Firms in the CEE region also tend to be less aware than western European firms of the implications of the green transition for their activities and those that are aware tend to focus on the costs of the transition, rather than the potential opportunities. Improving skills and reducing inequalities could be a driver of transformation for the region, but could also be an important obstacle if they are not properly addressed.

An official observed that CEE countries are facing a middle income trap - i.e. an economic situation in which a country attains a certain income level but then cannot exceed that level, which is a threat to sustainable growth – due in particular to shortages in skills and workforce accelerated by a 'brain-drain' in certain countries. This is something that is very difficult to overcome, especially in the current high-inflation environment.

An official stated that the pandemic and Russia's invasion of Ukraine have created unprecedented challenges for the global and European economies. The Baltic countries and Latvia in particular overcame the Covid crisis very successfully, being one of the first regions in Europe to return to pre-pandemic output levels in Q2 2021, without the need for major structural change. Production sectors showed resilience to the shock of Covid and service sectors recovered much faster than expected after the restrictions were lifted. This was also possible thanks to a huge support from the state to preserve jobs. There is hope that new challenges can be overcome in the same way, building on this experience.

The current energy crisis necessitates far reaching structural changes, the official observed. It is the most pressing challenge, together with security, for the Baltics following the invasion of Ukraine, due to the border and the historic ties with Russia and the much higher dependency of the energy sector on Russia than the rest of the EU. Historically positioned as a bridge between the West and the East, Latvia has progressively reduced its dependency on Russia and this movement was accelerated after Russia's annexation of Crimea in 2014. Food exports to Russia ceased for example when mutual sanctions were introduced. The Latvian financial sector exited the non-resident business. Cargo through Latvian ports also declined very significantly when Russia opened their own port in the Baltic Sea.

Another official stated that the influx of refugees from Ukraine is a further challenge for several CEE countries. There have been about 4 million border crossings from Ukraine to Poland since the outbreak of the war, and about 1.3 million Ukrainians are currently officially living in Poland, to which a certain number of unregistered people who came just after the outbreak of the war have to be added. Almost half of these refugees are adults, mainly women, and about half of them are employed, which is a great achievement of the Polish economy. However, on the negative side, house rental prices are skyrocketing with an increase of + 30% or 40% in the last couple of months in certain areas and the fiscal burden for Poland is increasing with the schooling and access to social and public services that need providing. This will represent about 1% of Polish GDP in 2022. A recent report also showed that in the first three months after the outbreak of the war, Polish citizens provided almost 10 billion Polish złoty for helping the Ukrainian refugees, which is 0.4% of Polish GDP. Special support is needed to address this situation, especially from the European Commission.

A financial industry representative emphasized the challenges of inflation. The initial predictions that inflation was temporary turned out to be wrong and inflation is increasing. The corporate sector and also the public sector were used to a more stable environment and many mismatches have appeared in their positions. There is also a need to adapt to higher interest rates and a stronger dollar. It is important that the financial services sector takes into account this new environment and provides clients with inflation-hedging products that may allow the achievement of stability within client value chains and the tackling of downside risks.

Another financial industry representative was optimistic that the CEE region would be able to overcome these unprecedented challenges that also offer opportunities to improve and grow. Access to appropriate financing is essential to achieve this. Before the Covid crisis the Czech economy was growing faster than the European average, mainly driven by household consumption and convergence with the rest of the EU. The Covid crisis has now been overcome. Banks that are well capitalized in the Czech Republic were able to support companies, providing liquidity and stability. The energy crisis is also being dealt with pretty well in the Czech Republic, although dependency needs to be reduced. The only aspect that changed with the invasion of Ukraine in economic terms is the perception of a political risk in the CEE region, because of the closeness to the current conflict. There is however a strong unity of Europe which should help to tackle the current crisis. It is important to also maintain social cohesion by helping the most vulnerable households to manage these difficult circumstances. The statistics indeed show that before the Covid crisis 25% of Czech households only had three months' savings ahead of them and it is now over 33%.

The Chair agreed that banks have moved from being at the origin of the crisis a decade ago to now being a key part of the solution to support and relaunch the economy. The weaknesses that existed in the banking sector at the outset of the financial crisis have now been addressed.

2. Key economic opportunities for the CEE region

2.1 Opportunities from the candidacy of Ukraine to the EU

An official stated that the possible enlargement of the EU to Ukraine would have a significant impact on the economic growth prospects of the CEE region and of the EU as a whole. It is unfortunate that the EU has not had official discussions about this yet, following the decision on the candidacy status of Ukraine. Ukraine can indeed provide a significant economic impulse for the EU despite the cost of reconstruction. Fears that Ukraine may destabilize current European policies such as cohesion policies and structural funds are also unjustified. It is indeed possible to see the positive consequences of the 2004 enlargement of the EU for the original member states when it comes to the internal market, the labour force, and businesses. Some local financial institutions such as savings banks have also grown to become significant European players thanks to their presence in the CEE region, with positive impacts in terms of cohesion. The positive experience of the 2004 enlargement can be replicated with Ukraine. It is also very important to have in mind that one of the key challenges faced in the CEE region are regional disparities. The least developed parts of the CEE region are close to or on the border with Ukraine. This could be a unique opportunity to overcome some of the regional disparities that Europe is facing.

A key question is which tools are needed in the case of Ukraine, the official stressed. The EU has recently had positive experiences with the so-called 'carrot and stick' approach, which is the combination of smart investment with structural reforms. The EU can try to replicate the investment side of the NextGenerationEU (NGEU) programme towards Ukraine. A third element should be technical assistance, which should be on equal footing with investments and reforms. Technical assistance is linked to the implementation of resilience-enhancing reforms in the context of EU economic governance, and also to the improvement of the quality of governance, the fight against corruption, and the rule of law, which are key prerequisites for a functioning democracy. All the important structural reforms in the last two decades in a country like Slovakia for example, have been made together with technical assistance provided mostly by the European Commission, through the Technical Support Instrument (TSI), and also by some international bodies such as the World Bank. One of these was the introduction 20 years ago of a reform of the pension system. There is still space for improvement in some areas however, notably in terms of governance and the rule of law. The EU should use the TSI as a key pillar in the future plan for Ukraine, building on the experience of the present CEE member states.

The Chair noted that it is important to proceed in the right order. The process should start with technical support, followed by reforms and then investment, because that will make the investments more relevant and profitable. Reforms should not be a top-down process starting in Brussels. They should be conducted at the member state level with support from Brussels through a regular dialogue. The TSI is a very effective and flexible instrument, provided there is sufficient commitment on the member state side, and it works for countries at different stages of development. Its costs are moreover limited: Europe spends €120 million a year on TSI out of a budget of €120 billion.

2.2 Opportunities from the green and digital transitions

An industry representative stated that the main issues to work on in the CEE region for fostering future growth are renewables, infrastructure and innovation. The focus on renewables is a consequence of the Ukraine war. European policies such as Fit for 55, NextGenerationEU and the EU Emissions Trading System are all moving in the right direction, but the capital needed cannot be provided by governments alone. Financial services firms and banks need to play a role in funding some of these initiatives, which are also attractive for investors, such as those interested in investing in green funds. Both elements should work together.

The industry representative added that innovation is critical in this perspective. Central Europe has much talent and excellent universities. Major banks such as the speaker's organisation, which are investing a great deal in innovation, with programmes around artificial intelligence, frictionless payments and asset tokenisation for example, conducted in cooperation with national and global authorities around the world can also contribute. One area of cooperation that should be considered is the

digitising of cities, and how banks can support sustainable investments and public-private partnerships in digitalisation by leveraging data sources. This has been undertaken in cities such as Milan and New York. Citigroup has developed a platform called City Builder, that enables users to explore location-based 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. which looks at big data and allows citizens to leverage their data to become more efficient. A second area of cooperation is for banks to work with universities to encourage the development of a risk-taking attitude to business development and innovation such as the one that exists in the Silicon Valley and Israel.

An industry representative saw many growth opportunities related to the restructuring of the CEE economies. Investments into education, reskilling, upskilling, further digitalisation and automation are the right way forward. The financial sector and banks in the CEE region however need to learn how to finance such projects, because many of them are still in the mode of financing traditional industries. Banks should be ready to support more risk-taking and help companies and their clients to restructure, because it will make the economy more resilient. The same is true for regulators.

An IFI representative agreed that in the CEE region there is the capacity to lead in terms of innovation. It is true that innovation is mostly on the adoption side, but there are exceptions. Latvia is one, where true innovative players are emerging and financial markets are starting to operate in a different way.

An official noted that the CEE region should focus on three main areas: making real use of digitalisation and the green transition and also transforming energy-intensive industries. At a national level more focus is needed on education and on reskilling and upskilling, where there are big deficits in all CEE countries.

3. Measures needed for fostering further growth in the CEE region

3.1 Strengthening and diversifying the financing of the CEE economies

An official stressed that bank lending is the main source of financing for Baltic and Latvian households and corporates. Looking back, Latvia has had a very long period of protracted weak corporate credit. More needs to be done to develop capital markets, which is why the Capital Markets Union (CMU) initiative is essential, but it is also important to bring in the regional perspective. The Baltics have very close economic ties, and some years ago there had been an agreement to develop a pan Baltic capital market, which involves harmonising the capital market regulation and dismantling barriers to investment. The capitalisation levels remain very low in the Baltics compared to the EU average, with 3% of GDP in Latvia and 8% in Estonia. Positive trends were however observed in 2021 with new IPOs and bond issuances. There are also positive initiatives underway at the regional level such as the project to create a Baltic IPO fund for acceleration, targeting especially SMEs, which play a pivotal role in Baltic economies.

An official agreed that the work on the CMU needs to continue. That is of high relevance for CEE countries, many of which are mostly or fully dependent on banking financing, as is the case for Slovakia, where 100% of financing is provided by banks. There are no alternative possibilities to finance innovative projects and intangible assets because bank financing requires collaterals.

An industry representative was of the view that multisource financing is important, as no kind of state budget or European funds can provide the financing that is needed. The financing needs to be a combination of at least three sources, ideally with capital market funding in addition to banks and public financing. At present multisource funding is very weak in the CEE region but it has to be developed with further cooperation. The Czech Republic has launched a National Development Fund, but in the last three years no projects have been financed this way, because there are other sources of funding available from EU funds, which are easier for the government to use. A priority should be to establish clear investment objectives e.g. related to digitalisation and transport infrastructures and combine different sources of financing to support these projects: public and private, EU and domestic.

The Chair noted that multisource financing with a clear link to the local level is something that the European Commission has been developing in Europe for some time. This was already a key aspect in the Juncker plan.

An IFI representative felt that the fiscal space for public investment would be limited in the near future. Every time there is a need for fiscal consolidation to reduce government deficits and debt accumulation, public investment goes down and gets deprioritised. The Recovery and Resilience Facility (RRF), the key instrument at the heart of NextGenerationEU programme will help to preserve the money and resources committed for investments for a while, but going forward there is a need to find a way to maintain public investment at a time of fiscal consolidation. There are also barriers to private investment that need tackling, such as fiscal barriers in some countries.

The IFI representative added that in the current uncertain economic environment and with the tightening of monetary policy that adds constraints to private investment, derisking of the private sector is important. 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.

An industry representative noted that foreign direct investment (FDI) is another important source of financing for the CEE region, where labour productivity is good.

FDI into the CEE region has been stable, with most of it coming from Europe and the rest from Asia but what is important is the quality and the variation of the FDI. Significant FDI has been coming into the electric vehicle (EV) sector which is important for the green transition. Hungary has attracted investment from Samsung on the EV battery front, Poland from LG, and Slovakia from Volvo. Some countries are relying on becoming production centres for EV and then becoming exporters, taking advantage of the current weakness of the euro. Policymakers and businesses should encourage more FDI into their countries, because FDI can support growth and can help to attract skilled labour. Sources of FDI should also be diversified so that the region can grow in tandem with the rest of the world economy.

3.2 Enhancing policy coordination at the European level

An IFI representative stated that coordination at a European level is extremely important. There is a general agreement that a structural transformation of the EU economy including the CEE has to take place, with a transformation of the energy sector, a decarbonisation of the economy and digitalisation. Public and private investment are needed to support these evolutions. This requires defining how the European energy market will function in the future in order to have a secure and sustainable supply of energy at the European level. The definition of the long-term view for the energy sector needs to come from the public sector because public investment in infrastructures is needed for implementing it. It will need to be conducted much more than in the past at the European level because there is the need to define a common strategy for energy markets and coordinate the approaches. The REPowerEU initiative is moving in the right direction in this regard.

The IFI representative added that concerning digitalisation, it was observed during the pandemic that firms based in areas where the internet connection was very good were much more likely to digitalise, which shows that infrastructures are important also in this area. Another observation during the pandemic was that low-income regions that are lagging behind in terms of infrastructure have less capacity to transform their economy e.g. in terms of digitalisation, and react to the pandemic. It is essential that public and private investment are combined to address these issues.

3.3 Adapting EU fiscal policies

An official stated that the digital and green transformations would not happen without proper financing. The three main ways of financing these transformations are a mobilisation of private capital, financing provided by the EU, and public financing provided at the national level. The latter national level of financing is dependent on fiscal rules which are currently suspended in the EU until the end of 2023 in order to support the post-Covid recovery. A debate is needed on fiscal rules because the current rules are no longer adapted to the needs of the European economy. When looking at defence spending in Europe, in 2019 Poland and Greece spent about 2% of their GDP on defence, but Ireland only spent 0.3%. This is a huge discrepancy that will probably increase with the Russia-Ukraine war. Poland has decided to increase its defence spending in 2022 from 2.2% of its GDP up to 4.2% in 2023. The current budget deficit in Poland amounts to 4.5% which means that the difference with the stability and growth pact (SGP) objective of 3% of GDP is due to defence spending. There is a question as to whether the EU's future fiscal rules will allow Poland and other countries in the region such as the Baltic countries to spend more on defence purposes. Moreover, since defence spending will be made anyway, there is a risk that this may crowd out fiscal spending on digitalisation and the green transition if the SGP rules are not amended.

Another official stated that sound public finances are a prerequisite for long-term growth. Quality of spending is very important, both in terms of where the money is invested and prioritisation. The European Commission is setting an example with performance-based budgeting, and something similar should also be done at the national level. In addition, the aim of a possible amendment of the SGP rules should not cause any delays in the fiscal adjustment effort that is needed in some countries. An agreement on some basic principles regarding the SGP should be found at the beginning of 2023, on which the discussion can continue.

European open strategic autonomy: way forward for the financial sector

Introduction

The Chair reminded the audience that discussion on 'open strategic autonomy' was generated by Brexit, which moved a reasonable part of the financial infrastructure outside of the European Union, and tensions with the previous US administration, mainly on sanctions for Iran and the extraterritorial extent of the US sanctions. Later, the broader weaponization of finance brought another ingredient to the subject. It can be asked what the current degree of autonomy is, what else is needed, what the main ingredients of open strategic autonomy are and whether they include the Capital Markets Union (CMU), the Banking Union (BU) and financial infrastructures, what risks, costs and trade-offs will be faced, and what the prerequisites are in terms of broader integration.

1. What does strategic autonomy mean in the financial sector

1.1 Open strategic autonomy: a theoretical concept that has become concrete

A policy-maker noted the Commission issued a communication in 2019 on open strategic autonomy. The context has evolved since then in a way that makes it easier to explain and to justify what that communication was about.

The discussion was initially largely theoretical, covering what Brexit and US sanctions, and the extraterritorial effects, might or might not mean, but the pandemic and the war in Ukraine made this matter much more concrete. Supply chain vulnerabilities can and do exist, both in the economy and the financial system. Moreover, the unthinkable can and does happen.

The EU must identify and address the strategic vulnerabilities in the economy and the financial system, even if the consensus view is that the materialisation of some of these risks and vulnerabilities is unthinkable. Strategic vulnerabilities have to be addressed as they are there, even if they do not seem very likely.

1.2 European financial autonomy: a means to an end

An industry representative suggested the concept of strategic autonomy is especially tricky for financial market infrastructures. Their organisation has a strong base in Europe but is a global institution. To be strategically autonomous, international outreach should be strengthened and enhanced, meaning a base in Europe with a global perspective. Strategic autonomy is a means to achieving an objective. The main objective of strategic autonomy is for the euro to become a widely accepted international currency. That will not happen without a proper mechanism to preserve, prevent and manage crises, i.e. with no common safe assets or a complete Capital Markets Union.

Achieving autonomy depends on what is done at the European level and in each of Europe's institutions to strengthen the resilience of the financial sector, reduce dependency on third countries for key services and technology, and minimise transaction costs.

An industry representative's organisation can be a gateway for international investors and has strong interest from them to access the European market and even to settle in central bank money. It decided to integrate its platform and connect it with the TARGET2 securities platform, which would mean giving the option to settle both in commercial bank money and in central bank money. This has received a great deal of interest from international investors. Autonomy means integrating further in global capital markets and eliminating the barriers that remain within Europe to trade securities cross-border.

A public representative highlighted the difficulty in defining 'strategic autonomy' when talking about the financial sector because issues are so deeply interconnected. There is a need for stronger European banks and financial institutions, and an appropriate ecosystem not only for European banking groups but also for foreign entities. The competitiveness of banks is not only about regulation. The industry has been very vocal in light of the Basel III review and has constantly highlighted that the problem in Europe is regulation and that Europe cannot be competitive because of the regulation.

The notion of strategic autonomy not being an end in itself but rather a tool can also be applied to Banking Union. Banking Union is always mentioned as the final objective, but it is a tool many things cannot be achieved without. It is needed, and not only for European banks and financial institutions that are strong and believe in the European market.

1.3 What strategic autonomy can mean in practice for capital markets

An industry representative suggested strategic autonomy is based on having enough domestic capacity and control to transform the savings of 450 million Europeans into investments by EU companies. Some European companies tries, in a corporate consolidation way, to rectify the fragmentation of European markets to realise the CMU.

The debate on strategic autonomy in the financial sector is very similar to the debate in the industrial sector on antitrust and competition issues. It is asked whether the European Union is working for consumers or producers, and if it is working to build a continent of finance takers who benefit from services provided by the rest of the world. Some non-EU players are present to only cherry-

pick the juiciest segments, and, for them, Europe is just part of the division called Europe, Middle East and Africa (EMEA). For an industry representative's organisation, Europe is home, and there is a collective ambition that goes beyond finance. That is the core of the strategic autonomy debate.

The more strategic autonomy sought, the more open Europe must decide to be, and the more honest it must be on what it does in terms of 'open bar' regulations or unilateral disarmament regulations. Seven years ago, the six largest global banks, which are US banks, had a 44% market share in Europe. Today, they have a 58% market share. There cannot be meetings promoting strategic autonomy and then a return to the office to build an open bar set of rules and an environment such that it will be realised some years later Microsoft is the leader of operating systems everywhere, like Amazon in e-commerce and Google in search engines.

1.4 Open strategic autonomy does not mean "fortress in Europe"

A policy-maker remarked that the Commission's communication was also clear that addressing strategic vulnerabilities cannot mean disengagement from the globalised financial system and adopting a protectionist stance. It is about continued international engagement, but on a basis that is as resilient as possible to shocks. 'Open' is implicit in strategic autonomy, but it was included for clarity. Open strategic autonomy means that the EU develops, in financial services and elsewhere, its domestic capacity within the single market while continuing to attract participation and investment from outside.

Panellists have different views on the balance between building domestic capacity and how to handle foreign participation, but all agree that there has to be a balance. The rules also need to be the same even if those playing by those rules are themselves uneven.

1.5 Stop transforming Financial Europe into an open bar

An industry representative stated that the fundamental issue is how to stop unilateral disarmament regulations, stop an open bar for the rest of the world or having non-reciprocal regulations. The way the US players act in Europe is very different from the way European institutions can act in the US.

There is also the issue of how to create a consolidated vision. Europe's strategic autonomy is stronger with a strong Santander, BNP, Deutsche Bank, Intesa, with strong European insurers - Allianz, Generali, AXA -, with strong financial infrastructures - Deutsche Börse and Euronext. The weaker those financial organisations are, the weaker the strategic autonomy is. The trade-off is to carefully manage a world such that there are continental leaders, as otherwise Europe will be extremely weak.

1.6 Open strategic autonomy means crisis resilience autonomy and the ability to keep the financial system operating in extreme conditions

An industry representative noted the importance of agreeing or at least defining what strategic autonomy is about, and there are many different opinions. There has to be resilient, deep, diversified and complete markets and institutions in Europe that guarantee a constant supply of funding for the economy to grow. That takes care of clients and producers, but the crucial part is that whatever the nationality, the entity is a committed participant in the European landscape.

There could be different approaches to having a deep committed, resilient, complete market. There can be a more closed or more open economy type. For Europe, the open economy approach is the winning one. It is an open economy in all dimensions. It relies on open trade. That is where its comparative advantage is, and it would be very strange to have an open economy approach for everything except financial markets. Currently in the financial market, if it is looked at superficially, there is a large market share for non-European banks but to make European banks or institutions stronger, which is needed, the best approach is not to cut off the non-European banks. An ecosystem which is highly attractive for everyone to come to and stay in should be created, so the system guarantees competition and European institutions can grow, become stronger and compete everywhere in Europe and the world.

Some American institutions have perhaps gained some comparative advantages that come from huge economies of scale, which does not come out of regulation per se but, for example, a home market which is not as fragmented as Europe's. The way forward is continuing to build the European market in a deep, complete and non-fragmented way. Banking Union and CMU are necessary; Europe will never have true strategic autonomy if it does not complete its own financial market. The first thing to do to ensure Europe is financially autonomous is to keep building its own unions and to make the fragmentation of the financial sector less and less important.

An official remarked that usually the way Europe operates most important reforms are made in response to crises. When the focus is fully on solving the crisis, it is harder to keep focusing on long-term strategic behaviours. That may be something policymakers also have to integrate in the way they operate.

The digital euro, which will allow citizens to access central bank money in digital form and enhances or preserves the role of public money as a money anchor, also presents two strategic autonomy benefits. The first is reducing the dependence on a specific handful of foreign providers, particularly in terms of digital payments. It also enhances the role of the euro, particularly in these very challenging geopolitical contexts.

An industry representative suggested building a great ecosystem will also guarantee resilience under extreme stress. The open approach is the route to take. Then there is working on the weaknesses and the completion. The objective, or at least the interpretation of what financial autonomy is, has changed from 2019 because of what has happened since. One additional lesson from the pandemic and the war in Ukraine is that the way through them is with cooperation and further integration at the European level, with the like-minded countries around the world. Part of strategic autonomy under extreme stress is making sure everything needed is at

home, with the cooperation of like-minded countries that believe in the rule of law.

A policy-maker stated it is possible to build an open ecosystem and to become resilient. There is not a need to choose between open versus autonomous. Financial people understand the notion of diversification. Not everything has to be at home, but there should not be over-reliance on any individual external source of supply.

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

A Central Bank official noted the puzzle has many pieces and it is not possible to only implement one of them because a holistic perspective is required. Banking Union and CMU are two of those pieces. If there is an attempt to build European strategic autonomy in finance and compete on cross-border activities, there will be a need to harmonise national insolvency and taxation regimes among European Member States.

The European Union consists of many countries, and how decisions are taken is important. This European strategic autonomy must not be built on national or local champions. The pitfalls of picking national or binational winners should be avoided, and the focus should be on European goals rather than national goals, with standards set in areas where Europe is not technologically competitive. Doing so would stifle innovation and put the SMEs from smaller EU member states at a disadvantage.

The EU should identify key European ecosystems that deserve support and foster deeper EU-wide cooperation. Horizontal rather than vertical policies should be pursued, with vertical policies embraced only where they contribute to EU-wide strategic autonomy without undermining the level playing field.

While completing all pieces is a prerequisite for achieving European strategic autonomy that is not the goal itself. The goal is to achieve the key economic policy items, such as the recovery of economies after Covid, overcoming the most recent challenges stemming from Russia's war in Ukraine and ensuring the twin transitions towards a digital and more sustainable economy are successes.

1.8 Moving towards a true single banking market

A public representative was shocked by the limited numbers for cross-border mergers and acquisitions in the banking system in the European Union. In the five years between 2014 and 2019, there were less than 10 cross-border mergers and acquisitions compared to 180 national deals. That means that bankers do not believe in the European market. So, there is a need to create an ecosystem where banks believe in the European banking market. All have to believe in building a European banking and financial sector that will lead to more open strategic autonomy. This is a shared responsibility.

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. It is clear that currently the situation in the EU is not good. Banking Union is at a standstill; European finance is still largely segmented along national lines. To unblock the debate on Banking Union the issues should be addressed from another angle by asking why Banking Union is 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 through scale and better face up to foreign competition, especially from the USA. Banking Union would enable, in conjunction with progress towards a CMU, a better channelling of our abundant savings toward the EU targets in terms of digitalization and green transformation of our economies. Moreover, Banking Union would decisively enhance private risk sharing within Europe. The political discussion remains primarily focused on public stabilisation mechanisms, but private stabilisers are important as well.

2. Moving forward remains challenging, especially without political leadership

The Chair noted that one issue was open strategic autonomy meaning crisis resilience autonomy or industrial policies and the 'Europeanisation' of finance in a more general sense. There is also the question of whether to emphasise openness or autonomy, and which strategic considerations are paramount. Then there is a question of whether to count on creating so attractive an ecosystem that European finance is made into a powerhouse, and autonomy created that way, or whether it is more defensive.

2.1 Wake-up calls in recent years

An official remarked that with Brexit the first financial centre of Europe exited. There was then the pandemic. Guaranteed loans had to be provided to corporates in a matter of days or weeks, and having a functioning financial sector was key. Trump was another wake-up call. It has to be possible to rely on allies, and when allies are not trustworthy ways to be autonomous must be found.

Europe must be resilient under stress, but it must also be ensured that it has an ecosystem which provides for the upcoming investment need for digitalisation and the green transition. There are strong assets, a very strong infrastructure, strong banks, strong financial institutions and a great deal of savings, but the question is whether Europe is at the point where those savings can match the investment needs.

2.2 Prerequisites for moving forward

An official explained that for the twin transition needs there are public and private investment needs that will be faced in the next decades. Then there is the impact of uncertainty and the consequences of Russia's invasion of Ukraine, and the way financial sanctions in these areas are being managed. All of these are very good reasons to discuss strategic autonomy in the financial sector.

There are some prerequisites for moving forward. First is reducing the dependence on foreign critical operators. Second is increasing the funding potential of both the banking and non-banking systems, which means the capital markets depth. This would improve the overall resilience of the financial system against all threats, including the challenges coming from the technological improvements and cyber. Openness should not come at the cost of undermining the defence of our multilateral approach.

2.3 Areas to progress: Banking Union, CMU and digital transition

An official stated there are three issues that are in the minds of everyone and part of the preferred discussions within the Economic and Financial committee (EFC) and the Eurogroup. The first is completion of Banking Union. The third pillar is one of the main elements still missing and there is the importance of the European deposit insurance scheme (EDIS). There was an agreement at the Eurogroup level last June in terms of asking Commission colleagues to come forward with a proposal on one specific area related to crisis management. The ambition should be retained, and further steps should be taken in that area.

Having stronger and deeper capital markets is one main objective. The securitisation segment is a good example of what can be done to fully unlock the potential of capital markets to help with funding for the challenges there will be. One specific area that is a clear example of the importance of the EU's financial and strategic autonomy over the course of the last few weeks or months, is enhancing its clearing capacity and reducing over-reliance on third countries' central counterparties (CCPs).

The third element is trying to reap all the benefits of the digital transition. The positive side of this is the digital euro project. The other side is facing the challenges that come with technological improvements related to cyber risks or integrating all the developments related to the crypto world.

2.4 Deepening the CMU

The Chair noted a key question is about how to proceed with CMU. It looks like a slow grind of working on small things for the next few decades. There are huge deliverables like insolvency, taxation and common supervision. These are difficult but hugely important.

2.4.1 Deepening the CMU is crucial

A Central Bank official remarked that finance is a very regulated area. Building European strategic autonomy is about regulation. The funding of companies in Europe is very bank based, and the call for banks to believe in something before financing it is understandable. However, this is about having alternatives and picking priorities. It is about the completion of CMU, which will reduce the debt-overhang risk for corporates and put less pressure on fiscal and monetary policies. CMU has to be built to accelerate the economy's growth and move towards greener financing and innovative technologies. For companies that are at the edge of innovation attracting funding in the capital markets should be easier.

2.4.2 Going beyond words for combining financial integration and resiliency

An official remarked the aim is not to create a 'Fortress Europe'. Europe is very open to foreign banks. The issue is to assess whether Europe has structural weakness in times of crisis and how to enhance the financial markets and Banking Union in order to finance the great investment needs upcoming.

There is a need to go beyond words and make sure the commitment to build a strong, competitive home market for financial services is delivered. If strategic autonomy is taken seriously, final agreements on Basel transposition and Solvency II should be ensured collectively in order to support the capacity of the banking and insurance sectors to provide sufficient funds for the digital, green and energy transitions.

On CMU, the MiFID review has been progressing with the project to create a consolidated tape for key financial asset classes. It is an important project, but the EU has fallen behind the US and that needs to be addressed. Beyond the current text on the table, France remains firmly committed to making sure strategic autonomy becomes one of the pillars of the upcoming financial legislation, in particular on CMU. There are projects on the Listing Act. The harmonisation of insolvency proceedings is being supported, as it remains one of the key barriers to cross-border investment. The European financial sector should fully embrace the digital transformation, in particular the upcoming legislation on digital issues, AI and data. European consumers need to benefit, and European financial actors need to be strengthened.

The European Banking Authority (EBA) study on the assessment of current dependencies of the European financial sector is welcome and will provide a good analysis of the strengths and the weaknesses and further guide policy in the area. This is the beginning of a long journey but there are political deadlocks.

2.4.3 Four measures for transforming the ambitions for capital markets into actions

An industry representative stated the European Union is the most open financial space on the planet. Nowhere else is as easy for external players to settle in and do business. It is far easier than in the US or anywhere else.

There is a need to be very careful about where physical financial infrastructure is located. It makes a big difference for European strategic autonomy when the physical infrastructure where the trading is happening is ultimately under the supervision or the arbitration of the European Court of Justice. There is no such thing as the 'cloud', which is like referring to slavery as a predictable labour relationship. There is no cloud; there are large Amazon or Google data centres. Having a strong view on where the physical infrastructures of European financial institutions are, is important.

Second, there must be a focus on Europe's aspirations for more simplification in EU rules. The Listing Act and the possibility of having the equivalent of the US single S-1 form in Europe are welcome.

Third, the consolidated tape story should be amended, because everyone is suggesting it is going to create a new

data vendor in Europe. The proposed framework, if enacted, will mainly benefit players outside Europe. The reality is that the life of existing data vendors is going to be made easier and Bloomberg, MSCI and Tradeweb have decided to work together to be the European data vendors.

The last point is consolidation. Unless the rules of the game for the consolidation of European players are changed, there will be on one side, enormous companies and on the other tiny companies that are desperately trying to consolidate.

2.4.4 Focusing on what is urgently needed in Europe

An industry representative noted Europe needs a huge amount of capital for the energy transformation. The green transition is one of the key pillars of the European strategy. The financial sector has to accommodate and support the green transition. There is a sense of urgency and a need to attract capital from wherever is possible to serve those needs.

Of the proposals being made, such as the Central Securities Deposit Regulation (CSDR) proposal to simplify the cross-border transactions, some are very controversial. The most controversial ones sometimes halt the less controversial ones. The less controversial ones, like the simplification of passporting throughout Europe, should be moved forward and then the implementation of CMU can be considered.

2.5 A need for a Hamilton moment but political leadership is missing

2.5.1 A Hamilton moment

A public representative agreed there is a need to push, but at the same time there is concern that there might not be the preferred degree of political attention on these issues in the upcoming months due to the war and the energy crisis. There will always be emergencies, and attention will need to be brought back to these issues because they are also part of the solution. They are part of the system needed to address the challenges, including the energy and security crises.

There has been a great deal of discussion recently on building the public resilience stabilisation mechanism. Private stabilisers are also needed, because it is not possible to address all of these crises requiring enormous investment with only a public stabilisation mechanism. There should be clarity about the need to work on both tracks if the upcoming challenges are to be addressed. There will need to be some bold moves and maybe not the Listing Act but one listing for Europe, which would be some sort of Hamilton moment.

2.5.2 Becoming less of a priority due to the war in Ukraine and the energy crisis

A policy-maker noted that, given the current emergency, where energy markets are in difficulty and the economy is deeply stressed, there is the understandable risk that political oxygen will be absorbed by these subjects and the financial agenda will slip down the priorities. The DG-FISMA has not become less important, but it now has to compete with many other equally important files. Letting it slip too far down the list of priorities would be a mistake because developed and integrated capital markets, and what they do in terms of efficient resource allocation and private risk sharing, will be needed even more going into what will be a structural change in how the global economy will work. If Europe is to come out the other side of that in good shape, the financial system needs to be fully functioning.

2.5.3 Two ways to proceed on CMU

A policy-maker suggested the frictions between separate national markets can be addressed in order to build a single market in financial services, this is the very purpose of the Capital Markets Union. It is then possible to ask what the fundamentals of a single market are. There can be single laws on taxation, single laws on accounting or securities. There can be single laws and single supervision. These are harder and take longer, so it is necessary to go for the easier issues first.

2.5.4 Proceeding differently for the Banking Union

A public representative suggested all Member States should abandon their respective red lines and make an effort to identify new objectives that will make it possible to move towards greater financial autonomy.

Sessions

II

VULNERABILITIES AND FINANCIAL STABILITY CHALLENGES

Financial stability risks in Europe with high inflation and indebtedness

1. A stark risk environment

1.1 Financial stability has become increasingly vulnerable

A Central Bank official explained that the EU post pandemic recovery has been disrupted by Russia's aggression in Ukraine. Together with the sanctions against Russia, this has caused serious economic problems and energy price increases. The record inflation in the euro area has led to a substantial rate hike by the European Central Bank (ECB). This is happening in the context of weakening growth outlook.

Another Central Bank official remarked that the year began with an improvement in the Covid crisis. The consequences of this Covid crisis for economies are not yet understood both in terms of the financial side and the longer-term behaviour of citizens. Russia's war in Ukraine has now tremendous consequences for the energy market, the food market and the financial market as a whole and for the growth prospects for the coming years. The Covid related supply side disruptions and the Russian invasion of Ukraine exposed the fragilities in the EU's food and energy systems and its high dependence on the foreign supply of raw materials and technologies, including those which are very important for the green and digital transition. The reaction of many firms was an increase in inventories, which caused prices to rise further.

A Central Bank official queried whether the present situation is a Minsky moment. The accretion of risks has made a financial stability event more likely. Along with the continuing aftereffects of the Covid pandemic and the 'low for long' scenario, there are enhanced credit market and operational risks. There is a generalised economic slowdown, further geopolitical fragmentation, supply chain disruption and persistent inflation, which could lead to disorderly risk price resetting and/or the renewal of sovereign bank feedback loops and commodity market disruptions.

1.2 A challenging macro environment with near term and long-term issues

An industry speaker emphasised that a positive yield curve is more beneficial for banks than a negative one. However, if the rise is too fast, banks will carry the negative result of replicated savings. Higher rates are good, but the pace is important. The world is currently fixated on the growth reducing implications of inflation, higher rates and wartime issues such as energy squeeze. There are more near-term issues, but there are also longer-term problems like demographics, resources and climate.

The macro-economic environment is becoming challenging and is raising various risks. In the near term, the well-known problems around food, energy and fertiliser will create price pressure, which will hopefully force households to choose between eating or heating. Secondly, while China has carried the majority of global growth for the last 30 years, it is now facing a shortage in the supply of workers and significant real estate issues. Thirdly, there is fiscal tightening taking place as governments wean their economies from the Covid stimulus. In the longer term, there will be a shortage of workers in the developed world. Resources is another key topic. Many metals are in short supply. The world currently has between 5% and 20% of the materials required to reach net zero by 2050. There is also climate risk. In history, there have never been great droughts, dangerously high temperatures and fires on all continents at the same time. The policy response will have to be broader than the central bank response; a much broader and more coordinated effort will be required from all stakeholders.

1.3 High energy prices in Europe and rising downside risks to growth in the euro area

A Central Bank official described how the year started very positively. The first quarter was very good, and the second quarter was even better. The figures for the euro area were revised upwards. However, the situation in the second half of 2022 and 2023 will probably be rather different. In the baseline scenario, growth will slow significantly in the third quarter and then decrease further in the last quarter and the beginning of 2023. The ECB has downgraded prospects for the period ahead.

An official agreed that there are unprecedented shocks. The pandemic was a huge shock with a huge monetary and fiscal policy response, the impact of which is still being felt. As the EU exited the pandemic, inflation was higher than expected. It became more persistent and supply chain disruptions took longer to resolve than expected. Financial stability was not an issue, however. The decisive shock was the war in Ukraine. This was an enormous trade shock. Inflation became persistent and high. It is reducing the purchasing power of households and putting pressure on corporate profit margins. The cost of servicing debt will increase further with the inevitable tightening of monetary policy that accompanies persistently high inflation.

To complicate matters, the Ukraine shock is also adding a massive terms of trade shock with a reduction in incomes, which again impacts the recovery side. On one hand this might dampen aggregate demand pressures, but it is also dampening aggregate demand. Recessions in euro area countries should be expected in 2023. Policymakers need to have consistent and coherent policy settings on the monetary side, on the fiscal side and on the macroprudential side, including structural reforms. These policy settings will be extremely important in terms of limiting the financial stability risks as the EU exits the crisis.

A regulator stated 2022 was meant to be a great year for the financial sector and Europe's economies, but that optimism has drained away. There is now a very pessimistic business outlook. From BaFin's perspective, there might be unforeseen risks in the future, but the financial system has started this difficult phase in robust shape compared to its position before many crises.

1.4 Frailties in the non bank financial sector and real estate markets and are a source of concern; credit risks are also increasing

A Central Bank official stated that the non-bank financial sector is an important subject. March/April 2020 demonstrated the frailties in the non-bank sector that can emerge during periods of stress. There were frailties in the less liquid open ended fund (OEF) segment and in volume market funds, which have not been addressed. That is a real question around addressing further stability dynamics, because they could play a significant role here. In the current environment, it is also important to consider technological innovation and the rapidly changing dynamics around crypto and distributed finance. It is not known how effectively they are integrating into the financial sector.

A second Central Bank official observed that one of the most important financial stability developments is the shift from the banking sector to the non bank financial sector. In this regard, much was learned from the previous financial crisis. The institutional system related to the banking sector was strengthened, but the non bank sector is outside of this domain.

A regulator suggested that there are several issues that affect the robustness of the system. The first key concern is the state of the real estate markets, which in many parts of Europe have been heating up for a long time. As they cool off, which should be expected, the question is whether there will be a soft or hard landing and for which parts of the market. The commercial real estate market is very diverse, with many sectors and regions, but there are areas where valuations have reached an unsustainable level. There are the classic risks of importing problems from the real estate market into bank balance sheets and stretched borrowers having issues with their household budgets. In addition, rising mortgage rates and worsening debt-servicing capacity will exert downward pressure on house prices and lead to a cyclical downturn.

A Central Bank official confirmed that the housing market in many countries around the world is a financial stability issue. The situation is improving, but this is one of the most significant risks. There is a deterioration across the board, but the main assumption for the next two years is that positive growth momentum will be maintained. The figure for the year will be positive; the following year a significantly lower but still positive figure for overall growth is expected.

A regulator agreed that real estate markets and corporate credit are significant concerns in an environment that will be challenging for many sectors. It is difficult to predict what will happen, however. There is unprecedented state intervention in the credit markets. State intervention during the pandemic neutralised credit risk, but the selective approach being taken at present makes it difficult to determine where credit risk is greatest. Energy intensive sectors without the pricing power to pass on inflation to customers are going to struggle. The banks are built to absorb credit losses, but there is no visibility on where the concentrations could be. Supervisors will try to determine this, but it is difficult. Almost no one has lived through a period of entrenched inflation in the advanced economies. This dynamic is very new. While the current position is nowhere near a financial stability crisis, the distance to one has narrowed.

1.5 The Minsky moment has not been reached

A Central Bank official noted that 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 not a uniquely European problem, but the institutional framework in a currency union poses its own challenges.

An industry representative agreed that the risks are mounting and are plentiful, but the tipping point or Minsky moment has not yet been reached. The ratings outlook for large sovereigns in the eurozone is currently stable. A Minsky moment requires a dramatic change in the environment, the economy and the financing world. A high debt load alone is not predictive of an imminent Minsky moment. A change in the environment and a trigger is needed. The Covid pandemic could have triggered a Minsky moment, but the policy response helped to avoid that. The current energy price shock and the shock on the terms of trade is historic and could be such a trigger. So far, the European economy has been resilient to the strong headwinds. For now, real interest rates and returns are deeply negative. That will probably not remain the case in two years' time. Consumer price inflation should recede after this wave of soaring commodity prices has passed. In real terms, yields may be much higher than they are now, which would make the question of debt sustainability entirely different.

A Central Bank official doubted that there would be a Minsky moment similar to the reversal of fundamental underpinning assumptions in 2007/08 or the rude awakening from the Reinhart Rogoff 'this time is different' thinking. Assumptions are changing and have had to change, but this is not the same as the sudden and shocking reversal of assumptions seen in 2008. For example, the geopolitical shocks have been significant and there is the fragmentation, but in some sense that geopolitical fragmentation has been accreting over a period of time. In relation to risk-price resetting, it has been reasonably well understood that the recent period has been rather unusual, and that normalisation would come sooner or later.

In any case, however, there are heightened stability risks. They need to be understood differently, though, which is always a challenge with financial stability. A piece of perceived wisdom in the world of boxing is that the punch to fear is the one the boxer does not see coming. The fact the tipping point was concealed was very powerful during the last financial crisis. At present there is the somewhat concealed erosion of resilience due to the impacts of the recent supervening crises. Not only are there increased frailties and vulnerabilities, but there are also frailties and strains resulting from massive public interventions.

Secondly, and somewhat ironically, there is a danger of excessive complacency. With expectations of public intervention comes the real danger that risk pricing becomes skewed.

1.6 Two positive recent developments: The exit from negative interest rates and an already achieved asset price correction with little contagion in other parts of other financial system

A regulator emphasised that the exit from negative interest rate policies is extremely positive for certain business models like banking and life insurance. This considerable tailwind is already flowing through bank results in the first half year. There may be some casualties among institutions that misjudged the risk of a rapid upward interest rate movement, but it is unlikely to be systemic. Additionally, it is also positive to see the substantial corrections and volatility in some markets, such as the meltdown in the crypto market, happen with extremely little contagion to the banks.

A Central Bank official agreed that for some business models the changing interest rate environment is favourable. For large financial institutions there are positives and negatives. A bank's business model might benefit as rates rise, but there is a risk of possible credit losses and other challenges.

2. EU policies for addressing the main risks

2.1 Global coordination is needed

An official highlighted the importance of having a consistent and coordinated policy response. Europe also does not live in isolation. There are many external risks which require international coordination, especially on the climate side. It is not enough for Europe to succeed on climate if China is not on board. International policy coordination is extremely important.

2.2 Europe has been successful in dealing and mitigating the risk of a Russian gas shutdown

An official explained that there has been success in mitigating the risk of a Russian gas shutdown. In July, it was predicted that a Russian gas shutdown would require a number of central European countries, including Germany and Italy, to ration gas. Rationing has a huge GDP cost. The estimated negative GDP impact was between 2.5% and 4%. There has been a massive policy response in terms of acquiring alternative resources, saving energy and spending on infrastructure, pipelines etc. Europe is currently balanced on a knife edge. If Russian gas is shut off, there will not be rationing in the winter if the winter is not unusually cold and there are no other shocks.

2.3 Monetary policy has to ensure that inflation expectations remain anchored

An official stated that the setting of monetary policy is right. Monetary policy should focus on limiting the risk of unwarranted second round effects, i.e. ending up in a wage price spiral or a de anchoring of inflation expectations. As inflation pressures persist, in most scenarios monetary normalisation will need to continue expeditiously. Any weakening of demand or softening of the medium term price outlook would be a reason to slow down the normalisation, however.

2.4 Fiscal measures need to be targeted to the most vulnerable and temporary

An official noted the importance of the fiscal response. The fiscal scorecard is not quite as good as on the energy side, however. The IMF advocates targeted support to address the cost-of-living crisis. Europe could protect the most vulnerable by fully compensating them for the cost of living increases caused by energy and food price rises. The cost for the lowest 20% households would be 0.4% of GDP; the cost for the lowest 40% of households would be 0.9% of GDP. In reality, broad based measures were pursued which blunted the price signal on the energy side and therefore blunted the demand response while being hugely costly. For many countries, the fiscal cost is above 1.5%; in some cases, it is above 2%.

A Central Bank official explained that there is a common monetary policy at the European level, but fiscal policy is still largely diversified among the Member States. This has an additional impact in the decisions about the speed of the normalisation of monetary policy. That is the main reason why the transmission protection instrument (TPI) was introduced: to protect the integrity of monetary policy throughout the jurisdictions.

2.5 Structural reforms, banking union and Capital Markets Union (CMU) will make Europe more resilient to market shocks

An industry representative largely agreed with the IMF's policy recommendations. Fiscal and monetary policies cannot perpetually play a firefighting role. A German would say Ordnungspolitik also matters. One growing risk is financial fragmentation in the eurozone. In this respect, structural policies have a role to play perhaps more so than fiscal and monetary policies. There is a very large pool of savings across Europe. If this circulates as easily as citizens do across borders, there will be greater resilience than there is currently. That is why completing Banking Union and moving forward with CMU are important. Small and medium-sized enterprises (SMEs) are the backbone of the European economy. Great work was done on banking regulation and monetary policy to ensure there was no financing gap for SMEs, but these measures did not make SMEs in Europe more dynamic in terms of innovation, turnover and employment. The CMU and a genuine Banking Union would develop private and venture capital to support productivity growth via SMEs in Europe.

A Central Bank official agreed on the importance of completing Banking Union. Having an integrated banking market would serve the economy. There are huge benefits to be gained. Being halfway through this process has active negative effects because it results in duplication, and there are worries about a mismatch between centralised supervision and nationalised failure. One important aspect of CMU is the securitisation markets, where Europe suffers. Europe will need them in the times

ahead. It needs to do what it can to revive them. Time should be granted to work on the difficult issues around, for example, the most efficient and effective regulation for securitisation. Europe may do itself a disservice by trying to move too fast and then not actually solving the problem.

An official suggested that the macroprudential settings are right. They should be tight, but if there is softening there could be an argument for some loosening. For the IMF, structural reform is extremely important for increasing productivity, supporting long term growth and helping the countries most impacted by the pandemic. The combination of reform requirements and the provision of money for investment is working, but there should be further structural reforms across EU countries.

2.6 Strong capital and liquidity buffers will prevent financial institutions becoming part of the crisis

A regulator emphasised the importance of preventing financial institutions from becoming part of the crisis. When making policy choices, there should be caution about not drawing financial institutions deeper into the risk zone. There are still ideas floating around about passing the risk in the energy markets elsewhere. Governmental and state interventions to cover current risks are not going to be able to cover everything everywhere forever. There is a need to follow the old recipe of a cautious approach, with first-class risk management and strong capital and liquidity buffers. It is liquidity that is hit fastest if there is a sudden loss of confidence.

2.7 Implementing the FSB recommendations on money market funds and open-ended funds

A Central Bank official praised the terrific work done internationally and regionally on money market funds by the Financial Stability Board (FSB) and the European Systemic Risk Board (ESRB) and on Open Ended Funds (OEFs) by the FSB and the International Organization of Securities Commissions (IOSCO). The recommendations made by these organisations should be implemented. These recommendations should not remain international 'nice-to-haves'. These are very important regulations which seek to fix a risk that has emerged from the successful diversification of funding markets post-crisis.

2.8 The EU must show its political unity upfront

An industry speaker sympathised with governors of central banks, as the last 15 years have been a very difficult time to do their jobs. As a systemically important financial institution (SIFI), ING has experienced many more impediments to integrating the systems of its business units since 2008. There is a huge amount of goodwill in EU institutions but addressing the challenges ahead will require a continuous monetary response, continuous centralised supervision and the management of failures at a European level. Now more than ever, it is time for this to be addressed by Europe's political representatives.

Vulnerabilities from non-bank financial intermediation

1. Remaining vulnerabilities from non-bank financial intermediation

1.1 Liquidity risks

The Chair stressed that, with the significant growth of non bank financial intermediation over the last few years, the vulnerabilities created by these activities are a regular subject of debate. In the United States, the latest figures show that the non banking sector now provides more credit than the banking sector. This is not currently the case in Europe, but it illustrates the changing nature of the dynamics in the financial sector and the importance of considering the potential implications of this evolution for financial stability in the context of rising market stress. Liquidity mismatch issues create substantive vulnerabilities within the investment fund sector in particular, and the stress events experienced since 2008 demonstrate the importance of addressing these issues. The fact that central banks had to intervene significantly in March/April 2020 in the short term funding markets that underly money market funds (MMFs) shows that further actions may be needed to ensure resilience in the non-bank financial system.

A Central Bank official agreed that there was serious cause for concern in 2020 due to the large scale and widespread redemptions observed across a large part of the MMF sector. During that period, reporting data had to be escalated quickly because investors were making persistent large scale redemptions. This could be called a 'dash for cash', but these redemptions corresponded to many different business needs. MMFs are used by investors to meet their treasury needs and for a variety of other reasons.

1.2 Implications of changes in the macroeconomic and monetary environment

The Chair observed that high levels of inflation, rising interest rates and the probability of a recession in the months to come will be difficult challenges for the public authorities and also for the financial industry, including the asset management sector.

An official emphasised that MMFs have some structural features that make them vulnerable in stress situations. There is a need to solve this problem, possibly with a stricter policy approach to MMFs, before any further central bank intervention is warranted. It is in the interest of the industry to preserve a situation in which business can be maintained without causing financial stability risk. The ongoing increase in interest rates offers a window of opportunity to reform MMFs. Historical trends in the US over the last 20 years show that the MMF market has grown each time the Federal Reserve has increased interest rates, albeit with some lag. European MMFs have not yet experienced significant inflows in aggregate terms since rates started to rise, but this should happen, based on the US experience. Fundamentally addressing MMF vulnerabilities seemed difficult when interest rates were low, but with interest rates increasing there is an opportunity to amend the legal framework for MMFs without hurting the market. A sudden strong rise in interest rates can lead to mark-to-market losses in funds holding debt instruments, but MMFs are less exposed to this risk than other funds, because they are required to keep their duration low. In the first half of 2022, MMFs significantly reduced the weighted average maturity of their portfolios from 44 days to 30 days, which is a three year low. On the other hand, rising rates, accompanied by heightened market volatility, pull capital towards MMFs because the yield being offered is higher. MMFs also provide more certainty for investors who are worried about market risks than some other fund categories.

The official acknowledged that the sheer number of risks emerging at the moment may dilute the sense of priority for policy intervention related to MMFs. However, if no legislative action is taken, MMF vulnerabilities will have to be tackled by the next Commission and Parliament, which means that MMFs may create financial stability risk in the interim. The Commission should make a proposal for reviewing the Money Market Funds Regulation (MMFR) so that the political process can start under the current legislature. It is essential that these discussions are not further delayed. MMF vulnerabilities are well known and a number of authorities have already issued recommendations, including the European Systemic Risk Board (ESRB), the European Securities and Markets Authority (ESMA), Financial Stability Board (FSB) and some national authorities.

An industry speaker observed that changes in interest rates are not particularly relevant for the management of MMFs. The interest rate environment has changed markedly in a short period of time, not least due to the European Central Bank's (ECB) unprecedented hike of 75 basis points. Tweaks have been made by asset managers to manage interest rate risk, which mostly means reducing duration in funds. There is a need to monitor flows very carefully. Whilst there have not yet been significant inflows to MMFs, this will change if investors see more competitive rates from MMFs compared to leaving money in a bank or savings account. Although there is no strong need for a connection between regulation and the present market cycle, policy-makers should move ahead with the most relevant and impactful reforms while preserving the potential of MMFs.

2. The impact of MMFR and areas of improvement

2.1 The overall performance of the MMFR framework

Answering a question from the Chair about the level of common understanding of MMF issues between the industry and policy-makers, an industry representative considered that the positions are now much closer than when the MMFR was initially developed. The MMFR was introduced just over five years ago, and it has provided remarkable resiliency for the EU MMF sector during two of the largest live stress tests imaginable, the pandemic and the Russian invasion of Ukraine. With MMFR mandating that all MMFs should hold a minimum amount of liquidity, funds entered these crises with higher levels of liquidity than previously. Most good MMF managers had anticipated the possible negative consequences of such events to a certain extent and had between 45% or 50% of weekly liquidity, higher than the levels required by regulation. All MMFs were able to reach redemption requirements, but they were confronted with stasis in the underlying short term markets, which made it very difficult to sell any assets.

Fund managers hold sufficient liquidity in normal times to manage inflows and outflows without having to sell assets, the industry speaker emphasized. That is the nature of the MMF product, and it is why 98% of underlying assets are held to maturity. MMF managers normally only sell assets if they want to go further down the yield curve, e.g. sell a short piece of paper and buy a longer one to benefit from a higher rate of interest. Otherwise, fund managers hold their store of liquidity to meet redemptions. This is what happened during both of the stress events of 2020 and 2022, for which MMFR fundamentally worked, showing that no substantial reform programme is needed.

Another industry speaker agreed that the MMFR framework had proven to be robust during the latest stress events. There were no MMF suspensions; there was no use of redemption gates; no liquidity fees were applied; no low volatility net asset value MMFs (LVNAV) breached their collar requirements[1]; and there was no need for direct interventions from central banks. The US regulatory framework governing MMFs did not prove to be as effective. In the EU there is a constructive discussion between the industry and the public authorities following the recent market events about possible targeted adjustments to MMFR that should be further considered.

A Central Bank official agreed that MMFR effectively tackles the main issues created by MMFs. However, there is a case for targeted improvements to ensure investor protection and mitigate unexpected stability shocks, such as those observed since MMFR was implemented in 2018. Some parts of MMFR are not useful, such as linking the level of weekly liquid assets to the consideration of redemption fees and gates. This causes potential cliff edges and incentivises investors to get out before they are caught by gates or liquidity fees. There are also problems with meeting redemptions, which led MMFs to sell assets which were meant to be held to maturity. All MMFs were able to meet their redemptions eventually, but only with a significant central banking intervention in the underlying short term markets. This means that there probably is a case for considering the functioning of the underlying short term paper market. Regulators should also consider implementing remedies that will enhance the MMFR operational framework and investor protection. This is also a global issue, for which an international alignment of frameworks and standards is needed, as well as cross border cooperation between regulators and supervisors to avoid unnecessary frictions.

2.2 Areas of improvement for MMFR: liquidity management tools (LMTs), MMF product categories and liquidity buffers

Several panellists emphasised that the delinking of the imposition of LMTs, such as gates and liquidity fees, to minimum liquidity requirements is a priority and should be tackled as soon as possible. An industry speaker observed that this delinking is essential in times of stress, but is also needed in a normal market environment.

A Central Bank official suggested that the MMF regulatory framework needs strengthening to consolidate the central role of MMFs in the European and global landscape. This must be done in a way that is well understood and well calibrated so that the framework works as expected and provides resilience in times of stress. Significant work has been done at the international level by the Financial Stability Board and IOSCO and at the European level by the ESRB and ESMA to identify the root causes of the issues experienced by MMFs and provide a menu of options. There is also a broad alignment between the main measures proposed at the global and the European levels.

The Central Bank official highlighted two types of measures likely to close out the present gaps in a practical and effective way. Firstly, it is very important for there to be widespread and effective availability of LMTs, on which there is a broad consensus, and appropriate guidance on how to use them. There should be no stigma to using LMTs either. The applicability of these tools to different kinds of funds remains to be fine-tuned, notably concerning swing pricing, which may not always be suitable. In addition practical guidance on the use of LMTs needs to be provided. The key element will be creating a framework that allows the use of these tools in normal times, so that the market stakeholders know how to use them, rather than restricting them to extreme situations. Additionally, solutions need to be found to mitigate the risks from LVNAVs, which is a more controversial issue. Many authorities are suggesting that there is a problem with amortised costs and that the stable element of these MMFs should be removed.

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

The Central Bank official suggested that strengthening weekly and daily liquidity requirements is a more important objective than reviewing MMF categories. Liquidity should be available for fund managers to use as necessary in a structured and calibrated way. This means having rules so that liquidity can be depleted in a proportionate way, when needed, with a floor, and rebuilt when conditions improve. It has been proposed that public debt buffers could potentially enhance MMF resilience, but there are different opinions on this subject that need to be further examined.

An industry representative emphasised that during times of stress all MMFs in the EU had significant redemptions, whether it was LVNAV, constant net asset value (CNAV) or variable net asset value (VNAV) MMFs. These different MMF categories should be retained because they correspond to different investor needs and performed as intended during the two major stress events of 2020 and 2022. Eliminating or significantly modifying these products in the legislation does not seem to be the right way forward, because the industry would then have to wait for another three or four years before the framework is stabilized with new product categories. This would hinder the capacity of the MMF sector to support the Capital Markets Union (CMU) and the banking sector at a time when additional low cost funding in multiple currencies is much needed to assist the real economy.

An official mentioned that the UK Financial Conduct Authority (FCA) has recently issued a consultation paper on MMFs covering similar areas to those mentioned by the panellists. A number of options are being considered by the FCA regarding MMFs, including minimum liquid assets and the removal of the ties between liquidity thresholds and the triggering of LMTs such as gates. It is also considering how to make buffers more usable, whether to pass on the costs of liquidity to investors and whether or not to remove the stable NAV element from LVNAV funds. The FCA has made clear that the UK is not in favour of reliance on sponsor support and does not intend to rely on capital buffers. The FCA's intention is to legislate in a way that is consistent with the approach taken at the global level. The ongoing UK public consultation reflects in many ways the report that was issued by the Financial Stability Board (FSB) in cooperation with IOSCO, which is also being considered in the EU.

2.3 Issues related to the short term funding markets underlying MMFs

The Chair observed that the short term markets, which are a large part of the assets in which MMFs invest, do not benefit from an effective market or market structure at present and are part of the liquidity issues that MMFs face. Short term papers are close to buy and hold assets and are extremely difficult to sell if a buyer comes under pressure.

An industry representative confirmed that one of the main lessons of the liquidity crises that MMFs have faced in recent years is the need to improve the short term funding markets. These issues were purely about liquidity and quite different from the credit crisis of 2008 09. Every single piece of paper that MMFs held paid on its due date, so there was no issue about bad assets. In normal times, these assets would be sellable into a good marketplace. The reason why MMFs wanted to sell assets was due to the improper linkage between liquidity levels and fees and gates. They were trying to ensure there was a 30% weekly liquidity level and a 10% daily liquidity level, as required. Improvements are needed in the short term paper market in terms of transparency and liquidity in order to avoid a state of stasis in the market in the future.

A second industry speaker agreed that the short term paper markets are the main issue underlying the liquidity problems associated with MMFs. While fully eliminating the kinds of market stresses that emerged at the outset of the Covid crisis is impossible, it is possible to enhance the structure of the short term paper market in order to make it more resilient in times of stress and to develop contingency plans. Central banks do not want to be lenders of first resort, which is understandable, but they should at least fix the limits beyond which they may need to act as lenders of last resort. There are several key issues to also address in the short term paper markets. First, there should be a focus on supply to ensure that paper is available with robust issuance. Banking regulations do not currently encourage short term issuance and there is at present a lack of government supply outside the US. Secondly, there needs to be the ability to make two way markets and intermediaries such as the global systemically important banks (G SIBs) have an important role to play in this regard for achieving sufficiently deep market trading. Thirdly, there is a need to enhance transparency. The ECB and other central banks in Europe do not publish issuance information in the same way as the Federal Reserve. In the US, there are weekly updates on commercial paper issuance, size, rates and ratings. Finally, if there is no appetite to issue more short term debt, it may be necessary to create a European equivalent to the Federal Reserve's overnight reverse repo programme to avoid direct intervention in the market.

A third industry speaker concurred that addressing the structure of underlying markets would help to mitigate the impact of future crises on the MMF market, although it is a challenging issue to tackle for industry participants, regulators and policymakers.

The Chair commented that aiming to enhance the supply of paper and market-making in short term paper markets are relevant objectives, but figuring out the first steps to take to improve the very weak structure of these markets is quite challenging.

3. Possible actions needed concerning open-ended funds (OEF)

Asked to comment on potential financial stability issues related to OEFs structured under the Alternative Investment Fund Managers Directive (AIFMD), an industry speaker stated that AIFMD has been a very strong regulatory framework for investment funds in Europe, ensuring the resilience of the broader OEF sector throughout recent stress events. The level of nervousness observed concerning MMFs during the Covid crisis in particular did not happen for OEFs. However, some areas of AIFMD could be improved when

taking a practitioners' perspective. First, it is important to ensure that a wide variety of LMTs are available and that they are used in a consistent way across EU jurisdictions. The choice to use those tools should be left with investment managers and fund boards, because they are closest to the markets and they know about the nature of the holdings and liquidity profiles within their funds and are aware of the changes in investor sentiment. Investment managers are therefore best placed to make expedient decisions around the best tools to use at the best time. There is also a choice to be made about whether to develop regulatory technical standards regarding LMTs or issue guidance. The latter option seems preferable because it can allow an iterative process. Being too prescriptive on LMTs might compound stress in a stressful environment, whereas guidance can allow practitioners to react and learn because every crisis is somewhat different.

Invited to comment on whether guidance is the right approach to make further changes to AIFMD, an official was satisfied with the Commission's proposal to review the AIFMD and UCITS Directives. LMTs will help asset managers to deal with redemption pressures in stressed market conditions – of course provided that the tools are not only available, but in fact used when required. There are however additional action points to consider. Firstly, to further enhance financial stability risk monitoring, proper figures and statistics are needed for UCITS, which is not the case at present. Secondly, structural liquidity mismatches need to be addressed, especially in funds investing in inherently less liquid assets (e.g. real estate) while offering frequent redemption opportunities. Finally, while MMFs are resilient to monetary policy rate increases, which is something that is regularly tested in stress tests, this might not be true for all OEFs. The ESRB has recently published an update of its NBFI Risk Monitor indicating that a rise of 100 basis points of interest rates would result in bond fund losses of around 4% of NAV. The impact would however vary widely by fund – with up to 35% NAV losses for some. As the yield curve is moving rapidly, some market participants will win and others will lose.

The Chair emphasised that, whilst UCITS reporting is probably not justified solely in relation to securities regulation, it is needed to establish and monitor criteria that determine financial stability for the UCITS fund market. This is very important for the financial stability oversight of the marketplace, even if UCITS funds are generally safe. In addition, the size and the importance of the fund sector is now such that this type of reporting is essential for UCITS.

Sustainability risk in the EU banking sector

1. Sustainability risk in the EU banking sector

An official explained that sustainability risk in the EU banking sector is a key topic for both regulators and market participants. The Basel Committee on Banking Supervision (BCBS) is working on all aspects of climate related financial risks, including regulation, supervision, and disclosure.

2. The lessons to learn from recent regulatory reports

2.1 The ECB's thematic assessment: banks must assess the materiality of sustainability risk and disclosure exposures and conduct stress testing

A Central Bank official outlined the action being taken by the European Central Bank (ECB) on climate risk. In 2020, the ECB issued guidelines on its supervisory expectations around climate and environmental risk. This was followed up by a bank self assessment. Following discussions with the ECB, the banks created action plans for how to adhere to the ECB's plan. The ECB conducted follow ups on disclosure in 2021 and 2022 and a thematic assessment. Currently, a thematic assessment is taking place on different topics related to the ECB's supervisory expectations. The ECB has also published the results of the first stress test on climate risk. 90% of banks report that they are working with the ECB's supervisory expectations and have a plan in place. However, some banks still have not assessed the materiality of their climate risk or customer risk, and there is much more to do on exposures and disclosure practices. 80% of banks under ECB supervision claim to have a plan to address climate risk and aim to be able to operationalise these plans by the end of 2023.

2.2 Lessons learned from the stress tests conducted by the Japanese Financial Services Agency (JFSA) and the Bank of Japan

A regulator advised that, with the Bank of Japan, the JFSA has conducted a pilot scenario analysis. The purpose of this exercise was not to evaluate capital adequacy but to deepen banks' understanding and create the basis for a discussion between supervisors and banks. The estimated increase in banks' costs due to transition and physical risks was considerably lower than their average net income. However, it is not enough for banks to be able to absorb the loss of existing portfolios; the sustainability of earnings is essential to the long term resilience of the business model. Banks need to take more dynamic approaches in risk management and consider the medium to long term impact of managerial decisions, changes in business strategy and changes in clients' business models.

2.3 European Banking Authority (EBA) priorities: data disclosure, supervisory practices, the prudential treatment of climate risk, stress testing and risk assessment

A regulator considered that discussions about sustainability often focus on climate, but sustainability is a much broader topic. An official noted that the BCBS is working on applying its climate work in a broader way. Another official suggested that the ECB's stress test proved there is more to do on issues such as physical risk and biodiversity.

A regulator advised that the EBA's priorities are: data disclosure; supervisory practices, the prudential treatment of climate risk; and stress testing and risk assessment. On data disclosure, the EBA has taken a sequential approach. Earlier this year, the EBA published Implementing Technical Standards (ITS) on Pillar 3 disclosures for banks. On supervisory practices, the EBA published a report on enhancing governance and risk governance practices within banks. On stress tests, the EBA is working with the European Supervisory Agencies (ESAs) and the European Systemic Risk Board (ESRB) on a risk assessment to be completed between 2023 and 2024. The EBA is also working on guidelines for institutions and supervisors on climate stress tests, which should be published next year.

2.4 Determining the prudential treatment of climate risk poses several unusual challenges, demonstrating the importance of stress testing

A regulator explained that in March 2022 the EBA published for consultation an early paper about the focus on Pillar 1, which contains two key messages. First, by definition the prudential approach to any risk should be risk based. Climate is a risk, which means it should be risk based. Secondly, double counting must be avoided. The three key areas of concern are the forward looking nature of climate risk, the possibility of additional climate related concentration risk not captured by the current framework and the long time horizon of climate risk.

Another regulator agreed that the key features of climate related risk are the long-term horizon, the uncertainty and the forward looking nature. While the typical time horizon of risk management and capital planning is two to three years, climate related risks will materialise over a much longer horizon.

2.5 The outcomes of stress testing processes depend on analytical models and assumptions

A regulator explained that the JFSA's stress testing has revealed that the estimated results of these tests depend

not only on banks' analytical models and selection of variables but on several additional assumptions. There is a lack of information and a data problem, but this is compounded by the uncertainty inherent in assumptions about the evolution of businesses and technologies in specific sectors, whether and how clients' business models will be transformed to meet the climate challenge and the extent to which clients will require finance to transform their businesses. On 12 July the JFSA published supervisory guidance on climate related risk management focusing on client engagement. The resilience of banks depends on how corporate clients respond to climate change. Risk management and client engagement are two sides of the same coin. Enhancing the opportunities for banks and contributing to the transition to net zero should go together.

3. Despite uneven levels of preparation, EU banks are enhancing their contribution to the transition while mitigating their own risks

3.1 Sustainability risk and financing the transition have become central to EU banks' strategy

An industry representative reminded that banks are increasingly deeply mobilized on ESG risk management. Work is still in progress, but efforts and results are becoming more and more concrete. The situation also varies between banks, where EU banks are the frontrunners and leaders on the global sustainability journey. As such, several EU banks have been acting on sustainability risks for a long time and have capitalized on the ECB's guidelines and the EU's regulatory pressure to deliver advanced ESG risk management tools and processes. Importantly, ESG is no longer a topic reserved for a few specialists, but a business imperative and a risk management imperative. From a business point of view, banks are aligned around a sense of purpose and urgency, with ESG at the heart of their strategy and commitments. From a risk management point of view, EU banks are working on including ESG risks end-to-end, in credit analysis, rating, stress testing, and risk appetite.

3.2 Sustainability is now a key element of banks' governance and risk management; banks are designing the trajectories for aligning their portfolios in order to contribute to the transition

An industry representative emphasised that Société Générale has strengthened its governance. First, sustainability is discussed by the general management and is embedded in all of Société Générale's risk and business committees. Second, Société Générale's management incentives include a significant ESG component. Third, Société Générale has operationalised sustainability by launching a Group-wide programme called ESG by Design, which incorporates ESG end-to-end from client onboarding to risk management to products.

An official explained that the Italian Ministry of Economy and Finance is looking at whether the financial sector is playing its part in supporting the green transition. Sustainability is not only relevant for the banking sector. The private and public capital markets also play a fundamental and complementary role to the banking sector in supporting the transition.

3.3 Data availability, data comparability and the fragmentation of related standards

An industry representative suggested that banks need to address several important knowledge gaps. Bankers need to be very knowledgeable about industrial challenges. Notably, there are issues around data availability and data quality, and there is also considerable regional fragmentation of related standards and regulations. For global banks with global clients, this is a challenge. It is therefore important to take an industry by industry approach because there is a need to understand what is at stake from a transition and technological point of view and how business models are shifting.

An official advised that data needs to be complete, verifiable, and comparable. When Italy had the G20 leadership, Italian policymakers sought to build a consistent framework of reporting disclosure, scoring methodologies, rating methodologies and labels across the globe. A regional approach is being taken by the European Financial Reporting Advisory Group (EFRAG), and the International Sustainability Standards Board (ISSB) is leading a global initiative. There should be a common global baseline, which will enable regional approaches to be even more ambitious. Having more information that is not comparable will not create market efficiency.

3.4 Enabling small and medium sized enterprises (SMEs) to provide sustainability data will require more than legislation

An official emphasised the importance of SMEs in the discussion on climate risk. Europe's 23 million SMEs represent the backbone of the real economy. The data reporting obligations cover a small fraction of them. This also applies to the Corporate Sustainability Reporting Directive (CSRD). These SMEs cannot bear the cost of producing this information. They do not know what they must produce, and they do not know how to produce it. This might not require legislation; it could be addressed through industry led initiatives and financial education. If Europe's SMEs are notable to provide the information, banks will have to stop lending to them. The scope of ESAP should go beyond the 50,000 firms covered by the CSRD. The European financial industry needs to continue to work on data quality and data production, and there is also a need for a taxonomy that incentivises brown firms to become greener.

4. Quality, comparability, and reliability: benefits from the CSRD

An industry speaker stated that the CSRD would improve data quality by creating standardised information. Everyone in Europe will apply the same regulations,

which means they will be speaking the same language. Common reporting standards are currently being written by EFRAG, and the third party review of information will improve reliability.

4.1 The CSRD will be progressively implemented and improve non-financial reporting, but requires some convergence between standard setters

The industry speaker advised that the journey will be long. The CSRD will be implemented progressively from 2024 until 2028, but it will not cover some SMEs in the EU and non EU entities. Therefore, convergence between standards setters is important. Currently, there are many differences between draft European regulation (ESRS) and the ISSB's proposals, for instance. It is not necessary for every jurisdiction to have the same reporting standards but having a common backbone would improve comparability and reliability. Europe has taken a different path to some of the international standards setters. For instance, there is no convergence on the concept of double materiality. Europe is insisting on the importance of considering the impact of climate risk on financial key performance indicators (KPIs) and the impact of entities on the climate. This is not clearly stated in the ISSB framework, which is more focused on investors.

5. Global and EU priorities to make progress on sustainability risk mitigation in the banking sector

An official noted that data is a big issue. The more data can be standardised across jurisdictions, the better. The EU is leading in this area, but there is a high degree of variation even between EU banks.

5.1 Sharing best practices, building common tools, and leveraging market discipline

A Central Bank official emphasised that this is an important topic for society at large. The ECB is trying to push the banks, but this must happen holistically. There is a need to cooperate with global fora to ensure there is a joint view of cross border banks. As always, Europe is ahead in some respects and behind in others. Data is one problem, but there are also other important challenges. Some banks have made very good efforts, and the wider financial industry can learn from them. The supervisors can use their example to show that it is possible to be better and to demonstrate that it is possible to disclose more information to the market.

An industry representative suggested that this issue should be looked at in terms of business and strategy. Some European banks have paved the way because they lead on energy financing and project financing. For example, Société Générale is one of several large European banks that have been financing renewables for 20 years. These banks have identified the need for transition due to their sectoral focus, their business focus and their expertise on project finance and export finance. Regarding capital markets as well, EU investment banks are the frontrunners in designing green and sustainability bonds and incentivising clients to embark on the sustainable journey. To complement these initiatives, as the Capital Markets Union will move forward, ESAP will be an important tool to enable all banks to have access to sustainability information without engaging large and redundant resources for data collection.

5.2 Stress testing will continue to be the yardstick and catalyst of progress in the banking sector

A Central Bank official noted that the ECB's stress testing was not the usual number crunching; it was about qualitative information, governance and risk management and it looked at how well banks are able to calculate their exposures under stressed circumstances. These stress tests help regulators formulate and prioritise the next steps on climate and sustainability risk. The goal is to ensure that climate and sustainability risk is part of the normal supervisory cycle.

An industry representative agreed that stress testing has been an important learning exercise for banks and supervisors, but there are challenges around the quality of data and the assessment of the credibility of certain transition paths. There are also questions regarding how climate risk can be modelled and how a forward looking view could be considered when other statistical measures are backward looking.

5.2.1 Top down stress testing should be complemented by other bottom up approaches

An industry speaker suggested that the stress testing exercise made all stakeholders speak the same language, which accelerated the ongoing work on measurement methodologies and data collection. However, stress testing should be supplemented by bottom up corporate by corporate and collateral by collateral analyses.

5.2.2 Stress testing outcomes should eventually be reflected in financial statements

The industry speaker stated that stress testing is also important for Financial Statements. At some point, institutions' financial statements should be linked to these analyses. If climate risk is a key driver of credit risk, market risk or operational risk, it should be reflected in financial statements. The current framework of IFRS 9 could incorporate this in the measurement of expected credit losses.

5.3 Defining sustainability-related capital requirements will require forward looking risk assessments and new approaches to regulatory capital that enable banks to continue financing the transition

A regulator considered that the real challenge with environmental risk is how to assess risk in a forward looking way. The regulatory framework for capital is based on methodologies that are backward looking and statistically based. In that context, stress testing helps supervisors and market participants think in a forward looking way. However, this kind of risk analysis focuses on exceptional scenarios rather than the central scenario. There is a need to enable forward looking analysis under the central scenario.

An industry representative emphasised that further capital requirements should not be imposed on banks, as banks need sufficient financial power to finance the economy and its transitions (e.g., green and digital transitions, higher interest rates etc.).

5.4 An iterative improvement of data quality and availability

An official noted that there is a lack of historical data and high quality data. The sequential approach followed so far is beneficial. Eventually, the time will come to shift from Pillar 3 to Pillar 2 and from Pillar 2 to Pillar 1. Data is the most important task, and the ESAP initiative is key to this. This is the link between the Capital Markets Union (CMU), the digital transformation and the shift to sustainability. ESAP will help banks get the right information and help SMEs to produce information in a less costly way.

5.5 Policy makers will have to devise possible transition pathways alongside sustainability targets

An official highlighted the substantial uncertainty in these assessments. Climate risk is better understood than other ESG risks, but there is a question about how translatable the work on climate is. A regulator considered the work to be translatable at an aggregate level. The challenge is how to sequence and process the change. The presence of clear targets has made the biggest difference on the climate transition. Clear targets help identify the right way to go. In some of the environmental and social aspects, the targets are not so well defined. For instance, the financial industry has been pushing on diversity issues such as the pay gap because there is a specific target.

5.6 Setting appropriate, progressive, and proportionate ambitions will help address the wider set of ESG challenges beyond climate related risk

Responding to a question, a regulator stated that it is conceptually possible to extend the work on climate to other areas. For climate related risk, however, there are clear KPIs such as emissions. As other areas lack specific KPIs, in practice this will be very difficult.

An industry representative advised that the Taskforce on Nature related Financial Disclosures (TNFD) has 3,000 risk metrics, which shows that frameworks other than climate-risk are still in their infancy. The entire industry is mobilised, but discussions should remain pragmatic. If banks seek data on ESG risks when data is not available at the client level, more noise will be created at the cost of focusing on what matters. The priority is therefore to find the correct means to facilitate and fund the transition as it will take a significant time for clients to align. Optimistically, climate is a topic which has eliminated the silos between policymakers, governments, banks, and industry players. It has led to a constructive and fruitful dialogue, which has enabled substantial acceleration of sustainable initiatives in recent years.

Sustainability risks in the EU insurance sector

1. A complex and dynamic issue encompassing dramatic changes in many dimensions

A regulator indicated that the panel would discuss sustainability risk in terms of sector resilience and the contribution insurers can make to a smooth adaptation of the EU economy. The framework involved in analysing these issues is complex and very dynamic. Risks and the way they are measured are evolving. The business model is evolving. Regulation is also evolving, and a great deal of regulation is being produced in this field. The management of a company considers the sustainability risk borne by the insurer, but also what the insurers could do to contribute to a more sustainable world. The term 'sustainability risk' will be used, although much of the work has been done on environmental, in particular climate risk.

2. In the US climate change presents various risks in relation to underwriting and investments of insurance undertakings

A regulator stated that the level of preparedness is evolving in the US and globally. The National Association of Insurance Commissioners helps state insurance supervisors foster a degree of uniformity and coordination, while also enabling differences from state to state. While some may see these differences as a weakness, we see this as a strength of the US system as it allows for innovation among the states but within a well-developed supervisory and regulatory framework.

2.1 A wide variety of physical environments in the US

The NAIC recognises that climate change is an existential risk to the US and its financial system. There are three approaches to addressing climate risk: mitigation, adaptation and, at some point in the future, migration is expected. Given the wide variety of its physical environments, the US is an ideal place to study the impact of climate change. Connecticut has a relatively high income and a significant portion of insured property along the coast, which is threatened by climate change. Risks faced by California and Colorado include wildfires and lack of water. An integrated solution is essential.

2.2 Supervisors require insurance companies to provide climate related adaptation plans

Regulators of insurance companies have two primary considerations: underwriting and investments. At supervisory colleges and annual meetings, companies are requested to provide their plans on addressing the impact of climate change.

2.3 Making accurate and understandable information available is the most important focus of supervisors to accelerate adaptation and mitigation

Information is the most important focus. In April 2022, the NAIC adopted an updated disclosure survey based on the Task Force on Climate-Related Financial Disclosure (TCFD) template. This aims to ensure that the disclosures are accurate and comparable across jurisdictions. Currently, 80% of the premiums in the U.S. are subject to this disclosure. Also, the NAIC has created a new Catastrophe Modelling Center of Excellence within its Center for Insurance Policy and Research. This aims to provide supervisors with the information that is needed as the system evolves.

2.4 The American Risk-Based Capital system risks have been adapted to properly reflect risk to regulators and inform consumers

The US system avoids being prescriptive with the focus on consumer protection. Ultimately, the aim is to ensure that an insurer can pay the claims and fulfil its contract when a qualifying event occurs. The Risk-Based Capital (RBC) system recognises the threat to capital that certain investments or underwriting will cause and is the need to evolve as new risks emerge. For instance, supervisors recently recommended that an RBC charge for wildfires be added to the RBC framework for catastrophe risk exposures. s The data is for informational purposes now as supervisors consider how best to levy RBC charges.

3. In the EU insurance supervisors have started to assess insurance undertakings' sustainability risks and are considering whether the regulatory framework should evolve

3.1 EU reinsurance arrangements help the industry to mitigate risks

A regulator stated that underwriting investment is a key point of attention. An analysis of physical climate change risk was performed. Considering the recent tragic events, it can be said that the European system is well-placed to handle the risk, thanks to reinsurers.

3.2 Many undertakings should further integrate these increasing risks in their Own Risk Solvency Assessment (ORSA)

The European system has an important tool for starting the dialogue between industry and supervisor, the ORSA.

However, it has been discovered that only a minority of groups in the industry measure the risk in the wholesale in their own risk assessment.

3.3 The development of sustainability risk will improve customers' knowledge and awareness to prevent possible insurance gaps

The European Insurance and Occupational Pensions Authority (EIOPA) explored best practices and issued an application guidance to improve the self-assessment analysis. The increase of the risk and of prices can lead to exclusion and other issues. The consumer and their needs must be considered. Information, analysis, and risk management are of primary importance. Other measures relate to the disclosure of this information and the clarity of the contract with the policyholders.

3.4 EIOPA launched a process to define whether a specific prudential treatment of sustainability risk is necessary and what the related methodology should be

EIOPA will be mandated to perform the capital charge. The Commission proposal for the review of Solvency II stated the need analyse if an exposure or an asset substantially associated with environmental risk requires a differentiated treatment in terms of potential capital requirement. EIOPA's analysis will first consider the methodology to measure the differential treatment that may be needed. Stakeholders will then be consulted. A great deal of debate is expected in this area.

3.5 The next stress tests will be driven by the European Systemic Risk Board (ESRB) in 2023

A regulator confirmed that a global stress test for the entire financial sector would be carried out in the following year, under the aegis of the ESRB.

4. At the global level the International Association of Insurance Supervisors (IAIS) is building a common doctrine from members' practices and leveraging ongoing monitoring to raise awareness and catalyse insurance supervisors' progress

An official commented that monitoring helps to raise awareness among the community of supervisors and stakeholders and to prioritise the many actions. A good platform for this is the Global Monitoring Exercise, one of the pillars of the holistic framework, which is two sets of data collection from a pool of insurers. It provides a very interesting perspective on risk in general and global risk.

4.1 The impact of climate risk on insurers' assets is being embedded in the Global Monitoring Exercise

The information required is not always available, so the exercise proceeds step by step. The Global Insurance Market Report (GIMAR), with a special topic on climate, was an important pilot exercise that aimed to produce a global assessment of the impact of the transition risk on the asset side.

4.2 The insurance sector globally can absorb the extreme stress scenarios involved in the Global Monitoring Exercise, which is reassuring regarding the solvency of the sector, although the cost of a disorderly transition is much higher

The exercise concluded that, in different scenarios, from an orderly transition to the climate target to a more extreme scenario of 'too little, too late', there is a huge difference in terms of the impact on the solvency of the insurers. The approach to achieving the climate target is going to make a huge difference. The exercise also considered the overall resilience of the sector and indicated that the insurance sector has the financial capacity to absorb even the extreme scenario, but this does not mean that the insurance industry should not continue this work. The liability risk is now included in the Global Monitoring Exercise.

4.3 Stress testing the creation of a tool kit and support to supervisors are key bedrocks of the IAIS action in the area of sustainability risk

A supervisory response and a sector response are needed. Stress testing is crucial. There are challenges in implementing stress testing in smaller jurisdictions. IAIS is providing support on implementation of stress testing. Supervisors should include this risk in their approach to supervision. The IAIS standards support the supervisors, because they are very principle-based, but there is also the possibility of providing concrete solutions and an adequate toolkit for implementation. Work is ongoing in this area.

5. Each undertaking has to fundamentally review its strategy since sustainability has profound and holistic impacts

An industry representative commented that sustainability must be a Copernican revolution. A Weltanschauung, a new view of the world, is needed.

5.1 Sustainability influences product design, investments, operation and management arrangements, business models and main human resources demands and interacts with undertakings' geographic footprint. It requires horizontal cooperation

Sustainability must be the foundation of any strategic activities. From an organisational perspective a proper setup is needed. The industry representative's organisation has defined a hierarchical set of committees, in addition to new ones dedicated to sustainability. Sustainability topics are also addressed in committees such as the risk and control committee.

An other industry representative commented that their group believes that it is very important to mainstream sustainability. The sustainability committee is co-chaired by the Group chief risk officer, the Group chief investment officer and the Group head of sustainability. This

transversal view of the business and sustainability is at the foundation of climate leadership being one of the five pillars of the current strategic plan.

5.2 Investment strategy is influenced by the long-term nature of sustainability risk, possible subsequent impacts on nature, earth and society, and the interconnectedness and interplay of surrounding events

An industry representative outlined the three points that characterise these types of risk in relation to investment. The first is the long-term nature of the risks. The second is double materiality. The external impact of the stress test and the impact of the company on society must be considered concurrently. The third is interconnection.

5.3 The insurance industry is dealing with the data challenge since defining its strategy and behaviour requires measuring many external parameters specific to each player, sector, and geography

Data is the key to carrying out a proper assessment. On the investment side the industry is in a much more mature state. Internal data is easy to identify but obtaining data on the carbon footprint of the investees relies on an external provider. Plans of these investees and how to distribute exposures across geographies and sectors must be considered. This is very similar to what happened in 1990 and 2000 for the catastrophe (CAT) modelling. Regarding internal data, a great deal of additional information, sometimes acquired while writing new business, has to be captured. This requires internal cooperation as well as a more transparent way of sharing the data. The value is not in owning the data but in how the data is used.

5.4 Developing tools and initiatives pooling data is urgently needed

An industry representative commented that there is a need for more platforms to capture and distribute data. Ensuring pools of data are publicly available to all the companies is fundamental. A massive request on the reporting side must be avoided, so progress should be measured.

6. Going beyond climate related challenges is a necessity globally given that S or G are essential performance factors for investment in addition to the material risk they represent

An industry representative noted that in an analytical assessment of the risks faced by insurers, sustainability is top of the list. ESG is not just E and E is not just climate. For instance, their organisation aims to promote good governance as a basis for sound investment. As an underwriter, when they sell a director and officers' liabilities policy, there is also an emphasis on good governance. More generally, the volume of insurers' business is correlated with GDP and so the state of their business is like a seismograph of society.

An official emphasised that insurance is embedded in real life. This is particularly relevant for the IAIS because it has a broader membership. It also has an emerging market jurisdiction, where the questions of financial inclusion and affordability are important topics. Social is a very broad topic. Diversity, equity, and inclusion is a key strategic theme for the IAIS, partly because it is socially desirable and morally right, but also because embedding diversity will deliver better outcomes for prudential and consumer protection. A consensus that this area is key to fostering and enhancing supervision is vital.

7. Addressing possible insurance gaps regarding climate risk

7.1 Risk prevention and retention must be developed, and clarification sought on whether threats are insurable or require state intervention when systemic

An industry representative stated that insurers are at the forefront of climate change, as clients are indemnified for natural perils such as drought and wildfires. Sustainability is therefore embedded in how risks are managed, and the design of products is considered.

Underwriting in insurance requires a series of criteria. The first one is a demand for the provision of insurance, which has been increased by recent events. The second criteria needed is an alignment of interest between customers and insurers to offer the appropriate cover: both prevention and retention – deductibles – are needed. Then, for insurance mechanisms to work, there must be some degree of uncertainty, with the hazard component being one of the drivers of climate change (besides vulnerability and exposure) on which we need to act. Finally, we need a pooling mechanism so that the risk does not become systemic. There needs to be a top layer where policymakers step in.

7.2 Protection gaps unveil unaffordable risk which demand first addressing root causes including behaviour or society choices

Insurers want to be tough on risks, but also on the sources of risks. Insurance reflects the underlying risks and choices of the society: insurance is a reflection of it, not the root cause of it.

8. The ongoing contribution of the insurance sector to the climate related transition of the economy

8.1 Role of the Net-Zero Insurance Alliance

An industry representative indicated that the Net-Zero Insurance Alliance (NZIA) was founded in the previous year. Members have committed to transitioning their underwriting portfolios to net zero by 2050, which involves helping clients to transition their business models, lower their emissions and improve their carbon footprint.

8.2 The insurance sector will play an increasing role in providing information and assisting particularly SMEs with prevention

An industry representative noted that the penetration of insurance premium into GDP is still relatively low, meaning that a major increase is possible. Rather than prevention, there is the logic of being paid ex-post. Advice is especially relevant when working with small and medium enterprises (SMEs). SMEs are supported in understanding risk areas through stress testing. Information on upcoming climate related events is provided, so policyholders can prepare and avoid damages that are paid ex-post.

8.3 Services embedded in insurance contracts will accentuate insurers' added value and the contribution of the sector to risk mitigation and prevention, as well as the transition of customers

Technology can assist with spatial analyses. Real-time imaging of an event will enable a better understanding of the damage and support the rescue. The product is not only an insurance policy, but a set of services provided to the policyholder. Agriculture businesses are helped to understand how to better use biotechnology and artificial intelligence. This is relevant to how the crops are insured and reduces the weather dispersion and use of fertilisers that are one of the key elements for CO2 emissions.

The basis of any correct risk assessment is the data and scarcity of data means that the assessment can be improved. Insurers should not stop giving the right pricing. Different products should be used, like the parametric insurance that can be more tailored to a need. The aim should be to produce a sustainable balance sheet where pricing is adjusted over time with the data. A private-public schema or pool and conversations around data availability are needed.

8.4 The profitability of products must be combined with their ability to mitigate risks which is beneficial in the long term

A regulator commented that insurance can mitigate climate risk and help with adaptation to climate risk. A trade-off could be identified between profitability in the short term and the ability of products to mitigate the climate risk. An industry representative commented that, when insurers are faced with a trade-off between the short term and the long term, they opt for the latter. An industry representative commented that it is not possible to be sustainable if the long term is ignored in order to focus on the short term.

9. Cooperation between public and private sectors will improve insurance coverage

A regulator stated that the US perception is that risks must be addressed holistically. Reporting requirements, the ORSA, governance disclosures, climate disclosures and net zero involvement can be considered together. Supervisors collectively must be committed to addressing these risks. Products, including the micro-insurance and parametric products, must be available for consumers.

9.1 Transition and mitigation may require deep investments, made affordable by combining and coordinating financing and premium incentives, requiring the participation of life insurers as long term investors, public banks, foundations etc, in addition to insurance undertakings

The effects of climate change will be disproportionately felt by communities that are least able to address them. In response, US state supervisors are working with industry on select initiatives to help mitigate damage in those communities, including the Strengthen Alabama Homes programme, and the Connecticut Green Bank's leveraging of private investment, including from the insurance companies.

9.2 Insurance regulators must also adjust their practices

In the US, the American Council of Life Insurers (ACLI) is working to bring large-scale impact investing to traditionally underserved communities. This will require regulators to be flexible in their approach because impact investing is different to a normal investing profile. The investment partnership enables smaller insurers to invest and pool their money, as many larger insurers have already started to do, to ensure that communities that cannot finance mitigation of and adaptation to climate change and to environmental damage are able to do so.

9.3 In addition to improving insurers' ability to underwrite, better insurance coverage stems from monitoring developing risk and related insurance gaps, pricing issues etc.

A regulator stated that regulators should be self-critical. The drive is currently towards enhancing sustainability. Sustainability touches all the different areas at EIOPA: policy, oversight, consumer protection. Regulators need to help and sometimes could do better. The concept of the impact on underwriting was developed some time ago to assist the insurance sector to collect from an underwriting point of view. Regulatory barriers to proper assessment in a risk-based system like Solvency II, with any adaptation to climate risk, must be reflected in the technical provision in the capital requirement. In the future, there should not only be a focus on the capital requirement.

Information is key to improving insurance penetration. In EIOPA have developed a dashboard to enable the government and all the stakeholders to identify where the risks are. Affordability and pricing of the product is also important. The shared resilience solution was introduced some time ago. There are some systemic risks that the sector itself cannot afford and where it therefore cannot play its proper role as the risk manager for society. It is good that the Commission has set up the roundtable on climate resilient dialogue. A clear understanding of consumer engagement on this difficult topic will be important. Raising awareness and financial education has a role, but it is maybe too long term an objective. An understanding of how to help consumers buy these products is essential.

AML challenges in the context of AMLA and the Ukraine war sanctions

1. Comprehensive efforts in the EU are unfolding on the long run to address witnessed AML vulnerabilities and the specifics of such a risk

A policymaker welcomed the panel to the important discussion focused on anti-money laundering (AML) in the context of the Anti-Money Laundering Authority (AMLA) and the Ukraine war sanctions. The deficiencies in the current EU legal framework resulted in a legislative package of four pillars including AML regulation, the AML Directive, the establishment of AMLA and the money transfer regulation (which introduces the Financial Action Task Force (FATF) travel rule). A compromise on the money transfer regulation as well as a partial general approach in the Council on the AMLA regulation has been reached and there will be further deliberations on the AML regulation and AML directive, both in the Council and European Parliament.

A speaker from the industry noted that financial crime is another challenge that is a different category of risk to the traditional financial risk given the huge impact it can have. More maturity is needed to explain and manage this type of risk from the institutional and public sector perspectives and to avoid excessive suspicious activity reports being filed in the event of any slight uncertainty.

1.1 Effective consistency, coordination and information sharing across the EU is key for making EU AML arrangements successful

The discussion will focus on where progress has been made in terms of regulation, how the war has impacted work in the AML area and how the effectiveness of the EU framework can be improved. A speaker from the industry stated that AML being a transnational phenomenon meant that the main challenge is to have international rules and implementation to efficiently fight money laundering and terrorism. The Commission's proposal is a step in the right direction towards harmonised rules across Europe and ensuring that all international banks have strong internal control systems that can be applied in all groups.

AMLA is a positive step to ensure that the rules are implemented consistently and that practices across different national authorities and FIUs are harmonised. AMLA will have supervisory powers over riskier entities from the financial sector and this will improve the efficiency of the rules by ensuring consistent implementation across countries. One difficulty is with sharing information, in particular when the information needed to fight financial crime is protected by data protection rules. It is important that information can be shared even between one banking group. A speaker from the industry agreed that there is a need to develop information systems to ensure there is the ability to share information between private entities and authorities as well as between public authorities in general. The industry requires feedback on the information that is being provided to authorities to ensure that it is effective.

An industry representative stated that they had had to terminate a cooperation with an international small banking entity because they were not able to fulfil the AML requirements according to the regulator. There is a problem on-boarding multinational customers across the group due to different data rules in each country. The uniformity of rules is necessary to properly serve customers. It is necessary that those entities with the less strict AML requirements are able to upgrade their processes to the level of those that are regulated more strictly to ensure cooperation is possible. This operation is made more difficult if the regulation, infrastructure, software and hardware are not unified.

1.2 Further efforts are still required to be up to technology and knowledge challenges, as well as the difficulties raised by value chain complexity and the involvement of large third-party service providers

A regulator noted that areas that had not been sufficiently addressed included outsourcing, the rules on consumer due diligence, beneficial owners and supervisory capacity. The technological advances in outsourcing are becoming faster and there will always be smaller entities in the market that need to outsource due to their lack of resources. Supervisors will require more knowledge and skills to monitor outsourcing, in particular of centralised service providers. The same approach can be used as with the Digital Operational Resilience Act (DORA) for key ICT third parties. Internal audit can create a disproportionate burden for small entities and supervisors, and it is important to not overburden them with disproportionate requirements.

1.3 Practical and effective implementation requires an appropriate phasing in, as well as proportionality and cooperation between the private and public sectors

A policymaker noted that the challenge was that proportionality should not be related mainly to size but rather to risk. An industry representative observed that the second phase of the regulation will need to include patterns and models, as well as ensuring that these are adjusted to be feasible for organisations to achieve. It is necessary to gain feedback from those who have to implement the regulation and ensure there is sufficient time to implement the changes in processes and have official repositories before the industry is obliged to comply.

2. AMLA: large ambitions but delivering faces coordination, resources and capacity challenges

2.1 Capacity building is the first challenge ahead

A regulator commented that AMLA is a good solution because it will have enforcement powers and will build a single rulebook. It sends a message that Europe is taking action to address money laundering. In practice capacity building and resources will be required to ensure that the single rulebook is being complied with at both national and AMLA levels. Special technology will be needed to ensure AMLA can supervise crypto assets. The main issues are the fragmentation between the 65 European regulators in terms of information and supervision and that the system will require strengthening to avoid gaps that could result in failure.

2.2 AMLA adding value should prevent antagonisms emerging by creating cooperation among EU and national public authorities as well as the private sector

A regulator highlighted the fear that the relationship between AMLA, national supervisors and banks will become antagonistic. Supervisors will need to put pressure on institutions to work against that antagonistic relationship to ensure the battle is won in Europe. There will be an overlap in decisions made by the Single Supervisory Mechanism (SSM) and AMLA. A collaborative approach will be required to ensure that everyone acts in accordance with the legislation to ensure that the fight against money laundering and terrorist financing moves forward and is spearheaded by using technology.

2.3 Implementing AMLA should be the first priority for the EU

A policymaker asked the panel for what they wished the negotiators will achieve over the next 12 months as they conclude the AML package. An industry representative wished for adequate financing for AMLA. A regulator stated that a European centre of excellence on compliance and AMLA would support efforts to build capacity at both a national and European level. A regulator believed that a collaborative approach and use of technology is required to raise Europe's game. A regulator wanted to see AMLA using data effectively in terms of supervision. An industry representative requested effectiveness to ensure the endeavour reached the finish line. A regulator wanted uniform interpretation and implementation locally.

3. Improving data and technology

3.1 A data protection Hippocratic oath is necessary to both achieve data sharing improvements without unduly harming privacy

Improving information could be a game-changer in AML and, in terms of where information is lacking and how the interests of information sharing and data protection could be reconciled, a regulator advised that public authorities should aim to fulfil the principles of the Hippocratic oath: to refrain from causing harm, to only prescribe beneficial treatment according to ability and judgment, and to live an exemplary personal and professional life.

3.2 Help and advice enabling national supervisors to better leverage digital technology and maintain and make available high-quality data would be AMLA's high added value and a priority for policymakers

A regulator stated that in terms of prescribing only beneficial treatment, AMLA should utilise technology to do things more efficiently to ensure certain standards, rather than just using additional inspections which will provide limited value. Electronic IDs can replace the laborious work on physical documents and make identifying those related to politically exposed persons less difficult and laborious. Registers of beneficial ownership cannot be used as a sole provider of information and there is a joint job on information sharing required to ensure that data can be used for corporates. Establishing utilities for sharing information is a political decision but a proper discussion on the trade-offs needs to happen.

3.3 Leveraging technology is not straightforward and is subject to many success factors to deliver effectiveness

In terms of the tension between data sharing and data protection, an industry speaker stated that the ability to use technology to understand who customers are is critical although access to technology is not uniform. The hope for AMLA and AML reform is to focus on measuring effectiveness and the private sector is only one piece of the puzzle. Information needs to be shared via secure channels at authority level with the purpose of stopping illicit activity. This cannot be resolved only at the political level because it will require discussions with experts on data security to determine the right protections and restrictions. Institutions have an obligation to both prevent money laundering and meet customers' expectations that their data is secure.

An industry representative stated that regulations need to be adjusted to allow the exchange of information and if the private sector is not in the circle of information flows it is impossible for the industry to do its job as expected.

3.4 Improving and leveraging data requires deep system design improvements and investments across the board

A policymaker asked for comments on the best use of technology for data sharing. A regulator stated that it will be important for experts to contribute to the design of AMLA because they have operational experience. There is a need to have clear and uniform parameters for feeding the central database to ensure that the flow of information is uniform and information does not overlap, as well as having protections for accessing the data. Artificial intelligence (AI) provides opportunities for solving the problem of sharing information between institutions. The legislative AML package needs to be comprehensive and help all of those in the system.

3.5 Outsourcing is unavoidable but raises challenges to both financial entities, managers and supervisors which remain accountable

An industry speaker commented that their organisation relies on outsourcing within the group, because it is unnecessarily expensive to build all capabilities and solutions in each of the group's entities. The capacity in compliance continued to increase, not only due to the requirements, but because of the increase in false-positive alerts. This issue could not be solved without investment in AI and compliance would likely be an early adopter of these technologies otherwise it would mean more compliance people in the branches.

A policymaker commented that supervisory authorities could view outsourcing as a way of shifting responsibility, whereas the other side suggested it could improve the quality of AML. A regulator observed that almost everything could be outsourced except responsibility. The European banking landscape could not survive without outsourcing, particularly small institutions that cannot develop the production machine.

An industry speaker agreed that responsibility cannot be outsourced and will sit with the obliged entity, so the procedures and controls need to be outsourced at that level. It is counterproductive to restrict categories of activities that can be outsourced or tie this to the issue of responsibility when it is not necessary. With a unified approach the quality of outsourcing will be better. Provided the responsibility is effectively implemented outsourcing should not be a big concern.

4. The measures imposed in the context of the war in Ukraine challenged supervisors' coordination in the EU and globally, and increased the size and complexity of the operational requirements completed by the financial sector

An industry speaker stated that the war had presented an unprecedented challenge from a compliance perspective, acknowledging the impact on the people of Ukraine which could not be separated from the measures that have been imposed. Their organisation has withdrawn from operations in Russia and Belarus from a values standpoint, while keeping services operational in Ukraine in order to stand with the people of Ukraine. The AML programme had to adapt to the movement of people at scale and changes in behaviour.

There has been impressive collaboration between jurisdictions to impose measures on the right actors but it has been complex to implement with the national competent authorities not always ready to provide guidance on this implementation. AMLA should be vested with the authority to provide guidance for the private sector, because sanctions need to move quickly by their nature. Those in the private sector require instantaneous guidance on how to treat assets, what types of transactions can flow and what is covered by different authorisations and licenses. AMLA could allow financial institutions and the public sector to understand and implement the policy.

4.1 Operationalising the measures specific to each wave of sanctions would require further guidance from supervisors for financial institutions to efficiently and timely adapt internal systems and arrangements

An industry representative agreed that guidance on the implementation of sanctions will be helpful. An internal management system needs to have the right guidance to ensure that transactions are not able to flow into the system in advertently. With each new wave of sanctions banks have to update their internal systems and ensure they can fulfil the legal requirements. There are people who want assets moved away from Russia or want to change the denomination of investments from roubles. Checks are required to ensure the transactions are legitimate before they proceed which is not an easy task.

4.2 Ukraine war sanctions widens AMLA's role

A regulator noted that AMLA has to supervise entities with respect to their systems and controls with respect to AML, but it is not clear whether this also addresses sanctions. It will be good to have a convergent approach at national level. The skillset required for sanctions checks is similar to that required for checks in relation to AML and every onsite inspection for AML also checks the implementation of sanctions systems and controls. AMLA should be the European supranational authority for the implementation of sanctions, extending that power to supervisory convergence to ensure there is a discussion at European level.

Sessions

III

BANKING AND INSURANCE REGULATION PRIORITIES

Basel III implementation issues

1. Where does Europe stand in the preparation of the implementation of the last Basel III evolutions?

1.1 The challenge is to address European specificities without deviating from the Basel agreement

A public representative in June attended a meeting in Basel with the officials of the Basel Committee who gave a presentation about the application of the Basel recommendations and how different jurisdictions had applied the previous recommendations. There are some specificities in all jurisdictions, but it is not clear why other parliaments or legislators are not able to implement the Basel recommendations with a final proposal more or less in the scope of Basel except Europe, especially when Europe always claims to be in favour of an international order based on rules.

In their draft report, a public representative tried to move the initial proposal of the Commission toward the Basel recommendation. The G20 mandate noted that the final increment of capital requirements does not need to be very high. Knowing the numbers set down by the European Banking Authority (EBA), the direct implementation of Basel does not represent an important increment of capital in Europe. Europe must be a reliable partner in international fora.

1.2 The Czech Presidency is fine-tuning the regulatory package which might be agreed at the level of the EU Council before the end of 2022

An official explained that the Czech Presidency was now in the middle of the discussions within the Council working party on the proposal implementing the final Basel III, as well as other changes to the CRD.

French colleagues have concluded their Presidency with the first draft of a compromise that was shared with the member states in June. The member states sent to the Czech Presidency all their written comments, and the Presidency is now analysing these over the Summer, discussing with the member states bilaterally and with the Commission, and preparing the upcoming meeting of the Council working party scheduled for September.

The Council working party should continue discussions on the substance as well as technical changes that are necessary but need further discussion, especially as there are more options how to proceed further. The Czech Presidency plans to have these discussions done in September, in order to be able to draft a revised draft compromise text that will be built on the French one because it already strived a good balance and there is a majority of member states clearly saying that the French compromise text should be the basis.

The Czech Presidency will check the accuracy of the legislative texts and make some targeted changes, in order to improve either the technical formulation or the solution of the issues that are still pending. The revised draft compromise text is to be issued to the member states within a four weeks' time – at the turn of September to October. The member states will again have time to go through all the details and give feedback, both at the Council working party as well as in writing. The Presidency hopes to a compromise before the end of its term.

The Presidency is trying to move as fast as possible because the banking package is seen as one of the crucial files within the financial services. It has been assigned the highest priority, with a clear goal to get the general approach done by the end of the Presidency. That means for it to be approved at the November or December meeting of the ministers at the Economic and Financial Affairs Council (ECOFIN).

1.3 The topics discussed encompass the evaluation of the real estate as collateral, the transitional arrangements, notably regarding nonrated corporates, and the output floor, which is expected to stay at solo level

An official called for a brief discussion on the real estate evaluation because mortgage credit represents a significant part of the loans issued by the banks. The evaluation of the real estate as collateral is quite crucial, and the rules need to work and capture all the specificities of EU markets.

There are transitional arrangements which should again help the European banks to implement the rules more smoothly and to avoid any sharp cliff effect in the implementation. But in general, the overall goal in mid-term and long-term is to be in line with Basel.

There is a major view of member states that the level of application of the output floor should stay at solo level, which is a change from the original Commission proposal. This is a part of the overall package where there is a consensus that that should be one of the pillars of the future compromise within the Council. But there may be a possibility to go for a sub-conso level if applied inside a member state.

A public representative stated that there is a clear European specificity within the transitional arrangement on the rating corporation, but more should be done to correct this European specificity. There is now opportunity to think what should be done from the demand side in this market.

This is the reason the scope of the transitional arrangement for the unrated corporation has been reduced for only the minor unrated corporation. There is not public interest to protect by avoiding a better

credit condition for unrated corporations with millions and millions of profits. These companies need to be moved to the credit rating agency market. There is the transitional arrangement for doing this; if nothing is done during this period, at the end this specificity will remain. This is the moment to do more on the demand side.

1.4 Many policy makers in the EU consider that transition measures should be sufficient to smooth the adoption of the full Basel package and address EU national specificities

An official related that Finland supports the closest possible implementation of Basel standards, though it also understands the need for the transitional periods. It is interesting that an economic area with such a diverse banking sector needs these exceptions. This is not only being discussed in the context of Basel III but also crisis management. The system does not converge very quickly, so understanding these specificities is important. The French Presidency did positive work and now the Czech Presidency is on a very good track in finding the compromise.

Economists who look at legislation often think 'first best', and it has to be accepted that if everybody is a bit unhappy, then it is probably about right. Finland is definitely supportive of the idea of getting this through as quickly as possible because it has been discussed with the industry for the longest time, and they are worried about many things. This discussion will continue, and once the transitional arrangements are there, hopefully they can be got rid of before moving to the fully implemented accord.

A public representative stated that some banks will have to live with more capital, but this is the objective of the regulation. After many years, some banks applied the internal models with more room for manoeuvre than they should, even though the direct implementation should not represent a very important increment of the capital requirements. With the Commission proposal, and even more with the transitional arrangements, in the short term there is a decrease on capital. Such a decrease should not be done, especially given the crisis now, a very different crisis from the one suffered during the Covid pandemic.

The European banking industry needs time to apply the Basel recommendations. It is also true that they cannot be kept indefinitely in the regulation because in that case the deviation introduced will represent a very relevant deviation from Basel. This could create some problems in the level playing field between banks which use internal models versus banks with a standardised approach.

The Commission proposal for the transitional arrangements is welcomed. The issue is that they cannot be kept indefinitely.

The Chair summarised that it is important to negotiate efficiently in view to the deadlines agreed in the Basel Committee. The Commission is determined to facilitate this process. The The Commission´s proposal is a very good basis for the negotiations. The Commission has suggested some targeted exemptions to take into consideration EU specificities that should however be limited in time.

2. Industry concerns that the 'no significant increase' pledge will not be met are reinforced by the recent impact assessment published by the Basel Committee in February 2022

An industry speaker noted that concerns remain. The Basel Committee published an impact study last February that shows a 300-basis-point reduction in the Common Equity Tier 1 (CET1) ratio of large banks in Europe, representing the equivalent of an increase in capital requirements of 20%. The overarching principle of the 2017 Basel Accord 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. This has consequences because this freeze of capital implies that there will be less resources to finance the European economy. Copenhagen Economics evaluated that this significant increase in capital requirements would reduce the financing capacity of European banks by roughly €3 trillion.

2.1 An effectively faithful implementation of the Basel accord should encompass the 'no significant capital increase' pledge, and the calculation of the output floor at the consolidated level

Many people speak about a faithful implementation of this accord, but not on the two main aspects of this agreement. There is no significant increase in capital requirements, and there is the implementation of the output floor at the consolidated level because the Basel Committee only proposes rules at the consolidated level. This position is supported by the Commission and the European Central Bank (ECB), and it is very surprising that the industry is backing down on this issue, looking at the proposal of the French Presidency, but also the many amendments proposed at the European Parliament.

2.2 The calculation of the output floor at the consolidated level is one of the key components of the Banking Union

A public representative agreed with the Commission proposal regarding the debate on the level of application of the output floor. Applying the output floor at consolidated level solo is a good sign for advancing the Banking Union. Banking Union cannot advance more without a common insurance network because some host countries now have doubts on this matter. More capital cannot be put in the host countries if the host countries do not have a European Deposit Insurance Scheme (EDIS).

On the debate on the level of the application of the output floor and on the crisis management framework, there is a need to recover the debate on EDIS because otherwise some countries will be lost in the process for advancing in the Banking Union.

2.3 The assessments of the anticipated level of regulatory capital in the EU banking sector are controversial

An official stated that the debate on the impact is very interesting. Reference is made to the old figures, but with all the transitional arrangements and adjustments done, an initial analysis shows that it does not actually increase the capital requirement.

3. Defining the avenues for applying the Basel accord to Switzerland raises very specific questions given the unusual size of its banking sector

An official commented that Switzerland's draft regulation is currently in public consultation until October, and looking towards entering into force on 1 July 2024. Switzerland discussed if it should have worked harder on certain definitions, especially the one on what an internationally active bank is, coming up with the solution that all banks are going to be covered under Basel III. Questions remain on the definition of internationally active and whether there would still be a level playing field in Switzerland. It was agreed that Basel III would apply to all banks in Switzerland.

Switzerland reached a consensus. The pillars were ready in terms of what could be agreed before hammering out the details of the regulation. The deal was for Switzerland to aim for a compliant rating by Basel III. Furthermore, it is easier than for the EU in that it is not necessary to go to Parliament. This is going to be built into existing capital adequacy requirements ordinance and will be a decision by government.

3.1 Specific trade-offs made in Switzerland

There are three trade-offs in achieving this. First, as a small country with an average-sized economy, a huge banking sector and huge exposure on the risk side international compatibility, following the international standard and being part of the group of best-in-class was absolutely beyond discussion; secondly, having high capital costs and not being able to gather this regulatory capital due to other jurisdictions not doing so and investors not considering them as attractive; finally, there is the absolute robustness of the global system.

In Switzerland, it is necessary to be very clear about the costs and benefits of every bit of legislation. Banks put the cost of implementing Basel III across the board at nearly € 740 million because of the change of systems that goes with it. It was important to come up with an explanation as to whether that change of ordinance would be worth it.

The stability of the system, clarity, and the robustness of the Swiss financial market and banks that are internationally active are worthwhile. However, there will be very clear and sometimes maybe very controversial or harsh reactions to the consultation that is out, but it is ready to be done after coming so far.

3.2 Accepting any reduction of regulatory capital for the banking system, is not envisaged in Switzerland

Switzerland is in a rather different position from the EU. The EU fears that capital requirements would or have to be raised. Switzerland has the opposite problem, that in a one-to-one implementation of the standard there would be a reduction of the capital requirements, especially in the hotly debated real estate market.

Switzerland needed that extra stability, so there was also a consensus on neutrality, neutral capital movements along the system. This is not going to be an easy task and solutions have been found that are compliant with the standard. It will be necessary to wait for the assessment.

3.3 Switzerland closely monitors the consistent implementation of the Basel accord in other important geographies

The many banks that are in Switzerland might not think there is a consensus yet. The text is now finalised, and it is being consulted on.

What makes it so important to be here and to know what happens, in the EU, the UK, the US and elsewhere, is of course the international solution that is needed. This is no time to go back on the promise. Switzerland cannot afford to not be ready for whatever crisis strikes next, but also has more particular interests.

4. The implementation delays observed in the EU and US lead the Japanese FSA to also delay its Basel accord implementation rules

An industry speaker stated that Japan is waiting for the Europeans (and others) to finish the job. The Japanese Financial Services Agency (JFSA) published the draft rules in September 2021 with a one-month consultation period.

The European Commission came out with a proposal in October of last year saying that there will be a two-year delay in the implementation compared from the international agreement. The JFSA decided after the Paris Eurofi meeting that it would push the implementation back to 2024.

4.1 Some Japanese banks, notably international ones, will adopt earlier Basel latest demands

In addition, the JFSA stated that financial institutions are allowed to go for early adoption if they want to, and some banks are planning to go early. Banks are weighing the benefit of being able to free the resources needed for the related system changes against the increase in the capital requirements.

A distinction between internationally active banks and domestic banks is useful in dealing with the trade-off between the international level playing field; the other one is the consideration of the effects on the real economy. Internationally active banks will be subject to

international rules and then, for the domestic banks, the authorities can think about the best way to adjust from the international agreement to suit national specificities. This is one of the reasons some jurisdictions are being able to implement the Basel standards in line with the international agreement.

An industry speaker stated that the unrated corporates issue is more a non American specificity because Japan's banking sector is more dominant than the capital market. This is likely the case around the emerging markets that are members of the Basel Committee or the Financial Stability Board (FSB). This is not a European specificity; the US is rather the outlier, and the rest is more like Europe.

5. The challenges faced defining a regulatory framework with a single set of requirements which fit all regional specificities and level the playing field

An industry speaker stated that, although supervisors in Europe could have promptly adapted the potential requirements after the Basel Accords through the systemic buffers or Pillar 2, the modifications have been limited, showing that there might not be as huge a regulatory capital gap as suggested by Basel.

Implementation is not a big deal for countries where the Basel III overarching principle of no significant increase in capital requirement has been respected. According to the most recent progress report published by the Basel Committee in October 2021, most countries, including the EU, US and UK, have not yet implemented the final Basel III Accord.

5.1 In certain geographies the scope of the standards implemented is reduced

The main issue is the level playing field. Adopting an international recommendation does not mean there is the same content or impact for all jurisdictions. For instance, the US standard approach does not include operational risks nor the Credit Valuation Adjustment (CVA), which roughly brings about a 30% reduction from Basel. Moreover, economic structures matter, and many significant 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.

5.2 Factoring in the global framework the specificities of the risk profile of the different regional banking systems as well as local Pillar 2 practices proves challenging

The consequence of is that while an international convergence of prudential regulation is desirable to avoid a distortion of competition, whenever international standards do not take into account the specificities of the different jurisdictions, they may actually lead to distortion of competition.

In addition to that, Europeans usually gold-plate international standards so that the convergence is often theoretical. For instance, the minimum requirements for own funds and eligible liabilities (MREL) are higher than the total loss-absorbing capabilities (TLAC) and both the systemic risk buffers and Pillar 2 requirements add other layers to already thick capital buffers.

An official explained that the EU is quite prudent. It applies many requirements to all banks, including the MREL. On the other hand, one of the goals and also advantages if the prudent approach in the EU is that it continuously tries to be more resilient and stable, in order to rely on resilient banks as the major suppliers of funding to the economy as well as to be ready to fight potential crises in the future.

An official explained that the concerns of the banks must be taken seriously. The Swiss Finance Ministry was not at the table when Basel III was negotiated, although was writing the legislation. The Swiss Government had to implement a standard that it did not negotiate. The Ministry made the best of its experiences when finding solutions to include the private sector. There is room for manoeuvre to not only be suspicious of the market actors but include them in solutions.

6. One challenge is to improve the Basel and EU regulatory/standard setting processes in order to identify earlier what are the specifics of each jurisdiction globally

6.1 Ways for involving at the global level all the stakeholders at an early stage should be further worked out

An industry speaker explained that Japan tried to involve all stakeholders at an earlier stage so that authorities and representatives at the Basel Committee can figure out where the red lines are. Once there is an agreement because those red lines have been tested, it is easier to follow on the agreement.

The international process can be improved to find out the red lines for the different stakeholders. The idea would be to have at least one round of international negotiations after at least one round of domestic consultation in all the relevant jurisdictions. It would be good to come up with a proposal that would make it easier for all the jurisdictions to get a positive implementation without having to change any of their domestic rule-making processes.

An industry speaker stated that the proposal to better associate the private sector in the process of designing these international rules is very interesting. The way international agreements are designed could be improved with an earlier and better association of the banking sector.

An industry speaker stated that currently there are public sector bodies that are not involved in the Basel

process that could be involved from an earlier stage by the improvement in the international process.

6.2 The legislative process in the EU is complex and lengthy

An official stated that the legislative process in Switzerland is much faster while in the EU, it is much more complicated as national legal frameworks of member states need to be adapted on revised regulations and directives need to be transposed into national laws. In general, some countries in other jurisdictions have a much quicker legislative process, like Switzerland, than the EU club of 27 member states, with 27 national legal systems.

The Chair stated the decision-making process in the EU has changed a lot over time with an increased role of the European Parliament and a much higher focus on stakeholder consultation.

6.3 The limited role for market finance in the EU compared to certain regions, and the current competitive state of play in the single banking market, compound any possible negative consequence stemming from the global common framework

An official believes strongly in common rules, particularly internationally, for competitive banks. Banks should move with the times and with the competition.

The world is changing and European banks are forced to change. They can be protected and isolated, but in the end, this needs to be a global financial market and not a fragmented one, as now seems to be the political scene, due to the Russian aggressive war in Ukraine.

A public representative stated that the debate around the structure of the competition level in the banking sector is very relevant. The Commission proposal does not include any significant increment on capital. When the industry claims that more capital represents less credit, it depends on the level of competition in the banking sector. If this trade-off is true, the EU still has to evaluate whether competition is increased and whether it leads to a clear reduction of lending by the banking sector.

Banking Union after the June Eurogroup decisions

In December 2021, the European Council reiterated the mandate to the Eurogroup to deliver a work plan charting the ways towards the completion of the Banking Union. The Eurogroup has explored ways to:

- Strengthen the framework for the management of failing banks in the EU;
- Create a more robust common protection scheme for depositors;
- Facilitate a more integrated single banking market for banking services;
- Encourage greater diversification of banks' sovereign bond holdings in the EU.

The President of the Eurogroup proposed 'a phased gradual approach' delivering across all these four objectives to unlock progress, not only to foster private financing of our green and digital future but also to support the EU's ability to prosper in a changing world.

In June 2022, the Eurogroup agreed that, as an 'immediate step, work should focus on strengthening the common framework for bank crisis management and national deposit guarantee schemes (CMDI framework)' and has invited the Commission to bring forward legislative proposals for a reformed CMDI framework before the end of this institutional cycle (early 2014).

In the meantime, no further concrete steps are envisaged for improving the single banking market ('cross-market integration') or for tackling the link between banks and their country's sovereign debt.

Commenting on the results of this June Eurogroup, most speakers noted that the failure of Member States to agree a way forward is disappointing and will have damaging consequences for the EU banking sector (e.g. fragmentation, under-competitiveness at the global level) and the real economy. They also agreed that the costs of inaction should be avoided: some possible solutions to move forward were discussed.

1. The Eurogroup decisions on the future of the Banking Union are disappointing

1.1 The failure of Member States to agree a way forward is disappointing for the integration of the banking sector and the real economy

An industry representative stated that the June decisions of the Eurogroup were not up to the challenge due to political disappointment. The European authorities and Member States produced a collective response to Covid that had positive results, giving the idea that Europe can respond to a common threat. But the Banking Union discussions have revived the debate of returning to risk mitigation rather than risk sharing. The Eurogroup has not managed to define a path towards achieving all four pillars of the Banking Union, which was their mandate, and this failure is disappointing.

There was no agreement on the European deposit insurance scheme (EDIS) and no progress on the actions to achieve a single market for banking services, which is a problem for further integration of the banking sector. A true Banking Union ensures European banks can efficiently fund the European economy, develop private risk sharing, reinforce financial stability in the Eurozone, and maintain the competitiveness of European Banks. It is critical in particular to support a more efficient flow of liquidity and capital between subsidiaries of the same banking group, allowing cross-border groups to manage in the euro area their liquidity and capital at a consolidated level. This is 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.

The industry representative continued by arguing that he did not think the EU will make any progress on these issues in the short run. It is necessary to ask what will happen to the monetary union and the Banking Union in the current situation and whether we can do without what was expected. In the meantime, the markets will react to a situation in which there is no full Banking Union. The trend will be towards more integration at a national level and less at a European level and a negative interaction with the expected recession. It must be hoped a different approach to strengthening the monetary union can be taken. There is also a risk that the European banking and financial industries will suffer from competition from other regions, including the US and Asia. This will be a challenge and Europe will have lost an opportunity to close this competitiveness gap.

1.2 No agreement to achieve the same progress and level of ambition in all four building blocks (crisis management, deposit protection, single market for banking services and diversification of sovereign holdings) explains the 'limited' results of the Eurogroup in June

An official stated that completing the Banking Union is an issue of equal progress and level of ambition but will not be easy given the amount of decisions to be made. The discussion is about risk sharing versus risk reduction, burden sharing, financial stability, harmonization of legislation, a level playing field for all types of banks...The four pillars of crisis management, deposit protection, single market for banking services and diversification of sovereign holdings are interlinked. The discussions showed that the Eurogroup did not have an equal level of ambition in all four building blocks. There had not been any ambition with regard to the EDIS or sovereign holdings at the first stage. The same level of ambition and progress

needs to be shown on all blocks to reach an agreement otherwise progress on only one or two blocks risks creating imbalance for many Member States.

Although some progress was made on crisis management at the Eurogroup in June, an agreement could not be found, and it will be complicated to reach an EU solution in this area.

1.3 The results of the Eurogroup appear all the more disappointing as completing the Banking Union is an even more urgent task in times of uncertainty

A Central Bank official stated that completing the Banking Union is the most important political and economic objective. It is essential for the proper functioning of the market and economic monetary union and to increase resilience against the coming shocks. The conditions have not yet been met to allow political agreement on EDIS and it would be preferable to see a roadmap towards this, because the answer is not inaction. The gaps in the EU crisis management framework have been identified in terms of managing resources to exit banks out of the market efficiently. It is costly for mid-cap institutions or medium-sized banks to go to the markets and fund the minimum requirement for own funds and eligible liabilities (MREL). A lack of EU progress to improve the resolution of medium sized banks in particular would create a spiral of a fragmented market that is not good for the banks or the investor.

Prudential regulations are not the most efficient means to break or reduce the link between the sovereigns and banks. The European response to the pandemic, providing notably flexibility on prudential rules, was a good example of an appropriate response. This type of initiative, along with the NextGenerationEU funds, will reduce the links between sovereigns and banks.

The authorities and supervisors have the power to define capital liquidity in cross-border groups but in some situations, there is pushback because Europe is in a vicious cycle. There should be clear powers for SSM to sensibly set up liquidity and capital across cross-border institutions, but the EU does not have the Banking Union and CMU: there is a fragmented situation where Member States ring-fence their banking sectors. We need to act together and start working together.

Banco de España is interested in reducing the fragmentation of the market for banking services, but this will be almost impossible without first narrowing the gaps between the different legislations and local rules on the national options and discretions (NODs).

2. The costs of inaction should be avoided: some possible solutions to move forward

2.1 The agreement to move forward in Crisis Management Deposit Insurance (CMDI) is a step to be welcome

An official stated that while there will not be a European deposit guarantee scheme until the end of the legislative term of the current Commission, the resolution for banks is only a partial solution. If a bank does not pass the public interest assessment or does not fall under the resolution regime it will come under the national insolvency rules - which are very heterogeneous in Europe - and eventually benefit from external support, justified by financial stability objectives. Therefore, there must be a broader application of the public interest assessment which needs to be defined in a single way in Europe.

The resolution tools are a positive element for future crisis management, as is the flexibility of the deposit guarantee scheme and least cost test.

As much as possible should be copied from the Federal Deposit Insurance Corporation (FDIC), which requires the resolution tools to be used according to the least-cost test. The least-cost test means different things across Europe and need to be harmonised. Introducing indirect macroeconomic costs into the calculation results in the bailout becoming the most cost-efficient way of resolving a banking crisis, which causes a potential conflict.

It is also important to harmonise key aspects of national insolvency laws. There should be one bankruptcy system for non-financial corporations and another for banks, because the liability side of the banks' balance sheet is much more volatile and there is no time to go through the normal insolvency procedures because the assets and liabilities will melt away. Therefore, economically speaking, we need to set up and entirely different system for banks which is not the case for the national insolvency rules of many Member States.

The resolution procedure should also be the same for all banks but there was too much controversy to achieve this. The debate surrounding the Regulatory Treatment of Sovereign Exposures (RTSE) and Home-Host is now off the table. This is more than welcome as it posed a stumbling block for making progress.

2.2 It is up to the European banks themselves to reverse the widening gap with US firms

A market expert highlighted the scale of the challenge. In 2007 the 20 largest European banks had a market capitalisation that was 58% higher than the largest 20 American banks. Currently the 20 largest European banks are 43% smaller than the largest 20 American banks. The profits of some of the largest American banks exceed the market capitalisation of some of the largest European banks. So, the European banking system has become disadvantaged over the last 15 years. Europeans are increasingly marginalised in global business lines and there is an annual erosion of the market share of European banks. This also means that investment budgets are lower in European banks.

The solution to this is to be provocative rather than wait for the Banking Union because Europe does not have a decade to wait for this. The change in the interest rate environment is positive because European banks can use that surplus profit to transform their earnings multiples by offering technology services and creating data solutions for the market. While the balance sheet for a warehousing business might reach 10 times in terms of earnings multiples, that of a data business can be up to 40 times.

European banks need to begin to close the gap that has emerged over the last 15 years.

The chair asked how the banking sector can contribute to help generate the necessary confidence and capabilities to make progress when it is proving to be very difficult politically. An industry representative noted that progressing in the Banking Union has become largely a political issue at this point. Nonetheless, financial institutions could still contribute to achieve further progress in at least three ways: by highlighting the practical issues causing fragmentation in the EU (eg: differences in national bank insolvency laws affecting NPLs rules); by providing examples of best practices that are relevant for the design of regulatory and supervisory policies in the EU (particularly relevant for new regulatory areas under development such as sustainability, governance, and technological risks); and by ensuring sustainable business models for investors. Applying a long-term view to banking activities may also prove useful. The Banking Union is a long-term goal. To align banks and policy-makers planning horizons is also a way to generate trust and credibility on the European model of universal banking.

One practical suggestion in relation to the link between sovereign debt and banks is to stop referring it as the "sovereign bank loop" and become calling it instead the "sovereign-country loop". The real nexus between sovereign debt and banks is the economy. Macroeconomic factors – such as GDP growth, industrial production, etc – play a major role in explaining the nexus between sovereigns and banks. In fact, country of location is a main determinant of such a nexus. An incomplete Banking Union contributes to reinforce this nexus. The main tool to tackle this problem is the EU fiscal architecture.

2.3 More progress needs to be made on cross-border lending

An official asked how the industry can generate pan-European products to foster cross-border activity. An industry representative commented that a greater focus is required on the consumer and household credit being offered in the EU. Only 0.9% of credit in the Eurozone is issued on a cross-border basis due to a divergence in the scope of creditworthiness assessments and access to credit bureau data, as well as a lack of harmonisation around know your customer (KYC) and anti-money laundering (AML) when onboarding customers.

The question is what needs to be fixed at the EU level in order to create the opportunity in consumer credit, which lacks the complexity of the mortgage product. Indeed, consumer credit lacks the complexity that the mortgage product has with foreclosure, variation of collateral, differences in underwriting approaches, loan to value (LTV) constraints, and so on. That does not exist with consumer credit. That is why our bank is considering moving one product that we have created with a digital retail partner in Germany to an adjacent market where we can offer the same consumer credit product to finance. It is essentially a sales finance product.

On the mortgage side it is much harder although more impactful. The Mortgage Credit Directive has focused on foreign exchange loans and little else. That is why the focus will be to solve the easy things first and use that success as motivation to do more on other products.

2.4 As Banking Union progress slows, the importance of Capital Markets Union grows

An industry representative stated that there is little that can be done by banks in the traditional sense, but there is the opportunity to focus on products that have more potential for cross-border acceptance. One of the successes of European-regulated products is on the investment side with Undertakings Collective Investment in Transferable Securities (UCITS). There is an opportunity to create a green standard that will avoid greenwashing going forward with the advent of the sustainable finance disclosure regulation (SFDR), which will ensure there is understanding amongst investors around buying a properly sustainable product.

It seems that branchification is a mantra that is going to be the solution to the Banking Union, but it is not a panacea. This presumes there is a common rulebook across the EU, whether or not the point of origin has a set of rules that are applied transnationally. This needs to be addressed to allow branchification to be properly supportive. The more people can be rotated to operate in various countries the more it is possible to create a European culture of banking.

In the current political context and the following the "limited" decisions of the Eurogroup in June, the most fundamental thing that can be done is to focus on the Capital Markets Union and think about banks as an access point for investors looking to access financial products, companies looking to access financial markets and people looking to undertake payments. For banks to operate as an originator-distributor model it requires deep and liquid capital markets. The way to progress the Banking Union is to develop a pan-European deep capital market to ultimately create European banks.

2.5 Building an institutional setup of instruments – based on Support to Mitigate Unemployment Risks in an Emergency (SURE), NextGenerationEU and the ECB Transmission Protection Instrument that will exploit the advantages of the European integration

An industry representative stated that a slowdown in the European region would increase economic divergence across Member States, which is a structural source of financial fragmentation. This translates into a reaction in the financial markets, the appraisal of investment opportunities and the requests for support. Fragmentation has been a major element guiding the financial crisis of the past decade.

The policy toolbox is more equipped this time to react to the risks of fragmentation. There is SURE, the NextGenerationEU framework, and the ECB Transmission Protection Instrument (TPI). The TPI is similar to an implicit instrument, which relates to the 'whatever it takes' comments made by Mario Draghi. It is obvious that there should be no limit to the effort that public authorities will eventually make to preserve stability and avoid fragmentation. The EU can build an institutional setup of instruments that will exploit the

advantages of the European integration but which hopefully will not need to be tested. A public decision maker noted that the Banking Union can be seen as a technicality because there has been a lot of progress on integration in more important issues, like SURE.

2.6 Defining the right incentives to move forward

An official explained that the issue is quite complicated on the political side and the only way to increase trust and confidence is to create a stable economic environment to reduce risks and promote solidarity. It is important for Europe to become a stable environment to progress towards economic convergence and for the EU to look to harmonise where possible. It is not possible to achieve a total harmonisation of insolvency laws, but the banking industry can contribute to find a way forward if Europe can get closer together. Ringfencing is an important issue but these ring fencing measures have been introduced to protect all banks and their clients at a national level. It is not possible to simply have another regime for cross-border banks.

An official stated that he refers to a Banking Union in the narrow sense of the three pillars, because the single rulebook has got lost along the way. It is important to have a system that moves Europe forward, but this requires the right incentives and the right system. An incomplete Banking Union and an EDIS that, at its worst, could be an instrument for bringing back bailouts is worse than what there is have now.

The problem is that a Banking Union means many things to many people: cross-border distribution and banking, the three pillars, risk reduction and regulatory treatment of sovereign exposures. It is not clear how RTSE for sovereign bonds is risk reducing, because it has to be specified what the assets are replaced with in the balance sheet and there are no relatively safer assets than sovereign bonds. It is a struggle to see why a safe asset should be necessary to have good regulatory prudential architecture. It is possible that it is a safe liability being spoken of rather than a safe asset, which is another question entirely.

There is a lack of trust in Europe on these matters. EDIS should be a boring, technical subject but it is hugely politicised and blown out of proportion and seen as a danger. To others it is the perfect mechanism to continue business as before with as little pain and payment as possible. Both views are wrong, and Europe should return to the technical basics first. But this is in the realm of politics.

An official concluded that the majority agreed that the June decisions of the Eurogroup were not up to the challenges and that there was clear disappointment with an outcome that should have gone further. While there should be minor technical issues to address, they are somehow highly politicised. It is necessary to reflect on why it remains difficult to continue to build trust in something that was already on the table and to find ways to build back that trust.

Competitiveness of the EU banking sector

Introduction

The Chair stated that the question of the competitiveness of the EU banking sector is crucial and connects to a range of other issues, including how best to finance European needs, whether to have a single or multiple European banking systems, and how open European banking systems should be and to whom. This is also linked to the question of the profitability of European banks.

1. A diversity of bank business models is needed to finance the various needs of EU economies

1.1 Taking advantage of bank diversity in Europe

A regulator commented that there is still no single financial market in Europe. Looking at the banking market, there is still a need to distinguish between more bank based countries and mode market based financial systems and there is no definite answer to which system is performing better. Market dynamics have so far failed to equalise the banking across EU Member States structure because of underlying structural economic and social factors (e.g. differences in pensions systems, housing policies...), that have far reaching consequences and are very difficult to address.

Against this backdrop, it is not easy to say which type of bank is the best. Europe has to accept a diversity in the European banking landscape that reflects these differences. The question of whether a universal banking model with diversity united under the roof of a single bank is the right model for Europe needs to be answered from three perspectives: whether the economy benefits from it, what the impact on stability is and whether it is efficient.

The European economy, compared to the US, is very diverse and is dominated by small and medium sized enterprises. Diversified banks can offer tailored solutions for all of their customers' needs under one roof, and this is an advantage. A universal banking system also has benefits for financial stability because it is less dependent on the business and lending cycle and their lower return on equity can improve their shock absorption capacity. However, a universal banking system is more complex to manage, which risks subsidising unprofitable business lines and delaying identifying the erosion of business models.

1.2 A clear need for healthy competition and efficiency of diverse business models to protect customers and serve domestic needs

An official explained that Europe remains the sum of different social and economic systems, cultures and institutional set ups. As a result, competitiveness of large players in the international arena needs to be balanced with healthy competition to protect customers and serve diverse customer needs.

For assessing competitiveness of EU banks, it is necessary to look at all parts of the equation: cost, revenues and risk. Banks' ownership structure, return on equity, business models and where they operate, which affects their risk profile, should be looked at to assess their viability as well as risk adjusted return over a long period of time to gauge success.

A number of high performing banks have reported increasing customer satisfaction after the crisis without meeting the 10% threshold for return on equity. It is difficult to measure economies of scale when moving from large banks to very large banks, of scale when moving from large banks to very large banks, whereas it is quite easy to find a pattern of overperformance when looking at banks that have been able to react to changes in market conditions in a very agile manner, with innovation, automation and digital transformation.

All the efforts made by banks in Europe to restructure and revisit their business processes after the global financial crisis are paying off. Euro area banks' cost to income ratio by the end of 2021 was 60%, well below the average of US banks.

1.3 The optimal size of a bank is a market issue and not a supervisory one; the key issue for supervisors is the efficiency of banks' business models

A regulator explained that determining the optimal size of a bank is a question for the market, not for supervisors. Supervisors have to offer a clear and stable regulatory environment and adequate supervision that does not prefer anybody. Supervisors also need to consider where problems can arise, and in particular whether banks' business models are viable for the near of medium term future in order to intervene very early. This generation of supervisors believes that the drive for bigger sizes has much to do with becoming too big to fail, which is a very dangerous issue because government support should be a thing of the past, and exercising market power, which reduces social benefits. Questions of development, size and competition should be decided according to efficiency and investment in technology. Digitalisation is the issue where success and failure will be determined in the future.

The Chair observed that banks needed to be profitable to be able to make such investments.

1.4 We do need European champions for investment banking services

A regulator stated that climate change and the transition to a green economy is one of the many challenges Europe is currently confronted with and

requires an enormous amount of long term investment. These funds will need to be mobilised globally and channelled to those projects 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 dependent on foreign funds provided by foreign banks to finance its transition.

2. Economic, monetary and structural factors explaining the competitiveness gap between EU banks and their American and Asian peers

An industry representative explained that Europe continues to be a laggard compared to other large banking markets and there were cyclical and structural differences notably between European and American banks.

2.1 Cyclical causes

Weak economic growth has proved to be a hindrance for the competitiveness of banks in Europe. Over the past decade, average annual US GDP growth was 2.1% compared with 0.9% in the euro area, as the US recovered after the financial crisis more quickly than Europe. Secondly, the divergence of monetary policy over this period has also played its part. The Federal Reserve started to increase rates in 2015 while the ECB has just started to do so, meaning European banks' net interest margins have contracted. European banks' ability to extract value from liquidity has also been limited for longer.

Two additional structural factors explain the competitiveness gap between EU banks and their international peers: banking fragmentation issues in the EU and the absence of Capital Markets Union (CMU).

2.2 There is no Banking Union, and it appears that the EU is far away from it

The last 15 years have not been the most profitable period in the history of the European banking system. European banks are trading at six times earnings and only half tangible book value, which provides an indication of what investors think. Profitable banks are needed in order to be able to invest in platforms and infrastructure in order to serve clients.

The lack of deposit insurance in Europe is unfortunate. The 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. Despite laudable recent harmonisation efforts, the economic rationale for retail banking integration in Europe faces natural barriers from different legal and tax frameworks, capital or liquidity ring fencing due to the incomplete Banking Union, and obvious language issues. Chronic over capacity due to national authorities' reluctance to countenance market exits by failing banks has exacerbated the problem. Retail banking in Europe has, in other words, remained stubbornly national in nature.

2.3 Europe is held back by relatively shallow capital markets; there has been insufficient progress notably on increasing the use of securitisation within the EU

Some progress has been made on CMU, but it is not enough, so it is good that there has been a lot of focus during the conference on the acceleration of CMU. US capital markets are much deeper than in Europe and US banks take advantage this by using securitisation to recycle less profitable assets, which European banks tend to keep on their balance sheet. In Eurofi's Santiago de Compostela agenda next year, there should be more focus on securitisation to help European banks increase velocity in recycling their assets.

The good news is that rising rates means the profitability and earnings capacity of European banks will increase, enabling them to invest more in digitalisation and the green transition. This is an opportunity for banks to comply with regulatory requirements but also to make money.

The Chair commented that although it is incomplete and could be improved, there is a Banking Union. There was a first pillar with unified supervision and a second pillar with a unified resolution framework, although it is correct that there is still no CMU. There is a gap in competitiveness between American and European banks with consequences on market shares and valuations. There are also questions regarding strategic autonomy and the composition of the future European banking system.

3. Some priorities to bridge the gap

3.1 Implementing economic and financial structural reforms to create a stable macro-economic environment for economic agents and banks in particular

A regulator observed that there is agreement that EU banks are weaker than they ought to be. Ideally, the banking sector would be stable, innovative, cost effective, profitable and able to provide credit and services to the real economy in good and bad times. Profitability was basically the same between the eurozone and the US until the global financial crisis (2008) and then things have diverged quite radically.

Sweden and many of the Nordic countries had a significant banking crisis 30 years ago that forced them to undertake a number of structural reforms in different areas. This created a macroeconomic background that has been extremely stable and has helped the banks in those countries to remain profitable through the period since then, even though they operate in quite small markets. Macroeconomics and structural reforms beat scale.

3.2 For an open strategic autonomy in the financial area

The EU needs to deepen and integrate its capital markets in general, but the EU cannot come near the US situation in the foreseeable future. Openness to the rest of the world would allow the European financial system to benefit from economies of scale and enhanced competition. The importance of transatlantic cooperation has been illustrated during the previous six months and a general principle of friend shoring is better than strategic economy.

Being closed to the rest of the world is very costly, so it is necessary to pick the reasonable risks and earn benefits from them.

The Chair stated that defining friends is not exactly compatible with the free provision of services and friends could become less friendly than before. The first solution is not to close the market or to expect to close the gap in a few years, but rather to take a selective approach. Other elements are needed to have a stable, robust and innovative banking system.

3.3 Addressing banking fragmentation

A regulator commented that an issue paper published by Didier Cahen makes clear that Banking Union is not complete and there is much to be done. This is very important, but it is not the core of the problem. Before the financial crisis, there was an impetus towards mergers and acquisitions (M&A) in Europe. It is possible to foster this from a regulatory perspective, but the animal spirits of the European banking industry are missing, and they remain passive and concentrated on the national level.

Digitalisation could be the turning point because digital challenger banks are operating on a European level and in some areas are very successful. Big institutions need to be challenged to move towards European banks that are not limited to national borders. The preconditions for banks to use Europe as one room do exist, but they should be used. This is an issue for market participants. Finally a great deal of banking regulatory issues can be overcome if subsidiaries are converted into branches.

The Chair stated that he has noted completion of the Banking Union, the question of animal spirits and digitalisation as key issues.

3.4 Completing the Banking Union; EDIS would be a gamechanger

An official explained that policymakers' goal is to design conditions for banks to thrive, to support growth and to preserve financial stability. Their final objective is the integration of the market for banking services. The lack of a truly integrated single market is a clear disadvantage for banks in Europe that makes the comparison with other jurisdictions impossible. European banks seem to have reduced their international activities in a permanent manner and the European banking sector remains segmented along national lines. The regulatory framework is conducive to this fragmentation and inconsistencies need to be fixed.

However, the full removal of obstacles to optimal resource allocation will only be possible once the safety net in the Banking Union is established and reinforced. There is a need for a European Deposit Insurance Scheme (EDIS) and the introduction of the backstop to the Single Resolution Fund (SRF) to ensure the resolution of all banks in the euro area can be carried out without tapping into taxpayers' money. EDIS is the only way to ensure that all savers in the European Union can be protected in the same manner and to ensure the credibility of the Banking Union project.

Banking integration does not mean consolidated or bigger banks. There is a need to make progress on Banking Union to deepen the discussion regarding the optimal size of EU champions competing in the international arena. At this stage, it is impossible to say that the 'too big to fail' problem has been solved and the fact that the orderly resolution of global banks is still an open issue casts doubt on their superiority in terms of financial stability. There is a need to move forward step by step on the integration of the market, through harmonisation of insolvency law, standardised disclosures, equal depositor protection and a common supervisory approach. This will enable European banks to better serve domestic clients and international competitors.

The Chair commented that a number of Eurofi conferences would be needed to bring this to completion.

3.5 Simplifying and improving EU banking regulation

An industry representative stated that after 10 years of successful implementation of regulations around the Single Supervisor Mechanism (SSM), the next 10 years of regulation should focus on simplifying and improving regulation in Europe. The emphasis should be on focus and quality, rather than quantity. Edouard Fernandez Bollo has stated that the European Central Bank (ECB) is doing a self assessment with an independent body to look back over the last 10 years on what regulation has accomplished and what the next 10 years will be. There is reason to be optimistic that this consolidation is on the right path, but there is a lot of work to be done.

A regulator noted that the rule book 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 the formation of a true single market. Fragmentation in the 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.

A regulator observed that it is necessary to learn the lessons from the global financial crisis and the eurozone sovereign crisis. Basel III needs to be finalised to provide a level playing field in international markets and Banking Union should be completed. Other issues below the surface are even more important. Europe is over banked and there is a need for consolidation and the introduction of innovative players. That means that some other banks need to be removed. European policymakers need to understand that structural change in the financial sector is necessary to reap full benefits of Banking Union. Although there are short term costs, this will have will be long term benefits. Lessons also need to be learned from the pandemic. In Sweden, it became clear that capital market funding was too weak as corporate bond markets froze up. Deepening the CMU to provide capital to the real economy is therefore crucial also for Sweden.

Simplifying regulation without watering it down is a key issue because there is general agreement that the

system is complicated. Sam Wood' writings from the Prudential Regulation Authority (PRA) on the 'Bufferati' is a good starting point, as simplifying regulation and focusing on buffer usability should be the main principles going forward.

The Chair questioned whether the need for simplification is the real explanation for the gap in competitiveness because the level of complexity is extreme in the US. An industry representative commented that there is plenty of room for harmonisation and simplification, which would make things easier for banks and clients. An EU wide AML approach would bring down transactional costs and make banks' provision of services more efficient, faster and more reliable.

The other aspect is that capital is global. It is banks' job to bring together people who need money and people who have surplus money. London is a huge pool of liquidity that needs to flow within Europe to allow the efficiency of capital movements to help banks' customers. It is therefore time to rethink the lessons learned from Brexit. Many banks now have a strong footing within the European Union, but they still need to leverage access to capital in Europe, the US and Asia for the benefit of European customers.

Conclusion: The key priority to move forward

The Chair asked each participant to choose which of their ideas would be the first priority to improve competitiveness of the European banking sector and achieve their stated goals. An official stated that their priority is the digital transformation. A regulator commented that all of the European banking system's problems will be overcome if it is possible for a foreign bank to buy the biggest French, German or Italian bank. An industry representative stated that his priority is the completion of the CMU and securitisation. A regulator commented that their priority was to fix the real economy and complete the CMU. The Chair summarised that there is consensus on completing the CMU and that the next Eurofi financial forum will work on that.

Improving the EU bank crisis management framework

The discussion showed that using DGSs in resolution or facilitating access to the Single Resolution Fund remains a very controversial issue. Nevertheless, there seems to be consensus on four types of measures to improve the EU crisis management framework. These areas are: defining the public interest criteria in a single way, allowing smaller banks likely to be resolved to have smaller MREL requirements provided some conditions are respected, extending the scope for DGSs interventions to facilitate market exit of failing banks not subject to resolution and supporting limited harmonisation of national creditor hierarchies in liquidation.

1. Using DGSs in resolution or facilitating access to the Single Resolution Fund remains a very controversial issue

The amounts earmarked for the crisis management framework in Europe are already comparable to those in the United States. During this session, several panelists proposed measures to make this money usable for the sales and market exits of medium sized banks. This could be done by facilitating access to the Single Resolution Fund (SRF) and/or using DGSs to fill funding gaps while allowing resolution of medium sized banks. Such an approach would require replacing the existing super-preference of covered deposits by a general deposit preference. Industry representatives explained why they were strongly opposed to these measures.

1.1 Proposals to facilitate access to the SRF and to allow DGSs to support resolution for troubled banks

1.1.1 Make the safety nets money usable

An international official stated that there is a lot of bank backstop money in Europe today. One fundamental challenge is to make the industry monies and fiscal backstops usable. In 2023 around €80 billion will be in the Single Resolution Fund (SRF) and another €55 billion or €60 billion in national deposit guarantee schemes (DGS). If the ESM liquidity backstop is added to that it will total about €200 billion, as well as the very substantial mandatory internal buffers of minimum requirement for own funds and eligible liabilities (MREL). The idea should be to make the backstops usable, with due attention to checks and balances, and with a focus on facilitating a smooth exit of failing banks.

1.1.2 Democratise bank resolution: the EU resolution framework should ideally encompass all banks

An international official added that a second point would be to "democratise" bank resolution. Europe needs a resolution system more on the US model, which is one that spans a much broader set of banks than just the few largest ones. The business of resolution is often about medium and small banks. In order to unlock the door to resolution for small or medium-sized banks Europe should revisit the Public Interest Assessment (PIA). A key difference between Europe and the US is that there is no 8% bail-in threshold in the US, simply a least cost test. This reflects the complex, multi country nature of the construct, and associated issues of trust.

An international official noted that the next question is whether MREL should apply equally to smaller banks. There is an underlying issue of the desirability of business model diversity. Questions can be asked about whether small banks that have never issued subordinated debt or hybrid instruments should be required to do so. MREL requirements for small banks should be proportionately lower than for large banks.

A regulator agreed that there is a need to apply the resolution tools to a larger number of banks, including medium-sized ones. Supervisors need to define what is meant by small and medium sized banks, which is not easy because of the systemic footprint. What is called a small bank in one country can be a big bank in another country, but some harmonisation is needed. Not all banks should be covered by the resolution tools. Another way of exiting these smallest banks is through national insolvency procedures, which should be kept in the landscape. The other idea is the question of accessing the SRF. Supervisors want to avoid free riders, hence the level of MREL and the necessity to define conditions for the intervention of DGSs.

A regulator observed that it is unfortunate that Europe has, in addition to the SRF, more than 21 separate DGS funds in the various Member States, used for different purposes, compared with the same level of safety net in the US, which has one Fund under the Federal Deposit Insurance Corporation (FDIC). There is no legislative reform that can make resolution or insolvency of a bank a 'free lunch'. It will always mean the allocation of losses. It is clear that the first ones to bear losses are shareholders, and then creditors. Europe has made substantial progress for the resolution of significant institutions. The net can be broadened to a second layer, which is mid-sized banks, but if that is done then the same rules have to be applied.

1.1.3 Replacing the existing super-preference of covered deposits with a general deposit preference would allow industry funds to play a greater role to support a failed bank's smooth exit from the market

A supervisor noted that Europe has a situation where it has a significant amount of money that cannot be used, and then Europe does not benefit from a third party entering the market and offering to help banks in trouble. The economics do not work because there is no economic

incentive for using funds or other banks to enter the debate and try to apply the turnaround for a distressed bank, because they know that if things go bad, they will not be treated in the same way as the DGS. There is a huge amount of money that cannot be used at the moment due to legal constraints embedded in the EU directives and this situation should be unlocked. The question is why Europe does not consider treating all depositors the same.

A supervisor stated that the first point would be to try to remove the super priority in order to create the economic incentive for other financial institutions to intervene together with the DGS. This would reduce the probability of contributing banks to lose, because there could be a preservation of the economic value in the system. The current creditors hierarchy should be amended to introduce a general deposit preference where all depositors would rank pari passu.

A regulator noted that if a super-priority in the creditors' hierarchy of DGS funds was removed and a general depositor preference was introduced, then the DGS could still be protected by their position in the hierarchy. However, they would also be able to step in in lieu of deposits and to support market exits when this is less costly and more efficient than a pay-out.

An international official observed that there is a need to revisit the super seniority for DGS money and to replace the DGS super preference by a single deposit preference, as it would make the use of DGS resources more efficient. The current system makes it impossible to use DGS resources for anything other than payouts. The focus should be on making this money usable, not just for deposit payouts: DGS resources should be available to support purchase and assumption transactions.

1.1.4 Allowing DGS to try to facilitate the market exit and to devise a least cost test that creates and preserves economic value for banks that have to get out

A regulator said that there are two avenues the EU needs to look at. If a bank has a systemic footprint systemic footprint that has a financial stability impact, then resolution is the best strategy. There are different tools, but resolution does not mean resurrection. Following that, there are a large number of banks for whom there is not a major financial stability concern. The EU framework has not always helped those banks smoothly exit the market. Harmonising insolvency procedures does not mean immediately going to an FDIC model but harmonising some parts of the framework so that DGS can support the exit.

A regulator added that not every bank that gets into trouble needs to go into an insolvency procedure. DGS funds would be used in resolution only when it costs the DGS less than their pay-out to depositors. If a solvent wind-down is the best solution, then that might also be an option. In many cases, purchase and assumption transactions and/or transfer tools might be the better option. It will be important to harmonise the least cost test to make clear what the role of the DGS can and cannot be, and to include the question of what the position of the DGS is in the creditor hierarchy. In any case, the goal must be market exit of a failing bank.

The Chair stated that from a supervisor point of view there is already a consensus to have a framework where supervisors withdraw the authorisation to ensure that there is an exit from the market when it is used. The Chair asked a supervisor if a European harmonisation to ensure that there is a link between use of the funds of the DGS and a soft exit of the banking market can add value.

A supervisor stated that he supports the objective, provided that we ensure that the exit from the banking mark remains a soft one. This is the key issue to tackle. Otherwise, if central banks cannot rely on an efficient and consistent use of DGSs, then state aid should still be available.

The Chair noted that in June there had been a consensus at the Eurogroup that the EU needs to facilitate the market exit of small banks. There is an issue that the EU still has too many banks that are not getting out, and the ways to get out were using public money when they got out. Europe has to facilitate an orderly exit for troubled banks of all sizes through both resolution and liquidation, without economic disruption or indirect forms of bailout by public authorities. On these issues, the idea is to do so at the least cost by increasing the efficiency of the use of the money. If the EU admits that avoiding a formal insolvency procedure preserves value, then it needs to find ways to do that in a European harmonised way.

1.2 Objections to extended use of DGS for banks in resolution and easier access to SRF for medium-sized banks in resolution: same business, same risk, same rules

An industry representative stated that the bail-in of 8% of total liabilities and own funds (TLOF) being a requirement before having access to the Single Resolution Fund (SRF) is the existing rule. While banks are not necessarily attached to that level, banks are attached to one thing, which is having the same rule for all. There should not be a different rule for smaller banks and larger banks. Using the safety nets money is a false good idea. The contributions to the SRF and the DGS is costing the banking sector a great deal of money, at more than €14 billion per year currently. Investors are expecting this level of contribution to come to an end once these funds are funded at their target level as it significantly impacts the profitability of EU cross-border banking groups.

An industry representative added that the money being a safety net was mentioned in the statement of the Eurogroup. It is a safety net, which means it should only be used in exceptional circumstances. Reviewing the deposits or the DGS positioning in creditor hierarchies means changing the rules of the game in the middle of the game itself. Using DGSs and the SRF intensively means that the banks will have to replenish them, at the cost of investors but also of the customers. It will indeed increase the cost of the banking services for us all, i.e the European taxpayers. In times of high inflation that may not be welcome from a political viewpoint. The banks that are already barely profitable in Europe will become even less profitable.

An industry representative noted that when examining who is contributing to these funds, it is the largest and the soundest banks in the system, be it the national system for the DGS or the European system for the SRF.

That is an issue, because by doing so and by using those funds on a regular basis this would constitute a burden for the sound part of the banking sector. In the end, this would not only raise serious questions of a level playing field but could also threaten financial stability.

An international official suggested that, when a small bank is resolved using a purchase and assumption transaction, any backstop monies deployed usually form a sweetener for the acquirer, and the acquirer is typically a larger bank. So, when one speaks of making DGS and/or SRF resources available to support the resolution of small and mid-sized banks, typically the industry money will flow to larger banks. And, because the transaction is at lower cost than a straight deposit payout, everyone benefits.

An industry representative maintained that changing the creditor hierarchy to ease the least cost test (LCT) and extend the potential use of DGS for resolution would be a step in the wrong direction. A least cost test easier to pass would lead to repeated DGS interventions and increasing costs for the sound part of the banking industry. This would force healthy banks to 'bail out' failing banks and replenish DGSs much more often. Raising all deposits to the same level in creditor hierarchies would also reduce the 'bail-inable' instrument base, with potential negative consequence on the ratings of other debts and on liquidity.

1.3 Financial stability should be the underlying rationale of the CMDI review

An industry representative stated that he would not join all the complaints about the status of the Banking Union (BU). It is important to look at what has happened since 2014 when the Deposit Guarantee Scheme Directive (DGSD) was introduced, and since February 2015 when the Bank Recovery and Resolution Directive (BRRD) was introduced, and the Single Resolution Board (SRB) came into place. Since then, the national deposit guarantee schemes have worked quite well, and the SRF has never been used. Europe does not need to contemplate a fundamental change. When reviewing the crisis management and deposit insurance (CMDI) framework, the ultimate objective should be enhancing financial stability. A second objective is to maintain the trust of depositors. These objectives are particularly important when it comes to the scope of the resolution framework. A resolution is appropriate for failing institutions that pose a threat to financial stability. All other failing institutions should go into national insolvency. There is no need for a fundamental overhaul of the CMDI framework and there are no merits in blurring the lines between resolution and deposit protection.

An industry representative noted Europe has collected approximately €64 billion, which would otherwise be in the core tier 1 accounts of the European banks. It is unclear what contributes more to the banking sector's safety, either storing these contributions or applying them in the current situation, particularly for strengthening the banks themselves.

A regulator agreed that the funds should not just be used because they are there. It is important to be careful, as that money is the safety net. It is important to think about the mid-sized banks and say that the DGS can play a role to protect depositors and support market exits.

2. Four areas of consensus to improve the EU crisis management framework provided some conditions are respected

Panellists agreed that the four areas of improvement are: defining the public interest criteria in a single way, letting smaller banks having smaller MREL requirements provided some conditions are respected, using DGSs in resolution to facilitate market exit of failing banks with complete sale of business as resolution strategy subject to least cost test, and supporting limited harmonisation of national creditor hierarchies in liquidation.

2.1 Defining the public interest criteria in a single way in Europe

A regulator stated that the PIA should be revisited, but that also means that if Europe decides to implement a resolution decision that means there is a positive PIA. If there is no resolution decision it means that there is no PIA positively assessed for the liquidation processes.

An industry representative agreed that there are two layers in the financial institutions: large, pan European ones, and the small and medium-sized banks. That is where proportionality occurs. Clarity on whether a failing bank is undergoing resolution or being sent into national insolvency is essential. This dual framework should be strengthened by clearly defining PIA at EU level.

An international official noted that the EU resolution framework should encompass a broader set than it currently does. Unlocking the door to resolution of medium sized banks can be done by reinterpreting the public interest assessment or rewriting the EU legal texts.

2.2 Smaller banks can have smaller MREL requirements provided some key conditions are respected

A supervisor noted that the previous day's panel on business models touched on the principle of proportionality. Europe needs to ensure biodiversity of business models in the EU on a going concern basis, but on a gone concern basis people then claim that central banks should apply the same rule across all different business models. A question is why central banks cannot apply the proportionality principle in the gone concern aspect. MREL should be there, but it could be lower. Small banks cannot issue MREL instruments in the same way as larger banks, and if they did, it would be much more difficult and costly.

A supervisor added that the client base is not as advanced as it might be in other cases, but the EU should consider the biodiversity of the EU banking system on the resolution side. If MREL can be reduced then the resolution tools can be applied to a greater extent without creating a contagious effect or a disruptive impact in the

market, because then banks might still try to reduce the impact on the deposit base.

An industry representative observed that this biodiversity should be filled with life. Proportionality, subsidiarity and diversity are just words used at the beginning of speeches by regulators, central bankers and politicians. A Central Bank official has given some hints on how to properly take into account the diversity of the EU's banking system.

An industry representative stated that resolution must be primarily funded though MREL. It is the duty of resolution authorities to set appropriate MREL targets for all the banks potentially subject to resolution. The level of MREL should be proportionate to two things: the riskiness of the bank itself, and the type of resolution strategy that would apply to them if they failed. Access to the SRF should remain subject to prior bail-in of at least 8% of TLOFs, and DGS should not be used to finance a possible shortfall below that intervention threshold. Proportionality already exists today in the regulation, so it just needs to be applied.

A regulator noted that MREL has been discussed. Proportionality already exists. Adequate MREL capacities remain the most efficient way to enhance depositors' protection and a successful market exit in the event of a failure. Europe cannot escape the right level of MREL for all banks covered by resolution tools, and with the possibility to access the SRF. Proportionality already exists, so supervisors need to be able to use it more smoothly while taking into account that the right tool to use for medium sized banks is the transfer strategy. A credible transfer strategy should embed a lower level of MREL.

2.3 Using DGS interventions to facilitate market exit of failing banks not subject to resolution is logical, providing some key conditions are respected

2.3.1 Establishing a link between the use of the funds of the DGSs and a soft exit from the banking market

An industry representative agreed that there is room for consensus on many points in this area. There can be a way to use the DGSs, but there are some key conditions that should be respected. The use of the backstops should facilitate the market exit, and that market exit should be swift. The use should be to shield the depositors, not the shareholders or the other creditors, and it should remain subject to the Least Cost Test. The term 'unification' could also be used, because leaving all these rules at the national level is a recipe for divergence and a messy outcome. If Europe wants something that works, then all these rules should be made applicable at European level and made applicable by European authorities. Preventive measures should be reserved to a viable institution and should not be compared with anything like resolution.

A regulator explained that external funding in liquidation should only be circumscribed to the protection of deposits, 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.

2.3.2 The DGSD already provides for the flexible use of DGSs

An industry representative stated that a failing institution that does not pass the PIA should go into national insolvency. He added that Articles 11.3 and the 11.6 of the DGSD provide for the possibility for DGSs to apply preventive and alternative measures. So, the DGSD already allows for the flexible use of DGSs. Article 11.6 might offer a way out for mid size banks not going into resolution, because these alternative measures provide the possibility to make use of the DGS funds to support a failing institution. It would be applicable within the framework of the PIA, the least cost test, state aid rules and everything else.

2.3.3 Alternative measures should be part of a harmonised rule book

A regulator observed that alternative measures should be part of a harmonised rule book. Alternative measures are currently an option that is not implemented in all many Member States. The Chair noted that Europe can ensure the exit of the institution if it is linked to withdrawal of authorisation whenever the conditions are met, but the harmonisation needs to be pushed forward, as Article 11.6 is currently 'a complete mess' in Europe. Convergence is fine if preventive measures are linked when using DGS funds to exit the market. It would be a preventive measure as it avoids payout in insolvency. It is not preventive in the sense that it aims at making a viable institution that continues its activities. The real issue is to link it with market exit. Whenever the name Deposit Guarantee Fund is mentioned, it should be to get out of the banking market, not to stay in.

A regulator said that policymakers have to be precise on what they want to do when it comes to preventative measures. They are not used to prevent something that will obviously happen, but to make sure that there can perhaps be an earlier exit of the market at a better price. The panel has not discussed the elephant in the room, which is the 2013 Banking Communication. Europe still has inconsistent rules about what is burden sharing, and different ideas on how to potentially resolve the situation. Harmonising the rules there is urgent, otherwise there will always be the element of having an exit that is not insolvency or resolution but paid for by the taxpayer.

An industry representative reminded the panel and the audience that Articles 11.3 and 11.6 of the DGSD are applied as part of the existing legal framework with DG COMP monitoring that no competition laws are affected. Preventive measures apply before a failing or likely to fail (FOLTF) situation arises.

The Chair clarified that the discussion had centred around the idea that Europe will prevent the use of DGS funds to maintain unviable banks: these funds should not be used to keep banks alive, but on the opposite to prevent hat they continue their operations.

An industry representative stressed the need for enhanced legal certainty around these measures, including alternative measures. The Banca Tercas ruling

by the European Court of Justice had confirmed that alternative measures do not constitute state aid. Although Banca Tercas had been dealt with in another way in the end, but the court looked back in history stating that it could have been compliant.

2.4 A support for limited harmonisation of national creditors hierarchies in liquidation

2.4.1 A fully harmonised European insolvency framework seems out of reach

A regulator explained that a global harmonisation of the banking insolvency proceedings is too complex because it involves the Ministries of Justice. The first low hanging fruit suggestion is to harmonise the creditors' hierarchy. The second is to define common objectives for a liquidation regime at the European level.

An international official noted that it has traditionally been said that harmonising corporate insolvency across the EU is a 'bridge too far'. It is an area that sits with Ministries of Justice, not Ministries of Finance, is deeply entrenched in national legal tradition, and is essentially impossible to do. The BRRD shows, however, that it is possible to create a carve-out for banks across Europe. Regarding the national insolvency route, there are a lot of differences out there. The national insolvency regimes for banks in some countries look more like resolution frameworks. Others are essentially identical to non financial corporate treatment. Full harmonisation is a taller order than broadening the scope of the BRRD and the authority and reach of the SRB.

A regulator did not think Europe will get to a fully harmonised European insolvency framework in the short term, but harmonising "special" insolvency procedures through BRRD and SRMR worked well, so there is hope in the long run.

2.4.2 The least cost test should be harmonised at the EU level and national creditor hierarchies should also be further aligned in order to level the playing field among deposit-taking banks and to facilitate resolution in a cross-border context

A regulator noted that crisis management avenues at a national level that rely on national liquidation frameworks need to be further harmonised to ensure more consistency. The BRRD sets a common set of rules, and then supervisors need to respect two key principles. The first underpins the suggestion to align the creditors' hierarchy, which is the 'no creditor worse off', principle. No creditor should be worse off in resolution than in a normal insolvency procedure. The EU needs to find a way of harmonising the test about comparing the resolution implementation decision versus a normal insolvency procedure, which can currently be different in 21 countries. When there is a cross-border group with a subsidiary in one country and a subsidiary in another country then the resolution authority needs to twice compare the 'no creditor worse off' principle. It is important to harmonise the creditors' hierarchy for the banking institution.

A regulator explained that the second key principle is the least cost test. The discussion has shown that panellists consider in reality that at the centre of the crisis management there is resolution, and then for resolution a harmonised tool kit with common rules should be defined, with the same rule for different ways of dealing with bank failures. The least cost test should be assessed in different ways for DGSs to be able to be involved in the process. France has a DGS that can act preventively. What matters is that the preventive actions respect the same set of rules that have to be respected under resolution. The key principle is to be sure that there is a continuum and no risk of someone saying that an entity would have been better off if it had used something different.

A regulator added that the need to revisit state aid rules is on the agenda of the European Commission. The state aid rules coming from 2013 which was a time when the BRRD had not yet been adopted, need to be realigned.

Taking advantage of the diversity of bank business models and governance in Europe

The discussion showed that that various parameters and dimensions are needed to distinguish bank business models (i). The plurality of business models poses challenges for banking regulation and supervision in the banking Union (ii). It requires a flexible approach to cater for a variety of business models (iii).

1. Various parameters and dimensions are needed to distinguish bank business models

What constitutes a model and distinguishes it from another is not easy to define. Different criteria or features may be used. Bank business models can also be envisaged from the perspective of the transformations which are underway in the banking sector (ESG transition, new entrants such big techs and fintechs, technological advances such as smartphone technologies, artificial intelligence, big data...). But, in any case, business models need to be viable and sustainable.

1.1 It is difficult to define a business model, but it needs to be viable and sustainable

A regulator explained that the business model for a bank is that the bank collects deposits and grants credit. The way it has been looked at so far has mostly looked at the past, which may not be the main approach to what is going on, especially now that the banking sector is facing major transformations such as the green agenda, new entrants and everything related to technology. Bank business models should also be envisaged from the perspective of the transformations which are underway in the banking sector. It is therefore not very clear what a business model is at the outset.

A regulator noted that focus should be on viability and sustainability, and whether a bank can survive in the short term and in the long term. Evidence shows that when a bank does not perform well there is merit in changing the business model and in changing the segments in which it operates. The European Banking Authority (EBA) looks at it from three angles: a risk perspective, a regulatory perspective and an innovation perspective as new entrants (big techs, fintechs) will affect the more traditional activities. Over time large cross-border banks perform slightly better than others, because they have higher return on equity (RoE) and less capital depletion in the EBA stress tests.

1.1.1 Diverse criteria to define business models

A regulator explained that 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, providing them liquidity through the cycle (transforming risks, duration, currencies...) with sophisticated risk management and sustainable funding, and performing these critical functions efficiently, which does not necessarily mean bigger balance sheet anymore but requires reaping economies of scale and scope.

The Chair confirmed that a number of successful business cases have also showed that size may not represent the unique success factor any longer. Small and medium intermediaries have a more flexible cost structure and higher ability to react to market changes and are able to get competitive advantages. Reaching minimum scale does not represent a hurdle to invest in new technologies due to business opportunities offered by external platforms and access to information embedded in the banks' proprietary data.

An industry representative agreed with the previous speakers on the overall perspective of definition. There are well established criteria like activities, the structure of the balance sheet of financial institutions, the funding sources and the ownership structures. It is important to control the specific risks and vulnerabilities of financial institutions. The risk profiles can also take into account issues such as concentrations and can consider emerging trends such as digitalisation and provision of banking services via third-party providers. There should still be bucketing, but for the purposes of supervision and regulation there is a good basis to engage with banks in the course of the supervisory review process.

1.1.2 To preserve diversity, banks need to ensure the resilience of their banking models

A Central Bank official explained that 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. Since the ECB is strongly committed to a neutral and objective approach to different business models, the starting point is measuring financial resilience The main parameters measuring financial resilience of bank business models are income mix, customer mix, funding mix, size and geographical exposure. Strategic management, risk appetite and development strategies are also taking into account. The Single Supervisory Mechanism (SSM) is doing work in the same spirit as the EBA has done for all supervisory tasks.

A Central Bank official noted that the European Central Bank (ECB) is not using the legal form. The legal form is very important, but the ECB is trying to analyse the capacity to absorb shocks. What is important in measuring the financial resilience is the analytical underground of the sustainability and viability of the

bank. In Europe, lending remains the most important source of earning for a bank, but Europe has very different degrees of diversification.

A Central Bank official stated that the ECB has identified the importance of the six biggest banks in Europe, which is in line with EBA analysis for the whole EU. Those six banks make up nearly 50% of the total market of significant institutions directly supervised by the ECB. Universal banks form the majority of the EU banking sector. But the EU also benefits from specialised lenders and wholesale banks. The core issue is a bank's capacity to sustain its activity through the cycle, including absorbing risks in the event of a recession. Each bank needs 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.

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

1.2.1 This diversity is beneficial for the European financial system

An industry representative observed that the diversity of business models is very important, because it is of benefit for the financial stability, for the resilience of the banking system overall, and for the ability of such banking systems to effectively serve the economy and society. The existing set of business models has to meet European market needs and provide adequate support to finance the economy. It is important to ensure that regulators provide a level playing field for banks of different business models to be able to compete, to provide financial stability, and to protect EU citizens and society from excessive risk taking.

An industry representative underlined that banks and regulators should foster diversity, just as assessing the business model of a bank everyone looks for diversification of resources.

A Central Bank official added that the existence of different business models can be beneficial and sometimes necessary. Some credit institutions focus on specific areas or 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.

1.2.2 Taking into account different models

An industry representative stated that there are business models in Europe not conforming to the traditional banking framework, but they are relevant institutions in their country of operations. He mentioned institutions not taking credit risk and devoted to specific purposes, like, for example playing as intermediaries between sovereign issuers and the general public. He explained that there are financial institutions, often operating in different businesses and, apart from credit risk taking, they are subject to the same regulatory framework of banks. However, these institutions are important as they create diversity in the financial ecosystem and they have a long experience in the industry, though not often fully appreciated for their diversity in the EU prudential framework. As example of their relevance, some of these institutions have the mandate and ability to gather for the interest of some of those clients that are not at the centre or at the core of many other banks. Secondly, there are specific financial indicators that are used for banks which are not always adapted to the model, which sometimes provides a constraint as to what Poste Italiane can do for its clients. At the same time, he noted that these kinds of non-dogmatic financial institutions, often deposit taking or universal service providers, are a clear proxy of new entrants into the European financial ecosystem and they provide some insight on how to manage a series of newcomers offering only a selection of the solutions and products as a traditional bank may do.

1.2.3 Market share data

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.

A Central Bank official stated that 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 some banks specialise in certain activities so for them the market needs to be defined more narrowly. 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, 25% are other universal and investment banks, less than 15% are diversified lenders, and around 5% are other bank business models.

The Chair summarised that the definition of business models seems to be good, and regulators are looking at the right issues so there is adequate biodiversity in the system.

2. Prudential authorities need to adopt a flexible approach to cater for a variety of business models

2.1 Assessing the performance of a business model is a complex issue, and the plurality of business models poses challenges for banking regulation and supervision in the Banking Union

A regulator stated that strong conclusions should not be taken on what is a good or what is a bad business model. It cannot be one-size-fits-all and has to be a good comparison of a number of dimensions. Supervisors and regulators have to be business model agnostic, but need to compare, ask questions, come across benchmarks and challenge what banks do, otherwise they cannot go anywhere.

An industry representative observed that supervisors and regulators represent the public interest and are only accountable to them. Diversity of business models is needed, but care is needed when defining good and bad business models. Performance is usually defined as

financial performance relating to the amount of profit made, but the definition of performing should also include playing a role in good and bad times, in managing deposits and lending money....in other words serving the economy. The key performance indicators (KPIs) should also be examined. Looking only at profitability is not sufficient.

A Central Bank official underlined that the plurality of business models poses some challenges for supervisors. Europe has G-SIBs and very small-sized banks, so there is a supervisory challenge. Combining homogeneity in banking rules with diversity in business models is a difficult task. Close scrutiny of how business models are evolving, combined with a flexible approach, is more justified than ever. The role of the Joint Supervisory Teams (JSTs) is to use their expert judgement. Many efforts have been devoted to improving the management of the teams and the trust of the teams, and after almost eight years of joint supervision the SSM is up and running. It is doubtful that after eight years someone could think that local or national supervisors could be more understanding of different banks and different situations. The SSM compares peers with peers. G-SIBs across all jurisdictions are an excellent element for benchmarking and is very relevant for the supervision. In the meantime, SSM supervisors have to find the right balance between horizontal standardisation and banks' singularities.

2.2 Profitability assessed on a case-by-case basis should not be the sole compass for supervisors to assess the viability and the sustainability of business models

An industry representative stated that profitability is important in order to make sure that banks can resist shocks and can perform through the cycle. That enables banks to build reserves and face shocks. Certain business models such as cooperative bank business models force banks to keep a large part of their profits within the bank. Cooperative banks have raised money in tough times without much difficulty on a fairly stable basis. Sufficient indicators are in place, possibly with the addition of new ones. Profitability is an interesting factor, but the retained amount of profitability i.e. the residual income after distribution of the payout to equity holders - is the proper way to judge the ability of a number of banks to go through the cycle, resist shocks, pay for risks when it happens, and still raise money.

A Central Bank official noted that a key question is whether there is a direct link between business models and profitability, whether that is more connected to governance and different arrangements that Europe has, and whether they are linked to the cost of equity and the return of equity. Speaker's view is that all of them are interconnected. The technology on digitalisation and appropriate governance will be major drivers for the future and for structural changes in the financial industry. More precisely, the expected level of profitability relies and depends on its particular business model, the bank's funding configuration or the ownership arrangement. The SSM observed great differences of RoE or return on assets (RoA) across peer groups. The level of profitability of a bank needs to be carefully assessed on a case-by case basis. Good governance is an additional key component, and digitalisation will play a very important role in the coming months and years.

The Chair summarised that panellists' feedback reassured that the SSM has no ex ante assessment of a unique or common level of profitability, but conducting a case-by-case assessment is key. One development that has been seen is for players that do traditional banking with very innovative processes. Parts of the banking business are being moved outside the banking business with credit funds. Regulators also see an increasing role of the non-regulated firm, which is why it is important to strike the right balance to ensure both a proper assessment of risk and a compliance with the EU regulatory framework. Both the SSM and national supervisors are looking beyond the traditional scope of regulation and supervision.

2.3 Given the diversity of business models, a one-size-fits all that is based on one predetermined set proxies for assessing the performance of business model does not fit

A regulator noted that the regulators and supervisors have always wanted to be business model agnostic. They wanted to be able to compare, and to draw conclusions out of different types of indicators using judgement. It has never been as simple as looking at an indicator would immediately draw conclusions. The new EBA guidelines categorises banks into four categories: It is not only about size, but also about what a bank is doing, the complexity of its business lines and its respective weights. On the basis of this preliminary business model and strategy analysis, supervisors will determine the materiality of business areas and lines, identify different peer groups, and apply proportionality in what will be expected from the banks. The EBA considered it very important that supervisors go back to first principles and do not look at the past. Europe has a number of players which have superior information and good technology, and which might be in a position to do exactly what banks have been doing for decades. It is important for banks to understand that and see how they want themselves to deliver their role and their key functions. Having this competition in mind, it is also important for regulators and supervisors to see who should be put under the safety net to make sure that the landscape remains even, and that Europe does not have undue competition and risks arising around undue competition.

2.4 Benchmarking should be done in an intelligent way

The Chair stated that one of the many strengths of the SSM is that supervisors can benchmark the recovery plans, internal models, and peers against peers. Benchmarking should be done in an intelligent way. It is also important to talk about return or risk, not just profitability. The crisis in 2007 showed that an entity might have excessive profitability which hides excessive risk. The issue is the sustainability of the business model, and whether the high profitability is sustainable over time.

An industry representative explained that benchmarking may lead to the favouring of certain business models or criteria that are fit for some businesses but not necessary for all of them.

Another example (different from profitability) 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). Moreover, the ECB's analyses of European averages lead to comparisons of very different business models without more in-depth analysis. The regulation could. lead to numerous unintended consequences on different business models if the broad picture is not considered.

This industry representative also took 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 should be the cornerstone of supervision analysis. Each bank should be able to position itself vis-à-vis the benchmark and either comply or explain. A set of relevant diversification indicators should be defined and applied by the SSM in this perspective.

A Central Bank official noted that a concrete analysis of the situations of banks needs to be improved, as well the proportionality. More elaboration is needed on general benchmarking and individual assessments. The ECB does not have any precise rule on profitability by itself, because profitability should be commensurate to risk. Return on risk is an essential issue for the ECB. The nature of the costs incurred is also important. A bank with high costs for maintaining under-used branches is not the same as a bank investing large sums in digital transformation for the future. Only concrete case by case analysis of the numbers allows to assess the resilience of a bank.

A Central Bank official does not see a mismatch in the relationship between the ECB and the national supervisor. Indeed, they use for the supervision of less significant institutions (LSIs) the same methodology and mindset that the ECB has for significant institutions (SIs). The national authorities have also the payment institutions in their remit. It is important to see that sustainable business models are reached for all types of institutions when practices are evolving.

2.5 Risk-based proportionality is requested

A regulator stated that proportionality is essential. The EBA is at the second revision of the set guidelines, which will come into force in 2023.

The Chair noted that there is a potential limit to proportionality. Small banks might be exposed to huge risks, and then the size cannot be an excuse for not applying proper supervision.

An industry representative stated that proportionality should generate proportionally to risk, except for the understanding that if everything else is equal the smaller a bank is the less risky it is for the overall system. Risk-based proportionality should exist.

2.6 There is a need for regulatory changes, but Basel III can improve diversity in the banking sector

An industry representative stated that 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. In almost every European country the five largest banks account for more than 50% of all banking assets, and the average number across the EU is almost 70%. The EU's 37 largest banks account for 71,4% of domestic banking total assets.

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.

An industry representative noted that the capital rules for non-rated corporates are meant to serve smaller and medium-sized enterprises which are largely serviced by the big banks. There is a need to remove the use-specific rules, which would allow bigger banks to keep lower risk rates and therefore have a competitive advantage in credit pricing over their small and medium-sized competitors.

The Chair observed that it has been 15 years since the financial crisis started, and Basel III was designed at the beginning to try to tackle that crisis. The question is whether 15 years with transitional provisions that are in place until 2032 is the right regulatory feedback.

2.7 A case for structural reform

2.7.1 Separation of investment banking and retail banking

An industry representative stated that Europe has entities which run both businesses in the same entity, but the intention to address this – ie the separation of deposit-taking and commercial banking activities from capital markets-related activities- is no longer there on the table. However, banks that run big investment banking businesses have a very different risk profile during the business cycle and continue to benefit from the fact that their funding costs are lower because they have an implicit bailout guarantee from the state. 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.

An industry representative is doubtful whether regulators should separate investment banking and retail banking, as diversity is something to foster. Maybe we should not

necessarily change any regulation, but more rely on tools that would be a diversity score of the European financial system because at the end of the day, judgement has to be exercised. Different types of business models with different types of financing is appropriate for European societies, citizens and the financial system and they need to be preserved by European regulation and supervision.

2.7.2 Ensuring the sustainability of the business models for fintechs and newcomers

An industry representative stated that her organisation sees many non-banking financial institutions competing with banks, which puts a competitive pressure on the banks as they are more regulated. There is a need to subject those entities which provide the same services and run the same risks to the same level of regulation.

The Chair noted that size is not the only driver to sustain. Individuals accessing a bigger data repository might become a replacement for size, as then different types of banks could be added.

An industry representative underlined that more and more institutions use fintech solutions and outsourcing in order to accelerate the digital transition and to resolve some of the complexities that an in-house development may have. He argued that fintechs add not only to the competitive landscape, but they are enablers of innovation and new solutions, with relatively low implementation costs for the incumbents. Nevertheless, it is important that regulation develops in-house its own capacity to address these new solutions, like the use of sophisticated algorithms, artificial intelligence, till the expanding tokenisation of financial instruments. The landscape is changing rapidly and some of the fintechs may expand their activities or become attractive targets for larger tech companies, with a potential and more radical shift on the financial European landscape. So, he argued, it is important that innovation is well understood and, thus supported, also regulated to avoid distortions in competition and fair pricing of financial instruments.

An industry representative agreed that fintech can allow people to access data that can supplement the existence of a large customer base. Fintechs force banks to adapt. Relying on other sources of data than a bank's own is the way forward. The same kind of data needs to be able to be used by everybody in the same way. That is an issue that is becoming more and more prevalent, because data is growing in size and more and more open to value sectors, including the financial actors.

The Chair agreed that banks have different business models. Panellists agreed that Europe should not use regulation on supervision to reduce the diversity and should not change Basel III. The overall paradigm has changed. Governance includes informed management of new and current risks, monitoring aggregation, data aggregation, and interaction with all the counterparties, including unregulated ones, in order to apply the regulation and supervision tools, but not in a mechanical way. There will not be automation in the SSM to assess the business model.

Solvency II revision: main expected outcomes and remaining challenges

1. The legislative process related to the revision of Solvency II and to the Insurance Recovery and Resolution Directive is underway and will converge under the Swedish Presidency

A public representative noted that the European Commission (EC) had presented its proposals for the Solvency II review and the Insurance Recovery and Resolution Directive (IRRD) in September 2021. Solvency is widely considered a success. IRRD came as a surprise for some people, so its impacts need discussion. The Council has its general approach and the Parliament will begin its first round of scheduled meetings in the following week.

1.1 Solvency II weathered several crises appropriately, but emerging risks require some adjustments to further reduce volatility, deepen equity investment and improve the reaction to the macroeconomic environment

A regulator stated that Solvency should be ready for new risks. After five years, a review of Solvency is useful. There have been several crises and Solvency did what was necessary. Sustainability risks are a new risk that should be included in this review. Considering the advice of the European Insurance and Occupational Pensions Authority (EIOPA) on long-term equity investments, a more favourable yet prudent approach will be possible. Volatility is still an issue with the volatility adjustment (VA), as well as the macroeconomic situation. The key will be ensuring balance. The green transition must be financed while remaining prudent. The primary goal of the framework is to ensure financial stability and consumer protection.

2. Solvency II revision: what is at stake?

2.1 Better balancing policyholders' protection and a further involvement of insurance in the long-term financing of the EU economy is essential and requires policy makers to dive into technical details without underplaying risk

An industry representative commented that it is generally accepted that Solvency II has performed well throughout recent stresses. There is a need for an honest discussion about the balance between policyholder protection and the need to release capital in Europe. There is a large pool of capital in the sector and matching those long-term liabilities with long-term assets makes sense. This was discussed under Solvency I. Solvency II took a more prudent approach initially. After political changes, increases in stability and transparency and standardisation of risk models, there is a suggestion that now is the time to recalibrate. Insurers can be part of the productive capital long-term solution instead of being regarded as a risk to be managed. The way that adjustments are calculated is critical. The VA or the fundamental spread mechanism and the matching adjustment are all terms that politicians would normally avoid. ECON will need to take this very seriously. Technical decisions need to be monitored. There has always been tension between the political objective of releasing capital versus the prudential need to keep policyholders safe. Investors have to be able to take some risk but the question is how to balance this.

A public representative indicated that, as co-legislator, they would outline the Renew group's position. The main political objectives of the review have to be understood at European scale before going into the technical details. The review must prioritise the interests of the policyholders and enable the insurers to operate in the EU single market and play a role in the economic recovery. Freeing up capital for investment is key, but the stability of the financial ecosystem within the EU must be preserved.

A regulator commented that, with current geopolitical pressure, inflation rates of 9% and interest rate increases, it is not the time to make a substantial capital release. If capital is released, dividends will increase, and that is not the purpose of a supervisory regime. Supervisors should be very careful. In answer to a question on the extent to which the regulator can intervene in the level of the dividend, a regulator noted that, during a discussion in Europe in the Covid period, they advocated for a risk-based, individual company approach. The question is whether the purpose of the Solvency regime is to protect customers or to increase dividends.

A regulator noted that sometimes there are changes after productive dialogues with industry, but the supervisor has very little power to block the dividend from going out. This is addressed in EIOPA's advice for Solvency II. In serious cases it would be good to be able to take action.

2.2 Reducing volatility is key to leveraging the huge potential of EU insurers to invest in the EU sustainability transition

An industry representative stated that Crédit Agricole Assurances, with €400 billion of assets, heavily invested in the transition through financing major infrastructure project (wind farms, solar plants...). Major insurers all over Europe are also investing in direct assets and this investment fits extremely well with Life insurers'

liabilities. Long-term investments and cash flows are needed. Customers are asking for these investments and providing these cashflows from asset liabilities is good. The industry is looking for long-term investments in the transition, so there is a case to invest the money that policy administrators are giving to the insurer. There is the strategy and also the technical discussion around the need to adjust. Overall capital should be reduced. When managing asset liability and deciding whether to invest in a particular investment, the volatility of Solvency II and how it will evolve is considered. The priority is to reduce the volatility of measurements. The proposal to increase the VA mechanism, reducing volatility and freeing up capital, is welcome.

In answer to a question about the impact of the proposals on volatility, such as the extrapolation and the changes to the risk correction, on supervisors' positions, a regulator explained that the EIOPA proposal not only considered where changes are needed for risk, but how to reduce the volatility in the system. EIOPA reviewed how to resolve overshooting or undershooting of the VA. Changes to the VA as proposed by EIOPA involve several steps, making additional changes to one or some of these steps could result in more volatility. In the ongoing negotiations volatility needs to be constantly monitored. Markets are volatile, but some of the volatility is also a result of the framework that, to a certain extent, can be improved.

With regard to VA, an industry representative noted that the industry has information on the real-life parameters. KPMG has done a large amount of modelling on the UK proposals, which are more on the matching adjustment than on volatility, which is not such a big issue for the UK. Inputs matter. The sector is far more sophisticated now than at the beginning of Solvency II. There is much more data. Insurers are much better at collecting and inputting parameters. The industry is an ally, not a foe. The industry has data that others do not. Using this for real-life scenario planning, rather than just theoretically, is important.

An industry representative agreed that the VA is an important subject because it can be changed and can reduce the volatility. There are two ways that the capital can be released. It can be dividends to the shareholder, but, if released in some formula through the VAs, the cost of holding equity can be reduced. As an insurer, investment could be longer term and better investments made. The technical discussion about the VA or about how calibration is done is not just capital from insurer to the shareholder but also the way the company is managed.

2.3 Solvency constraints should be made further proportional to undertakings' risk profile, reducing accordingly unnecessary complexity and severity

A public representative noted that an important novelty in the EC proposal for the Solvency II relief is the proportionality regime, and, in particular, the introduction of a new category of insurance undertakings with a low risk profile that can automatically profit from this relief.

An industry representative stated that sometimes proportionality is missing. In 2019, there was a proposal for long-term investment. In practice, it is extremely complex and only a small number of insurers use it. Solutions should be simple and operational.

A regulator commented that BaFin would support even more far-reaching proportionality measures, but the current approach is going in the right direction. There is now a clear benchmark for each country and company. The undertakings that can benefit from the most extensive proportionality measures are defined. Proportionality means reducing the complexity of requirements to what is risk adequate, not reducing what is considered burdensome by the industry. With respect to the specific risk embedded, details on the long-term guarantees, VA and provisional measures have to be proven to be relevant for stakeholders. This is about transparency and comparability, not proportionality. The industry in some countries is against the requirement to have an audited Solvency balance sheet. An audited balance sheet makes the system much more credible and reliable and should not be discarded in the name of proportionality.

A public representative noted that a second priority is streamlining the legislative framework. Careful reconsideration of insurance company concerns about the Directive is needed, based on risk and proportionality. Flexibility and a risk-based approach should be the guiding principles.

3. Improving supervision of cross-border operation is necessary

A public representative noted that the current Solvency framework is weak in its approach to insurance supervision. Cross-border cooperation of supervisory authorities has not yet worked effectively.

In answer to a question on how to foster convergence in the supervision of cross-border activity, a public representative stated that cross-border supervision must be forced. Cooperation and communication between home and host supervisors must be clarified and strengthened, while the role and the missions of the European supervisor are enhanced.

4. An undertaking operating throughout the EU requires appropriate supervisory arrangements as well as fluid and intense communication in order to make the host and home supervisors comfortable

An industry representative stated that their organisation, an insurance company with Europe-wide cross-border activities, has been a case study for Solvency II and cross-border supervision. After an acquisition in 2010, all subsidiaries purchased in Europe were converted into

cross-border branches of an insurance company in an EU member state. The speaker's organisation to some extent overcommunicated with supervisors. Businesses that were already present were converted overnight. The inherent risk of the business did not change, but there was a question around the residual risk. Standardisation introduced with Solvency II reduced the supervisors' perception of the residual risk. The legitimacy of the model is dependent on overcommunication, so all four corners of the ecosystem work with an active host supervisor as well as the home supervisor. There have been frequent checks with EIOPA.

5. Is Solvency II a global 'gold standard'?

A public representative queried why there should be deviation from Solvency II if it is the international gold standard and whether the UK's own Solvency II review would be the beginning of a new phase of intense regulatory competition between the UK and the EU.

An industry representative stated that the UK Solvency II review is very similar to that proposed by the EU, with debates on the balance between releasing capital and the prudential requirement. The risk-based model was developed in the UK and it will not deviate significantly from it. The UK led discussions on matching long-term liabilities with long-term assets in Solvency II in the Council and lost, so now is the time to reopen those discussions. The insurance sector has indicated that there is a safe mechanism to release the capital needed to match long-term liabilities and assets. This should not be considered only in the context of protection of the policyholder. The objectives of the UK will likely be similar to those of the EU. With regard to the matching adjustment, the Prudential Regulation Authority (PRA) considers that the fundamental spread is flawed and has a more sophisticated method of dealing with it. The supervisor and the supervised will discuss where the risk should be. Clear debate on objectives, such as risk appetite and the mechanism to release capital, is important. There is some scope to release capital in certain instances, but the framework requires discussion.

5.1 Due to local specificities, regulators in the US and Japan have different views than Europeans on sovereign risk, mark-to-market balance sheets or long-term liabilities, yet all jurisdictions are moving in the same direction

A public representative commented that it is helpful for politicians to broker a compromise between not increasing the dividends and releasing capital for investments. A delegation of ECON had gone to the United States in July, where there was not much appetite for Solvency.

An industry representative stated that it is difficult to take a consolidated view of the 54 insurance jurisdictions in the United States. Overall there is a lot of respect for Solvency II. Many countries around the world are looking to implement their own version of Solvency II. For 20 years the US has taken a different view on things such as the mark-to-market and long-term liabilities. Questions are being raised around some of the zero, the risk-free, around sovereign bonds. The group capital calculation is still being worked on, though there is progress in the Insurance Capital Standard (ICS), where the US favours the aggregation method as opposed to the full Solvency II. Everybody is moving in the same direction but there are different views based on individual markets. Japan has questions about long-term liabilities.

6. IRRD: Recovery and Resolution in the insurance world

A public representative noted that switching from MiFID to Solvency had demonstrated that the banking world and the insurance world are totally different. In the IRRD proposal there is an impression of applying the banking world approach to the insurance world, rather than addressing the insurance world.

A regulator noted that recovery and resolution for insurance is currently disharmonised in Europe. Minimum harmonisation, at least, is required. Resolution is needed because insurers can fail. There were 219 cases between 1999 and 2020. That did not change with Solvency II coming into force but it is not a major concern. Businesses can fail and as long as that is orderly it is fine.

6.1 Dedicated and proportionate arrangements that fit the insurance sector specificities, as well as domestic insurance specificities, are necessary

A public representative stated that the IRRD is a 'diamond on the golden ring' standard. With a clear increase in insurance failures since 2008, the need for an insurance resolution regime is not in question. The issue is identifying the ways and means. There was no amendment rejecting the IRRD proposal, so presumably every political group is conscious of the need to anticipate failure of insurance providers, especially in the cross-border context.

A regulator explained that the supervisor must first establish why resolution would be needed. The next step is to assess whether there is in deed a matter of failing or likely to fail and that there is no chance of recovery in the near future. If that is the case, either insolvency law comes into force or resolution. More information must be shared around what is meant by resolution for insurers and whether it is a one-on-one translation from the banking recovery directive. Some similarities however are logical, e.g. a crisis management group can be organised in the same way for a bank or an insurer, however insurance specific aspects of resolution will have to be different.

An industry representative noted that this is already partially implemented in some jurisdictions, but not in exactly the same terms in all markets. However, the risks of banks and insurers are extremely different and this should be considered when framing guidelines. An example is the frequency with which resolution plans are requested because insurers do not change as fast as banks. Insurance guarantee schemes (IGSs) are very

local. It is questionable whether these should be used in resolution. They are there for the customer. An IGS should be market by market, not European level.

Two industry representatives agreed that the 'diamond on the golden ring' expenses of IRRD would be passed on to the customer.

6.2 Harmonising the necessary means to protect policyholders is essential notably in a cross-border context

A regulator noted that the damages faced need to be considered. If there is an IGS and the policyholders can be protected, it might be acceptable to have a fund to finance the authority but not to organise a great deal more capital in a resolution fund. However, at the moment aa minimum, harmonisation of IGS is missing. This means that currently insurance products can be sold across the border, but, if a business fails, it depends on where the consumer buys the product as to whether they will be protected.

6.3 It is key that the teams in charge have insurance knowledge

A regulator noted that a liquidator dealing with an insurer is not specialised in insurance, it could also be dealing with a bakery or a shoe shop. Alternatively, a resolution authority could be someone who already knows the entity and knows what insurance is. Implications on whether you would want a liquidator or resolution authority to deal with the matter, will be depending on what kind of insurance it is, how big it is and how critical the function is. Another question is how to fund the authority and the directive, keeping in mind dat an authority could be a team of 10+ people in a resolution authority. The most important factor is that the team has insurance knowledge.

6.4 An appropriate and common assessment of insurers' specificities in different jurisdictions is necessary to avoid copy-pasting the banks resolution framework and defining the appropriate scope and ambition for the legislation

A public representative noted that there are a wide range of amendments addressing all the issues in the banking sector and not yet proposed in the insurance sector. In the banking sector, there is a deposit guarantee scheme. There are no standardised or even European-wide IGSs, but IRRD refers to them. There are amendments to create a Single Resolution Mechanism (SRM), which is available in the banking sector and not in the insurance sector.

A public representative commented that the framework must be tailored to the specificities of the insurance sector. The IRRD proposal excludes any additional capital changes for insurance providers, contrary to what exists in banks, and also foresees the establishment of an equivalent to the Single Resolution Fund. Questions include the scope of application, how meaningful criteria are set up with the right level of proportionality and the role of the resolution authority. Renew does not favour the creation of a new authority, but there must be a clear separation between resolution and supervisory tasks. All the options for financing resolution face political opposition because the purpose of the resolution framework is to avoid taxpayers contributing. Renew requested an impact assessment of potential harmonisation of European wide minimum standards for the schemes from EIOPA and the EC. This could lead to a legislative proposal, which could be a less intrusive policy option. There are IGSs for some insurance types in a number of member states, so more assessment could be requested.

A regulator commented that supervisors had been surprised by the proposal. A resolution is dealing with the insolvencies of legal entities and insolvency law is still national law. Whether there is a critical function in insurance should be analysed. Historically, there have seldom been cases where the supervisory mechanism in the Solvency regime would not have been sufficient. The process should be risk based, taking into account the ability to fund the resolution, possibly through a national IGS. In Germany, there are two lines of business and a well functioning IGS, so the German market has a totally different view to other markets.

A regulator stated EIOPA would be happy to work on a request for technical advice for an IGS once such a request was received. Harmony is limited and supervisors need to discuss this.

6.5 The positions within the Parliament are not yet stabilised

A public representative commented that it is premature to talk about political differences. Informal discussions will start in the current week, so there will be more understanding of political differences in a few weeks. There will be some divergences, but many convergences as well.

A public representative added that normally the European Parliament does its work, the Council does its work, then the two meet. The starting point is that the Parliament amendments are discussed, not the general approach. That will be for the trialogue. It is not yet possible to identify differences as Parliament's starting position is not known.

Sessions

IV

THE EU AND GLOBAL SUSTAINABILITY AGENDA FOR FINANCE

Prospects and challenges faced by the green transition

1. Russia's invasion and war in Ukraine: indirect consequences

1.1 Alleviating short run pain and overcoming dangerous dependencies might hinder efforts on the climate transition

An official condemned Russia's brutal invasion and war in Ukraine. The indirect consequences of it have included increasing food prices, food insecurity, and damage to energy security. It is natural to focus on this short run pain, and it has been suggested that this might hinder the efforts on the climate transition. This situation demonstrates how difficult it is when the world relies on fossil fuels supplied by a small number of countries. It demonstrates the importance of the transition to clean energy and a decarbonised future. If anything, it will accelerate those efforts.

A Central Bank official emphasised that the current geopolitical situation makes it necessary to consider both the long-term rational approach to the transition and the economic reality in the short-term. European corporates are suffering from high energy prices, geopolitical shifts and supply chain interruptions. This makes the much-needed big move towards decarbonisation temporarily much harder, but more pressing. At the same time, private households and corporates will also need support over the winter months. The invasion demonstrates how vulnerable Europe is. Europe has made itself dependent on the import of fossil fuels and it is paying the price. The only solution is energy independence. This is not about sovereignty or complete independence but reducing Europe's vulnerabilities. The only way to do this is to speed up the transition to renewables.

An official considered the current situation to be an important crossroads for Europe. Europe must reflect on the challenges this poses, but the relative price shift is also an opportunity. It is important to use this as an incentive to move decisively towards net zero and accelerate the transition.

1.2 Europe has reacted with REPowerEU, a fast forward of the EU Green Deal

A policymaker agreed that the impact of Russia's brutal aggression against Ukraine is felt in Europe through energy. Europe has reacted to this in a united way. The European Commission immediately launched REPowerEU, which is a fast forward of the EU Green Deal. The four pillars of REPowerEU are: the reduction of energy consumption; the diversification of energy inputs; the acceleration of the clean energy transition; and smart investment and reforms. REPowerEU has already had a tangible effect in terms of stockages. In previous discussions, 90% seemed an unrealistic target, but Europe has nearly reached this goal through the four pillars of REPowerEU. The combination of ideas and technical support has allowed member states to do this. The Commission is providing technical support to 17 member states on REPowerEU. It will become part of the national plans for recovery and resilience (NPRRs).

2. Monitoring corporates and managing short term energy constraints

An industry representative advised that carbon neutrality is a universal priority, but the pathway to carbon neutrality differs by country and by region. In the meantime, capital flows globally. On a global basis, corporate carbon reduction activities are down. In this context, it is important to ensure that corporates can raise funds. The first risk is that the corporate transition does not progress in line with the pathway. To avert this, bankers and investors need to properly assess and monitor the ability of corporate clients to transition. The second key risk is excessive short termism, which will prevent companies from servicing existing assets such as power plants. A uniform taxonomy will bring clarity to the status of the transition. The different measurements and standards used today create many environmental, social and governance (ESG) ratings. A common language for ratings would create a consistent approach for both companies and investors, which is particularly important for global players. In the meantime, national discretion should be allowed on top of the standards, like the specificities admitted under the Basel Capital Accord. The Basel Committee on Banking Supervision (BCBS) is concluding its principles for climate related risks, but these are at an early stage.

A Central Bank official agreed that there is a question about the need for a global baseline of standards. In April, Janet Yellen suggested that there is a need to ensure that business in the G7 is incompatible with protectionist measures and compatible with global baseline standards.

An official agreed on the importance of reducing the costs of collecting, disclosing and consuming data. This will help guard against climate related financial risks. Governments are engaging through the Financial Stability Board (FSB) on encouraging the adoption of International Sustainability Standards Board (ISSB) standards. Governments are trying to encourage countries to adopt mandatory disclosure rules based on those standards, for example. However, it is important to acknowledge that different countries have different national needs and tools at their disposal. The United States, for example, has fiscal, tax and environmental regulatory capabilities. Europe, however, might focus on financial regulation. Regulators and supervisors across the world should do everything possible to ensure their approaches are harmonised and reduce the burden of disclosures.

An industry representative suggested that the Japanese financial industry is catching up with Europe very quickly, which means standardisation is essential. From the industry's perspective, there is no doubt about accelerating the transition. However, in response to rising energy prices and interest rates, the credit market is shrinking. There is a potential risk around credit shrinking at the margin between green and brown. It is important to monitor whether companies are raising sufficient funds for the transition.

A Central Bank official suggested that there is a willingness to develop European rules, but finance has a strong global dimension. There is a question around how the European effort will combine with the efforts being made in other parts of the world. A policymaker emphasised that one of the reasons European Commission officials attend Eurofi regularly is because they cannot facilitate the transition alone; without the financial sector, no transition is possible. A Central Bank official noted that the transition would also not be possible without member states.

3. Seizing the opportunities in the transition will require a sound and functioning financial system

A Central Bank official considered there to be opportunity in the transition. The Commission has estimated that Europe needs $520 billion, 3.7% of GDP. In 2019 in additional investment to meet the green transition goals. Much more must be done to develop the depth and breadth of the capital markets, to clean balance sheets, to ensure portfolios are understood and to ensure supervisory policy and execution is calibrated to deliver a strong banking system. Policymakers must create a Capital Markets Union (CMU) and provide a functioning framework for securitisation. Supervisors should not mandate what should happen in the energy transition; rather, supervisors should focus on strength, safety, and soundness of the banking system.

Another Central Bank official noted that the European approach is more focused on regulation and enhancing corporate sustainability reporting. Europe has made good progress. At the same time, there are no internationally aligned agreements. The taxonomy and the disclosure regime are relevant examples here. It is extremely important that corporates are not overburdened and that investors can compare international standards. More harmonization is therefore needed, without lowering standards or risking greenwashing.

4. Europe has led on the climate challenge, but further global coordination is necessary

A policymaker emphasised the importance of moving the financial sector. On a positive note, Europe is leading in this area. The United Nations Climate Change Conference (COP) in Paris was very clear. Europe led on this issue due to a variety of geopolitics factors, and its leadership led to the creation of the NGFS and an international platform. A Central Bank official noted that Europe was not alone in this work. The policymaker agreed, adding that Europe did lead this effort. The Americans joined this effort five years later, for example. The taxonomy is an instructive example. While shortcuts were taken on the taxonomy to make it usable and operable, it was important to do this. The leadership of the last few years was not wasted. It is pleasing to hear people talk about using the European taxonomy. Thankfully, politics changed. By changing the effort, the work on the transition became global.

While great efforts have been made, however, they may not be enough. Much more is needed in all three areas of environmental, social and governance (ESG) risk. More is needed in the 'E' areas, such as biodiversity. Equally, the war in Ukraine has highlighted the importance of the 'S' and the 'G'. Two days ago, the European Commission launched a flagship idea for regulating ESG risk. There were 160 participants from European regulatory and supervisory authorities. Supervisors clearly feel they must deliver on this. With leadership comes an inevitable responsibility. The only question is whether Europe will manage.

5. The high price of fossil energy could accelerate the transition, but there is a need to address the challenges faced by low income households

An official noted that the NGFS published a note about the challenges to the transition posed by the war. The war is a tragedy, but one of its effects has been to produce a dramatic shift in relative prices. Fossil energy prices went up significantly. This means Europe is at a crossroads. There are two different paths to follow. One is to rely more on fossil energy, and the other is to use higher fossil energy prices as an opportunity to accelerate the transition. In the short term there might be a need to temporarily increase the carbon intensity of Europe's energy systems, but it is critically important not to make this a permanent change. There are very severe challenges for low income households and there is a need to use the difference in relative prices to accelerate investment. It is possible to cushion the impact of higher energy prices and create incentives to invest in renewable energy. Finance will also be essential in this transition. In particular, private funding will speed up the replacement of fossil energy with renewables.

6. There are risks of dependencies on raw materials in renewables related technologies

A Central Bank official agreed that there is an obvious connection between the war's effects on the supply chain, food prices and energy and what needs to be done on climate change. What is not so obvious is the impact on macroeconomic stability, however. There is an opportunity

in front of the private sector and the public sector to meet very substantial needs and to make the right decisions. Europe should not fail to recognise the effect of dependency on citizens and households and its effects on the macroeconomic situation. When future decisions are made, it is important that we identify any potential dependencies. As an example, electric cars require six times the number of minerals to create them than combustion engine cars. It is important to understand and manage the risks that other dependencies may create.

7. There is an opportunity to leverage the EU's competencies and technological research capacity

A Central Bank official emphasised that sustainable sources of energy can give Europe more independence, but that will also involve mastering new technology. Another Central Bank official suggested that technology and knowledge are not the main issues. The economics demonstrates the need to develop technology, but the decrease in the cost of renewable energy shows that the essential technology exists. Europe has the competencies; now it needs to steer substantial financial flows into the right technologies. This also makes sense from an ecological perspective. This summer's drought has been the worst of the last 500 years and it has caused many different problems. There is more than enough evidence that the transition has to be done quickly and decisively.

A Central Bank official observed that the country with the largest number of patents in the green sector is the US. It would be much better if Europe financed innovation as well as creating rules. The rules are indispensable, and European policymakers can be proud of them, but without investment and innovation Europe will not be a leader. There is a need to finance the young people who have good ideas. It is important that European start ups do not simply relocate elsewhere.

A policymaker noted that one of the biggest obstacles to renewables in Europe is bureaucracy, in respect of licencing, permitting and so on. However, member states have realised this. This is one of the key elements of REPowerEU.

8. There is a need for increased momentum, strong policy incentives and continued monitoring

8.1 A systematic definition of corporate transition pathways would enable even carbon intensive corporates to access finance

A Central Bank official highlighted that private and public money is available for promising ideas. There is a concern around financing the transition in the carbon intensive economy, which cannot be left behind for a successful transition of the whole economy. The steel, coal and oil companies need to be brought on the pathway to net zero. It is important to give those companies a chance; otherwise, the world will be unable to make the transition. The UK, for example, has asked listed companies to have a clear and credible transition plan by 2023. It is extremely important for these firms to be able to access finance regardless their carbon intensity. Decarbonisation will be capital-intensive, but necessary.

An industry representative stated that how best to use carbon is a very good question. There must be a clear pathway and an appropriate time horizon. The key risks are excessive short termism and too much division between green and brown, both of which do not make sense.

8.2 This Schumpeterian creative destruction process will require global coordination

A Central Bank official noted that there are questions about the effective impact of what is currently being done. The politicians need to deliver.

An official noted that this was linked to the importance of supply. The Inflation Reduction Act and the Infrastructure Act will help the US achieve its climate goals. Credible estimates suggest it will close two thirds of the gap between the current trajectory and the 2030 emissions targets. This shorter horizon is sensible. It is important not to plan too far into the future without thinking about the path to get there. The legislation takes a number of steps on the supply and the demand side. On the supply side, it establishes regional hubs for demonstration projects on clean hydrogen, direct air capture and several other technologies. This will push down the cost curve, building on earlier government support in bringing down wind energy generation costs. There is also significant support on the demand side. The legislation subsidises electric vehicles and should spur on purchases of battery storage and clean power generation.

An official stated that the transition is a challenge of engineering; it is a Schumpeterian creative destruction process in which innovation plays a big role. The tragedy of the war has only accelerated the need for the transition. Everyone realises that the transition will require a coordinated effort globally and locally. There is a limited carbon budget, and many policies will need to be engineered to address needs on the demand side, on the supply side and on the regulatory front. Most importantly, no more time can be wasted. There might be a need for short term compromise, but it is important to be pragmatic. There is a need to make extreme and urgent efforts to use the power of finance to make sure there is diversification, investment in renewables and carbon capture and that new modes of transportation, new modes of consumption and that new production processes are available to everyone. This is what the Schumpeterian revolution is about. Equally, there is a need for coordination. Some countries and regions are showing the world a good example in this regard.

An official emphasised the importance of focusing on a broad definition of innovation. Of course, there is conventional innovation. Climate tech has raised a steady stream of funding in an environment where other forms of venture capital have not been available. Beyond the conventional idea of innovation, there is also managerial innovation. Additionally, there is policy innovation. Governments have been working on international

coordination around public private partnerships in developing clean energy infrastructure in emerging and developing countries, the Just Energy Transition Partnership programmes. Finally, international cooperation would help bring the public authorities in different countries as close to interoperability as possible and enable a mutual exchange of knowledge. It is extremely important to cooperate globally. Climate change is a classic example of an issue with cross border spill overs which requires coordination to make progress.

8.3 The ECB's stress testing demonstrates that earlier is better in terms of transition strategies

A Central Bank official agreed that Europe has taken a giant leap forward compared to the rest of the world on supervision of climate risk. The ECB ran a top down economy wide stress test, the results of which were made available to the market. It followed this with a climate risk stress test, which included a bottom up bank by bank exercise. The learning that emerged from this for both supervisors and market participants was enormous. It showed that the early adoption of transition strategies will be far less costly in the medium to long run for banks' balance sheets. Every bank that assessed their management of transition risk concluded that, without mitigating policies, there would be enormous effects on their portfolios in terms of supervisory metrics such as probabilities of default. Something very subtle yet very profound has happened: the discussion and management on climate risk in the industry has become a question of risk management, board strategy and balance sheet management inside the banks, not something that is the focus of solely policy parts of the bank. This has already had an enormous impact in terms of moving the banks towards managing climate risk.

8.4 Increasing global awareness remains an essential priority

A Central Bank official noted that people in Europe are beginning to ask what they should change. In the US, there seems to be more of this sentiment in some parts of the country than others. There are questions, however, about who European policymakers should work with to create global convergence.

8.5 It is important to maintain high carbon prices and protect vulnerable groups in society

A Central Bank official stated that it is important not to dilute the steering effect of high fossil energy prices. A policymaker suggested that it is also important to protect the poor. The middle and upper classes should be incentivised to move out of fossil fuel. An official agreed with these comments, noting that the shift in relative prices is an important incentive but it is also vital to take care of the most vulnerable groups in society.

8.6 Achieving effective coordination at the global level remains challenging

A Central Bank official stated that there is currently implicit carbon pricing due to factors and reasons beyond Europe's control. Being a leader involves convincing others. The key element for reducing CO2 is to continue to discuss this issue with China and India. There is a tragedy happening that is a violation of the most important principles invented to organise international relations. This is not a minor country or a local war; it is a violation of all of the principles of the rules based order. The votes on Russia at the UN illustrate that there is a significant amount of work to do with many countries in the world. Leadership is about making sure that the important countries are on board and that there is a fair path for the transition not only within Europe between rich and poor but also worldwide. People often say that Europe has the leadership on this issue. The idea that Europe should be in charge of and pay for the transition is widespread. Hopefully, public authorities across the world can manage to find a way to tackle this issue.

Transition pathways: definition and adoption challenges

1. For the financial sector the priority now is to focus on translating long-term commitments into near-term strategy by defining transition plans

A Central Bank representative stated that the panel will focus on how to decarbonise given the situation has been left very late and since the start of the war has only been worsening. The financial industry has a role to play and all parties need to be committed.

1.1 Turning individual targets into actions, reducing transition and reputation risk, and providing system-wide transition perspectives are among the many objectives of transition planning

A Central Bank representative asked the panel to comment on how the Network for Greening the Financial System (NGFS) sees the transition question. A Central Bank official explained that the NGFS is an opportunity for supervisors and central banks to join forces across the globe to answer the big questions that pose reputational risks to institutions. The stress testing indicated that banks and insurance companies require a better understanding of how to translate long-term commitments into near-term strategy and develop a system-wide perspective by combining transition plans. The NGFS would focus on how supervisors should approach this question.

A regulator highlighted the need to focus on what the finance community will do next with the commitments made at COP26 as well as how to prepare transition plans and turn those into actions. An industry representative highlighted that asset owners are more interested in whether funds are aligned with the 1.5° transition target. Investors' engagement with companies is focused on how businesses will transform to achieve targets and how portfolio risk can materialise into financial risk. Better disclosure is required to assess exposure to climate risk within institutions, sectors and countries.

1.2 Transition planning enables financial institutions to combine supporting existing customers and developing green financings with reduced reputation risk

An industry representative highlighted that reputational risks from climate change are multifaceted and trust could be eroded if shareholders do not feel that adequate action is being taken quickly enough by organisations. Banks are taking a two-pronged approach to the transition strategy by growing the customer base for the future and working to support existing clients to transition. It is important to have a clear transition plan because any reputational risk could harm the organisation's reputation as an employer. An industry representative highlighted that the risk is currently existential, but it is important to fix interim targets so it is clear there is a pathway to the 2050 net zero target.

2. Transition planning success factors

2.1 Useful transition plans require a general effort based on improved data and credible and comparable disclosures

A Central Bank representative queried whether there is a demand for action from both shareholders and staff. An industry representative emphasised the need for more data and improved disclosure alongside a mandated transition pathway. Only a small proportion of companies are reporting on Scope 3 and the data is needed to determine how quickly the 1.5° can be achieved.

An industry representative agreed that data remains a big challenge. Their organisation had already disclosed four net zero pathways, but due to the lack of an underlying framework this was based on many assumptions. The market will respect organisations putting forward best effort basis work to keep driving the transitions forward. A regulator agreed that industry will require 'safe harbour' and to understand that companies will have to provide a best effort of Scope 3, outlining their plan to obtain more accurate data. The industry would need to provide help to businesses to achieve this, in particular looking at the entire investment chain to ensure that the standards are real and green products can be trusted. While the pension funds want to achieve net zero they do not have the data and so do not know how to achieve this.

An industry representative highlighted that sustainability disclosures are at a different level to financial disclosures in that they are negatively assured whereas financial disclosures are positively assured. This meant that their organisation was spending a lot of time on integrating the reporting, and this would also require a framework so the auditor could assure and produce audit opinions. This would be solved by organisations providing further disclosure on how these things were calculated. A Central Bank representative agreed that the word 'humility' was important because everyone wanted to produce models that were as perfect as possible, but in this case industry could not afford to wait.

2.2 The transition plans of financial institutions must be consistent with those of their customers

An industry representative explained that UBS's pathway is about Scope 3 and that the financed emissions side will require UBS to work with its customers, introducing a critical need for stewardship. This would introduce a time-lag on disclosure as UBS would be waiting for clients to disclose their numbers. It will be important to pay attention to the granularity of disclosures to ensure that the underlying multinational could not be identified and to ensure that clients were comfortable with the disclosures made. Hopefully regulators will provide the industry with some 'wiggle room'.

2.3 The definition of consistent sectoral base lines is also essential

An industry representative highlighted fundamental issues relating to the ability to base line the pathway. The volatility meant that a pathway would look different if it was baselined from 2019 or 2021. There are other disclosures besides gross carbon being released into the atmosphere and these needed to be aligned across sectors. The pathway is demonstrated by a shrinking return meaning that the market is struggling to tease out the positive side of the equation and more is needed on the opportunity side.

An industry representative noted that the sector perspective is important to look at the materiality of pathways and indicators to find common ground, allowing for sector specifics when it comes to pathways. An industry representative stated that different sectors would decarbonise at different rates, and this should be considered when conducting transition planning. Regulation is needed to standardise ESG ratings from an understanding perspective but cannot be used as a way of making investment decisions.

2.4 Carbon pricing is a necessary tool to create appropriate incentives

A Central Bank representative asked whether the adoption of carbon pricing could be recommended and would allow a comparison with other countries. A regulator stated that the best solution would be to have a global price on carbon to ensure a wide reach, given that carbon pricing is important for creating incentives.

3. Regulators at the global level are expected to play an important role in improving information regarding transition plans

3.1 It is advisable to combine micro and macro approaches

A regulator highlighted the urgent need for a holistic approach and standardisation to be applied to transition planning, which will include both micro and macro aspects. The regulators should ensure that initiatives are consistent and comparable with common approaches to transition planning. GFANZ was an excellent example to build on from a policy perspective. The industry was confirming the need for standardisation. The Corporate Sustainability Reporting Directive (CSRD) does not set out the metrics and targets required in a transition plan, and this piece of work would need to be complemented on the opportunities side. The transition plans are incentivising the dialogue with the corporates. An industry representative stated that there is a need to understand what metrics could be developed to ensure that investors can compare the transition plans.

3.2 The definition of a disclosure framework should follow the definition of a transition planning framework

A Central Bank official highlighted the need to distinguish between a transition plan and its disclosure. It is difficult to disclose a forward-looking plan without the right metrics. It is tricky to determine the right metrics to illustrate what is intended and it is important to clarify that we want to see plans, not perfect metrics. A more harmonised way of communicating the plans would be developed, but discussing disclosure before agreeing what should be in the plans will mean a missed opportunity to move businesses forward.

3.3 The standardisation should be driven at the global level

An industry representative agreed with the need to achieve global consistency and standardisation. Interoperability across the globe and disclosure can help through the transition period, as a pathway to defend against greenwashing. Their organisation's sustainability report is already 174 pages with 185 different metrics, and this could get out of control if we do not focus on the common denominator. A Central Bank representative that there is a need for standardisation to ensure progress on ESG efforts is achieved and to counter those who deny climate change. A regulator agreed that an authority could struggle with this backlash. Creating different standards in different jurisdictions would hinder the comparability and create hurdles, so there is a strong incentive to strive for interoperability by building on the global baseline provided by the International Sustainability Standards Board (ISSB) . A Central Bank representative expressed a wish to achieve global standard while recognising the values behind those standards.

3.4 Better is the enemy of good

A regulator representative agreed that the ISSB would assist with the task of gaining more data, but it was important not to wait for perfect data and use that as an excuse not to make progress on transition planning. The UK is preparing a template that could be used internationally and would focus on real actions. The industry would be invited to provide feedback on what they did and did not like. An industry speaker agreed there could be a backlash in certain markets and that is where stewardship and clear objectives around engagement would play a key role. It is necessary to engage with companies that are not already transitioning, bringing in financial materiality to demonstrate that it does not make business sense not to take climate risk into account and then building on that.

An industry representative counselled against letting perfection be the enemy of the good. It is important to achieve in areas where there is already agreement and hope the other parts will come together over time. A Central Bank representative stated that it was important to not give up on global standardisation but to understand that there would be difficulties.

3.5 Cooperation, consensus making and adaptability are key success factors to achieve transition planning standards at the global level

A Central Bank official expressed that global efforts can work if everyone is building the same understanding of what needs to be done and was less worried about the divergence of standards. The NGFS was gathering all supervisors to hold a collective discussion about what parts of transition plans should be standardised and this process should build a collective mindset and reduce the risk of fragmentation.

An industry representative noted that their organisation could struggle with balancing the regulator and stakeholder expectations in the different markets. It is important to achieve the best out of the different initiatives, such as the double materiality view in the EU and Partnership for Carbon Accounting Financials (PCAF), and not let the perfect be the enemy of the good. It is important to have realistic expectations when everyone is starting the journey from different points and not expect a client in Sub-Saharan Africa to be in the same position as a client in France.

A regulator reflected that although there are global solutions it is not one-size-fits-all. The good cooperation globally between regulatory organisations is supporting the work.

An industry representative highlighted that industry collaborations are important because credibility can be established through consistency and gaps in the market can be spotted. An industry representative stated that it is important to communicate to SME companies why sufficient disclosure is required, so there is more sensitivity and improved disclosure going forward.

A Central Bank representative noted that one strategy employed by the European Parliament was to give SMEs more time to adapt as well as requirements proportionate to their size. However, many companies felt forced to produce sophisticated Scope 3 data as this is required by their larger clients. An industry representative agreed that SMEs require more time and have fewer resources to dedicate. A Central Bank representative noted that there is no more time to be given even to SMEs.

4. Expanding the data available and improving its quality requires a pragmatic and persistent process

An industry representative explained that the market has created the ESG data provider space and companies are often giving estimated or model data from these providers. The estimated data is also being used as a tool for engagement, encouraging organisations to figure out the correct number. An industry representative noted the importance that conversations would lead to a process of companies understanding why the data is needed. An industry participant suggested that one way to move forward is to introduce the PCAF methodology which includes the concept of a quality score that was based on an industry group and could be obtained direct from the company. It was agreed by another industry representative that the quality of disclosure is important, but this should relate to the real-world impact which is harder to solve if it is not clear whether you are decarbonising from 10,000 tonnes or 100,000 tonnes.

A regulator noted that the providers in this area will likely expand to offer Scope 3 data positions. It is important to help big industries that require carbon offsetting as well as engaging with companies that have no carbon emissions but a large influence and the ability to do something positive. It is important that some kind of standardisation is achieved this year and not hampered by fragmentation.

5. Competition is a key driver for developing efficient transition pathways

A Central Bank representative asked the panel whether competition can be used to push companies to improve without obliging them to disclose vital information that could break competition rules. A regulator stated that regulators will need help to devise a code of standards, but that conflicts of interest and transparency requirements are part of the chain. An industry participant noted that competition is a key driver of pathways to protect against greenwashing and that innovation and entrepreneurial spirit were required for the banking industry to succeed on this journey.

A regulator stated that the regulator will not expect everyone to have the same rating on the company but that there should be transparency about where corporates might fund rating agencies. An industry participant agreed that transparency is vital. Another industry representative highlighted that ratings were powerful and would drive disclosure and behaviour. Everyone would want to be at the top of the league table and this would be achieved via methodologies, so changes in methodologies could have a big impact. The industry representative suggested there will be a move away from ratings to the use of raw data by investment managers rather than relying on methodologies.

5.1 The provision of other ESG dimensions should improve the holistic understanding of corporates' performance

An industry participant highlighted the need to consider other standards, such as methane emissions or water waste. Some will be reliant on harmful sectors and there needs to be a just transition for all.

5.2 What is needed to go beyond a mere ESG rating and look at whether specific decarbonisation pathways are fitted to the various business models

A Central Bank official noted that measurement should not become the achievement because it is about decarbonisation pathways and plans rather than ESG ratings. A pathway should not over-favour certain technologies and prevent innovation. Non-financial corporates are not facing the same problems and they need to understand what their business model looks like in a net zero world. Financial corporates are focusing on how to transition their clients to their end points. A Central Bank representative noted that the panel discussion has confirmed that there is not so much difference between the views of public authorities and those committed to the business. In creating a community that is working together there is a reason to remain optimistic.

Clarifying the sustainable investment universe

1. Importance and limits of national sustainability labels in the EU

1.1 National and EU domestic experience

A regulator stated that Austria has one of the oldest sustainability labels in Europe. In the last few years, the label has been tremendously important with growth rates of 50% every year in the last three years. It is well known, there is standardisation and investors rely on it. The national label gives the possibility for a national market to include certain sustainability preferences, such as, in the Austrian case, the exclusion of nuclear power. The Austrian label is also used in other countries, such as Luxembourg, Germany, Ireland and France, but of course this does not help European transparency or transparency for investors in European markets. The reason for that is not the label but the lack of a mandatory EU minimum requirement saying what is and is not a sustainable fund. What is needed is a mandatory European solution. European legislation cannot be changed so quickly, so maybe standards by the European Supervisory Authorities (ESAs) would be a good possibility to bridge the gap. The labelling approach is a good requirement to prevent greenwashing and to contribute to harmonisation and a level playing field.

A regulator noted that France has had the same experience with its national, ISR (Socially Responsible Investment) label, which has grown to more than 1,000 funds labelled and more than €650 billion assets under management. Although it is well known and used in France, it has also been criticised and is currently under review (according to a survey last year only 50% of the French general public believed that the French label is reliable). Besides, the non-French labels are unknown from a French retail investors' perspective. More coherence is therefore needed across the EU and truly European labels should be promoted. National labels should also connect much more with the new EU regulations, particularly regarding data which will come from the taxonomy regulation in the coming years and from the Corporate Sustainability Reporting Directive (CSRD). There will be more and more data available, and these local labels have to be much more current with the European approach in this respect.

A Central Bank official stated that there is no doubt that labels have the potential to influence, to a great extent, the success of the sustainability transition by helping to avoid misallocation of funds and greenwashing, thus protecting investors. Many efforts have been made so far, but more needs to be done. The market needs transparent, comparable and credible labels for financial products. The regulatory regime and the regulatory framework have to evolve accordingly. The prudential rules that have to be adopted need to incorporate a dimension of financial innovation. Although the main obligations in order to fulfil the sustainability targets are with governments, central banks also have a role to play in sustainable growth. This is shared by the European Central Bank (ECB) and other central banks.

1.2 The Industry Perspective

An industry representative explained that it is incredibly important that regulators and asset managers do not lose sight of the end clients. Their company recently did a survey of clients, asking what they think should happen to tackle greenwashing. Surprisingly 'ESG labels' was the bottom answer. The solution people are calling for is much more fund-level transparency around what is inside the fund, and more transparency on how asset managers are making decisions. There were also calls for more regulation and enforcement. More transparency is something that everyone can make progress on in the near term.

2. The problem created by the use of SFDR for labelling

A regulator added that the SFDR is a disclosure regulation not a labelling instrument, but it is used as one. The Austrian regulators tried to map the Article 8 and Article 9 requirements with Umweltzeichen. There are 449 funds labelled Article 8, and 14 labelled Article 9. 11 of the 14 are labelled by the Umweltzeichen, and only 99 of the 449 are labelled by the Umweltzeichen, so there is a discrepancy.

A regulator noted that there are other areas where the EU needs to improve. Article 8 of SFDR was perceived as a label, whereas it is only an information tool, and so there is a void to be filled. Europe should be more ambitious. More than 50% of French funds are labelled 'Article 8', although it is not a label. Moreover, there should not be one single EU label; diversity in this field is unavoidable. Finally, oversight of the label producers and, despite the difficulty, some minimum EU thresholds, are also needed.

3. A need for EU harmonisation of labels?

3.1 The History of EU Harmonisation

Asked whether labels should be harmonised or coexist with an EU-level label, a regulator explained that the EU tried to build something with the Ecolabel, but it was never achieved. There could also be private industry

labels if public labels are not perceived as reliable enough by the general public.

3.2 Pros and Cons of Harmonisation for Industry Actors

An industry representative added that one of the biggest challenges in asset management is that much greater consistency is needed across the various label providers across the EU. It is important to harmonise the label space, because currently there is significant divergence. This creates confusion for the end investor, and risks putting investors off investing in sustainable products. This is especially risky in a high-inflation environment, and investors need to truly understand and have clear guidance from the label providers. If there is significant divergence that objective is defeated, so clear, easy to-understand labels are needed to protect from loss of value when investing in sustainable products.

From an asset management point of view it is very important that the label providers also apply all the EU ESG-level legislation. That legislation should be mandatory for label providers. In relation to the criteria which are currently in the law, the only step that that needs to be taken in addition is to make it mandatory, which would automatically minimise divergence and hence the end investors could rely more on the labels. That reliance and that trust is a key component to a stable market.

Political consensus across the EU needs to be sped up. It is good to have diversity, but time is running out with the climate emergency. What is more important now is to find the lowest common denominator and to act quickly, even if there is not a perfect solution yet. So-called renewable energy sources, wind and solar, are not necessarily as renewable or sustainable as would be liked, but they are better than fossil fuels.

An industry representative explained that as a product manufacturer, their organisation will look at the strongest areas of demand for a particular product within jurisdictions and try to look at the individual labelling regimes and find a common framework to apply to an individual product. It is inefficient to have five different funds, versus a single fund that can hit as many labels as possible. Implementation is where it becomes very challenging. Trying to solve for five different application processes and five different labels is enormously cumbersome.

A common label encompassing the majority or most significant of the EU labels is one approach, and one where there are challenges to try to find those common denominators. There are specific third parties that the ISR label works with to assign the label. It would make product manufacturers' lives significantly easier if those third parties could also act on behalf of some of the other jurisdictions of the other labels, to interface as a product manufacturer with a single third party to assign multiple different jurisdictional labels.

There has been talk about SFDR, and it has been highlighted that Articles 6, 8 and 9 are not a labelling regime but a set of disclosure parameters. Implicitly within SFDR there is a labelling regime. This is specifically when looking at the interface between the SFDR framework and the Markets in Financial Instruments Directive (MiFID) preferences for end clients, where clients are asked to express preferences either on the basis of percentage taxonomy alignment, proportion of sustainable investments, or consideration of principal adverse impacts (PAIs). That is important because these are quantitative measures and are not well-defined at the moment under the SFDR regulation. For a given set of assets, if the panellists all managed exactly the same fund, different metrics could be used when it came to sustainable investments or consideration of PAIs. Everyone would agree with that focus on protecting the end investor. If the end clients are using that as a discrimination point between asset managers and between funds, some level of commonality of a definition of sustainable investments and consideration of PAI is desirable. It is, essentially, becoming an implicit label in the marketplace.

3.3 EU regulation and supervision

A public representative stated that with the SFDR the European Union has clearly aimed at transparency but it is very open to improvement. At that time the European Union wanted to have clarity and transparency, but also flexibility, because lawmakers were looking for transparency and flexibility, giving market participants responsibility to explain what they are doing. Looking at ESG, it is clear that not every metric is well developed nor is there a clear common understanding. Without this it cannot be standardised in the form of a label. It is very clear that the market is not functioning because funds should move towards sustainable investment. If there is greenwashing that may not happen and it may affect the credibility of and trust in the market. Greenwashing is a problem in SFDR and what was not intended as a minimum standard is developing into one. Transparency is still important, but minimum standards are needed for Articles 8 and 9. Additionally, more competencies can be given to the supervisors to go after deceptive names or deceptive marketing. There are steps that can already be taken and it should be done quickly.

A Central Bank official added that it is important to develop this very concrete and comprehensive regulatory and supervisory framework for sustainable labels. It is also important to be based on science-driven criteria which are clearly defined and sufficiently detailed. This will facilitate transparency and the aim of adopting these sustainable labels will be served accordingly. It is important not to forget the juncture at which Europe stand right now. There are unprecedented parallel challenges: pandemic recovery, geopolitical tensions and this climate/energy nexus that needs to be urgently addressed. What is important is not only regulation, but regulation that will give the right and the appropriate incentives for the financial system to allow financial market participants to maintain or contribute to the sustainability of their actions.

A policy-maker outlined that the European Commission (EC) is of the view it is too early to draw firm conclusions, but clearly there are issues and additional safeguards may be needed to complement the existing disclosure framework. The EC also does not want to rule out an EU

label at this point but to first take stock of experiences with a fully applicable framework, seeing how the additional implementing measures, the regulatory technical standards (RTSs), are working in practice and then coming back to the issue.

4. Issues raised by the situation of ESG ratings in the EU

4.1 European Commission Initiatives on ESG

A policy-maker stated that the EC has been looking into the functioning of ratings and an extensive study was commissioned on this and published at the beginning of 2021. There are issues around the functioning of this market, in particular regarding clarity of operations and transparency of the methodologies that are being used for ratings. The EC is currently looking into what could be the best course of action and what type of intervention is necessary, not excluding regulatory intervention.

A regulator noted it is clear that ESG ratings have come to play a very important role in the sustainable finance ecosystem. The EC recently issued its summary report from its consultation, but the European Securities and Markets Authority (ESMA) also did a call for evidence and in November 2021 the International Organization of Securities Commissions (IOSCO) published a report on ESG ratings. The regulatory community is looking at this with care and interest. The information provided by ESG ratings is becoming more material for investment decisions and use of ratings by investors can only increase.

In the EC's recent initiative on the targeted consultation, 94% of respondents to the consultation considered that EU intervention is necessary. This is coming from the private sector. The first question is whether the investment world could go forward with a self-regulatory initiative or intervention. There are reasons for scepticism. First, as evidenced by the EC, the EU market is composed of a small number of large, mostly known EU-headquartered players and a large number of smaller EU-headquartered players. The market structure is so fragmented and not yet very consolidated, and a fast evolution to discourage potential self-regulation would capture the full universe of these entities. Secondly these similar steps for the credit rating agencies have already been experienced. The solution has been known in the end with a European regulation. Thirdly there is no time, so the investment world had to go straight to the ultimate endpoint.

4.2 Issues with ESG Ratings Data and Methodologies

An industry representative added that ESG ratings were always designed to be a measure of ESG risk, not to identify companies that are having positive environmental and social impact. Where they can be useful is identifying good governance or where there is no significant harm, but some funds not having very high scores on third-party ESG ratings does not mean that there has been a failure of SFDR. The quality of the data is also important; it is very frustrating that ESG data is subject to more user error and less cleaning.

An industry representative commented that the answer is to use ESG ratings from third-party providers in a very limited fashion. The utility is largely in getting some sense of who are leaders and the laggards in a particular sector, which can then be the basis for pushing companies to improve. However, the danger is where third-party providers are essentially using the sum of the parts in their ratings to give a fund rating. The methodologies behind ESG ratings are somewhat opaque, which is why the investment world is increasingly moving away from ESG ratings and going back to first principles and looking at the data. One of the problems observed is essentially the application of proxy methodologies in filling data gaps. If using an undeveloped or very basic proxy methodology for something like carbon footprinting, it is astonishing how providers would disagree on the carbon footprint of a portfolio. The consequence of that is poor consistency in the results; there is a correlation of 50-60% between the providers. The data providers' explanation for this is that they are solving for different things. One solution could be to make sure that data providers and rating providers are solving for the same output and the same objective function in their methodologies.

5. What kind of regulation for ESG ratings?

5.1 Transparency and Comparability

A regulator stated that a proportionate legislative intervention should be introduced that would calibrate with necessary flexibility and cater for large as well as small. The second principle is avoiding over-reliance. There is reliance to some extent in investment decisions, but by simply creating the conditions across a number of different legislations the possibility of over-reliance should be avoided. The first pillar of this regulatory framework would be improving transparency of the methodology. Common rules around transparency of the methodology are critical. The second pillar is improving the reliability and comparability of the ratings. The third would be improving transparency of the fees charged by providers. The fourth point is about avoiding conflicts of interest. There is clear value in legislative intervention.

A regulator noted that their organisation had published a position paper 18 months ago in favour of a new regulation on ESG ratings, encompassing also ESG data & services/providers. Very often these are the same bodies that publish ratings or data with a lot of additional services. There are conflicts of interest and this can have an influence on investors. That is why there should not be a narrower meaning of ESG ratings, but rather a definition of ESG data and rating providers. Ultimately, a good endpoint to this would be a common ratings scale, in order to not be trying to translate between a numerical output and a letter output or a grade across data providers. There should be a

commonality in terms of their output and the assessments being given.

An industry representative explained that the challenge of the methodology is threefold. First of all, there is a lack of transparency; clearer disclosure is needed from the rating providers about how their methodologies are being implemented. The second problem is about the consistency of application of those methodologies. There is significant variance, particularly when looking at high-yield companies or emerging markets. The third part is the need to put more pressure back onto the providers to explain why those differences exist. Having a panel of representatives from those providers to understand where those differences exist would be extremely interesting.

An industry representative noted that it is healthy to have disagreement in a market.

5.2 The Political Realities

A public representative noted the difference between ESG ratings and data. Improvements are being made in the area of data since work is now taking place toward an EU single access point (ESAP) and a Corporate Sustainability Reporting Directive (CSRD). There was no progress in the ESG ratings because, in order to learn, transparency of the methodology is required. In academia methodologies are exchanged in order to learn and make progress. The differences in methodologies will not be removed, because the investment world does not learn from each other. Politically it is very helpful if there is broad consensus.

A regulator added that the interaction, links and relationships with the non-EU should not be forgotten. If a regime is established and principles designed, there may be a need for a supervisor. This role could be played by ESMA, given the nature of the matter.

6. Conclusion

A policy-maker confirmed that the EC is currently looking at the need for a measure and action on ESG ratings. Proportionality is key, as well as not disrupting a market that is still evolving and not mature. The EC would side with those emphasising the need to encourage transparency and sound operations, and that includes issues like conflict of interest and not interfering at this stage of the development of the market in substantive methodological choices that providers make. There is a broad consensus around this.

SFDR/CSRD/Taxonomy: usability challenges and expected impacts

A regulator welcomed participants to the panel, which will provide clarity on data, sustainability, and reporting. In order to make progress on sustainability, data is key, and in order to have this data it needs to be reported.

1. Progress and difficulties in the implementation of SFDR

A regulator stated that it has been a year and a half since the Sustainable Financial Disclosure Regulation (SFDR) became applicable, and many lessons have been learned since that period. The SFDR is a very important piece of the regulatory framework on sustainable finance, since it has increased transparency and provided investors information on sustainability risks of the investment product, and on sustainability claims of investment products made by market participants.

When looking at the data and how the environmental, social and governance (ESG) market is growing, there is a need for this regulatory framework. Despite the net outflows seen in the last couple of months due to the economic situation, the percentage of the ESG market, in terms of assets under management at the EU level, remains quite stable at around 27%. This transparency and framework was needed.

There are three main challenges from a supervisory point of view. The first is a risk of discrepancies in application of the regulation among jurisdictions due to the lack of clarity. There is a risk among firms, but there needs to be awareness that there is a risk among jurisdictions. There is still no good understanding of what an Article 8 fund means or what minimum criteria it should follow. That is very important because. In a country such as Spain, more than 40% of promoted investment funds come from other jurisdictions. This might lead to an unlevel playing field or a lack of comparison for investors. The European Securities and Markets Authority (ESMA) is doing an admirable job and there is still a major role to play in terms of supervisory convergence.

The second challenge come from investor difficulties in understanding the information published by entities. One example of this is the use of ESG terms in the name of a fund (such as green, sustainable, or social) in a way that might not reflect the investment characteristics of the fund fairly. All this could result in the third risk, the risk of greenwashing. There needs to be a further focus on greenwashing.

An industry representative stated that the SFDR was welcomed, especially to prevent greenwashing, to provide comparable information and to increase transparency on certain sustainability aspects. However, it also brings many challenges for the implementation. The SFDR framework is extremely complex and certain required data (e.g., on Taxonomy-alignment of investments or PA-KPIs) is not available. There are also issues with different interpretations between the different regulations (e.g., MiFID II, SFDR and Taxonomy). The documents that need to be produced are very complex. It is questionable whether the detailed disclosures on sustainability are proportionate to the benefits for investors. There needs to be more clarity, significant simplification and better coherence of the respective regulatory framework.

2. Difficulties raised by the EU taxonomy

A regulator commented that part of the role of SFDR is to prevent the risk of greenwashing. On the European level an additional step has been taken to develop a taxonomy. Overall, the taxonomy is a step forward to create clarity on what is and what is not green, thereby supporting the market.

An industry representative stated that the taxonomy is clearly the first step on the sustainable finance agenda. The taxonomy reporting will show which assets are eligible and which assets are not. The first reporting season in the banks has shown the weaknesses and challenges of KPIs. The green asset ratio (GAR) for instance is affected by size and business model of financial institutions, meaning it only takes into account what is eligible, while other assets and exposures are being disregarded. Of the banks represented by the representative, 25% to 65% of their portfolios are eligible. The other 35% to 75% are non-eligible. The range for other banks are the same. In the end, it does not show the right result, although there are many loans to small and medium sized enterprises (SMEs), supporting the way to more sustainability. It is transition finance that is not shown in the taxonomy and the green asset ratio.

In addition, eligibility differs widely by sector. In automotive, 90% of the assets are eligible. In a chemical or pharmaceutical sector, just 11% of the assets are eligible. Simple KPIs have limited usefulness as steering parameters and should therefore not be used in any supervisory or regulatory requirement.

3. Challenges for financial institutions and corporates to implement EU regulation

An industry speaker explained that, having helped clients ascertain what is required from them, it is extremely challenging for financial institutions and

corporates to make sense of the different pieces of regulation and how they complement each other. There is a lot of confusion around how all the different pieces fit together and how one bit can be leveraged to work with another. This is particularly challenging for the financial institutions as they depend on the information provided by real economy players.

The data is hard to access because it has to be collected from several counterparts who are not equally mature and concerned by the information and it is provided in many different formats. Whilst the quantitative information is easy, there is a lot of qualitative information which will vary in terms of what is provided and will be hard to input into a system. In terms of useability, it is the beginning of the journey. A lot of improvements need to be made. The Corporate Sustainability Reporting Directive (CSRD) will be a game changer as it will help with the standardisation of information.

The other challenging bit is to make sense of how to use the information and how it will influence a business. There tends to be a focus on a tiny bit of data, and players are struggling to embrace what this means for their business today and in the future. It is more than just data.

A regulator stated that the industry is working on the challenges, and there are many questions as there is a willingness to do it right. There is also a sense of reputational risk if a business does not get this right which is providing extra pressure. A regulator commented that CSRD will definitively be a game changer however, it is not in place yet.

4. CSRD is welcome but also challenging

A regulator very much welcomed the CSRD. It is the piece of the regulatory framework needed in order to have all the data and information for the rest of the investment value change and sustainable finance. The problem is it will take time to implement. So far, the assessment is quite positive. It will enable investors to be able to assess the long-term value creation of a company, as well as how the economic activities on the undertakings contribute to a more sustainable economic development.

The approach is grounded in the double materiality concept of the EU. It broadens the scope of data and number of undertakings subject to sustainable reporting. It introduces the need of assurance from a third party. And it also stablishes the European Sustainability Reporting Standards.

There is no doubt that undertakings will have challenges in fulfilling the new requirements and that there is room for improvement.. Everything possible should be done to simplify without diminishing the EU ambition regarding the materiality approach. In addition, the rebuttable materiality approach is also unconvincing. There are maybe some ways to make it more similar to what exists in financial reporting. It is also crucial that there is a high level of assurance with the data, as the data will form the input for the rest of the value chain. To that end, undertakings should also have in place high-level quality internal control systems.

Regulators only review the information published by listed companies, which in Spain represents only 5% of the companies publishing non-financial information. There needs to be a strong framework around the assurance to ensure the quality and consistency of the data.

An official commented that the EU started with regulations that needed data. To a certain extent, they should have started with the CSRD. It was a political decision, and there was a big push to mobilise the energy of sustainable finance. CSRD's biggest interest is to put things in the right order. In terms of quality data it is moving in the right direction. This will probably not be too easy. Some believe it is too fast, whilst others believe it is not fast enough. Uses believe that they need information quickly.

The second point is to stimulate consistency. Financial reporting follows decades of standard setting, long discussions about new standards and a long period of implementation. Europe is confronted with an urgency, and as such, sustainability reporting must become the second pillar of standardised corporate reporting, on an equal footing with financial reporting, as quickly as possible bearing in mind the implementation difficulties that need to be overcome. The EU and financial institutions within the EU will benefit from such a move. It might look like creating an unfair playing field with other jurisdictions, but it is a good idea to be front running in innovative systems.

Consistency is key, which is why the SFDR disclosures were introduced in the standards. They are as comprehensive as possible because there was a feeling that without this information from the corporates, in the scope of the CSRD, it will be pretty difficult to make sense of the disclosures. While consistency is the key word, one also has to bear in mind quality. If there is a desire to have financial reporting and sustainability reporting on an equal footing, there needs to be a focus on five information qualities that are pivotal. The first is relevance. One should give a faithful, unbiased representation of information that is decision-useful and properly depicts the phenomenon that it is intended to be described. One piece of information may be relevant but not all the information that is needed. There is then comparability, which is of course key because decisions are made by comparing peers in sectors or globally. There is then understandability and verifiability because, ultimately, the level of assurance that will be given on the information, a key feature of the CSRD, is going to give credibility to the system.

An industry representative stated that the CSRD is good, especially from an industrial point of view. However, it is not easy to implement. The CSRD shows proportionality. This makes things easy and understandable and shows the reality. With the change from the Non-financial Reporting Directive (NFRD) to the CSRD, the company base increased from 10,000 to 50,000. Asking the companies that are new to the scope to provide data

needed to get clarity will be a challenge. There is still work to do and a lot of information needs to be produced on different levels.

An example is one simple report that required 600 requirements and 170 quantitative data points. Upon seeing the result of such a report, one would question whether the information is relevant. The CSRD is a really good starting point when it comes to integrate proportionality into the sustainable finance framework, and it is hoped that it is a blueprint for a future regulation for sustainability.

An industry representative observed that those who were initially most critical of the CSRD are now saying it may be a good thing. It will help standardise information and set the expectations. It creates some transparency and clarity on what is expected from everyone. Whether it is or is not reasonable is a different debate.

Larger companies familiar with providing such information are taking a deep breath as the extent to which the information must cover the entire value chain is raising several challenges. There is a worry about how to source good quality data. There is also a realisation that the data will not be 'thrown in a box' but be the result of a long process, including interacting with stakeholders and identifying what is material to them. This is a process that links back to identifying risks, impacts and opportunities. The data has to make sense. It is the result of an entirely new process, and at the core one needs to know what is or is not sustainable for them and their stakeholders. Individuals in different departments are required to build on new capacities and competencies. This is preconditioned to good quality data. You need to build the muscles to be able to both source the data and pick the relevant one, though this has been overlooked.

Now that CSRD is being implemented, it has been realised that this is not just a 'tick-box' exercise. In order for data to be accurate, it must be understood why it is being provided and this would be an additional challenge. Previously the industry and regulators learned to walk on one leg, but now are asked to walk on two; it is a whole new exercise.

A regulator noted that good data is much more than just a number. It is a process which includes knowledgeable people, knowing where to get the data and supervision.

5. The EFRAG proposal of sustainability standards should be simplified and progressively implemented

An official stated that it is too early to provide final conclusions. The deadline for the consultation was 8 August, and EFRAG received approximately 500 responses which were currently being analysed. This will not be an easy exercise. When organising the consultation, EFRAG asked stakeholders if, should this requested information be provided, it should be relevant, decision-useful, and faithful. The CSRD is not a 'tick-box' exercise. There has to be a real assessment of impacts, risk and opportunities.

Within a report produced in 2019 there were three big advantages to sustainability reporting: better internal decisions, the creation of good relationships with all stakeholders, and investors among stakeholders funding a transition. There are a number of remarks on the proposal, as regards to the relevance, because when putting together a taskforce of specialists and they will be asked what they think, and they will of course have designed the perfect expectations in answer. Officials probably, and most certainly, reduce their ambition because they do not want to overdo it. For example, in the social domain, it is probably not necessary to disclose the allocation for each and every entity over and above 50 employees. There are good reasons to say it would be useful, but the circle of people for whom it is useful is maybe too limited and that could be provided through other channels.

The consultation has received remarks on relevance. Certain topics are less mature than others. Biodiversity is a good example because it is one of the topics that is certainly moving forward quickly.

For certain specialists there will be an arbitration, but I think the arbitration will be in the sense of reducing what is relevant, which is very different from financial reporting. There are a series of topics while in financial reporting, there is one measurement: monetary units and summary statements that are called balance sheet and profit and loss. Equity or profit is not going in the right direction. In sustainable reporting, there are 12 topics to address, depending on the materiality assessment.

Once relevance is assessed, there are the difficulties to implement. There was a cost-benefit analysis because EFRAG needs to know how fast it is possible to go. You do not compromise on the ultimate objective, but you give time or you create optionality for the most advanced that will use and show the way, but others say they need more time.

An industry representative commented that at beginning of the session, there was discussion about taxonomy, and it would be great if EFRAG could prioritise the work, focusing on the climate issue, and then aligning with the other regulations and use the lessons learned from the market. An official explained that climate is considered a priority. EFRAG is making a huge effort, as is the International Sustainability Standards Board (ISSB), to avoid multiple reporting on climate. As regards to the Securities and Exchange Commission (SEC), it is not so much that EFRAG has different views, but it does not know if the project will go all the way, due to the political context. Though dialogue with the SEC is good, it is more detailed with ISSB, with certain hurdles to jump over.

However, CSRD is asking for more comprehensive reporting. EFRAG is a standard setter, but the Commission is of course applying what the co-legislators have decided. It is not bad news, but this is at least the constraint to understand.

The direction of travel established by the CSRD is pretty clear. There is a goal to reach a certain destination, but the speed is still to be discussed, depending on the political definition of what is a large entity in the EU. Supervisors cannot make a distinction between the very large and the smaller or large. There will be a question of alignment. If it is so easy for the very large, and already difficult for the smaller, there is an issue. SMEs also should be encouraged to adopt the system because the economy is not only the large entities.

A regulator noted that when thinking about the investors, as an official mentioned, simplifying and looking for ways to reduce the amount of information will help to reduce the gap between information supplied and information used. It is essential to always take into account the perspective of investors, the ones who are going to use the data, in addition to the perspective of the undertakings who supply this data.

6. The role of supervisors and of assurance and internal controls

A regulator highlighted that companies need to be ready to have procedures and resources to ensure data's reliability. The new framework is complex for everybody, but it is much needed. Supervisors also need to be sure that the data, that will be the input for the rest of the investment value chain in sustainable finance, has the quality needed.

There is a challenge in ensuring high level of assurance by third parties. For the first seven years, assurance will be limited. Anything that can be done to enhance and ensure a better framework for the assurance providers is welcomed.

An industry representative stated that regulators should take into account the learnings of the last one or two years of trying to implement the first standards, to work on the future standards. Authorities, regulators and the industry are facing more or less the same challenges, and everybody is having more or less the same learnings. In the end, everybody has to connect. The sustainability agenda is not only a European thing. It will connect the world together. Communication is one of the key points: a dialogue from the banks, the regulators and the companies. There of course needs to be more simplification in the standards and really good standards that are easy to apply instead of the best standards that are difficult to apply.

An industry speaker explained that everyone is on a learning curve and a journey. There are serious resource constraints in terms of numbers of people who actually understand what is going on and what needs to be done. There is a lot of benefit in being transparent and sharing the struggles and challenges, and the big and large victories, because this is how to learn from each other and manage the expectations of all stakeholders.

There are a lot of expectations from the markets about what systematic assurance on all that information will actually bring in terms of value for the market. In the CSRD there is a provision that says it is going to be limited assurance for the first few years before considering moving to reasonable assurance. This begs the question of what the limited assurance will look like.

It has been mentioned that it is all about negative assurance and that it has nothing to do with the positive assurance provided on financial information and queried how to reconcile the two. It will not be reconciled before a few years because the industry and regulators must learn to walk and mature standards at a reasonable pace so that practitioners can actually keep pace with that.

It will be really critical to achieve all of that, including assurance, with a logic and perspective of continuous improvement and learning, not looking at this as a one-off punitive. No one will be 100% ready, even if the standards are amended to make them less demanding. It will be key to be transparent on where progress is and how practitioners or preparers are going to change things and do things to meet the endgame requirement. It is critical that authorities are not too punitive and demanding. It is necessary to learn fast and some will stumble and fall.

An official stated it is good to have ambitions. In 2002, it took European businesses three years to move to the International Financial Reporting Standards (IFRS). This was a significant investment which should not be underestimated. Every business, including SMEs, should understand that this is crucial for the future and that it is not just a regulatory constraint. It is something that is much needed for the transition of the economy, and as a consequence, everybody should take the exercise very seriously. Standard setters will do our part by simplifying it and making it progressive.

A regulator commented that the timeframe on which EFRAG is working to develop the European standards is short and very challenging, but there should be every effort to do everything possible in time. Sustainable reporting is the input much needed for the other pieces of regulatory framework. Work should continue to finalise it as soon as possible.

Coexistence of sustainability reporting standards (ISSB, SEC, EU CSRD/Taxonomy)

1. Recent progress despite the differences of approach

An industry representative welcomed the dynamic evolution in the field and supported the European Financial Reporting Advisory Group (EFRAG) and the International Sustainability Standards Board (ISSB). This standardisation effort provides the right impulses to companies to report. There is a need for standardised, reliable underlying data reported by companies, which data users need to avoid being caught in 'garbage in/garbage out'.

An official welcomed as a positive development the different standard setters in different jurisdictions working on the same issue, demonstrating the importance of sustainability reporting. However, there is a risk of fragmentation and double reporting, which is useful for neither investors nor enterprises. It is key to have some consistency between the standards, and the G7 members issued a paper confirming there should be interoperable standards that work together to avoid fragmentation, and which work globally, because climate change and sustainability more broadly are global issues. The work of the ISSB and the European standard setter should, in some way, be combined so there is a global baseline. The building block approach of the ISSB can then itself be applied to add specialist standards for other jurisdictions to the global baseline.

The communiqué sent out by the G7 also highlights a desire to mobilise private funding for the transformation and to prepare the pathway towards net zero. The Commission said an additional €350 billion is needed each year in the energy system alone in order to meet the emission reduction target by 2030. Therefore, the financial sector has a crucial role to play, and the sector needs reliable, comparable data to decide where investments will have the biggest impact. Reporting standards that can be implemented globally are therefore key.

An official confirmed the ISSB has just closed the comment letter period on two exposure drafts, for which it received nearly 1,500 letters. It is busy processing those and there is a great deal of very good feedback.

It could be commented that there is a complicated landscape, with the ISSB, EFRAG, the US and others. However, this is an opportunity to see where there are opportunities to align. The message from the feedback letters was strong support for the idea of the global baseline, because of the global nature of markets and the efficiency for companies if they are able to use the same requirements in different parts of the world. There was also a strong message that it is important for the ISSB to find ways to work with others for the sake of interoperability with the various jurisdictions. That is being worked on and progress is being made.

The Securities and Exchange Commission's (SEC) proposed climate rules possess a large amount of commonality with what the ISSB has proposed. Comparing the ISSB's work and that of EFRAG, there is again a common core that both are interested in. There is focus on meeting investors' information needs and the interest is not only in climate.

As the ISSB is interested in investor information needs and EFRAG is interested in the needs of a broader range of stakeholders, including investors, there is a real opportunity to work together to find a common set of disclosures that are applicable in both circumstances and bilateral conversations are ongoing.

The hope is that a good intersection of information that is a common set of information needs will be found. Then the key is to make sure that within a set of disclosures that provide a broader perspective, which EFRAG does from a European perspective, that common set of information that is investor relevant is visible to investors. If they pick up a set of European disclosures, they should see the global baseline of information and make global comparisons. That is what is being worked on. There is much work to do, and some more time would be welcome, but this is a positive development.

An official suggested the perspective of the US, and many other jurisdictions, is that the ISSB is the locus for a global baseline standard. That is reflected not only in the G7 work but also in the G20. The US is also very pragmatic about some of the limitations of standard-setting processes generally, and this one in particular.

There are three buckets of differences. One is the materiality versus double materiality approach. The second bucket concerns deciding whether to focus on investor protection aims or to use disclosures to achieve other societal aims. That comes in two buckets. There is the materiality bucket and whether to apply a taxonomy to the underlying disclosure apparatus. There are many jurisdictions, including the US, that are very unlikely to have a top-down activity-level taxonomy, be it applicable generally or to disclosures. Then there is the choice between whether to pursue climate versus all ESG. Finally, there is the significant fundamental difference in liability that attaches to the various disclosure regimes, where the US has a much more significant liability hook.

Given that reality, authorities may focus on how to achieve commonality in a few discrete areas. One of those areas may be transition plans. Most jurisdictions are not going to require companies to have transition

plans. The question for those jurisdictions is how to encourage, rather than dissuade, companies from choosing to have a transition plan. Nascent transition plans could lack the methodological rigour or data necessary to make accurate public disclosures. Regimes that take that reality into account are likely to provide more valuable information to investors, while jurisdictions that do not are likely to have a chilling effect on the adoption of transition plans.

2. What should be done in the near future?

An industry representative stated the market needs reliable and high-quality data immediately. Some of these standardisation efforts are still in the early stages. For the ISSB, the climate part of the topics covered have been seen. This should move faster.

Some standards are voluntary, and some standards are mandatory, but the past has shown that it is making corporate ESG or sustainability disclosures mandatory for companies that leads to real progress. The ISSB needs to be encouraged to continue with its coordination efforts outside of the European Union for there to be mandatory reporting in other jurisdictions as well.

The materiality debate is important because the materiality perspective determines which topics are covered for specific sectors. If there is a pure financial materiality perspective, that limits the topics covered in a given standard. The ISSB giving more explanations on dynamic materiality is welcome.

Data users and providers of data insights and assessments need as broad a coverage of topics as possible. There cannot be a focus just on a few topics even if they are important, like they are for climate change. Entities are not only asking for climate data. They also ask for perspectives on human rights, labour rights, ESG and water consumption amongst others. One area to focus on is making the implementation as easy as possible for all participants. Market participants need clarity as far as is possible on what they have to do. This is particularly important for financial institutions as they are both users and preparers. There is difficulty using information when it is not similar to other information.

An industry representative noted the clarification work is quite technical and being done jointly by the standard setters in a co-construction mode. The financial impact of physical risk is needed for Pillar 3 reporting for banks under the Basel Framework, and there are typically very different ways of doing this so it is difficult for banks to use.

It would be useful to provide users with something that will tag the quality of the data. There is something in the International Financial Reporting Standards (IFRS) fair value levelling, for example, which will help people who are looking at the data to understand the quality of it and perhaps ease the tension in the discussion between regulators and market participants on the need to be exhaustive and reliable in the coverage.

An industry representative noted that there remains a real risk of fragmentation. There is a risk of double reporting, not just for financial firms but for all global firms. If each jurisdiction applies its own standards to internationally active firms and do so on a group basis without formally recognising the standards applicable in other jurisdictions, that would result in different rules, with different timelines and different legal bases. Then there will be issues of duplication and extra-territorial application of standards, unless there is a formal system of mutual recognition, determination of equivalence or some form of substituted compliance. If firms cannot apply substituted compliance, then what may be needed is a proportionality concept that will allow a third country firm operating in Europe to follow ISSB standards and still be compliant with the European system.

An official highlighted two challenges. One is a top-level threshold question. Although disclosure is vital, there is a risk of over-reliance on financial regulatory policy to the detriment of a focus on fiscal, tax and environmental regulation that may be more efficient and effective. With respect to disclosure in particular, one challenge concerns the potential for overlapping jurisdictions of various national domestic regimes. Overlapping jurisdictions may lead to a conflict of laws and perverse consequences for capital allocation. If the Corporate Sustainability Reporting Directive (CSRD) applies extraterritoriality, that may lead issuers to withdraw from the EU market if they have relatively narrow exposure to it. On the other hand, emerging markets have expressed concern that a jurisdiction-by-jurisdiction approach to reporting, rather than a business segment approach, may lead to a naming and shaming exercise that could result in different capital allocation outcomes and pull capital away from emerging markets.

A policymaker suggested the next big challenge is complying with the timetable. Assuming that is achieved there will then be the application of the framework from 2024. EFRAG is preparing the standards with usability in mind. As the standards are linked to policy developments, over time there will be a need to adjust the standards to still-evolving policies.

3. CSRD and convergence between ISSB and EFRAG

A policy-maker suggested this may be an opportunity to look at CSRD, which is the legal framework for the work on the standards in the European Union and that provides a comprehensive framework for companies' sustainability reporting. CSRD defines the scope of the companies covered and the dates of mandatory application. It also addresses third-country companies and assurance on sustainability disclosures.

The centrepiece of CSRD is a mandate for the Commission to adopt mandatory sustainability reporting standards that are prepared by EFRAG. These have to correspond to the double materiality principle. The aim is to avoid double reporting, which means the standards have to correspond, to the maximum degree, to international standards such

as the ISSB standards. That should be done by integrating the content of the ISSB standards into the European Sustainability Reporting Standards (ESRS).

Double materiality is an important point where there is no global consensus, but the European standards should also be policy relevant and that is another difference between the ESRS and the ISSB's standards. That means that the European standards build on the EU acquis, which is not possible at the international level. The EU's key definitions of pollution, water quality and others have to be covered. The objective should be to make sure that companies that comply with the European standards also comply with the ISSB's.

An official highlighted two key elements to the EFRAG standard-setting journey. One was avoiding multiple reporting at all cost. It is fundamental to build on and contribute to existing standards. That is why cooperation with other standard setters and dialogue with others was established. The other key point is that it is better to pool resources and co-construct because ultimately everyone is short in terms of resources. The very detailed dialogue taking place between ISSB and EFRAG is extremely encouraging.

There are nonetheless some hurdles to jump over. One concern is when an impact becomes financially or enterprise-value relevant, because that is difficult to state and could be relatively subjective. Another is a timing issue. The standards developed by EFRAG have to comply with the CSRD as a standard setter. It has to deliver these standards to the Commission in November because the Commission itself has its own timing to adopt the standards. The ISSB will probably be put in the position of deciding slightly after Europe has, due to the political objectives, so the hope is that the dialogue will minimise what issues there may be.

The Chair noted the usefulness of sustainability reporting had not been questioned, which was not the case at roundtables held only a few years previously.

4. The issue of small and medium-sized enterprises (SMEs)

The Chair remarked that there is the issue of SMEs. That is probably strictly related to the static view of sustainability reporting, whether they are able to do so, whether it is meaningful for them to do so in exactly the same way or whether there is proportionality.

An official noted that G7 members explicitly requested that the global baseline be suitable for SMEs as well. SMEs need to have reporting options if they ask for financial investments or loans from the financial sector, so it could be in their interest as well to do their sustainability reporting. However, SMEs are quite vulnerable with regards to the costs of bureaucracy. It is key that SMEs have a chair at the table when it comes to the development of the upcoming standards in Europe and at the international level as well.

An industry representative remarked that there has been growing awareness among SMEs about ESG and the importance of ESG as a competitive advantage. It remains a problem to turn this into operational implementation. SMEs have limited means, and though many things are available in the ecosystem many SMEs are not aware of them. There is also a lack of direction on what they need to do, and fear that the upcoming CSRD regulation and the banking regulation for Basel Pillar 3 will pose a problem for them to access financing or contracts. CSRD and what is going to be proposed for SMEs will be very important, because having something there can be a very good accelerator and give a direction, provided it does not come too late and is not disconnected from what their value chain will ask for in terms of information. There is a need for the public authorities to provide support and give direction for what needs to be done, including helping to implement the reporting.

An industry representative stated the need for reliable, comparable, verified data with global coverage, including going into the SME sphere, is very relevant for financial institutions, be they banks, insurance companies or investors. There are entities with large, broad investment portfolios. Some are very specialised. There are many different use cases, and not everyone is asking for the same type of data. As broad a perspective as possible is needed in order to be able to collect that data, and deliver it in various forms. Some entities sought raw data, some want an opinion overlay with the scores and assessments, and then others want data mapped to various different standards and labels. Banks and insurance companies are increasingly obliged to integrate ESG factors into their risk assessment, and they see challenges with physical risk.

On the climate side, the data and modelling is becoming better but biodiversity, which is such a huge, important and threatening topic for humanity, is very hard to quantify, very hard to measure and very hard to understand. The Taskforce on Nature-related Financial Disclosures (TNFD) just identified more than 300 different types of assessments for biodiversity impacts and dependencies. There is a need for clarification on that front as well.

5. Transition plans: a possible game-changer

An industry representative confirmed there is a positive development in that the ISSB's proposed framework includes the disclosure of transition plans, which is an important step for advancing the low-carbon transition. However, though disclosure is necessary it is not sufficient to achieve the goal, and transition plans have to be credible and globally comparable. For financial institutions, it has to be ensured that client firms are eligible for transition finance, which will be critical for that firm to successfully implement its transition plan.

Emerging markets need the money to transition. All of that money cannot come from the official sector. Private capital needs to be mobilised, and there again is the question of how to make sure the transition plans of those countries, not just at the country level but at the firm-by-firm level, are credible and justifiable in terms

of any additional finance provided from Europe, the US or Japan.

Another element is to make sure that those transition plans are credible at the client level needed to engage those clients. Publicly available information is not sufficient. There is a need to go in-depth, have real engagement with the clients and make sure that they understand why the bank is not just asking for more information, and also to perhaps be critical of their transition plan draft, and make sure the bank assists in upgrading whatever draft transition plan there is with that client. This will also apply in the emerging market context.

The official sector or public authorities should recognise the importance of transition finance based on credible transition plans, and the regulatory framework should not disincentivise such activities by banks.

An official explained that transition plan disclosures are a very important part of the package of the ISSB proposals, to ensure investors understand the consequences in terms of what is coming ahead for a company as a result of climate change and other sustainability risks. This is also an opportunity for companies. If an entity can present a credible transition plan, it can potentially attract capital for those who want to invest in those industries.

The other area the ISSB proposed in the exposure draft is more specifically on the planning for carbon emissions targets or carbon reductions targets. There will need to be consideration of the feedback and probably a strengthening of that area somewhat, to make it clearer that carbon reduction strategies are very important separately from stating what carbon offsets an entity is using, and also making sure there are good disclosures around what the carbon offsets are and the credibility of people's plans. The desire is for people to be able to examine carefully whether these transition plans are credible, so capital is allocated in the right places. One area where the proposed disclosures could be brought somewhat closer to what EFRAG has proposed is on the transition plans front.

An official confirmed the importance of transition plans because aesthetic vision plus a long-term commitment without the definition of a trajectory and the milestones that go with it does not create the right level of credibility. The gross/net issue can be solved. There are policy references in the EU and people expect information about the direction of travel and the speed to the destination.

The Chair recounted an occasion some years ago with students who stated they were carefully examining the sustainability reporting of French corporates. France was one of the first countries to introduce such reporting. This was to check whether they could work in those corporates or not, and whether they wanted to be hired by them or not. They were the first to express that the reporting was useful.

Sessions

V

CMU PRIORITIES AND NEXT STEPS

CMU priorities: what can be done in this European political cycle?

1. Progress made with the Capital Markets Union (CMU) initiative

1.1 Progress made with the implementation of the CMU action plan

A policy-maker believed that progress is being made on the CMU, whilst recognising that the project takes time. The CMU is very important in the current economic context to support the funding of the economy and the green and digital transformations. There is also a high level of political support for the CMU, as has been demonstrated in many European Council and Euro Summit statement. The Commission presented the project as a long-term initiative and it is the continuation of efforts launched 30 years ago to further integrate EU financial markets. A wide range of actions are needed, both legislative and non-legislative. EU legislators are taking action, but market operators are also expected to contribute to make CMU happen.

The policy-maker explained that the Commission set out a first CMU action plan in 2015. With the exception of one, the corresponding legislative proposals have all been adopted and are in force. A second action plan was subsequently published in 2020, on which significant progress is being made also. A package of actions was proposed in 2021 for implementing this action plan, including a review of the European Long-Term Investment Fund (ELTIF) and Alternative Investment Fund Managers (AIFMD) directives, of the Markets in Financial Instruments Regulation (MiFIR) including the proposal to set up a consolidated tape and the implementation of a European Single Access Point (ESAP) for corporate financial and non-financial information.

The policy-maker noted that in terms of concrete impacts from the CMU, a gradual increase in the participation of retail investors in capital markets has been observed in the EU over the last few years. That has been helped by the pandemic and the acceleration of the digitalisation of markets. European companies are also looking more to market financing than just bank financing, but the trend still needs to be accelerated.

A regulator agreed that the CMU is a long-running project that requires continuous efforts and step-by-step progress. It is clear that there is no single silver bullet that will deliver it. Incremental progress has been made, but the aims of the CMU have clearly not yet been achieved and continued political momentum is needed. Having a strong European capital market is essential for tackling the many economic and geopolitical challenges that Europe is facing. The supervisory authorities have a key role to play in terms of implementation of the regulatory requirements related to the CMU legislative packages and of market oversight. ESMA will be contributing in particular to the efforts made to enhance the provision of adequate data and market information with the ESAP project and potentially the consolidated tape, but these are challenging initiatives that will require the availability of the right resources and capabilities.

A second regulator was less optimistic about the progress made with the CMU. Much effort is being made, but the results do not seem very significant so far. The goals are simple and more relevant than ever, but the approach needs more dynamism. There may also be a branding issue, because it is not easy to understand what the CMU is, contrary to the Banking Union (BU) from which its branding was derived. The Banking Union had three pillars, two of which have been fully implemented, and it has an intellectual coherence. The CMU is more a package of different measures aiming to build a deeper capital market for Europe and diversify financing sources. An industry representative agreed that progress is slow, but remained optimistic about the capacity of Europe to move forward on the CMU initiative.

1.2 Next steps and challenges facing the CMU

A policy-maker reported that important additional actions are planned for the coming months. One is a retail investment strategy that the Commission is working on, together with a review of listing requirements aiming to make it easier for smaller companies to go public. Another important but complex issue is the heterogeneity of corporate insolvency laws in the EU that always comes up as one of the top priorities in public consultations and on which the Commission is planning to make proposals in the coming months.

The Chair noted that there is also a clearing proposal scheduled on the Commission agenda before Christmas 2022. There is effectively only 18 months left of the current European political cycle. This leaves until mid-2023 to make new legislative proposals, and then preparations for the parliamentary elections and for a new European Commission will start, meaning that any agreements on other new texts may need to wait for 2025. A political booster is needed to deliver as much as possible by 2023.

The policy-maker responded that the Commission is making good progress on the proposals that are on the table and it is expected that the whole of the November 2021 CMU package will be agreed in the current mandate. The Commission also hopes that this will be the case for the upcoming proposals on retail, insolvency laws and corporate listing.

A regulator supported the sense of urgency around the CMU. It is important to make the legislative and

regulatory progress that is needed over the next few months for accelerating the CMU. The upcoming proposals regarding the listing review and the retail investment strategy are very much awaited in particular.

An industry representative agreed that while progress has been made, the sense of urgency needs to change on CMU with a stronger focus on timing and a reconsideration of the priorities. A functioning CMU in Europe is needed right now. Absent of that, new dependencies are being created at a time when Europe is trying to reduce geopolitical dependencies. The post-Covid recovery and the investments that are needed in many areas such as the green transition, reducing the dependence on fossil fuel, rebuilding supply chains, enhancing infrastructure, and defence, including cyber defence all require a significant amount of additional capital.

The Chair noted that the capital needs in Europe for the green transition alone exceed €500 billion per year, and a capital markets function is essential for fuelling these investments.

The industry representative added that increasing the attractiveness of European markets for wholesale investors is essential, otherwise European companies will increasingly be seeking capital through listing in the US and in Asia. Europe already depends very much on US and Asian technology, on the US defence infrastructure, and energy imports.

The industry representative added that because of the insufficiency of capital market funding there is the perpetuation of the distortion in Europe that long-term capital is being provided by banks, when they should be focusing more on facilitating access to and providing liquidity for the capital markets. Instead, banks are tying a great deal of long-term capital in their balance sheets.

The Chair observed that this is a question of strategic autonomy. The industry representative agreed, noting that this concept in the capital markets area rests on the idea of facilitating a sufficient depth of liquidity in European markets. However the post-Brexit discussions in the clearing area focus on arguing about how to allocate liquidity across the Channel, which leaves major opportunities for US banks that tap into both EU and UK liquidity pools. This discussion goes beyond regulation and is a matter of geopolitical industrial design for European financial markets which needs to be recalibrated.

2. Key priorities for delivering the CMU

The speakers were asked for their suggestions in terms of priorities for delivering the CMU and accelerating its implementation.

A regulator suggested that it is necessary to streamline the CMU and re-focus it on a limited number of essential areas, because not everything in the current package is of equal importance. The first priority is to increase the depth and liquidity of wholesale markets. A large part of the CMU discussion focuses on retail markets and facilitating retail access, but it is the wholesale markets that drive the growth and liquidity of capital markets. Retail investors use capital markets and have some directional power with the investment choices they make, but they do not make the markets, which are very largely wholesale driven. Implementing the conditions in Europe for driving deeper and more competitive wholesale capital markets is essential. These include predictable regulation and supervision and an efficient market structure. In this respect, the present high number of wholesale capital market clusters across the EU needs to be rationalised. For retail markets that are more domestic, there can be more fragmentation. Securitisation is also essential for driving more financing into the markets and getting more velocity in bank balance sheets.

The regulator stated that the second priority is levelling up the supervisory standards in the EU, as has been done in the banking sector with the Single Supervisory Mechanism (SSM). Progress has been made in terms of supervisory convergence but improvement is still needed. Capital markets are currently still extremely difficult to supervise in the EU because financial institutions have business activities and corporate structures spread across several member states. One of the objectives of this is to arbitrage the different regulatory and supervisory setups that exist across the EU. This means that domestic supervisors are often supervising only one part of the chain without having a responsibility for the whole chain, which is dangerous and inefficient. It is necessary to accept a more European and consistent approach of supervision in order to support deeper clusters of capital market activity and less energy should be spent on competing between member states for capital market activity.

An industry representative stated that the CMU should focus in priority on SME and retail financing. It is essential for SMEs to get access to capital, because that allows them to build a European or global business plan rather than a local one and to grow faster, creating three to four times more jobs than similar companies that are not listed. Retail participation is also very important for SME markets. A large part of the success of IPOs in Sweden has been supported by retail participation. In 2021 130 new SMEs were listed in Sweden; around one-third of the capital raised came from retail, and 50% of the day to day trading is retail. Retail participation is also important for larger companies, as shown by the decision made by Volvo to list in Sweden because of the strong retail market there. Retail and wholesale markets work together and an active, well-functioning retail market supports the wholesale market. If the appropriate measures are put in place then Europe can win a large number of listings going forward and secure financing for SMEs.

The industry representative regretted that some of the current CMU proposals are taking the focus away from retail participation and SME financing, with much time spent on creating a consolidated tape (CT) for example. A CT can contribute to the functioning of European capital markets, but its relevance for retail investor needs or for increasing SME capital market financing is relatively limited.

A second industry representative agreed that both the retail and wholesale markets are important, but suggested that the wholesale end is most important for developing capital markets in the first place. Developing retail access to capital markets that do not benefit from the depth, scale and resilience that strong wholesale markets provide can actually undermine investor protection because shallow markets often lead to higher volatility and risks. The first issue to be addressed is securitisation. The second issue would be to fix all the enablers to the further development of cross-border capital markets in the EU that are not yet in place, such as withholding tax, corporate insolvency rules and depository passporting. The third piece would be enhancing the liquidity of EU markets in order to make them more attractive notably for pension funds. An additional objective should be to maintain the leading position that the EU has acquired on sustainable finance. Europe has indeed doubled its market share on mainstream green bonds. In 2021 53% of all green bonds issued were from Europe, and in 2022 the year-to-date figure is 40%.

The industry representative added that banks will need to bridge the gap in terms of capital provision until EU capital markets reach a sufficient scale and level of competitiveness. This would require allowing banks to redeploy capital currently committed in schemes like the Single Resolution Fund (SRF). €66 billion are tied up, going potentially to €80 billion by the end of 2023, which corresponds to a €1.5 trillion lending capacity. Putting the SRF funds at use could help to tackle the economic problems that Europe is currently facing such as the energy crisis. Focus is also needed on some Basel III measures which are too stringent for EU banks. The recalibration of the timing of some of the macroprudential measures needs to be examined, particularly on the countercyclical buffers, so that they are implemented at a time when buffers can be constituted and not when additional funding is needed for the EU economy.

A regulator stated that progress is needed both on the wholesale and retail sides of the market, which are mutually reinforcing. In addition, the different components of the financial system – i.e. banking, insurance, capital markets, pensions - should be brought together. Developing a capital market is not just looking at the potential individual contributions of instruments such as securitisation or market players such as stock exchanges, but about building the whole infrastructure that is needed to make a capital market happen. Further effort also needs to be made on supervisory convergence in order to implement regulatory measures in a consistent way on the ground across the EU and achieve consistent supervisory outcomes. This is an incremental process underway under the aegis of ESMA that involves bringing the national supervisors to focus on common priorities and identifying key issues where common action is important.

A third industry representative agreed with the suggestion that Europe should pick a few urgent battles and deliver appropriate solutions in these areas. Introducing any new complexity and restrictions should also be avoided. One topic that is particularly notable and could not be more urgent is the carbon space. Europe is in the lead, but this advantage should not be squandered and the market which is already functioning should not be disrupted, as competition from other jurisdictions on ESG is growing. The need for capital in terms of what it will take to decarbonise the economies and reduce energy imports into Europe over the period between now and 2050 stands at €10 trillion. That cannot be funded by governments and cannot be supported by the balance sheet of banks. The investment that is needed to build the necessary infrastructure will need to come through the capital market, which will require creativity. Implementing the taxonomy is important, but the market should ultimately be an investor-led market, not a compliance-led market. The industry representative cautioned against restricting the successful Emissions Trading System (ETS) and the carbon market infrastructure in Europe, in particular, as this may create unnecessary price rises for SMEs and hinder the achievement of decarbonisation goals. The digital agenda is another area where the EU has an advantage with the digital finance framework and the distributed ledger technology (DLT) pilot regime that needs building on without adding complexities and restrictions.

A fourth industry representative also agreed with the idea of stripping back the laundry list of the CMU. Nobody is against the CMU, but the challenge is getting it done because it is a complex package. There are two main essential objectives: ensuring the free flow of capital across retail and institutional markets and providing a common ground and level playing field for everyone across the EU 27. The current fragmented pockets of liquidity across member states hinder an effective flow of capital in the Union. Three key issues need highlighting in this perspective. Europe is still lacking a common pan-European framework for dividend taxation and this impacts both retail and institutional investors. There is also an absence of a depository passport for custodian banks, which means that investment funds are essentially restricted to a national deposit bank, when they should have a free choice of provider across the EU. A third area of focus should be pensions, where there are interconnections and capital flows between the retail and institutional parts of the market. A focus on pensions is important because of demographics, with the ageing population, and also because pension funds could help to deepen and broaden the capital markets, when considering examples such as the US 401(k) system. This is also important to consider in a context of high inflation which may reduce retail saving capacity. A regulator agreed with the importance of developing pension regimes via wholesale intermediaries that may provide depth in the capital markets.

A policy-maker agreed that both the retail and wholesale sides of the market are important. Pensions are an important but challenging topic, given the national prerogatives, that is being examined by the Commission. The US has a capital markets based pension system, but it is more complicated to achieve in the EU because there are 27 different pension and taxation regimes, as well as different historical traditions.

3. Further areas of focus of the CMU action plan

3.1 Securitisation

The Chair asked when the Commission would address the EU securitisation framework, which is an important driver for the development of capital markets in Europe. This is an area where regulators probably went too far in terms of restrictions and which would need reconsidering, because most of the failed securitisation tranches in 2008 were not of European origin.

A policy-maker explained that there are two aspects to consider. One is the securitisation regulation, which built a new framework for the market. The Commission has reviewed the functioning of that Regulation, noting that it has not worked as well as hoped for. The second aspect is the capital requirements side, which is the main point that was emphasised by market participants in the public consultation ran by the Commission some time ago. A mandate has been given to the three European Supervisory Authorities (ESAs) by the Commission to assess this issue. Based on their feedback, a decision will be made on how to address this matter. Before reopening the rules, it is important also to consider that there are different stakeholders in the debate and that in 2016 the European Parliament had strong views on securitisation and its role in the economy.

An industry representative stated that an acceleration of the work on the securitisation framework is necessary. EU securitisation markets are dramatically lagging behind the US, with volumes being left at less than 25% of where they were before 2008. The US market has now exceeded the levels before the 2008 crisis, and are now almost 10 times the size of the European securitisation market in terms of issuance.

Another industry representative agreed that securitisation can be an important driver for EU capital markets. What is needed is to reduce the complexity of the requirements around capital in particular, as well as other restrictions that hinder potential momentum around these instruments.

3.2 Developing retail investment

A regulator stated that greater participation of retail investors is needed. Some Nordic countries have shown that this is possible. It is expected that the upcoming proposals from the Commission regarding the Retail Investment Strategy due to be put forward in 2023 will foster progress in this area.

Answering a question from the Chair about the role of taxes, an industry representative noted that tax plays an important role in attracting retail investors. Sweden developed an investment saving account that is very successful, with more than 30% of the population holding such an account. Taxation is much lower for investments in securities through this saving account compared to direct investment. With the investment saving account there is also a simplification of tax declarations, with all tax declarations reported by the intermediary which handles the account. Beyond taxation, the existence of a proper market ecosystem is important for increasing retail participation with advisors, retail banks and brokers able to support retail investors. A further component is financial education. In Sweden, the stock exchange invests a great deal of effort in this area with an education programme. Some work is done in schools, but most of the initiatives are directed towards local banks and brokers to educate them about how to build an appropriate portfolio.

A policy-maker noted that DG TAXUD is working on tax issues related to capital markets and would put forward some proposals concerning withholding tax shortly.

3.3 Developing SME markets and simplifying listing

An industry representative explained that their company, a group of stock exchanges operating in the Nordic and Baltic regions, has a strong focus on helping SMEs get access to capital through the exchanges. Sweden has been the most successful in developing capital market financing for SMEs, with 130 companies listed last year. The stock exchange played a role, but this success is also the result of a political decision taken 10 years ago to diversify the financing of SMEs and ensure that the exchanges contribute alongside banks to the provision of capital for SMEs. The Swedish model was copied to a large extent in Finland, where the SME market is successful, but Denmark did not put the same focus on equity markets, retaining a high level of taxes for equity investment in particular. As a result, the size of the Danish SME stock market is one-third that of Sweden, and the number of new SME company listings is limiting.

A second industry representative emphasised the importance of improving the listing regime in the EU. Investors have different investment choices and companies also have choices about where to list, therefore it is essential to have adequate rules to retain these flows in Europe. In 2017, 25 European countries listed in the US rather than in their local jurisdiction. 50% of those were German, and 50% were in the healthcare sector. In the technology, media and telecom (TMT) space the situation is more favourable with more listings in Europe. The number of companies considering listing now is decreasing with the anticipation of a recessionary environment, but now is the right time to improve the market infrastructure and rules, so that when the backlog of European companies that want to go public are ready, Europe has a sufficiently attractive environment for them to list locally. That requires paying attention to the free float levels in particular, for entrepreneurs who want to retain control over their company. This could lead to a higher velocity of smaller listings, breeding healthier capital markets for the future.

A third industry representative agreed that simplifying the listing requirements and prospectuses would be relevant. On Nasdaq's First North growth market, only a short company description of around 60 pages is required for the smaller companies that want to list. Retail investors are likely to read a short and understandable document, but not the 300 page descriptions that are usually provided.

A regulator noted that it is positive that changes to the Listing Act are envisaged, because more capability is needed for companies to raise capital on the market.

Retail Investment Strategy: key priorities

1. Ongoing changes in the European retail investment market

The Chair introduced the session by stating that many changes have happened in the retail space in terms of investor profile and behaviour, types of investments offered and macro-economic conditions impacting savings. Investors need help to navigate these complexities. Addressing these issues is one of the objectives of the upcoming Retail Investment Strategy (RIS) that the European Commission is preparing as part of the Capital Markets Union (CMU) initiative.

An industry representative explained that the global economic environment has changed over the last year with increased geopolitical risks and the return of inflation, which is a significant game changer for retail investors. The sustainability agenda is also offering new opportunities and challenges for retail investors. Financial planning and defining the right savings strategy for their short-term projects and longer term pension objectives is essential in this environment. Diversification is increasingly important, with traditional savings no longer providing sufficient interest, as well as investing in real assets in order to obtain more return over the long term.

An investor representative emphasised that the key market development that retail clients are facing at present is 'financial repression'. This is materialized by the difference between the inflation rate and the nominal interest rate. Interest rates remain low although they are slowly increasing and at the same time inflation in the eurozone is above 9%. The result for retail savers is a historical level of financial repression. In 2022 it is anticipated that individual financial savers in the eurozone area will be losing more than €1 trillion on their financial savings in real terms i.e. taking inflation into account, because the majority of these savings are in interest rate related products such as bank savings, capital guaranteed life insurance and pension products that invest mainly in fixed income and money market instruments. This is not a new phenomenon, but it has considerably amplified. Even with 2% inflation, savers lose half of their savings value over 34 years, when keeping them on their bank account.

A regulator noted that positive trends in terms of retail investment are being observed in several EU member states, particularly following the Covid crisis. 85% of people in the Netherlands are indirectly exposed to the capital markets through the pension system. There has been an increase in participation in the capital markets of +11% in 2019 and +12% in 2020, mainly in the execution only channel. There is however still significant room for improvement. A recent AFM study showed that almost half of Dutch households could benefit from increased exposure to the capital markets. Retail customers could also invest in a more effective way. Only 25% of them have a specific investment goal in mind and one-third display sub optimal investment behaviour trading too frequently, which increases costs. There is also insufficient diversification in their investments on average and too many risky products in their portfolios. In addition, the majority of the increase in retail investment is through execution-only orders and 50% of new investors invest less than €25,000, which is insufficient for them to benefit from a financial advisor.

The regulator added that crypto buying is another trend in the Netherlands, with 14% of people owning cryptoassets, although half of those have invested €500 or less. 63% of people surveyed by the AFM said that investing in crypto had more to do with gambling than investing. The Markets in Crypto Assets (MiCA) regulation is welcome, although there are caveats. The current growth in cryptoassets and the global dimension of this market would require a common supervisory approach at the EU level. More generally problems that are common to member states should be handled at a European level also in the retail space.

A regulator noted that market data in Belgium shows that most of the growth observed in terms of equity investment has come from the younger generation, who are showing an interest in real economy investments. Since the beginning of the Covid crisis, there has been a fivefold increase in the number of people trading on the BEL20, the Brussels stock exchange index, compared to the pre crisis period. Young and infrequent investors were more active during the lockdown period, but they are still present and did not engage significantly in cryptoassets. The number of unique investors in the BEL20 has doubled. The volume traded on the stock exchange index also rose during the Covid crisis, with investments focusing on biotech, pharmaceutical and real estate firms. ETFs have also gained in popularity among retail investors.

2. Objectives and priorities of the Retail Investment Strategy initiative

A regulator emphasised the importance of the RIS proposal being worked on by the European Commission. It is essential to send a balanced message with this initiative and to approach the issues of retail investment and investor protection in a pragmatic way. Actions are needed to ensure that investment products and new concepts such as ESG can be understood by ordinary citizens and supervision needs to be enhanced at the EU level for cross-border investments.

A public representative observed that the issues surrounding retail investment are complex and require an effective dialogue between all stakeholders concerned to achieve a practical and usable legislation. Defining the end goal of the RIS is crucial. The RIS is part of the broader CMU project, aiming to develop and further integrate capital markets in the EU. This requires in particular a diversification of investments, with more capital market investment, and attracting a broader range of active investors to the market. It is necessary for policy makers to take the consumer perspective into account and explain why it is important for retail investors to actively participate in the market. A usual point of consensus is that capital market investment is the most effective way to enhance long term returns and guarantee an additional income for the future, notably for pension years. This is a question of long term investment and not of speculation, which should be appealing for the European market, which is more conservative than other regions in terms of savings. Pension funds can support this objective; such vehicles should be made available in all member states.

The public representative added that identifying the best way to interact with retail savers is another important issue. Digital tools can facilitate this. However, retail clients must be provided with sufficient protection and proper explanations when they use these tools, and they must have the same level of protection as when they go through an advisor. Investments going through advisory services are currently more regulated than direct investment, and digital channels rely on disclosures that are not always read or understood. An adequate balance needs to be found between the different investment channels in the level of protection provided. In some cases having personal advice is important as well, which must be kept available.

The public representative concluded that the RIS must take a holistic approach in covering the different drivers needed for fostering retail investment, including market regulations, information campaigns, financial literacy initiatives, and measures to reinforce trust such as cybersecurity. This approach must also be harmonised across all member states. In addition, a balance must be maintained in the measures proposed between the interests of financial advisors, service providers and retail investors in order to align incentives as much as possible and avoid principal-agent conflicts.

An industry representative highlighted the need to put investors at the centre of the strategy. No boost in retail investment in Europe will occur unless investors are confident and have trust in the markets they invest in. This is a common goal between the financial industry and the public authorities.

3. Key potential areas of focus for the Retail Investment Strategy

The panellists highlighted five key areas on which the RIS should focus: digitalisation; advice and inducements; disclosures; financial literacy; and product complexity and value for money.

3.1 Digitalisation

Several panellists stressed the importance of digital tools for supporting retail investment and the need for the RIS to be fit for the digital age.

An industry representative stated that digital tools provide many opportunities for interacting directly with customers on a regular basis and reinforcing their level of understanding of and confidence in financial investments. The regulatory framework must facilitate the on-going digital transformation led by financial firms with a 'digital by default' approach. This does not mean 'only digital'. Paper based information should be accessible, but only if requested by the customer.

The industry representative added that many investment products are sold through intermediaries. It is therefore important to consider how digital innovation may help intermediaries in their interactions with product providers and customers, notably for the provision of information and advice. The ability for advisors to get an immediate quote during a customer advice session thanks to digital tools is extremely valuable, because it facilitates the customer's decision making process and contributes to building trust. Digital tools may also help product providers to develop ongoing relationships with customers buying long term investment products, allowing them to easily access their accounts, track the evolution of their investments in real time and check the details of their products through their phone. This will contribute to engaging investors in a more active way than traditional annual statements and to enhancing financial literacy with a 'learning by doing' approach. These evolutions should be taken into account as a general trend in the framing of the RIS.

A regulator agreed that investor disclosure is an area where digitalisation can have a major impact. This requires eliminating the obligations to provide paper-based documents that are still embedded in some of the legislations regulating investment products. The European supervisory authorities (ESAs) are aware of this and are willing to contribute to changing the approach to customer disclosure and the way of engaging with customers. Behavioural research and consumer testing will also be helpful in this context.

More generally, technology is a potential game changer for retail investment, the regulator stated, facilitating access to different types of information, supporting transactions and allowing the industry to offer more tailored products. Digital tools can also play a role in terms of automating advice, but this can be challenging to use for long-term products such as life insurance. Open finance and its adaptation to insurance products also offers many opportunities. Digital tools may also support cross border retail investment, but this requires enhancing supervisory convergence in order to increase the trust of savers when investing cross-border. The ESAs are working on this, but the speed of convergence is sometimes slower than the speed of digitalisation and the increase in cross border business.

A second regulator concurred that there is a cross border element to digital distribution. The French AMF and the Dutch AFM published a position paper focused on execution-only transactions setting out the case for

an improvement of cross border supervision in order to tackle possible cross-border issues. Digital tools may also play a significant role in steering clients in a potential direction. This steering can be positive and facilitate investment decisions for example showing pre-determined allocations or lists of stocks or funds corresponding to an amount the investor is intending to invest, but it can also have negative consequences if it is not appropriately implemented.

A third regulator noted that the RIS has to be fit for the digital age. Technology fosters more retail participation in stock markets particularly among the younger population, due to the ubiquitous and permanent use of mobile phones in particular. Investing through a digital device is different from the traditional dialogue with an advisor, and investors do not get the same information. This needs to be taken into account in the regulatory approach. Technology is also changing the way supervision is conducted, facilitating reporting, fact finding and the extraction of granular information from databases coming e.g. from MiFID II and MiFIR reporting. Finally data supported by digital tools can also provide regulators with better market insight, allowing them to better understand and regulate the market.

3.2 Advice and inducements

An industry representative considered that savers need to be properly advised to navigate the new environment with rising inflation, geopolitical risk and sustainability objectives, but the advice gap is quite significant in some member states. It is impossible for example with execution only services or robo advisors to explain to investors, in accordance with MiFID II rules, what is to be considered as sustainable investment under the complex taxonomy of the Sustainable Finance Disclosures Regulation (SFDR).

An investor representative emphasized that fostering bias-free advice was initially put forward by the European Commission as one of the top priorities of the RIS. However, the objective has now been given a lower priority. Statistics from the French market show that classic active retail equity funds represent 93% of the market share in unit-linked life insurance contracts, whereas ETFs only represent 2% of the market, which is in line with the statistics for direct investment in funds. This is due to a selection bias by financial intermediaries, which also has an impact on performance. Over the last five years the performance of French equity funds that are included in wrappers managed by insurance companies is half that of French equity ETFs, which cost 10 times less. But since these latter products are part of the non advised universe, only a small number of literate people invest in them through online brokers. A first step would be to ban inducements on execution only transactions, because by definition there is no advice and no cost related to advice in this case.

A regulator agreed on the relevance of banning inducements. In the Netherlands the payment and receipt of inducements on advice is banned, which has been very successful. All advice that is provided is directly paid for by the clients and not by inducements remunerating the sale of products by distributors. That reduces conflicts of interest. There has been a decline in advice, however this trend already started before the ban was introduced in the NL. The main result of this ban is that the cost of financial products for investors has dropped significantly. An increase in investor trust has also been observed. It is crucial to build trust in this environment, where there is a structural information asymmetry with a better understanding of financial products among financial advisors than their customers in most cases. This requires ensuring that client interests are protected to the greatest extent possible, as well as adequate product oversight and governance requirements.

An industry representative stated that customers who want advice should be able to access it. A report published by the Commission in August 2022 on costs, disclosures, inducements and suitability shows that in the Netherlands 58% of respondents said that they would not pay for advice even if it was at an affordable price. This means that the majority of people are potentially excluded from access to advice. Some people are happy buying on an execution only basis and do not want advice. This is the case of those investing in ETFs for example, which have been a growing segment in the French market since the Covid crisis, and also of the younger population. It is important to remember what happened to research on SMEs after the implementation of MiFID II rules mandating an unbundling of research and order execution costs, which resulted in a quasi-disappearance of research on these companies. A diversity of models is needed in the market. While execution-only investment in ETFs works well for certain customers, it is important to provide investors with a varied range of options in terms of products and order execution, and also for them to have access to advice which is essential for certain types of products, for example those that offer a guarantee in terms of capital or that have a long term perspective. Cost is not the main factor in investment decisions. The first consideration is risk, the second is return, and cost is the third.

The industry speaker suggested that a preferable option would be to streamline and simplify disclosures requirements or improve suitability tests for instance. The enhanced suitability test as proposed by the Commission, is an interesting way to explore, with the replacement of the current product suitability approach by an approach at the portfolio level. Under the current MiFID product-focused suitability test regime, as soon as investors are considered to be averse to risk, then firms cannot sell financial products with a SRRI (Synthetic Risk and Reward Indicator) ranked above 5 or 6 for example, so they cannot sell equity based products to them. Evaluating suitability at portfolio level would be a better way to ensure that, even if they are risk averse, people can still have a limited percentage of their investments e.g. 10% or 15% in equity, which would provide them with a better level for diversification. The practical implications however need considering. In addition, the Personalised Asset Allocation Strategy (PAAs) along with the idea that these allocations could be portable from one provider to another are more concerning options as they raise a number of questions,

notably with respect to both the financing of this process by firms and the responsibility to keep the assessment always up to date.

3.3 Disclosures

A regulator considered that addressing information overload should be a key priority of the RIS because it does not improve investor protection. Lengthy prospectuses are unhelpful from an investor perspective because they dilute the useful information. There is a need to streamline the different disclosure requirements and adapt them to investor needs. Product information and communication, including publicity should also be appropriately supervised. For example, in the case of cryptoassets, advertising is the main source of information for investors. The Spanish National Securities Market Commission (CNMV) has extended supervision to publicity relating to cryptoassets, an approach which is now being implemented in other member states. Another proposal that has been made by ESMA is to use 'layering' techniques to provide relevant information step by step to investors in a more user-friendly way.

An industry representative agreed that investors should be provided with more meaningful information built with an investor-centric perspective. There is currently too much information which is too complex. A new layer is being added with the MiFID sustainability requirements, which might discourage investors from investing in this area.

Another industry representative also emphasised that customer information must be tailored to customer needs in order to empower them to make informed financial decisions. 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 between Solvency II and the Insurance Distribution Directive (IDD) is an important first step also. There are different formats for the same information, which not only adds unnecessary costs, but may also lead to confusion. This issue should be addressed in the RIS proposals. Regarding the Key Information Document (KID), customers could be further empowered by giving more prominence to essential information such as the existence or lack of insurance cover, payment flexibility and other benefits concerning insurance-based products.

An investor representative stated that digitalising key disclosures is an important priority because the younger generations particularly, conduct most of their financial activities on smartphones and need to be able to easily access information on products on their phones and compare them. In Norway there is an independent public finance portal which compiles the data of all available financial products, which in turn are used by commercial web comparing apps. A second important aspect concerns the data that needs to be provided. In order for retail investors to be able to compare products easily, information on the actual cost and performance of products should be included alongside the provider's benchmarks in the key information document (KID). This must be factual and comparable information based on historical performance, and not putative future projections such as those that can be found in the current packaged retail investment and insurance products (PRIIPS) KID, which is a significant regression from the original KIID[1].

3.4 Financial literacy and education

A public representative stressed that enhancing financial literacy is a key objective for ensuring a widespread participation of retail customers in the capital markets and is an important driver for the RIS. It should be everyone's responsibility - i.e. regulators, member states, national education systems, advisors or the financial sector - that a basic level of financial literacy should be guaranteed in Europe. Educating and informing customers cannot be the sole responsibility of the financial advisors, because this may lead to quite a selective and biased approach. It does not seem appropriate either to leave it to regulators alone because they do not have direct interactions with consumers.

An industry representative agreed that increasing financial literacy is essential. One approach to this is 'learning by doing'. Employee share ownership schemes and workplace schemes, which allow employees to invest a part of their revenue in the shares of the company in which they work or in products proposed by their employer can contribute to this objective.

A regulator observed that enhancing the financial literacy of retail investors is particularly important with regard to climate change and ESG objectives in order to help customers make better decisions concerning how to finance the climate transition and avoid greenwashing. There is much demand for this on the investor side but it is quite a technical area. A challenging aspect with regard to financial literacy is that the legal capacity of the Commission relating to financial education is very limited, so there is a need to enshrine the task of consumer education in the mission statements of the National Competent Authorities (NCAs) and the ESAs. This has been done in Belgium where a fully digital financial education centre was set up by the FSMA and opened during the Covid crisis. This centre is very successful with over 10,000 students having visited it, which shows that there is a need and a demand for such initiatives.

3.5 Product complexity and value for money

A regulator noted that providing products that can be understood by ordinary citizens is essential. This also applies to ESG products which must be easy to understand and have a clear objective of avoiding greenwashing.

1. KIID: key investor information document previously required for UCITS funds.

A regulator stated that for many small retail savers life insurance or pension products where they invest for 20 or 30 years is the only contact they get with capital markets. However, these products often do not offer much guarantee, because there is a possibility to escape from the capital guarantee in most cases. Adequate conduct of business is therefore essential for retail investors, including conduct supervision.

An investor representative noted that a report published in August 2022 by the Commission on costs, disclosures, inducements and suitability shows that products with inducements cost 35% more on average than products without inducements. This is not only a question of cost, but also of performance. The Commission has recently been considering the possibility of enhancing value for money rules, which seems relevant, but is only a proxy measure to the tackling of biased advice, which should remain the priority. There are already value for money rules in EU regulations such as the UCITS and AIFMD directives for investment funds, whereby providers are prohibited from charging undue costs, but they do not yet apply to other product categories. In addition, these rules are not properly enforced by the NCAs, as indicated by ESMA in its recent Common Supervisory Action report. A first step proposed by the Commission is to make sure these existing rules are enforced.

Asset management trends and regulatory evolutions

1. Current state of the EU asset management market

1.1 Status of the single market for investment funds and overall market evolution

An official stated that an audit on the European investment funds market recently performed by the European Court of Auditors (ECA)[1] concluded that there is so far no true single market for investment funds likely to benefit all European citizens. Three important aspects were highlighted in this report. The first is that cross-border asset management activities and the cross-border distribution of funds remain limited within the EU. The domiciles of the funds are concentrated in four main countries, with the largest domiciles in terms of assets under management (AuM) being Luxembourg, Ireland, Germany, and France. This allows a concentration of expertise, but at the same time means that large parts of the EU are not active in the fund sector, since the cross-border distribution of funds is limited. The barriers created by different interpretations of European legislations and different domestic investor protection and taxation rules hinder the functioning of the UCITS and AIFMD passporting regimes. In some cases investor protection rules also excessively restrict access to investment fund products. In Lithuania for example there are fewer than 200 UCITS funds which can be invested in on the local market, out of 64,000 UCITS funds domiciled in the EU. The ECA recommended that the European Commission should undertake fitness checks of the gaps in terms of cross-border fund management and distribution, and propose incentives for the further development of cross-border fund activities.

Secondly, the ECA audit found that for the supervision of the fund market, ESMA sometimes relies too much on the goodwill of the national competent authorities (NCAs) and that supervisory convergence still needs improving, although progress is being made. This is mainly an organisational matter of ensuring a full scale application of existing convergence processes and tools. A third aspect highlighted by the ECA report concerned retail investment and investor protection. The audit found that the existing level of protection is generally satisfactory in Europe, but two areas need improving. The first area is inducements, for which rules vary significantly across the EU, ranging from a ban in certain member states to a fairly wide acceptance in some others. The second area is information. This includes regulatory reporting that is not sufficiently granular, particularly for alternative investment funds (AIFs) and not sufficiently harmonised, which hinders risk assessment and macroprudential supervision. Moreover investor disclosures are not sufficiently comparable and are not adapted to digital devices. A single point of access, such as the one proposed for corporate information in the European Single Access Point (ESAP) project would also be useful for information regarding investment funds.

A second official noted that the asset management sector is significantly contributing to economic growth in the EU and supporting new evolutions such as ESG. The resilience of the sector was also demonstrated during the recent Covid crisis. The market is particularly concentrated in Luxembourg and Ireland, but it is also the materialisation of major centres of expertise in Europe. The single market needs continuous monitoring and deepening to ensure that all parts of the Union are appropriately covered. That is one of the main objectives of the Capital Markets Union (CMU) and the different projects that are part of it.

The official observed that the discussion about inducements is challenging and is being addressed by the European Commission in the context of the work on the Retail Investment Strategy (RIS). Further improving and harmonising reporting and the information provided on funds is also essential. Progress on this can be expected with the AIFMD and UCITS review proposals, which have recently been agreed. EU institutions need to move fast on the adoption of those proposals. When assessing supervision and the possible need for providing ESMA with more powers, it is necessary to take into account the ongoing actions in this area. A review of the European Supervisory Authorities' (ESA) operations has taken place providing the ESAs with additional powers, some of them only now coming into operation, such as peer reviews. These new powers and tools should first be fully implemented before adding more.

An industry representative observed that since the beginning of the pandemic there have been many changes in the market environment that have impacted the fund industry and capital market dynamics, including stresses on supply chains, the invasion of Ukraine and a significant rise in inflation. Central banks are forced to react to current inflation levels, increasing interest rates and tightening monetary policy. This is impacting fixed income markets, as well as the economic outlook of firms with expectations of reduced earnings, resulting in a negative trend in risk asset classes in general. In terms of asset classes year to date, asset managers saw inflows into equity and multi-asset products, and redemptions mainly in the money market and fixed-income markets. This is on the whole a positive evolution so far that contrasts with what was observed in past crises.

1. https://www.eca.europa.eu/Lists/ECADocuments/SR22_04/SR_SM-for-Invest-Funds_EN.pdf

Increasing the international distribution of EU domiciled funds is a key objective, the industry speaker added. Their company, a major asset management firm based in Luxembourg, manages approximately €420 billion assets for various types of investors. Close to 40% of these assets come from non-European investors, notably from Asia and Latin America, showing the global success of the UCITS and AIFMD frameworks and the importance of the rules embedded in these legislations such as those on delegation.

1.2 Development of sustainable finance

An industry representative observed that sustainable investing is a major trend, with inflows into sustainable products increasing across all European markets and management companies. Significant additional capex investments will be required in order to achieve net zero targets by 2050 and support the required structural change of economies. The asset management industry is extremely well positioned to support that evolution, and has an opportunity to play a key role in the transition to a more sustainable economy, channelling investments through UCITS and AIF funds.

An official agreed that there is an increased demand for ESG products, triggered in particular by concerns about climate change. Regulation is instrumental to sustainable finance but it comes with challenges, such as completeness, timeliness and ESG data availability and reliability. The Sustainable Finance Disclosure Regulation (SFDR) is very recent but needs tweaking on some key aspects, such as the definition of investment thresholds when disclosing under Articles 8 and 9 of SFDR. The regulation currently does not provide a definition of the thresholds used, which means that different rules may be applied in different member states to address the same issue, with some member states having implemented their own rules. This may undermine investor protection and the fight against greenwashing, and hinder supervisory convergence. In terms of timeliness, the SFDR regulatory technical standards (RTS) that were adopted in July 2022 are due to enter into force on 1 January 2023, which gives little time to all stakeholders to adapt to a very complex package. Supervisors realise the magnitude and the difficulty of the task, but they need to make sure that the supervised entities are complying with the sustainability rules applicable to them, as well as avoiding greenwashing and mis-selling practices, which may be challenging in such a timing. Finally, ESG data is currently scarce. The reliability of the data still needs to be worked on, but regulatory initiatives like the Corporate Sustainability Reporting Directive (CSRD) and market practice should contribute to improving data availability.

An official stated that regulation and supervision of ESG ratings is currently non-existent. This is a gap that needs filling, because retail investors are not aware of the limited value the ESG ratings used by the green funds in which they are investing. This should be tackled in order to ensure the trust of investors and support the development of the industry.

1.3 Digitalisation and technology use in the asset management sector

An industry representative noted that digitalisation and information and communications technology (ICT) are having a significant impact on the asset management industry and their different activities. The potential of distributed ledger technology (DLT) in particular is being assessed by the industry. DLT may provide significant benefits in the asset management sector in two main ways. First, DLT may help to reduce transaction costs and increase efficiency notably in the post-trading space. Their company, a major asset manager, carried out experiments in 2021 with the European Investment Bank (EIB) and the Banque de France that were quite encouraging, aiming to test bond issuance on the blockchain. Secondly, DLT may facilitate the distribution of fund units and reduce distribution costs for fund managers. Cryptoassets are also progressing as an asset class, despite recent issues with some stablecoins and lending platforms. Some asset managers have started investing in this market on behalf of their clients but many are still refraining to do so, given the fiduciary duty, which requires that they invest client money with care, including for non-retail clients. There is active monitoring of developments in this area.

Asset managers are developing internal expertise in terms of digitalisation but they are also outsourcing a significant and growing part of their ICT activities, the industry representative stressed, which may give rise to new challenges, as digitalisation expands further in the sector. Imposing due diligence on tech providers for outsourced activities that the asset managers have to take responsibility for can be challenging. Additionally, there has been a permanent increase in the cost of third-party providers of ICT services and data. The terms of contracts with those providers are not always as balanced as they should be between the parties, and in many cases large providers are able to impose their terms of contract, including with large asset managers. In terms of regulation, the digital policies being developed by the Commission provide an appropriate framework for supporting on-going digitalisation efforts and addressing related challenges. The DLT pilot regime will facilitate the testing of DLT-based activities and DORA will allow critical third-party providers to be brought into the scope of oversight and will provide a common EU framework for ICT risk management in the financial sector.

2. Ongoing policy initiatives impacting the EU asset management sector

The panellists commented on proposals of the Capital Markets Union (CMU) initiative relevant for the asset management sector i.e. the reviews of the ELTIF, AIFMD and UCITS frameworks, the project to implement a European single access point for financial and non-financial corporate information (ESAP) and the Retail Investment Strategy, aiming to increase retail participation in the capital markets.

2.1 ELTIF review

An official was hopeful that the review of the ELTIF framework would foster the development of the ELTIF market, which has not been a success so far.

An industry representative emphasized the importance of the review of the ELTIF regime for supporting economic growth and developing the overall investment ecosystem in the EU. Europe needs a vehicle for long-term investing in order to increase investments, notably in renewable energy, which requires deep structural changes across the entire economy. Having a product in the AIF space such as the ELTIF that can build on the success of the UCITS regime and can potentially attract more retail investors and also international investors is a great opportunity for the European economy. ELTIFs can provide investors with higher returns, capturing the illiquidity premia offered by long term investments. However, appropriately managing illiquidity risk and educating customers about potential risks will be essential for the success of ELTIFs. It is also important to allow a broad enough diversification of investment in the shaping of ELTIF products, due to the size of many illiquid assets.

Another industry representative welcomed the proposals made in the context of the ELTIF review. The Council and the Parliament still need to agree on some final details but their positions are close now. The main remaining issue within the ELTIF framework relates to taxation across member states. While it is understandable that each member state wants to keep its own tax revenue, minimum tax transparency principles are needed to foster cross-border investment, which is necessary for achieving a sufficient level of diversification of the assets that ELTIFs invest in. Among these assets, there are real assets such as real estate, for which taxation differs across member states. Member states must agree on solutions to improve tax neutrality across European jurisdictions in order to avoid double taxation.

2.2 AIFMD and UCITS reviews

Several panellists welcomed the fact that the AIFMD review was targeted at specific issues. The AIFMD review also involves a review of UCITS regarding common provisions. An official noted that the fact that the AIFMD review is focused is a recognition that the regime has worked well so far, contributing to investor protection and safeguarding financial stability. An official agreed that AIFMD is a success, together with UCITS, which has become a very significant and global brand. There is no need for a fundamental review of these frameworks. The AIFMD and UCITS reviews aim to foster a further development of capital markets in the EU in the context of the CMU, but the attractiveness of Europe for capital coming from other regions must also be considered.

Specific issues were highlighted by the panellists regarding delegation arrangements, reporting, liquidity management tools and competitiveness. An official noted that the process to transpose AIFMD into national law had taken eight years. It is hoped that the recommendations of the AIFMD review will be implemented faster. Generally, regulations should be preferred to directives to ensure consistent implementation.

2.2.1 Delegation arrangements

An industry representative stated that the current delegation framework works extremely well and is widely accepted. Any significant changes may threaten the functioning of the EU fund market. An official agreed that current delegation arrangements should not be unpicked, because that is part of the huge success of the EU fund frameworks.

A regulator observed that some selective changes have been proposed to delegation rules in the AIFMD review, notably aiming to increase transparency. The Commission proposal takes due account that delegation of activities is currently an inherent and key future of the EU asset management industry. It has led to an ultimately positive outcome for investors, with a high degree of specialisation and the development of competence centres inside and outside the EU. A strong regulatory framework in this area with initial and ongoing due diligence in place is needed, as well as a well-functioning oversight framework. In 2018 the CSSF issued specific guidance to the asset management industry in Luxembourg laying out expectations regarding delegation, which covers not only portfolio management but also other functions like the distribution network. These guidelines provide a framework that allows market players to anticipate regulatory expectations, as well as the associated cost.

2.2.2 Reporting

An industry representative was concerned that the review of the common provisions of AIFMD and UCITS would require elaborating additional reporting for UCITS funds and harmonizing it at EU level. In Europe there are currently 33,000 individual UCITS funds on which reporting may potentially be needed. Since 2014, following a requirement put forward by the ECB, fund managers already have to regularly report in a number of EU countries the inventory of each of their UCITS funds to the central banks where these funds are domiciled, identifying each security held, as well as the liabilities of each fund, as far as the information is available. Central banks should agree with securities regulators in the member states concerned to pass on the information already provided by fund managers on the assets and liabilities of each fund in order to avoid significant duplication. A further issue in terms of reporting is the proposal that has been made in the European Parliament's report on the MiFID review to extend MiFID transaction reporting to each UCITS and AIF. This would mean that fund managers would have to report transactions executed by each fund under MiFID, in the same way as brokers. That addition would be excessive, the industry representative felt.

The Chair agreed with the need to avoid duplication, but observed that statistical reporting that was designed 10 years ago for central banks might not serve the objectives of the regulatory reporting envisioned in the UCITS review, which aims to enhance risk supervision. Hence, a new, regular, detailed and supervision-oriented reporting regime seems inevitable.

2.2.3 Liquidity management tools (LMT)

A regulator stated that Luxembourg currently has a very strong liquidity risk-management regulatory framework

in place, and Luxembourg domiciled funds probably have access to the largest range of LMTs in Europe. An assessment of LMTs that has just been published by the CSSF in collaboration with the Bank for International Settlements (BIS) based on supervisory data and experience with the use of these tools, concludes that LMTs are essential for ensuring investor protection and safeguarding financial stability. The importance of having a proper and robust liquidity risk-management framework in place was demonstrated again during the recent market turbulence.

Implementing a liquidity-management framework at EU level and providing access to LMTs is an important addition of the AIFMD review, the regulator observed and will help cement investor protection, but it is important to be mindful of several elements. In order to deliver on the objectives of such measures, the responsibility for the choice and activation of LMTs should clearly remain with fund managers. Fund managers should continue to manage liquidity appropriately, even if LMTs are more widely available. These are important aspects of the framework, which also appear in the IOSCO recommendations on liquidity-risk management. The use of LMTs by fund managers will vary, especially during crisis periods. Supervisors need to provide fund managers with sufficient flexibility so that they can have recourse to the most relevant LMTs at a given point in time.

An official agreed with the importance of LMTs for avoiding liquidity mismatches and the need to harmonise them across the euro area. LMTs are currently missing in a number of member states and are not always well understood. The essential point is that the decisions regarding LMTs remain with the fund managers, who are the experts in this regard, and not with the supervisors.

2.2.4. Competitiveness

An industry representative noted the importance of considering the impacts of the ongoing regulatory reviews on the competitiveness of EU asset managers, in order to allow the European asset management industry to develop. A competitiveness test could be introduced requiring an assessment of the impact on competitiveness of every new regulation within one or two years of its introduction. Significant impacts should lead to reconsidering the regulation. Such a test already exists for SMEs in the EU in certain areas of regulation. In the UK there is also the intention to provide regulators with a roadmap aiming to preserve not only the interests of investors, but also the competitiveness of the industry. It is important that the EU asset management industry is able to sell funds to investors outside Europe, which requires making sure that EU champions remain sufficiently competitive.

The Chair agreed that regulations should preserve the competitiveness of the sector. The challenge is granting a competitiveness mandate to a supervisor that at the same time provides authorisations or may issue a fine.

An official stated that the need for competitiveness is recognised by policy-makers, as well as the need to evaluate the impacts of regulations on costs. An adequate balance however needs to be found between competitiveness and investor protection.

2.3 The European Single Access Point (ESAP) initiative

An industry representative noted that data is at the heart of developments in terms of ESG and also supports digitalisation. The EFRAG (European Financial Reporting Advisory Group) work on EU sustainability reporting standards is moving in the right direction, and cooperation with the ISSB (International Sustainability Standards Board) and the US SEC (Securities and Exchange Commission) will allow the implementation of standards that are more easily usable by asset managers and that will provide more reliable data. Cost of data has significantly grown over the last 10 years. This significantly impacts the costs and competitiveness of asset managers at a time when the need for financial and non-financial data is increasing in the industry. Asset managers are price takers in the data market and are dependent on a limited number of powerful non-EU data-providers who control the market and keep prices high. There is hope that the ESAP initiative will facilitate access to good quality financial and non-financial data provided in a comparable way by companies. This could also be an opportunity for new data providers to enter the market, which would improve both competition and prices.

An official agreed that the creation of the ESAP is essential. An additional proposal would be to have a European Single Investor Portal (ESIP) providing access to information about management companies and investment funds for investors all over Europe, including in regions such as Central Eastern Europe, where capital markets need to be further developed.

Listing Act and DEBRA: prospects and priorities for SME equity markets

1. Equity financing trends and drivers

1.1 The equity funding gap and related trends and challenges

The Chair introduced the session by emphasizing the limited size of EU capital markets and the risk averseness of investors compared to other regions. This may result in a lack of availability of financing for European companies, particularly for small and medium-sized enterprises (SMEs) potentially impeding innovation and more broadly economic growth.

An IFI representative noted that reports produced during the pandemic by the International Monetary Fund (IMF) and the Association for Financial Markets in Europe (AFME) concluded that there is an equity gap in Europe of €300-600 billion, which is very significant. This concerns corporates of all sizes. It is unlikely that these figures will have changed very much, because most companies increased their level of indebtedness during the pandemic. The need for equity is very significant, particularly for financing the digital and green transitions. In addition, firms need a strong capital base to obtain additional financing. The current changes in the macroeconomic environment, with rising interest rates and inflation, will further affect company economics in the near future.

An industry speaker stressed that, with reindustrialisation and sovereignty objectives following the Covid crisis, financing needs are expected to increase. The higher interest rates will also increase funding costs, which will further widen the funding gap. Non investment grade private companies in particular that finance themselves on the bond markets will face a much higher financing cost. Over the last 5 years, financing costs in the high-yield market decreased significantly, reaching 3%, while the average rate 20 years ago was around 9%.

A policy-maker observed that the restructuring of supply chains towards Europe with current geopolitical developments should lead to European SMEs playing a larger role, with related financing needs. The green and digital transformations also play an important role in this discussion, because they can only be funded with equity or, more broadly, with risk financing, including hybrid equity.

An investor representative emphasized that the funding of SMEs needs to be enhanced because those are the companies that can make the difference in the future in terms of growth, innovation and sustainability. Attracting retail investors to SMEs is essential, because research demonstrates that it is the retail investors who drive the market and set the prices in the market. Large institutional investors mainly use index replicating techniques, rather than stock picking and invest with a great deal of conservatism and heard behaviour. Therefore a combination of retail investors and SME issuers is vital for innovation. In addition, equity investments providing higher returns in the longer term are necessary to help retail investors prepare for their retirement.

An industry representative observed that the demand for equity among retail investors has significantly decreased in France since the beginning of 2022, when considering the volumes handled by retail e-brokers. Many retail clients who were quite active during Covid are leaving the market. Market volumes are quite low at present, leading to high volatility. The current situation in the debt market is also challenging, with rates and spreads increasing, but this is not a retail market.

An official stressed the importance of taxation for the growth of equity markets. In Estonia, for example, the equity gap is not that big in aggregate. That is due to a taxation system that fosters the provision of equity to SMEs by not taxing profits before dividends are paid out. The levels of capital raising by SMEs in public and semi-public markets in Estonia in recent years and particularly in 2021 are encouraging. Causality is difficult to identify however. Factors may include the macro environment and the increased maturity of the market.

1.2 Current IPO and listing trends

The Chair noted that there is a widespread general decrease in public listings in many regions of the world, Asia being a notable exception, with more than 30,000 listed companies having delisted globally since 2005. Concerning Europe, a recent article in the Financial Times reported that, for the first time, there are more initial public offerings (IPOs) and equity financing deals of Chinese companies in Europe than in the US, but these deals happened mainly in London and Switzerland.

An industry representative added that there have been fewer IPOs in the EU in 2022 due to the current macroeconomic environment and mounting geopolitical risks. It is expected that there will be 20 to 30% fewer SME IPOs in 2022 compared to 2021. The decrease will likely be more significant for larger corporate IPOs, which need the support of global markets that are more impacted by macroeconomic and geopolitical risks. SMEs are more local and local investors focus more on the situation of the individual companies.

An industry representative stated that their bank, a major European bank, is very active in IPOs, for large companies and SMEs, in France, Belgium and Italy. A strong correlation has been observed between market volatility and the number of IPOs over the last 20 years. When market volatility is above 25%, the IPO market generally disappears. Another issue that has to be taken

into account in the context of the EU Listing Act, is the significant level of competition in the listing market. The UK is reviewing its regulations to increase its competitiveness after Brexit, for example introducing shares with multiple levels of voting rights. In the UK market alone, €125 billion have been raised in the last 10 years, corresponding to around half of the total achieved in the EU and the depth of the UK market is increasing. Nasdaq in the US is also an important competitor for listings in the tech, biotech and health sectors. Advancing quickly on the Listing Act in order to enhance the competitiveness of the EU listing market is in the interest of EU sovereignty.

An IFI representative mentioned that the tech sector, which has grown extremely fast in recent years, is experiencing value adjustments which will affect the IPO market. This first happened in the US and is now coming to Europe. A further issue to consider is that 75% of fast-growing scale-ups in the EU are refinanced by US investment funds, with most going on to file for IPOs on the US Nasdaq at a later stage. Some initiatives have been launched to address this issue such as the Scale-up Europe programme that was agreed under the French EU Presidency.

An industry representative observed that a similar issue within the EU hinders the development of local SME markets. The larger companies with deals exceeding €300 million usually list in London or one of the main EU financial centre with the support of global banks, which takes resources out of the local EU markets and limits the development of local market ecosystems.

2. Obstacles to listing for SMEs in the EU and potential areas of progress

Several panellists highlighted the challenges that SMEs face when going public.

An industry representative observed that, while listing fees are lower for SME IPOs, the costs of legal advice and intermediaries are proportionately very high. In addition, cross-border IPOs are difficult to implement for local SMEs, because prospectuses and documentation have to be drafted in English and the cross-border execution of order can be challenging. Some other issues include the Market Abuse Regulation (MAR), which should be simplified to make compliance easier for smaller issuers and brokers. A common definition of SMEs is also needed at the EU level.

An official agreed that the costs of intermediation and the ecosystem are relevant when considering measures to support further listing. In Estonia, the increase in market activity coincided with a decrease in legal advisory fees, partly due to regulation and also to an improved maturity of the legal advisory market.

Another industry representative emphasised the obstacles related to the fragmentation of the EU securities market. Specifications for equity markets differ from country to country, increasing complexity. For example, payment for order flow is allowed in Germany but not in France. Cross-border post-trading is also very inefficient in Europe and increases transaction costs. As a result, clients prefer to buy US shares on Nasdaq or NYSE. Further issues are the lack of research on SME stocks and the fact that the development of index products is reducing the transparency of equity markets in general.

An IFI representative noted that governance issues also hinder equity financing for SMEs. 60% of SMEs are family companies. Many SME managers are not in favour of equity financing, particularly from external shareholders, because of the dilution of capital controls it entails.

An investor representative agreed that while there are obstacles to the development of SME equity markets on the supply and demand sides, the supply side presents more structural challenges, because of the unwillingness of many SME owners to share control. Also, listing is complex and costly for SMEs. On the demand side the availability of capital is not a major problem in Europe, because there is a high level of savings and an interest in investing in SMEs. The problem mainly relates to information asymmetry with insufficient analysis and research on the smaller companies and risk averseness.

The industry representative emphasized that the availability of research on SMEs is an issue that needs to be tackled by the Commission. Building trust in the market is also essential. Investors, especially retail investors, are concerned about the possibility for SMEs to be taken over or bought out, which is quite frequent and may have major impacts.

3. Objectives of the upcoming Listing Act and priorities for supporting SME listing

The Chair noted that there is no 'silver bullet' for improving SME equity financing and listing. The Listing Act needs to explore a range of actions.

An industry representative emphasized the importance of an ambitious Listing Act for achieving the objectives of the Capital Markets Union (CMU). The Listing Act should however not result in lowering the disclosure standards of the market, in order to maintain investor trust. The diversity of local interpretations of regulation and of market practices needs to be reduced in order to facilitate and simplify listing on equity markets in the EU. The EU market also 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. The retail distribution channels also need to become more efficient, and pension and insurance holdings by individuals should be encouraged. In addition, specialized investment funds investing in SMEs should be developed. If there were some incentives to direct asset manager funds towards SMEs, asset managers would have more scale to invest in this segment. The

industry speaker added that evolving towards one common insolvency law in Europe is also essential for the CMU. In addition, while equity is discussed a great deal, the debt capital market is also very important in this regard.

A second industry representative stated that strong support is needed to improve the functioning of SME markets. Government support is the most effective but it is dependent on the level of political commitment to the development of capital markets. The Swedish SME market was very successfully developed with the creation of a retail saving account and effective tax cuts. But the measures taken in Denmark by the public authorities were less ambitious e.g. with less tax incentives and as a result the SME market did not develop in the same way. Stock exchanges can also support SME markets. The profitability of SME markets is usually limited, but stock exchanges cross-subsidise them with other revenue coming e.g. from data services, because SME listing represents a long-term growth potential for the exchanges. That is why it is vital to preserve and strengthen local stock exchanges and ecosystems. The consolidated tape project of the MiFIR review proposal is a challenge in this regard because it may take revenues away from the exchanges that could be used for supporting SME markets.

A regulator suggested three main areas on which the proposals of the Listing Act could focus for developing SME listing.

A first area is providing investors with appropriate information in a way that does not put an unnecessary burden on issuers. Prospectuses are a first issue. They have been reviewed several times and alleviations have been introduced. The latest changes date from 2021, when a short recovery prospectus was created, but it has not been a success with only 19 issuers having used this format. Further areas of improvement were identified in an ESMA peer review of the way that prospectuses are handled by national competent authorities (NCAs). In the French SME growth market for example, prospectuses are not mandatory for IPOs below €8 million. While eliminating prospectuses in this market seems difficult, it should be up to the stock exchange to define what kind of information memorandum is needed. However, some exchanges are reluctant to take on this responsibility. Equity research on SMEs is a second issue. Its availability has been diminishing in Europe, in part due to MiFID requirements to unbundle research and trading costs, but the problem is also that stock exchanges and brokers do not earn enough money when they organise SME listings. Broker equity research has been increasingly replaced by issuer-sponsored equity research, which creates potential conflicts of interest, but is the only viable solution at present. This kind of research is classified under the MiFID regulation as marketing documentation. Conflicts of interest should be more prominently disclosed and rules should also be proposed to ensure the independence of equity analysts drafting this research. For example, a code of conduct was established in France, which could be used as a basis for defining standards at EU level. The proportionality of disclosure requirements is a third issue. At present, disclosure requirements apply only to listed entities, but some disclosures, for instance those relating to non financial reporting, should apply according to activity and size criteria rather than the listing of the entity. Listing should not automatically lead to additional disclosure.

A second area that needs considering in the Listing Act concerns voting rights. Founders often want to retain decision-making power, especially for innovative companies. It should be possible to provide a multiple voting structure for shares in every European country, as is the case at present in the UK and certain EU member states. Finally, market abuse rules, which have been debated in Europe for many years need adjusting, the regulator believed. The same definition of inside information applies to users of this information and to companies providing it, which is not always the case in other jurisdictions. Another definition could be useful for companies, leading to a more restrictive distribution of confidential information.

An investor representative suggested that solutions to make SME markets more attractive should mostly concentrate on the investor side. Issuer focused solutions to reduce the administrative burden associated with listing, such as lowering regulatory requirements will have limited impact, because the main obstacle to listing is in most cases the fact that owners want to remain in control of their company and do not want significant changes in terms of governance. The investor representative was moreover opposed to rules allowing multiple voting rights because a balance must be struck between former and new owners of companies and the 'one share, one vote' principle must be maintained.

The measures for developing SME listing must therefore consider the interests of investors, the investor representative stated. In addition they should foster a combination of institutional investors who can perform a detailed assessment of companies and of a wide group of retail investors. The aim is eventually to achieve a more effective capital allocation in Europe and to diversify the funding of European firms. This requires making the SME market more attractive for retail investors in particular, developing a real equity culture and also providing an adequate framework for individual savers to invest. There are a number of obstacles to overcome. Most retail investors prefer investing in larger companies which seems safer and is less costly or in investment funds, which offer more diversification. A business case for getting SMEs into ETFs, which are a less costly vehicle for investing in equity markets, could help to stimulate the market. Building investor trust is important as well. If companies are not properly managed or fail to prevent fraud, investors need to be able to seek redress. Currently, in Europe, it is only possible to do that at national level. A pan-European collective system of redress is needed.

A third industry representative suggested that improving the cost and efficiency of SME markets, in particular at the post-trading level, is essential, possibly with a consolidation of the EU post-trade infrastructure and the use of more blockchain technology. This however is in the field of private initiative. Enhancing the transparency of SME markets is also important,

which requires moving towards common specifications for SME markets across the EU.

The Chair summarised that there are issues on the supply and demand sides, but SMEs can be an important asset class, even for retail investors, for both equity and debt. This must be taken into account in the Listing Act and also in other initiatives to support the funding of SMEs.

4. The DEBRA proposal and expected impact on the debt-equity bias

A policy-maker noted that taxation also plays a role in the development of equity markets. The current debt-equity bias in terms of taxation makes debt financing more attractive for companies, since interest expenses are tax deductible. The debt-equity bias i.e. the difference between the cost of capital for debt and equity, is high in the EU, at an average of 1.8 percentage points in 2021, with a range of 0.1 to 3.1 across member states[1].

Companies should be able to make the trade-off between debt and equity funding without tax rules influencing those business decisions. This would provide a better basis for businesses to take on the risky investments that are needed for the green and digital transitions in the coming decade. Six member states have already taken action to address this issue: Italy, Belgium, Cyprus, Malta, Poland and Hungary. While the measures differ in policy design, all provide for tax allowance on equity. These actions prompted the European Commission to develop a common approach. The Debt-Equity Bias Reduction Allowance (DEBRA) proposal seeks to rebalance the costs of debt and equity financing in order to achieve higher equitisation levels and discourage excessive debt accumulation, while 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 to a period of 10 years[2].

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 as well. 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 will apply to all non-financial companies, as the financial sector is already subject to regulatory requirements that prevent under equitisation. Discussions on the DEBRA proposal have just begun, the policy-maker concluded. EU Member States are supportive of the objectives of the initiative. The main challenges to overcome are the relative complexity of the measures and the difficulty of getting DEBRA to the top of the political agenda in the current environment.

An investor representative welcomed the proposal to address the current fiscal bias, which perpetuates overreliance on bank funding and upholds leverage. Transitory provisions should however be considered to ensure that the time to market of DEBRA does not have unintended consequences, i.e. incentivize companies to delay expansion of their equity, in anticipation of the entry into force of DEBRA. This would be contrary to policy objectives. The policy-maker confirmed that there will be grandfathering for all equities.

A regulator agreed that addressing taxation issues is essential for the development of capital markets. Care must however be taken with these measures not to provide bad incentives for equity listings, because otherwise it is private equity investors who will benefit from these measures, rather than the general public. An industry representative added that while the objectives of DEBRA are relevant, there should be caution about attracting vehicles to listing solely for fiscal benefits, bearing in mind the negative example of certain special purpose acquisition companies (SPACs[3]).

An official commented that, although DEBRA looks like 'low hanging fruit' from a distance, from closer it is clear that a complex construction is needed to address the debt-equity bias. Whether this is worth it is not yet certain. If DEBRA was confirmed implementing it as a regulation would be necessary, in order to achieve sufficient consistency. The policy-maker mentioned that the specificities of certain tax systems, such as the one in Estonia will be addressed at Level 2.

An official concluded that DEBRA addresses a structural issue in the market and it is the right time to solve it. The proposal must be appropriately calibrated, given ongoing developments at the macro level.

1. 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.

2. Under DEBRA, a notional interest rate allowance would be granted on new equity for a period of 10 years, 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 to 1.5% for SMEs. This top-up in the risk premium approximates the difference in the EU average of financing costs between SMEs and larger firms. On the debt side, the deductibility of net interest payments (interest paid less interest received) would be limited to 85%.

3. A special purpose acquisition company (SPAC) is a company without commercial operations and is formed strictly to raise capital through an initial public offering (IPO) or the purpose of acquiring or merging with an existing company.

MiFIR Review: key pending issues and expected impacts

1. Context and objectives of the MiFIR review

The Chair emphasised the importance of the Markets in Financial Instruments Regulation (MiFIR) review initiative, which aims to update the operating system of EU capital markets. Issues being tackled in the context of the review include the possible approach to setting up a consolidated tape (CT) and how to address payment for order flow (PFOF), as well as market structure and transparency issues raised by the current legislation. Following the publication in July 2022 of the report from the European Parliament on the MiFIR review proposal, the objective is to complete this review under the Czech EU Council Presidency.

An industry representative noted that the European Union is at a crossroads, not only with the current energy crisis and high inflation rates, but also with an increasingly constrained public financing system. Accelerating the development of capital markets in the EU is vital to support economic growth and the green and digital transitions. In respect of equity markets, the European Union is falling significantly behind other jurisdictions. In 2021, 60% of the IPOs at the global level went live in the US or Asia and only 12% in the European Union. One single US GAFA company has more market capitalisation than all of the German DAX combined. European capital markets are also probably the most fragmented in the developed world, largely as a result of the MiFID I and MiFID II / MiFIR reforms.

An official noted that significant progress has been made over the last few months in the discussion on the MiFIR review proposal, especially on the evolution of transparency regimes and market structure issues. Particular attention should be on ensuring Europe benefits from an efficient and competitive market structure in order to preserve and develop a diverse and competitive trading environment. This is all the more important after Brexit.

2. Proposals regarding payment for order flow (PFOF)

An official emphasised that strengthening capital markets is a key objective of the EU. There should be an openness to all mechanisms likely to facilitate access to capital markets for investors and retail clients in particular. One of those forms of access is building on PFOF, which makes it cheaper and easier for retail clients with very small volumes to access markets. In Germany, PFOF played a key role in boosting the participation of retail investors. A study from BaFin shows that prices at PFOF venues for small volumes are similar to or better than the reference market. In the German stock market, PFOF order flow is usually executed on regulated markets, operating in full compliance with the existing transparency requirements. In addition, a recent academic study based on trading data in Germany did not find any negative impact from PFOF practices on the quality of bid and offer prices at a reference market.

A regulator agreed with the final objective of making markets more accessible to clients and lowering fees, but stressed that the PFOF system can create detrimental conflicts of interest between the broker and its clients. The broker potentially has an incentive to direct order flow to market makers offering PFOF arrangements, rather than acting in the best interests of its clients. In addition, the added value of PFOF is not demonstrated. Studies on the benefits of PFOF are not unanimous, with some concluding that there is equal or worse execution in 80% of cases with PFOF. There are also other ways of lowering fees, such as fostering competition among execution venues and encouraging efficiency improvements at the broker level. Some new brokers that are not using PFOF have significantly decreased commissions by being more efficient and increasing reliance on IT. For these reasons a ban on PFOF is worth considering.

The official acknowledged the possible conflicts of interest created by PFOF and the importance of ensuring a level playing field. However, imposing a ban on PFOF before assessing in greater detail the impact of these new structures seems premature. A mandate should be given to ESMA to assess PFOF practices, particularly their impact on clients and in terms of facilitating access to capital markets and whether conflicts of interest could be addressed by transparency requirements.

The regulator suggested that MiFID best-execution rules, which aim to ensure that retail clients get the best conditions when they access the market, should help to tackle these issues. However, best execution rules have been transposed in different ways across the EU leading to the possibility of regulatory arbitrage. ESMA should be asked to develop common technical standards under MiFIR determining how best execution should be measured, for example how many venues must be compared, how frequent the comparisons must be and how to aggregate smaller or bigger shares, rather than simply assessing the ways to improve best execution in relation to PFOF.

The Chair summarised that the potential for regulatory arbitrage is a key factor in discussions about PFOF. One of the main roles of ESMA is ensuring a level playing field in the EU capital market.

3. Market structure issues

An industry representative explained that market structure is extremely important for the proper functioning of primary and secondary equity markets. A report published by Liquidnet in July 2022 shows that regulated markets in the EU accounted for only 28% of the market share in the first semester of 2022, compared to 27% for systematic internalisers (SIs). There has been a drop in the share of trading executed on exchanges, which are the most transparent venues, by more than 50% since the introduction of MiFID II in 2018. The proportion of lit trading is significantly higher in other leading capital market jurisdictions such as the US. A study published by the French AMF on SIs indicates that the average order size in SIs is around €37,000. Given that some of these transactions are very large, this means that a great deal of small transactions are also running through these vehicles, which were initially introduced for handling large in scale institutional orders in order to avoid market impact.

The industry speaker considered that many of the changes already proposed in the context of the MiFIR review concerning SIs are positive. The changes to the reference price waiver to avoid the matching of smaller trades at midpoint by SIs are welcome, as well as the increase of the pre-trade quotation size for publication requirements. However, the threshold should not be artificially set at Level 1 but instead defined by ESMA. If it is set at Level 1, the threshold for the pre-trade quotation size for publication requirements should be at least two times average trade size, rather than two times standard market size. Further action is needed however in some other areas. An authorisation and monitoring system should be introduced for SIs. This would allow a better monitoring of SI activity for elements such as tick size application, matched-principal trading compliance and the application of the share trading obligation for ad hoc and infrequent trading. A large in scale threshold for SIs should also be considered, although this may be difficult to achieve in the current regulatory environment.

A second industry representative had different views on how the competitiveness of EU equity markets may be improved. The focus should be on achieving the best outcome for investors and less on the market structure, which means offering investors choice, including through different trading modalities. New entrants over the last 15 years, since MiFID I was introduced, have brought some complexity and liquidity fragmentation in the market, but also innovation and better outcomes for clients. Studies conducted by the speaker's firm, a large investment bank, have shown that the competition that was introduced by MiFID with new venues entering the market, led to a reduction of 20% of implicit trading costs for institutional clients. Explicit costs of trading also decreased significantly over the same time period. This has resulted in a reduction of average trading costs, which has been passed on to end investors. In surveys, clients state that they are satisfied with the different trading modalities proposed and see improved execution quality. This competition across venues needs to be maintained and liquidity should not be forced out of venues that provide satisfactory outcomes in terms of cost, otherwise investors will trade less and that will be to the detriment of companies seeking financing and retail investors. Where there are still major differences in terms of trading costs and potential structural issues is between primary exchanges and multilateral trading facilities (MTF). On average, trading on a primary exchange costs six times more than on an MTF in Europe, excluding Austria in their experience.

A regulator suggested that, for SIs, adapting the limits, the quoting sizes and the use of the reference price waiver to the current market reality seem the right way forward, as the standard market size has slowly but steadily decreased.

A third industry representative stated that significant improvements in transparency have been provided in the bond market by regulated MTFs since the inception of MiFID II in 2018. MTFs have increased the proportion of lit execution significantly and this should be preserved. MTFs have also brought stability, operational resilience, regulatory reporting, surveillance, fairness and order to the bond markets, by virtue of having an order book in particular. However, the same problems outlined by the first speaker with regard to the development of off-exchange trading for equities are happening in the bond market. Software solutions are synthesising the experience of MTFs without being regulated, which has consequences for the trading venue perimeter defined in MiFIR. In addition, all the software solutions that are currently operating this way are third country solutions, predominantly from the UK, that are unregulated in the EU. In some cases the communication around these solutions is quite misleading, presenting them as trading venues. ESMA is aware of this threat and is seeking comments from market participants on a draft opinion piece addressing this issue. The proper definitions and criteria need to be put in place to tackle this issue.

An official outlined the approach that had been taken to transparency issues during the French EU Council Presidency. A first objective was to better encode public policy choices in quantitative analysis and produce better informed cost-benefit analyses on every aspect of the MiFIR rulebook. Precise and evidence based decisions are needed regarding thresholds and calibrations. In this respect, ESMA would benefit from clearer directions and mandates from the Level 1 text, so that it can carry out the analyses needed to better calibrate the thresholds and requirements. Secondly, it is necessary to take into account the ongoing review of the capital market regulation and transparency regime in the UK, because it is not in the market players' interest for the UK and the EU to have regulations that diverge significantly. The two approaches are not that different so far however.

A second regulator stated that even more important than ensuring a level playing field between the different venues is ensuring that the perimeter of multilateral trading is clearly defined so that the transparency regime is implemented appropriately and is not misleading. The work conducted by ESMA to define what constitutes a multilateral system is important in

this respect. The review of the share and derivatives trading obligation, to achieve a trading obligation with sufficient flexibility if a suspension is needed, is also important. ESMA should be asked to define a proper calibration of the conditions for implementing this obligation, also taking into account market conditions and the need to remain competitive.

4. Proposals for enhancing transparency

An industry representative considered that the dark trading double volume cap for equities has not functioned. The introduction of a single volume cap is relevant, but the threshold could be increased from 7% to potentially 15%, if the mechanism captures all types of trading in the market, including SIs and especially frequent batch auctions which are developing and may constitute a potential loophole in the future if they are not included.

Another industry representative indicated that in bond and derivative markets, ambitious transparency regimes with limited deferrals improve pricing, liquidity and resiliency. Some are concerned about how additional transparency could compromise liquidity provision, but the reality is the exact opposite. The benefits of transparency in bond and derivative markets have been demonstrated by academic research and market monitoring of the US capital markets for over 20 years in liquid and illiquid segments and for large and small size trades. The positive impact of short deferrals on spreads and the benefits for market participants have also been emphasized in the Econ Committee report on the MiFIR review proposal. Limited deferrals support deeper liquidity and a better quality of pricing for investors in bond markets, but also enable other indirect improvements, such as the growth of bond exchange traded funds (ETF), an increased robustness of the credit derivatives markets, a growth in portfolio trading and a greater transition to electronic trading. All those developments may further improve the liquidity and resilience of the underlying cash corporate bond markets and also provide additional tools to enhance price discovery and hedging capabilities. This type of transparency also gives dealers and liquidity providers more tools to effectively intermediate the markets. A phased-in approach to the improvement of deferrals is fine, but excessively long deferrals should be avoided. The endpoint reached in the United States capital markets with respect to deferrals is a 15-minute maximum deferral. It is fine to start with T+1, for example, but the end goal should be clear and there should be a plan to phase that in. Another industry representative agreed that short deferrals are beneficial to the market in general.

A regulator was supportive of the objective of further harmonising transparency requirements and curbing dark trading, but emphasised the need to be mindful of the trade-off between liquidity and transparency. The main point that should be addressed at Level 1 concerning transparency is the double volume cap mechanism. A single volume cap would be the right solution For the remaining issues, the solution would be to empower ESMA to e.g. consider reference price waivers and define delayed periods for price and volume deferrals.

Another regulator observed that there is a tension between the cost of trading and the quality of price formation. The MiFIR review aims to simplify and adapt the present transparency regime and also to increase harmonisation. In terms of simplification and adaptation, moving towards a simpler volume cap regime is necessary, as well as having a class of instrument approach for the post-trade transparency for bonds. Concerning harmonisation, the aim is to move as many rules as possible to MiFIR in order to reduce current national specificities is very relevant. Care must also be taken to avoid the introduction of new national specificities. For instance, it has been suggested that the transparency regime for government bonds should be defined at national level and that the level of transparency could be lower for these bonds, which are the most liquid ones. This does not seem to be an appropriate way forward because such issues should be addressed from a regulatory perspective at the EU level.

There is also a question as to how changes in legislations such as MiFIR could be handled more effectively in order for the EU to keep pace with changes in the market, the regulator stressed. The way other jurisdictions such as the US or the UK function should be considered. Indeed, legislative reviews of Level 1 texts such as MiFID II and the MiFIR review take several years. Having to go through the full legislative cycle for adapting technical standards such as certain caps and thresholds to changes in market conditions puts the EU at a disadvantage compared to other markets. An authority such as ESMA should be empowered with making such changes, without needing a full legislative review..

5. Issues remaining to be addressed concerning the Consolidated Tape proposal

Answering a question from the Chair about the priorities that should be pursued in the consolidated tape (CT) project in terms of asset class and type of data, an industry representative commented that they are agnostic as to which asset class goes first. If equities go first, bonds will follow shortly after, and vice versa. Creating the proper regulatory and economic environment for a CT to emerge and for a consolidated tape provider (CTP) to be able to operate that CT is more important. A first question is how the transparency improvements proposed in the MiFIR review in terms of e.g. deferrals, waivers, etc. will materialize and whether they will facilitate the implementation of a CT. The details of this need to be examined. In addition, operating a CT is not a technical challenge, because a CTP will do something very similar to what the Approved Publication Arrangements (APAs) do currently. It is mainly an operational and economic challenge and this explains why no CTP has emerged since 2018, when the

legal framework for operating a CT was set out in MiFID II. In the MiFIR review proposal text there was a plan B, with ESMA potentially operating a CT if no commercial CTP emerges. The direction of travel is now moving away from that option. However it is still uncertain whether the conditions will be met for a commercial CTP to emerge.

A second industry representative agreed that the implementation of the CTP project needs some fine-tuning, but it is important that it moves forward at a deliberate pace in order to avoid the EU falling further behind other global financial centres. There are indications that the UK remains committed to progressing a CT for the fixed income and equity asset classes. The US is assessing options for further enhancing the timeliness and scope of their existing CTs, with consultations on the possibility to add US Treasuries to the scope of transparency and to shorten deferrals on the non-equity side. The simplest and most logical approach for the EU would be to start with a real-time post trade CT for both equities and non-equities. That would be simpler to deliver than a pre-trade CT, with less message traffic involved. In addition there would be less latency concerns with post-trade data and the controversy over potential impact on exchange market data revenues would be removed, since those revenues largely stem from the sale of pre-trade quote data, and not post-trade execution data.

A third industry representative stated that the fact that a CT will help to improve capital markets is indisputable. The main arguments for deferring the project so far have been based on commercial factors, such as cost and complexity. A real-time post-trade CT for equities and non-equities is a reasonable compromise but should not be the ultimate aim, because a pre-trade tape would eventually be much more useful. The CT also needs to be designed in an appropriate way. Most of the major banks already have invested in systems that provide them with accurate and timely data, but they do not look at the same elements as clients, so there is an issue of reconciliation and consistency that may be addressed with the post-trade CT. A 'simple' real-time post trade CT that would be limited to recording trades that may happen at different times and cannot be compared is not particularly useful. There needs to be a timestamp with the European Best Bid and Offer (EBBO) for liquidity assessments. But if the decision is made to go that far, moving to a pre-trade CT may be a better option. A CT could help to alleviate some challenges as well, such as those related to exchange outages, which impact reference prices and cause significant financial losses for brokers.

A fourth industry representative noted that what has blocked the emergence of a CT so far is mainly the insufficient level of data quality from alternative execution venues. This is not a question of waivers or deferrals, but of accuracy and control of the market data reported to the national competent authorities (NCAs). Several exchanges had tried to set up a CT when MiFID II came into force, but the projects were abandoned mostly because of data quality issues from alternative execution venues. The reality of this problem is reflected in commercial offers that exist on the market, providing 70% to 90% market coverage. A CT with 100% coverage across the EU would provide investors with significant added value, but is dependent on major improvements in terms of data quality that ESMA needs to lead in connection with the NCAs, because previous industry-led initiatives have not been successful. The industry speaker agreed with previous speakers that a post-trade CT would be the best option to pursue. A pre-trade tape would create a two-tier market, with some of the investors provided with reference prices that would be illusionary, because they would always be delivered more slowly than those that large market players have based on low latency feeds. In addition the CT must be cheap and fast to implement, which does not seem possible for a pre-trade CT. In terms of sequencing, starting with bonds makes most sense because that market is far less transparent than equities.

An official stated that the CT remains one of the most challenging topics of the MiFIR review discussion at political level, although there is a clear need for a cutting-edge CT for equity and bond markets in particular. The benefits of a CT are multiple, including better integration of European markets and providing visibility to European and foreign players on the state of liquidity in European markets. This is all the more true for smaller markets that also need to be in the remit of the CT. A CT will also provide valuable market data that regulators and policy-makers can use for establishing regulations and market standards. The CT is not intended to be a substitute for the data services offered by stock exchanges. Stock exchanges will be remunerated by the CT and therefore will benefit from it. The US market demonstrates that a CT is likely to attract much demand and therefore generate significant revenues.

A regulator agreed that the CT project is worthwhile but stressed that the expectations should not be too high. A CT cannot solve all the transparency issues identified in the MiFIR review and cannot be a substitute for the other measures proposed. In addition, a pragmatic approach should be taken. Phasing the CT is part of this, meaning that the optimal scenario will not be reached in the first step of implementation. Data quality and data revenue issues also need to be considered. The first step should be an equity post-trade CT, before moving into non-equity, starting with bonds and then derivatives, and potentially ETFs could follow. A pre-trade CT can be introduced once sufficient experience has been gained with the implementation of the post-trade CT.

Strengthening EU clearing: key issues and priorities

1. Current status of the EU clearing sector and main challenges to consider

1.1 Resilience of the EU clearing sector

The Chair explained that the situation of the EU clearing sector has been analysed in detail by ESMA in its comprehensive assessment of the risks and vulnerabilities that result from certain services of systemic importance provided by key CCPs (central counterparties) based outside the EU. Higher risk exposures were identified for certain targeted services provided by UK-based CCPs. The suitability of the existing supervisory framework to address and contain such risks was also evaluated. This assessment fed into the European Commission's (EC) comprehensive reflections regarding clearing in the EU and this process is ongoing following a public consultation issued by the EC on enhancing the attractiveness and resilience of EU clearing.

EU CCPs demonstrated their continued resilience during recent stress events in February 2022 that were close to worse case scenarios, the Chair observed. They were able to conduct their activities as expected and clearing members and clients were able to fulfil their obligations. However, these events also demonstrated certain vulnerabilities in terms of concentration and interconnectedness risks, in particular in the commodities and energy markets, that remain insufficiently addressed by the current regulatory and supervisory framework. Certain participants, mainly non-financial institutions, also experienced liquidity stresses during these events potentially putting the entire clearing ecosystem at risk. This may also lead to some further considerations in terms of market structure and access to central clearing.

1.2 Challenges posed by the reliance on UK-based CCPs

A policy-maker noted that clearing has a strong international dimension due to the global and interconnected nature of capital markets. This has led the EU to take a number of equivalence decisions in this area over the years with third-country jurisdictions, to ensure this international connectedness is maintained. There is however a specific situation with the UK following Brexit, with an excessive reliance of the EU on UK-based CCPs. This is related to the broader debate about the 'open strategic autonomy' of the EU and is an additional dimension to take into account with regard to the resilience of financial market infrastructures.

An official stated that the current situation where EU market participants continue to have large exposures to UK CCPs post-Brexit is not sustainable. There are inherent financial stability risks for the EU due to this that must be addressed in the medium-term.

Another official illustrated the financial stability benefits of cross-border clearing. Resilient cross-border CCPs in well-regulated environments help to enhance financial stability by a centralised netting of risk exposures and also by the diversification of risks provided by large pools of liquidity. Large CCPs, such as those in the UK, support the netting of exposures across counterparties, currencies and products and benefit from significant economies of scale and scope. The regulatory choices made as part of the G20 post-crisis reform package were made with a full understanding of these characteristics and of the global nature of the central clearing landscape. Fragmenting the market would split liquidity and drive clearing costs higher, which may reduce incentives to hedge risks, thus increasing the amount of risk to the real economy.

The G20 reforms have put CCPs at the heart of the global financial system, which is why questions about managing risk exposures in overseas jurisdictions are understandable, the official observed. The Bank of England is steadfastly committed to supervisory cooperation and informed reliance on other supervisors, in order to preserve the benefits of cross-border and interconnected markets while managing the related risks. Three main factors are important to consider in this context. The first factor is having equivalent high-level standards between regulatory regimes. The UK has on-shored EU legislation and in the resolution space, the Bank of England is going to be given additional powers to ensure that CCPs can be resolved in the most efficient way, bringing the UK into full alignment with Financial Stability Board (FSB) guidance. The second factor is strong supervisory cooperation and transparency both in business as usual and crisis situations. In this respect the Bank of England has agreed detailed cooperation agreements with European supervisors and other supervisors around the world regarding the supervision of UK CCPs and is committed to making those arrangements work. Additionally, the Bank of England was the first authority to establish global crisis management groups for CCPs, providing a framework for authorities to plan crisis management measures, including a possible orderly resolution, for CCPs that are systemically important in more than one jurisdiction. The third factor is non-discriminatory laws. Given the cross-border nature of clearing it is important to recognise the systemic importance of certain UK CCPs in overseas markets. As part of the Bank of England's new statutory objectives for financial market infrastructure regulation, specific obligations will be in law to consider the impact of the UK's decisions on financial stability in other jurisdictions and non-discrimination on the basis of clearing member jurisdictional location.

A policy-maker agreed that cross-border supervisory cooperation is essential for global CCPs, although it is not necessarily a sufficient tool in all crisis situations. That is why solutions for addressing the potential systemic risks from the excessive dependence of the EU on UK CCPs are being worked on. The fragmentation caused by Brexit and related cliff-edge risks remain a concern for the EU. Those issues have been addressed in the short term by the decision to extend the recognition of UK CCPs until 2025 but solutions are needed to reduce financial stability risk from this dependence in the medium term.

The Chair added that as part of ESMA's assessment of Tier 2 CCPs, several scenarios were identified in which the two Tier 2 CCPs established in the UK may potentially pose a financial stability risk to the EU or individual Member States. Distress or disruptions in the provision of critical clearing services could significantly destabilize financial stability in the Union, in particular given the size of the exposures of EU clearing members, clients, and currencies and the limited alternative clearing services in certain markets. In the field of crisis management, ESMA has currently only limited powers over Tier 2 CCPs, which constrains the ability of ESMA to act and mitigate the impact of a Tier 2 CCP recovery or resolution on EU clearing participants and financial stability. This is why ESMA is very supportive of the Commission's efforts to reduce the EU's excessive dependence on UK CCPs, but also to enhance the supervisory system to better withstand crises.

An industry representative stressed that interest rate swaps (IRSs) are a crucial component of the market from a risk management perspective and are a key output of the G20 reforms. What was possibly not anticipated is that the market for euro denominated IRS and for some other currencies would end up being concentrated in London. In this debate about the reliance on the UK for certain instruments and activities, it is important to consider that strong market infrastructures, such as stock exchanges and clearing houses which are not regional infrastructures but are among the leaders at the global level, have been successfully developed in the EU. The position is very different in capital markets from the type of dependence there is on third-country cloud service providers for example. Their institution, a leading EU-based CCP, has licences in many jurisdictions in the world, including the US and Asia, and trades the global benchmarks in the equity and fixed income sectors. They are also active in the IRS market.

2. Measures proposed for strengthening EU clearing

The Chair emphasised that strengthening the EU framework for CCPs is important both from a financial stability perspective and for building the capital markets union (CMU), due to the central role of these infrastructures for the functioning of capital markets.

A policy-maker agreed that linking the clearing debate back with the CMU is very relevant, as clearing is indeed a key element for the development of capital markets. In the feedback to the Commission's recent consultations there was a confirmation of the importance of looking at the supply side in terms of how to increase clearing capacities in the EU, but also looking at what needs to be and could be done on the demand side to encourage more use of EU-based CCPs. The EC is assessing the potential impact of incentives and disincentives that may be used for increasing central clearing in the EU and considering how supervisory arrangements may have to evolve in this perspective. The aim is to put forward legislative proposals later this year.

2.1 Policy measures proposed

An official observed that different measures enabling EU CCPs to expand their EU-wide clearing capacities and to attract additional clearing volume need to be implemented in order to reduce the large exposures EU market participants have to UK-based CCPs and the related financial stability risks. Market participants and supervisors also need guidance on how to assess the progress made towards reducing the overreliance of the EU on UK CCPs. Explicit overall exposure reduction targets or guidelines on an overall plan to reduce the exposure to UK CCPs could be established.

An industry representative suggested that the measures for strengthening EU clearing need to find an appropriate balance between regulatory requirements, guidance, and measures to improve the attractiveness of the EU clearing market, the latter option potentially being the most effective. A widening of the scope of the clearing obligation and extending voluntary clearing seem appropriate. EU public institutions should voluntarily clear in order to increase the intrinsic liquidity in the EU market and show confidence in central clearing. That would contribute to attract further investment by non-EU clients in the EU market. The expiry of the clearing exemption for EU pension funds could also bring further intrinsic liquidity, provided appropriate measures are put in place to accompany this change. As the main issue for pension funds is to convert their securities into cash to face margin calls, they are dependent on the proper functioning of the repo market at all times at reasonable pricing conditions. This requires ensuring that banks are able to support these activities, taking into account the prudential treatment of securities financing transactions (SFT) activity (capital requirements and balance sheet leverage ratio) which needs to be amended, and possibly providing a fall-back repo facility at the ECB available to banks in difficult times, especially for European government bonds, to support the increasing needs of pension funds. Sponsored clearing which extends the benefits of direct CCP membership to the buy-side may also be part of the solution, but it is not in the speaker's view the optimal solution, for risk purposes.

The industry speaker moreover emphasized that the fact that EU clearing members do not have a dominant market share also needs considering. Forcing EU banks alone to move their liquidity to EU CCPs may harm them and not have a significant impact on the overall market in the absence of measures also targeting non-

EU actors such as binding extraterritorial measures, which are not on the table at this point in time. Indeed non-EU actors are not particularly inclined to move to an EU CCP because of the current lower liquidity pool. In addition, given that for non-EU players the main currency in which they operate is not the euro in most cases but the USD, moving to an EU-based CCP may reduce their current level of cross-currency netting efficiencies.

A second industry speaker also welcomed the measures proposed by the EU authorities for strengthening EU clearing, although some may be better suited than others to accelerate the build-up of volume. Broadening the list of institutions and instruments subject to mandatory clearing seems a good idea in particular e.g. including other sovereigns/quasi-sovereigns and the pension funds.

A third industry representative suggested that in terms of policy measures, the EU should stay away from any restrictive measures, which may destabilise markets, focusing instead on EU competitiveness, international attractiveness and supervisory cooperation with the home supervisors of non-EU CCPs. Measures that would result in locking EU firms into the EU or into EU CCPs would impede competitiveness. The same goes for any artificial impediments that may be put in place, such as higher capital charges on EU firms clearing in non-EU CCPs. What is mainly needed for reinforcing clearing on the continent is a regulatory level playing field ensuring that the EU is not at a disadvantage compared to other jurisdictions, because clearing services are very international. In this perspective, EU clearing obligations need to be reviewed to ensure consistency with the US in particular. The US has a CDS (credit default swap) clearing mandate, which the EU does not. The Derivatives Trading Obligation (DTO) is also somewhat restrictive in terms of being able to clear European CDS in EU CCPs. Addressing these issues will make EU clearing more competitive and will benefit the clearing system.

A fourth industry representative stated that one important factor to consider in the context of this initiative is the reduction of the number of the players actively participating in market infrastructures with the growth of internalisation related to order execution services provided by certain intermediaries. This is detracting flows from infrastructures that operate in a more transparent way and is potentially impacting the quality of price formation and the competitiveness of EU post-trading. While the measures proposed by the EC to enhance the competitiveness of EU markets, such as increasing the scope of players accessing CCPs, broadening the range of collateral included and active account requirements are positive, it is necessary to ensure that all market stakeholders, including financial intermediaries, are moving in the same direction. It is important also to bear in mind that clearing is a global environment and the products are easy to substitute. The flows can go to different jurisdictions depending in part on the regulatory framework. Therefore the proposals made by the EC should aim to enhance the attractiveness of the EU central clearing market. A harmonisation of rules concerning Central Banks is moreover needed to allow an equivalent access to the facilities of the Central Bank, extend timetables and conclude reciprocal agreements between Central Banks with regard to clearing activities.

The Chair noted that there is a need to evaluate precisely the potential impacts of the different proposals that are on the table and make sure that they are calibrated in a way that does not create unwanted side effects. This assessment should not be limited to the bipolar situation between the UK and the EU but should take into account the broader clearing market. Measures should also consider the functioning of the wider ecosystem, including clearing members, intermediaries and clients, also bearing in mind the reduction of the number of financial institutions willing to take on clearing business in the current environment.

2.2 Market-led initiatives

An industry representative emphasised the importance of market-led solutions for developing the EU clearing capacity. Their institution, a major EU-based CCP, is growing an EU-based alternative pool of liquidity for the clearing of euro denominated instruments, providing efficiencies across listed and over-the-counter (OTC) instruments to portfolio margin the euro exposures, with repo as an important component. An alternative liquidity pool was launched for euro denominated IRS with the support of 10 financial institutions who share the governance and the benefits and which now represents a 20% market share in this segment. This shows that it is possible for the EU to be competitive in this business and this EU-based pool of liquidity can also help to limit cliff-effects if the recognition of UK CCPs is discontinued at relatively short notice.

Another industry representative further illustrated the potential of market-led solutions for developing clearing capacity in the EU. Their organisation, a major UK-based CCP which also has a large EU-based business clearing euro fixed income and equities in particular, was able to also acquire a significant position in the European CDS business over the years, reaching a 50% market share thanks to a continuous investment in developing risk management practice and business development with clients. This shows that it is possible to develop capacity on the continent through market-led initiative.

2.3 Mandating live accounts at EU CCPs

A Central Bank official suggested that to foster the usage of EU-based clearing houses, a regulatory requirement for EU clearing members to establish and maintain an active clearing account at an EU CCP should be introduced. Such an account could be accompanied by a predetermined minimum activity level, which could be adjusted quantitatively depending on the remaining level of systemic overreliance on UK CCPs.

An industry representative agreed that mandating a second active account with an EU CCP seems appropriate from a systemic risk perspective in order to allow market participants to test-drive their connection with an EU-based CCP. A second industry speaker was favourable to a qualitative assessment of the benefits and possible impacts of active accounts. Such a measure

needs to be handled with care because of potential impacts on market liquidity and trading decisions.

A third industry representative explained that implementing an active account requirement at EU CCPs aims to encourage EU clients to seek a credible clearing solution in the EU for derivatives of substantial systemic importance and also to make sure there is a reliable fallback option if the access to the UK CCPs is for any reason suddenly stopped. This is an account where open positions are held with daily margin calls in order to ensure that payment channels are operating smoothly at all times. Starting with a market-led approach for the implementation of this tool, supported by qualitative guidance defined by the public authorities, seems preferable to legislative measures that will be longer to put in place. Regulatory measures could however be developed in parallel, so that they can be implemented if there is insufficient impact from the market led approach at the end of the temporary equivalence extension period for UK-based CCPs (2025). In addition, imposing a minimum quantitative threshold in absolute or relative terms is not the right approach. However, if this option was retained, the client-clearing and market-making activities conducted by EU banks for non-EU clients (and EU clients which are not subject to the clearing obligation) should be carved out from this threshold. Care must also be taken that EU clients do not suffer from such measures. In this perspective, further data need to be gathered during the transition period, about the extent to which EU clients rely on non-EU clients clearing at UK CCPs to match their hedging needs. If the level of dependence is still high that will mean that cutting the access of EU clients to UK CCPs would be detrimental to them in terms of cost and margin predictability.

3. Improving the supervisory approach to clearing activities in the EU

The Chair noted that the EU needs an agile and effective supervision of EU clearing activities and also of the interactions with third-countries. ESMA has made proposals for streamlining these activities that could be implemented very quickly, What is sought is a more effective supervisory system with a holistic view on the users of CCPs, the interconnectedness with the rest of the financial system and the allocation of risks in the market.

An official observed that the current supervisory system based on colleges has a good track record and it is important to make sure that all relevant stakeholders are involved in the supervisory process. Significantly changing the current system with a greater role for a new EU supervisory authority does not seem necessary at this stage. An enhancement of the current supervisory processes and procedures aiming to preserve financial stability would be preferable.

An industry representative felt that the supervisory structure of EU CCPs is currently too complex with a multi-layer supervision, including the ESMA CCP Supervisory Committee, the college of supervisors of each CCP, and the National Competent Authorities (NCAs) concerned, resulting in excessively slow processes to launch new products and services or implement changes to risk models or parameters. In addition, timelines are not defined precisely enough. This is a significant impediment to EU CCPs' time-to-market and their competitiveness relative to non-EU CCPs. There are some recent examples of product approvals taking two or three years to complete as in the case of the sponsored clearing of repo business for pension funds, which is a critical product to launch given the planned removal of the clearing exemption for pension funds that will need an access to liquidity in the future. Authorisation processes take much less time in other jurisdictions, which is a competitive disadvantage for EU CCPs in a global market where first-mover advantage can be decisive.

Moving towards a higher degree of EU-level supervision could help simplify and improve these authorisation processes, the industry speaker suggested. Solutions can also be proposed to shorten approval timelines and enhance the transparency of authorisation processes, such as introducing non-objection mechanisms or self-certification rather than full authorisations and parallelising certain steps of authorisation processes, rather than having to go sequentially through the different regulatory bodies involved. The criteria in Articles 15 and 49 of the EMIR regulation, which determine the need to go through an approval process for new products or services or for changes to CCP risk management models and the procedures for consulting the supervisory college on these changes, should moreover be more proportionate to potential material impact on risk, allowing CCPs to move faster when impacts are limited. This requires a more precise categorisation or tiering of what is really a material shift in terms of risk and operations, similar to those that exist in some other jurisdictions.

A second industry representative agreed with the comments made about time-to-market. Whilst the principles behind the current regime under Articles 15 and 49 are relevant, practical thresholds and timelines need to be set. Approvals for simple changes such as adding a clearing currency in a product like IRS can take over a year to obtain. Comparatively, in the US there is a non-objection system with a 10-day filing period and more self-certification. If the US CFTC raises questions or objects to a new product during that period more information needs to be provided; otherwise, the product can go live. Improving such authorisation processes is essential, but this does not require changes to the supervisory setup. The first step is to define appropriate thresholds of what needs to go through a detailed approval process.

A third industry representative was also in favour of measures to accelerate time-to-market, because remaining competitive in the clearing space requires launching many new products. There are different perspectives across EU jurisdictions on how supervision and approvals should be conducted. Some timelines are defined in the EU, but not for the entire process and all

authorities involved. Which authorities to involve should also be defined more precisely, depending on the importance of the adaptations desired and potential risk implications.

A fourth industry representative was very supportive of a stronger and simplified role for ESMA regarding EU CCPs, for easing, shortening the time-to-market and also enhancing supervisory cooperation between the EU and the UK for third-country CCPs.

The Chair acknowledged that time-to-market is an issue. ESMA has defined stringent and short deadlines for the actions it undertakes, requiring a reaction within 20 business days, but there are often no fixed deadlines at the domestic level. Some specific suggestions on what could be done to streamline and improve these processes have been made that need to be further considered.

EU securities infrastructures: on-going initiatives and prospects of DLT

1. The state of play in EU securities post-trading and ongoing initiatives

1.1 The progress made on competitiveness, resilience and integration

The Chair emphasised that securities infrastructures are an essential part of the backbone of the EU financial system and significantly contribute to the efficiency and safety of capital markets. The objective of enhancing the functioning of EU securities infrastructures has existed since the launch of the euro and discussions on how to lift the barriers to cross border clearing and settlement were initiated in 2001 and 2003 with the Giovannini reports. Much progress has been made in this area by regulators, central banks and market participants, even though some legal and fiscal barriers remain to be tackled. In addition, the process of digitalisation and the increasing adoption of new technologies create new opportunities and challenges in this space.

A Central Bank official agreed that significant progress has been made from a regulatory and infrastructure perspective. The European market is more integrated in terms of infrastructure, with TARGET2-Securities (T2S) in particular and the resilience of the post-trading system was once again proven during the stress events in 2020. However, securities post-trading remains fragmented along national lines, with most transactions taking place within domestic central securities depositaries (CSDs) with limited cross border activity. EU trading and post-trading regulations such as the CSD Regulation (CSDR) aim at enhancing EU integration. This is difficult, however, because the root causes of fragmentation lie in the differences in taxation, insolvency law and corporate law regulations across member states, which are mostly determined at a domestic level and are partly outside the scope of financial authorities.

An industry representative emphasised that, while the EU post-trading market is still split across 31 CSDs, huge efforts have been made at industry level on the harmonisation of systems and on developing synergies across platforms. Another industry speaker agreed, noting that much has been done to lift the technical and operational barriers identified in the Giovannini report in particular, which has fostered liquidity and efficiency in the EU post-trading market.

1.2 Ongoing regulatory initiatives

Answering a question about the expected impacts of the ongoing CSDR review, a Central Bank official expressed support for the proposals regarding passporting and supervisory colleges and also for the proposed amendments concerning the provision of banking-type ancillary services by CSDs. This could foster cross-border settlement activity and facilitate multicurrency settlements, especially for currencies where CSD access to central bank money is not practical or available.

Regarding the settlement discipline regime, it is sensible that the current proposals exclude two kinds of settlement fails from penalty calculation: settlement fails caused by factors not attributable to the transaction participants and settlement fails occurring in the context of transactions that do not involve two trading parties. The mandatory buy in provisions, however, should be omitted entirely, the Central Bank official felt. They impose a high operative burden on the non failing counterparty and therefore also increase risk without addressing illiquidity in the market, which is the main cause of settlement fails due to missing securities. In addition, ESMA has made relevant proposals to simplify the process of collection and distribution of cash penalties for settlement fails relating to cleared transactions. ESMA's proposals would change the existing practice by allowing the central securities depositories (CSD) to collect and distribute all types of penalties, including those for settlement fails relating to cleared transactions. Currently, central counterparties (CCPs) are responsible for the collection and distribution of cash penalties for settlement fails on cleared transactions.

An industry speaker agreed that the mandatory buy in regime would impose an unnecessary burden on market participants and clients and could hurt liquidity and negatively impact the European post-trade market. The discussion about post-trading is related to the ongoing Capital Markets Union (CMU) initiative, which promotes the development and integration of EU capital markets. In the context of Brexit, this is an essential objective for reasons of strategic autonomy in particular, although it is a challenging one to achieve.

Quick actions are needed on the regulatory side to solve some of the technical issues that impede EU post-trade. First, the Shareholder Rights Directive (SRD2) should be reviewed as quickly as possible to harmonise certain elements of it. Since SRD2 is a directive, it was transposed differently across EU member states. A key issue is the definition of 'shareholders', which is different across the EU27. This makes it difficult for cross border investors to exercise their voting rights. Secondly, an EU wide system for withholding tax should be introduced. This was part of the original Giovannini barriers. The idea would be to simplify the withholding tax process for cross border transactions for investors and intermediaries in the EU. Tax issues are usually dealt with at national level, however. Political will is required to move this issue forward at a European level.

Moreover, it is important to maintain a fair competitive landscape for all players operating in the European market, the industry representative stressed. On the clearing side, the work launched by the Commission aiming to strengthen clearing in the EU and reduce the

excessive exposure of EU market participants to UK CCPs for euro denominated interest rate swaps (IRSs) in particular seems relevant, but focusing measures only on EU based clearing members would put them at a disadvantage and would go against the objectives of the CMU.

1.3 Evolutions at Eurosystem level

A Central Bank official emphasised that in addition to the CSDR review and other CMU related legislative proposals led by the Commission, much work is being done by the Eurosystem to improve the EU post-trading infrastructure with the consolidation of TARGET2 (T2) and T2S, and also with the Eurosystem Collateral Management System (ECMS), which will increase efficiency and reduce the cost of liquidity in the post-trading system.

Another Central Bank official stated that much is indeed being done by the Eurosystem to provide the necessary infrastructure and act as a catalyst for a further integration of EU capital markets. Over the last 10 years, this can be seen with T2S and the T2S related harmonisation journey. Significant progress has been made in the tackling of the Giovannini barriers in the field of settlement in particular. This has created momentum and new markets are currently migrating into T2S, such as Finland, Croatia and Bulgaria and also Euroclear Bank. Larger issuers and the European Commission via its NextGenerationEU (NGEU) programme are also increasingly relying on the T2S settlement space, which is increasing volumes and creating further synergies and efficiency gains.

Beyond the narrow field of settlement, the ECB has an important role to play in other post trade areas which are less harmonised, by acting as a catalyst and a provider of infrastructure. Experience shows that a combination of these two actions is the most effective approach. The Single Collateral Management Rulebook for Europe (SCoRE), which covers areas such as tri party repo, corporate actions and billing is an example of this catalyst role. The ECB has worked together with the industry in the Advisory Group on Market Infrastructures for Securities and Collateral (AMI-SeCo) on the SCoRE rulebook and there is a collective commitment to implement it in the coming years. There is a link to infrastructures in this project, since the SCoRE rules will be implemented in ECMS in particular.

There has been a strong push on ECMS, and it will be going live from November 2023 with a migration of national central banks' (NCBs) systems for accepting collateral towards a common one. A large amount of standardisation is required to make this project manageable and to avoid the coexistence of different sets of rules for treating post trade actions. One element of standardisation and simplification that has been agreed with the industry is the use of ISO 20022 for messaging in asset servicing, although it may not need to be fully adopted by clients in the post trade downstream beyond the CSDs and custodians. There is still a need to consider an end date for full migration to the new messaging standard, however. As long as different standards and systems coexist, it will not be possible to reap the full benefits of collateral harmonisation and of T2S.

Finally, the Debt Issuance Market Contact Group (DIMCG) can also play an important role in this space, the Central Bank official mentioned. The DIMCG is a follow up to the European Distribution of Debt Issuance (EDDI) initiative[1] which aims to act as a catalyst and infrastructure provider on the primary market issuance side. DIMCG is a catalyst in this project, bringing together Eurosystem representatives and industry professionals involved in the euro area primary debt markets. The DIMCG group delivered a report which was strongly supported by the industry. In 2023, there will be a review of its progress and objectives going forward.

An industry speaker observed that there is a growing interest from policy-makers and the industry to discuss the opportunity to move to a shorter T+1 settlement cycle in Europe, as in the US and other jurisdictions, in order to reduce post-trade risks and margin requirements. However the competitive impact of this project on EU firms needs to be carefully assessed. In Europe, the implementation of T+1 will be much more complex than in the US. Europe has many currencies and many financial market infrastructures (FMIs) including 31 CSDs and a number of CCPs. There are significant differences also between member states' legal frameworks, particularly in areas such as insolvency law.

The Central Bank official mentioned that the European authorities are at a very early stage in assessing the implications of T+1 settlement. It is still uncertain whether T+1 can be imposed in the European market. There is no incompatibility from a T2S perspective, but there are many complexities and differences in the market that need tackling. A first step will be to discuss these issues within the AMI SeCo.

2. Prospects and challenges of digitalisation and DLT in the post-trading space

2.1 Opportunities from DLT in the post-trading space and relevance of the DLT pilot regime

An industry representative considered that distributed ledger technology (DLT), while not being a 'silver bullet', can contribute to increasing efficiency and reducing costs in the capital markets, which should benefit both issuers and investors. DLT can potentially bring many benefits, including a reduction of the reconciliation load between intermediaries and a facilitation of the identification of end investors and of the management of registers. DLT also supports innovative models combining trading and settlement, which are currently separate activities. An interesting experiment was recently conducted by the

1. EDDI aims to support integration in the current issuance and initial distribution ecosystem in the EU by providing new choice for the location of issuance. In particular, with EDDI, European issuers will be able to issue debt securities into all national EU markets on an equal basis.

Banque de France, which tested the possibility of issuing and trading French government bonds against Central Bank Digital Currency (CBDC). The test was successful, but it revealed that implementing DLT in the existing market architecture does not allow the realisation of all the benefits of DLT. Core custody and settlement activities are a complex area with high stakes. It would be preferable to prioritise use cases in other areas to test the added value of DLT. For instance, DLT could bring many improvements in the area of primary debt market issuance on which the DIMCG is focusing, and where manual processes involving Excel spreadsheets still prevail.

The DLT pilot regime, which will go live in March 2023, provides an appropriate framework for the testing of potential uses of DLT in the post-trading space and may bring significant value to the market. The DLT pilot regime will create an experimentation zone that is limited in terms of issuance size and duration, the industry representative explained. It will provide exemptions from the current legislative framework, i.e. Markets in Financial Instruments Directive (MiFID), CSDR and the Settlement Finality Directive (SFD), for the trading and settling of tokenised securities. DLT could be deployed under CSDR, but the choice was made to exempt tests under the pilot regime from these requirements. Another foreseen exemption is the possibility of retail participation, which is not possible under MiFID. The underlying idea is that changes are needed in the legislative framework to reap the benefits of DLT in the securities market. One caveat of the DLT pilot regime is the potential difficulty of drawing conclusions from an environment in which both a technology and a regulatory framework with exemptions are being tested. There is also the risk of creating further fragmentation in the market with systems that may only work for certain groups of issuers and investors or under specific rules.

Another industry speaker concurred that implementing DLT for core settlement processes would be a very complex issue and is a long term objective for the market. As for T+1, the competitive impact of the rollout of DLT on EU firms will need to be carefully assessed.

A Central Bank official agreed that, in advance of rolling it out, it was important to consider exactly what can be achieved with DLT and the extent to which it can be a game changer in the post-trading space. While DLT has great potential, many of the suggested changes to market architecture could be achieved using other technologies. It is therefore essential to distinguish the incremental benefits specifically provided by DLT from those attributable to the changes made to the existing securities post trade architecture. This is something that should be better understood before any decisions on DLT are made.

2.2 Implementation challenges and possible solutions concerning the cash leg

An industry representative emphasised that DLT also creates many challenges in terms of implementation. Implementing DLT in the post-trading space will require a very long transition period with a need for interoperability between new and old platforms. This transition phase should be managed over time in a centralised way with a potential role to be played by CSDs in accompanying the market towards a new market architecture. In addition, DLT implementation may be hindered by existing sources of fragmentation such as the differing national laws that apply to digital assets. It is also essential to avoid the creation of new barriers during this transition process, e.g. related to digital finance rules, which would undermine the success of this new model.

A Central Bank official observed that the cash leg of securities settlement also raises questions, i.e. how securities will be paid for on the blockchain. There are three possibilities for handling the cash leg of securities transactions on DLT. The first would be for the cash leg to be in commercial bank money, i.e. the market would be allowed to handle transactions fully. From the perspective of central banks, this option should be excluded because it could result in the piling up of huge credit risk in the system. Secondly, central bank money could be introduced to the ledger, which would involve tokenisation. This is technically feasible and has been done experimentally. However, this raises questions of monetary policy control. If digitalised money can be traded on DLT, it reduces visibility on liquidity in the Eurosystem since tokens can easily be exchanged around the world. The full implications of such a move must be evaluated. This leaves a potentially more pragmatic third option, which would be to use the current centralised system, i.e. the TARGET system, to settle transactions on DLT. This is possible. Banca d'Italia has just published a paper demonstrating the relative ease of connecting any DLT system with the TARGET system and the Bundesbank has also been experimenting this. There could be a transition scenario in which the market can trade on DLT while benefitting from the security and resilience in settlements provided by the present system and allowing an appropriate conduct of monetary policy. This would also overcome the problem of liquidity fragmentation inherent to DLT platforms. It is an experiment that can be refined, but it shows that a pragmatic path already exists for implementing DLT in the securities environment.

A second Central Bank official was convinced of the advantages of the third solution mentioned by the previous speaker, consisting in the development of a bridge technology between platforms trading digital assets on DLT and more traditional payment systems. This is the basis of the 'trigger solution' developed last year by the Bundesbank. It is technically possible, but it should not be positioned as a long term solution. In the longer run, the introduction of a wholesale CBDC (wCBDC) should be considered. Such a setup would nevertheless provide more time to develop a solution around wCBDC and to define more precisely the form of the CBDC and how it will be built. It is expected that the issues with the cash leg can eventually be solved, which will allow the industry to reap the advantages of DLT in the post-trade space. Progress on these issues will also be contingent on the private sector's commitment to conduct further experiments with DLT applications.

A third Central Bank official noted that the proposed bridge between a DLT platform for the trading of tokenised assets and existing payment infrastructures does not necessarily need to be linked to DLT technology and could be applied to a number of systems beyond DLT.

While this 'trigger solution' has significant potential, its implications should be carefully considered, particularly in terms of re fragmentation of the system. The idea behind this solution is to make wholesale central bank money available 24/7 via application programming interfaces (APIs) for any usage with immediate settlement. This is a powerful idea that is feasible, but its precise workings and its policy implications need to be fine tuned. Additionally, it is worth considering the potential to use private stablecoins in such an environment. The ninth principle of the Principles for financial market infrastructures (PFMI) stipulates that central bank money should be used by infrastructures where practical and relevant. At the same time, it is important to be open to innovation. If transactions can be securely settled using stablecoins, such an approach should be tested by the market on a limited scale.

The Central Bank official disagreed with the concerns raised about the potential difficulty of exercising monetary control when using wCBDC on a DLT securities settlement platform. This should not change the set of counterparties, and the same banks will be using central bank money albeit in a different form. It would not necessarily mean that a bank in a non-EU jurisdiction could directly hold wCBDC.

The Chair noted that central banks appear willing to accommodate or support an evolution of the market towards a more decentralised settlement system and that different options are available. What remains to be seen, however, is the practical form this might take. Further evolutions such as decentralised finance (DeFi) should also be considered. There is not yet any visibility on what type of settlement asset might dominate in such an environment.

Securitisation in Europe: quick fixes or deep overhaul?

1. Despite varied legislative initiatives the securitisation market in the EU has stalled

1.1 Securitisation is promising for EU financial markets

A regulator commented that securitisation is a hot topic, but certainly not a hot market. The European Banking Authority (EBA) is in the process of finalising a call for advice that was requested by the European Commission (EC). A workshop held with the industry before the summer managed expectations. Anything that could happen between now and when the EBA makes a statement publicly would be either the same or an improvement. That is probably the best position possible. In the past, securitisation was very promising, with hope in the market, interest from market participants and enthusiasm in the public sector for those products to disseminate risks in the system and provide new asset classes for investment for long-term investors. Then the market ground to a halt.

These instruments could potentially damage the economy and the financial sector itself if they are misunderstood or misused. Effort in Europe, from the legislative and regulatory sides, has been focused on starting afresh. The EBA produced the simple, transparent, and standardised (STS) framework. The STS, to some extent, replaced some of the amortisation products and did not enlarge the market segment. The current situation in Europe is not working. In the US and other jurisdictions, the situation is different. Securitisation is back. The discussion will consider why it is not working and whether that is related to the environment or regulatory constraint. There is probably a need for movement on both sides.

1.2 Further than funding, securitisation provides capital relief for banks

An industry representative commented that, although true sales securitisation is very important for banks to obtain funding at an attractive level, banks also need to hold capital for the risk that a loan may not repay. Their organisation invests in synthetic securitisations, which help with capital relief. It takes over the first loss credit risk from these banks. The banks pay a premium for that. The industry representative's organisation then tries to achieve more premium than is paid out in losses to the bank.

2. A vanishing market

2.1 All the figures, in absolute and relative terms, suggest a vanishing market

An industry representative noted that the total issuance in the EU market to the end of August was €35 billion. €12 billion of that was STS. €6 billion was residential mortgage-backed securities (RMBS).

The comparable issuance in mortgage-covered bonds for the same period is €145 billion. €6 billion of systemic risk is not comparable to €145 billion. Europe has retained volume. Globally, banks do not typically retain asset-backed securities (ABS) or RMBS in order to go to the central bank.

The European market outstanding is shrinking. The outstanding ABS/RMBS market in Europe is less than the annual issuance of covered bonds in Europe. Covered bond issuance is more than half a trillion every year. The covered bond market increased from €2.1 trillion to almost €3 trillion in the last 10 years. Europe issues less ABS per annum than Australia. It is a misperception that the US market is all an agency one. Last year, the US issued more than $800 billions of non-agency securitisations against an agency market of around $3 billion. About $60 billion of that was private sector RMBS, which could not be eligible for the agency market.

An industry representative noted that the role of securitisation in the capital management toolbox has, unfortunately, reduced over time. This is a missed opportunity, given the additional investments that are needed to finance the green and digital transition in Europe and strategic autonomy. His firm has currently outstanding securitised loans to the tune of €47 billion. In one year, it has securitised only €12 billion, compared to a balance sheet of €2.6 trillion. Securitised loans represent 1.7% of his banks' total assets, compared to an average of 9% for US banks, excluding agency RMBS.

2.2 Synthetic securitisation is now increasing

An industry representative commented that the good news about the securitisation market is that the market for synthetic securitisations is growing. Synthetic securitisation is also called 'credit risk sharing' because it is about sharing the credit risk with banks. In the first six months of this year their organisation has done more than on average in a year in the past. Europe is a world leader in this. Some of its investments in the first six months of this year have been STS-qualifying transactions.

There is also an STS qualification for credit risk sharing transactions, after it has been introduced for the true sale. Most of the transactions closed have this STS qualification and there a number of new issuers the industry representative's organisation's books. The Landesbanken in Germany are looking at this market. Their organisation did a transaction with Helaba in June. There is a securitisation market in Europe that is working, growing fast, and seeking more investors.

3. Nowadays, the longstanding stigma does not weigh on EU legislators, but reinforcing supervision and resolving the factors holding back this financial technique is necessary

A public representative commented that there is no stigma currently. In 2016, regulation was concluded by Council and Parliament after work on securitisation. PGGM is heavily involved in synthetic securitisation. As part of the green bond standard, work is now ongoing on the possibility of green securitisation. For the European Parliament, it is one of the instruments. Historically, it was not just the market that failed, but also the supervision. The European Parliament is looking forward to a review, which will enable the European Insurance and Occupational Pensions Authority (EIOPA) and the EBA to share their views on development and possible improvements. The article by Ian Bell considers the P-factor in depth. Contributions from supervisors are welcomed. The European Parliament is open to it if supervision is adequate. The European Parliament and others are concerned about a systemic-risk build-up, as seen in the past. This should be avoided.

An industry representative commented that stigma is not mentioned elsewhere. The regulation is done. It is 17 years after the crisis. The products that caused the crisis were outlawed. In Europe, the underwriting criteria were tightened.

An industry representative stated that enthusiastic investors are available. BNP Paribas is one of the most active banks in Europe in the securitisation area. This began prior to the 2008 crisis and even during the financial crisis the credit track record was excellent in Europe. What happened in the US should not be confused with what happened in Europe. This is a very safe type of asset.

A regulator stated that there are no concrete suggestions to improve the framework for insurance undertakings. However, EIOPA will retain an open mind and continues to receive feedback, analysis and data and provide technical advice. The supervisory community cannot do more to encourage insurers to invest more. Supervisors must be neutral on investment choices.

4. Regulation, in particular, is questioned by EU market figures

4.1 The financial industry considers that insurance securitisation-related capital constraints are unnecessarily penalising

An industry representative stated that investors are needed to grow a market. The insurance companies in the US are between 10% and 30% ABS issued. In Europe, the holdings of the insurance companies have dropped from 8-9% in 2010 to 2-3% now. The EIOPA paper indicates that solo insurers are at 0.5% of assets under management.

An industry representative suggested that the lack of issuance is not due to a lack of investors. On the insurance side, investors have disappeared because the regulation has been as punishing as for the banking side. The shock that is applied when assessing the capital requirements for insurers is heavily penalising and unrealistic. Insurance companies have almost stopped investing but are ready to restart if the regulation allows. It is hoped that this will be included in EIOPA's report to the EC.

4.2 Making consistent regulatory frameworks across financial products is necessary

An industry representative stated that diverting collateral to another instrument leads to a difference in the treatments of collateral and instrument, incentivising banks to go elsewhere. For example, the Netherlands was a major RMBS issuer, but no longer is. There is current discussion about potentially auto loan covered bonds, which would end the auto ABS market as a funding instrument.

4.3 Combining transparency with appropriate capital charges is essential for incentivising investors

An industry representative commented that stigma is the wrong name for complexity. It is not a simple instrument. Knowing what is being invested in requires information. In addition to some regulatory changes, good data that is ready to be used will make the market more attractive for investors. Enormous amounts of time are spent reviewing the data to assess an investment.

4.4 Banks suggest that the capital relief accepted by the prudential framework deters issuers, though they increasingly need freeing capital

An industry representative commented that there is no lack of willingness to securitise. Their firm uses securitisation mainly for risk transfer purposes. It aims to sell the equity tranches and, the mezzanine tranches, but retain most of the amounts, included in the senior tranches with a very low level of risk. This reduces risk-weighted assets and offloads risk. The huge amount of liquidity provided by the European Central Bank (ECB) is irrelevant in explaining the reduction of securitisation. Ongoing supervisory pressure on capital increases the necessity of securitisation, particularly in relation to the upcoming Capital Requirements Directive VI (CRD VI). The reason for not securitising is the difficulty in achieving the conditions to get the economics required to securitise. To be an attractive transaction, the cost of securitisation plus the revenues transferred to sold tranches should be lower than the cost of the equity that is saved. This is difficult to achieve because the capital relief is limited, due to the calibration of the rules for the securitised product. This does not create any incentive to securitise the portfolio.

A regulator noted that there is a tension around the size of the capital relief. Regulators should propose improvements.

An official commented that there is an issue when talking about levers or stocks. The market is very thin

when compared to others. It is also an issue of the flows. Since the end of the financial crisis there has been a divergence. The gap has not been closed. This gap is often attributed to structural differences between markets, particularly the US and EU markets. The residual unexplained difference tends to be assigned to regulatory differences.

5. The limited involvement of insurance companies cannot be explained only by existing capital requirements

A regulator stated that there is no stigma from an EIOPA perspective. In 2015, EIOPA differentiated treatment of capital for the less risky assets. EIOPA worked on the call for advice with the EC and tried to manage expectations. The consultation paper states the possible approach, the data available and the analysis conducted. The final document will be ready shortly. EIOPA has asked insurers why demand is low. The main reasons for the low appetite are the availability of more appropriate assets, for example those that present a better risk return profile or better match their liability, the availability of data and the capital requirement. As such, EIOPA is reviewing the capital requirement. However, fewer entities are investing, and this cannot be explained simply by the capital requirement.

6. The positive impact of the STS framework on the previous stigmatisation of securitisation, the need to finance green and digital assets, and the much-needed strategic autonomy should favour the revision of the securitisation framework

An official commented that the 2019 reform did not achieve much in terms of volumes. The importance of STS can be seen in how the market is qualitatively composed, with an increase of up to 30% in recent years. This reduces the stigma. Given current discussion around strategic autonomy and the green and digital transitions, EU member states must unlock their full investment potential, including public and private funds. Securitisation will be one of the key elements going forward to complement the public investment effort. The green transition highlights the importance of green securitisation, which is at a very incipient stage. Challenges ahead include developing sustainable assets as a basis for green securitisation and developing the applicable framework. There are recommendations in this area from the EBA. The green bond standards would be a good basis for discussion.

7. Possible areas for progress

7.1 Further distinguishing the regulatory treatment of STS and non-STS securitisation

A supervisor stated that the evolution of this framework will facilitate a number of goals mentioned by other speakers. For insurers as investors, distinguishing more between STS and non STS securitisation and developing a more incentivising way of weighting these STS securitisations in Solvency II would be beneficial. It has been stated earlier that, if supervisors were ready to support changes to the framework, Parliament could follow. The Autorité de Contrôle Prudentiel et de Résolution (ACPR) is ready to support changes to the framework on Solvency II and is comfortable with insurers investing within stated limits.

7.2 A possible recalibration of the P-factor should be undertaken carefully at the level of the Basel Committee

A supervisor noted that non-neutrality of capital is addressed through the P-factor, which can be calculated from 130-200%. A simple idea would be to lower the P-factor. However, there could be unintended consequences of lowering the P-factor because there is a nonlinear element that could create more volatility. That does not mean that the P-Factor does not need to be decreased, but it should be done collectively at the Basel Committee meeting after a full assessment and not when discussing the next steps in the European context. Within Europe, without creating a big deviation compared to the Basel framework, the risk-weight floors, which determine the minimum risk-weight applicable to securitisation positions, could be easily lowered.

7.3 Under scrutiny of supervisors, capital charges should factor in that agency risk is, by essence, reduced for originators

A supervisor stated that the level of agency risk for the originator is lower than for the external investors because originators handle their own data. Under the scrutiny of supervisors, a lower risk-weight floor could be introduced for senior securitisation tranches retained by the originators, provided that safeguards are in place. This would be a less costly step in the right direction rather than a big deviation.

An industry representative noted that capital charges for those retained tranches, through the flow and the P-factor, could be recalibrated. The P-factor is supposed to compensate for asymmetry of information in the context of STS, but this asymmetry does not exist for a retained tranche.

But he warned that adding limited safeguards and new restrictive rules at the same time would offset the positive impact.

7.4 An explicit target for the involvement of insurers in the securitisation market should be reflected in any recalibration of the capital charges

An industry representative suggested that European insurers should be brought into the European

securitisation market to the same degree as US insurers. Capital neutrality is not only for banks. It does not make sense for a triple-A tranche to attract four to six times more capital than the underlying. The methodology is different, but action should be taken.

7.5 Addressing the genuine complexity of securitisation requires sufficient data as well as issuers having an appropriate level of 'skin in the game'

An industry representative commented that banks originate the risk, know the risk and have the data. Insurers want to see the data, but do not need to know the names of clients. The credit work is not going to be redone. To ensure origination proceeds in a sound way, banks should keep 'skin in the game', which means 20% and not 5%.

7.6 Improving the regulatory treatment of project finance securitisation is essential to developing green securitisation

An industry representative noted that their organisation has done a number of transactions since 2008 on project finance portfolios, some for green energy projects. Portfolios can be made up of grey and green. The economy is gradually transitioning from grey to green. A deal in which a bank gets the green parts and a pension fund is stuck with the grey parts is not a great proposal. Sharing that transition in portfolios would be preferable. Their organisation did a transaction this year with such a transition agreement in place.

An official noted that the most frequent request from the industry, aside from issues related to proper risk-based calibration or regulatory arbitrage considerations, is to optimise the administrative burden. This issue would be easy to address going forward.

7.7 An important issue is to increase the contribution of securitisation to bank liquidity ratios

A supervisor noted that it had been stated that liquidity was not the purpose for originators. For investors, subject to the liquidity coverage ratio (LCR), it can be an issue. The treatment of some STS securitisation tranches in the liquidity ratio could be revisited.

7.8 An appropriate combination of regulatory recalibration and improved supervision is necessary

A public representative advised that clear supervision is needed. Supervisors will play an important role, whether that is in adjusting the P-factor, the senior tranches or elsewhere. Fortunately, the European Parliament does not do risk calibration. Digitalisation and sustainability are demanding, so private investment needs to be unlocked. In that sense, there is cause for optimism that the market will grow. The era of cheap money is over. This will also provide a boost for the securitisation world.

8. Conclusion

A regulator concluded that securitisation needs to be back at full force in Europe. There is appetite on all sides, but supervision must be appropriate. Issues of complexity must be tackled, but STS is helping here. This complexity includes the data needs of investors and the problems for issuers of complying with administrative burdens. On capital neutrality, work is needed to make the products more appealing for investors and for issuers willing to share the risks. That may not be systemic, given the volumes seen so far. On the data gap, the originators' idiosyncratic information gives them an advantage. That will assist in considering calibrations of the capital treatment, maybe not with regard to the P-factor but floors instead. The title securitisation products, not only the synthetic ones, might be very much needed in the near future, given the new environment that is developing.

Sessions VI

DIGITALISATION AND PAYMENTS

Digitalisation trends in the financial sector and policy implications

1. Current market trends, future prospects and challenges

1.1 State of play of digitalisation in the EU financial services sector

The Chair indicated that digitalisation is rapidly changing the world, and financial services are one of the most obvious sectors for embracing the vast range of new opportunities that technological advancement brings, given the strong data-driven nature of the sector. That has been a trend for some time, but the experience with Covid has further accelerated it and has changed how technology is used and perceived by the wider public.

An industry representative suggested that one way of looking at the progress of digitalisation in the financial sector is to take a historical perspective. While many people consider digitalisation to be something that is of the current time, it has in fact been taking place over many decades. The first ATM in Europe was introduced in 1967. Telephone banking came into effect in 1984. Mobile banking started in 2008. Digitalisation is therefore a long-standing trend of modernisation in the financial services sector aimed at removing manual processes and optimising human interaction between consumers and financial institutions.

A new wave of digitalisation has come in 15 years ago with cloud computing that was launched in 2006 and also artificial intelligence (AI), machine learning and the blockchain. The EU is still in the early days of this new phase of digital modernisation. Some other parts of the world are slightly ahead. For instance, in the US, according to Gartner, 81% of enterprises have applications in the cloud and they are using it pervasively throughout their operations. There is also rapid adoption of cloud in Asia Pacific and Latin America.

A second industry representative agreed that these technologies are the ones that are the most relevant for the financial sector. Cloud services is critical for the digitalisation process with financial players increasingly moving IT infrastructure and workloads to the cloud. AI allows banks to go to the market quicker and to develop services that are more personalised with less expense. Blockchain also has significant potential, although it is still at an experimentation stage in most cases.

1.2 Key trends driving digitalisation and main benefits from digitalisation

An industry representative suggested that three key trends are driving digitalisation in the financial sector. First and foremost is customer experience. Many organisations have embraced digitalisation to improve customer experience. This was already the objective of the previous wave of digitalisation with ATMs and mobile banking. The second trend is using data and analytics for developing new revenue streams and improving risk management. Third, is the modernisation of core systems, which is necessary to change organisations and the way they operate and also to reap the full benefits of enhancements in terms of customer experience and data analytics.

A public representative suggested three types of improvements that may be provided by digitalisation. The first is that digitalisation is part of the modernisation of financial services, helping to improve customer experience and to facilitate the provision and accessibility of products. This is progressing but much still remains to be done in this area. An additional advantage of digital financial services and products is that they can be easily rolled out over the entire single market, if the underlying regulatory framework is sufficiently harmonised. The second level of enhancement is using digital tools to improve the efficiency of the processes of financial institutions and public authorities. There is also a great deal to explore in that respect, with significant room for improvement, especially on the public sector side. Anti-Money Laundering (AML) rules applied to cryptoasset transfers is a good example of an area where digital tools can significantly alleviate the administrative burden for supervisors, service providers and customers and also enhance the effectiveness of reporting and supervisory work. This is an area where more investment is needed and possibly the digital euro will be a driver in this respect. The third level is that digitalisation can potentially support product and business model innovation, helping not only to introduce new ways of providing financial services but also to create completely new services such as those that may be developed under the MiCA framework. That is the most challenging part due to the rapid pace of change. It has to be ensured that a business-friendly and innovation-friendly environment can be created and maintained in terms of regulation across the European Union with an appropriate balance with customer protection and risk mitigation aspects. The public representative added that digitalisation can also help to enhance the financial literacy of customers and entrepreneurs. A strategy should be developed by the public authorities in this respect.

The Chair agreed that digitalisation presents many opportunities in terms of enhancing supervision and developing cross-border business, but this also requires appropriate cooperation between supervisors. Digitalisation also offers many possibilities for enhancing financial literacy, which is a responsibility that should not only lie with the public sector, but to which the industry should also contribute. Digital tools can indeed facilitate the provision of information and explanations on products and product comparisons and provide information flow that may support customers in their financial decisions.

An industry representative highlighted four key trends on which their organisation, a leading fintech, is focusing for the future. The first is open finance[1] and open data, building on open banking on which Europe led the way with the payment service directive (PSD2). This is about enhancing data use and sharing, not only financial data but also data from big techs for example, and empowering customers with their data, so that they can make better financial decisions and get better services and offers.

The second key trend is instant payments. Proposals are underway at the EU level and there is already great work being done at the national level with instant payment systems such as iDEAL in the NL for example. Instant payments should be made available throughout Europe at the lowest cost possible and there should be an ambition to extend this globally.

The third trend is digital identity. The EU is making significant progress in this space, although aiming for 2025 would be better than 2030. Enhancing the way people engage with financial services and data will depend on appropriate authentication and identity verification processes and also empowering people to have control over their digital identities.

The fourth trend is Web3. Cryptoasset trading is only a small part of what can be done with the technology underlying cryptoassets, which may support further digitalisation through tokenisation in particular. Whether it is digital identity or loyalty there are also many interesting use cases for an immutable and decentralised ledger. Building on MiCA, the EU has a major opportunity to lead the way in this area.

Additionally, thanks to digitalisation, financial services providers may shift from acting mainly as intermediaries in the middle of the ecosystem to creating value for customers by helping them to get better services and deals and connecting financial services with the non-financial world. Financial services should be a one-stop shop providing a range of services that may improve people's lives. For example a financial app should not only allow customers to pay for their airline tickets but should also help them to solve problems e.g. receiving automatic refunds in case of delays.

1.3 Challenges from digitalisation

An industry representative noted that going through a digitalisation process is a complex journey for any company. This usually comes from employee pushback, budget constraints and a lack of expert skills. For a regulated company there is an added complexity and cause of delay coming from regulatory and supervisory requirements. An additional issue for regulated entities is that digitalisation might lead them to operate in a new ecosystem with new players such as third-party technology and data providers that may not be subject to the same level of regulation.

A Central Bank official suggested there should be talk of the readiness and feasibility of all parts of society to access digital financial services. With a further move to digital, there is a risk that some parts of society will be excluded. Steps should be taken by public authorities and market participants to help customers if new technologies and digital services add complexity in some areas or create barriers to access for certain categories of customers. Business models are becoming increasingly complex, and sometimes consumers do not know who is providing the service. If something goes wrong consumers do not know where to get help from and who are the regulators in charge. Further cooperation is needed between the public authorities and the industry to address these issues. This will reinforce customer confidence which is essential for the development and credibility of these new services.

A policy-maker agreed that innovation can only succeed, in particular in financial services, if users have confidence that they do not incur disproportionate risks. Managing risks and taking care of user interests is indispensable for more and faster innovation in the financial sector.

2. Policy approach: key objectives, success factors and main challenges

2.1 Update on the EU digital finance policy framework

A policy-maker stated that there has been significant work on a comprehensive digital finance agenda since 2020 when the Digital Finance package was presented by the European Commission. The aim is to regulate in a way that preserves the capacity to innovate. The EU will be the first major jurisdiction to have a comprehensive framework for crypto assets with the markets in crypto-assets (MiCA) regulation which is in the final stage of preparation. The Digital Operational Resilience Act (DORA) was recently finalised. It is the first supervisory framework for addressing cyber risks and Information and Communications Technology (ICT) risk management in the financial sector and takes into account changes in the value chains with the increasing role of critical third-party tech providers, for which an oversight framework will be implemented.

There is also close work with the European Central Bank (ECB) in view of the Commission proposal for a digital euro, where Europe is again one of the leading jurisdictions to work on a central bank digital currency (CBDC). For a digital euro to succeed a number of crucial issues have to be addressed. One is the risk of disintermediation, so the digital euro should remain mainly as a means of payment and not become a significant store of value. There are also privacy and data protection concerns that need to be looked at, as well as anti-money laundering and terrorism-financing aspects (AML-FT) that have to be addressed. The aim is to make a proposal on the digital euro in the early part of 2023.

Finally, open finance is the next step in the EU digital finance agenda. The work on open-finance builds on a thorough review of the Payment Services Directive 2

1. Open finance refers to third-party service providers' access to (business and consumer) customer data held by financial sector intermediaries and other data holders for the purposes of providing a wide range of financial and information services.

(PSD2) experience. It aims to foster innovation, while giving consumers and business users better control over their financial data and making sure that there is a level playing field across different sectors.

2.2 Challenges regulators and supervisors are facing related to digitalisation

The Chair noted that digitalisation is a significant challenge for all market stakeholders. The right skill set and resources, both in the companies trying to exploit these opportunities and in the supervisors and regulators, is key. In addition, financial regulators and supervisors need to consider many aspects in the design and implementation of digital policies such as balancing innovation and risk mitigation and also ensuring a level playing field between existing players and newcomers in the market. One question to be considered is whether financial supervision needs to evolve in the digital world in order to take these different objectives into account.

A policy-maker emphasised that, with digitalisation, regulators and supervisors are facing similar challenges in terms of skills in particular. Supervisors and regulators need to develop their technical skills and human resources to properly supervise and regulate these new developments. However many of them are still in the early stages of creating and implementing the expertise and instruments that are needed.

An industry representative observed that getting the regulation related to digitalisation right in the financial sector is going to be challenging. Disruption is coming to numerous areas of financial services and this has only started. Regulation will be essential for making sure that end users get a better deal as a result of these evolutions. From a regulatory perspective one question is also whether something is a real innovation or just a rebrand or a modification of an existing product or service. While genuine innovations may solve some problems, they will probably also create some new ones. If this is not the case, then this is probably not a real innovation.

The objectives of most EU digital regulations are appropriate, the industry speaker believed. The challenge is getting the details right, particularly in terms of keeping up with how rapidly technology is changing. When rules are written they must still be relevant several years later, which is a major challenge. In addition, while Europe is leading on many aspects of digital finance regulation, there are areas where Europe may be leapfrogged by other jurisdictions, for example with Australia moving fast on open data or the US and Gulf countries progressing in the areas of crypto and stablecoins. Europe needs to make sure it retains leadership, not just so that European citizens benefit from the potentialities of digital finance but also so that European fintechs and legacy banks can leverage these opportunities and take advantage of them to further extend their activities geographically. Accelerating digitalisation indeed requires regulations but also players able to shape the evolution of the financial system on the basis of new digitalised tools and services. A further point is that with CBDCs, central banks are going to become competitors in a way to many legacy payments entities, potentially leading to retail payments being made with no cost. This needs to be considered in the work on the digital euro.

2.3 The need for cross-border and cross-sector consistency and coordination in the policy approach to digital finance

A public representative suggested that digitalisation requires changing the way regulation is considered, because it is not possible to only use sector-specific regulation as was the case in the previous decade. There is now an amount of horizontal legislation being introduced on the EU level such as the Artificial Intelligence Act, Data Act and Data Governance Act, which all also have an impact on the provision of financial services. How to combine sector-specific and horizontal legislation in the most effective way still needs to be considered. An example of an area where this is particularly relevant is cybersecurity with the interaction between DORA and broader cybersecurity regulations, such as Network and Information Security (NIS2).

Secondly, the regulatory work on digital finance should be conducted with an international perspective. While it is positive that the EU moves forward on new issues such as the regulation of cryptoassets, it should be borne in mind that close cooperation will be needed on the global level to achieve an effective regulation of such activities. In addition there is an opportunity for Europe to set the standards for such an area where global standards do not exist yet. That may support the international expansion of European companies.

The Chair agreed that the interaction between cross-sectoral approaches and financial legislation needs to be closely examined. Concerning cyber-security and the implementation of the DORA regulation, this is an issue that the European Supervisory Authorities (ESAs) will be working on with the European Union Agency for Cybersecurity (ENISA) and other authorities involved in the regulation and supervision of cyber-risks.

A Central Bank official noted that the consistency of legislation in different areas relevant to the digital space and collaboration among the regulators and supervisors concerned are essential to achieve an appropriate regulation and supervision of these activities and ensure their proper implementation by market participants. Collaboration is key particularly at the cross-border level, from the early stages of any legislative initiative. This helps to define the appropriate tools for regulating these activities and also the practices needed for supervising them.

An industry representative stated that harmonisation at all levels, EU and global, is conducive to encouraging further modernisation and digitalisation in the financial sector. Fragmentation creates compliance challenges not only for the financial institutions but also for their service providers. When there are different regimes and approaches, this complicates risk management. The political agreement on DORA is encouraging because it will allow the provision of a harmonised set of rules on ICT risk management across the EU, but this level of harmonisation needs to be maintained when the rules are implemented.

Another industry representative remarked that while finding an agreement on rules among 27 different countries is a challenging process, this also generally means that the rules agreed are effective, working for

countries with different cultures and economies. Such rules then provide a sound basis on which Europe can potentially lead the way internationally.

2.4 Areas of improvement in the regulatory approach to digital finance

An industry representative acknowledged the efforts made to build an appropriate digital finance framework. There are however some gaps and obstacles when considering the two objectives of the framework which are (i) supporting the growing digitalisation of the finance sector and seizing opportunities associated with digitalisation, and (ii) ensuring a customer-centric approach where customers can benefit from improvements in terms of access and new services thanks to digitalisation. Regulated financial institutions, notably banks, face significant obstacles when engaging in digitalisation, related to the layers of supervision and regulation imposed on them. When banks want to move workloads to the cloud, for example, they face a number of challenges. They need to manage fragmentation of the supervisory space and requirements that are too cumbersome, such as pre-approvals from supervisors that may take months to obtain. In some other jurisdictions such as Singapore no pre-approvals are needed for moving workloads to the cloud. There are also some cybersecurity requirements that can prevent financial institutions from going into the cloud. Alleviating these requirements somewhat would be helpful for allowing the European financial sector to compete.

A second industry representative stressed that regulatory certainty is essential for enabling the adoption of new and emerging technologies. It can be challenging for organisations to move forward if regulation is not clear enough or does not take into account the latest evolutions in terms of technology. When requirements are clearly known, that creates confidence and it is possible for tech providers to move much faster to serve customers and help organisations to evolve.

A third industry representative flagged three areas for improvement concerning digital finance regulation. One is harmonisation. Europe is in theory a single market, but in reality there are many domestic rules, requiring products to be built with 27 different variations. Larger companies can build local branch structures under a core bank license in one EU member state in order to e.g. be able to offer local IBANs, which is essential for developing sufficient activity in each local market. But smaller fintechs will not have the scale to do so and that will slow their expansion and capacity to enhance innovation.

The second area of improvement would be moving towards more outcomes-based regulation. This is necessary for regulation to remain valid in areas where technological innovation is very rapid, such as cryptoassets and transfers of funds. Regulation should be designed to deliver a given level of risk and a given level of control. In additional new approaches are needed for mitigating risks and reducing fraud e.g. by embracing new technologies like behavioural biometrics.

A third issue is the speed and ambition of the EU regulatory process and whether they are sufficient to support innovation and accelerate time to market. Europe could be more ambitious in certain areas of its policy-making, for example not just building for open finance but building for open data or bringing forward digital ID to 2025. This would help to deliver new opportunities from digitalisation faster.

A policy-maker stated, regarding the point made by the previous speaker on harmonisation, that the objective of the Commission with the Digital Finance package is to support the creation of a single market for payments and capital, which requires a harmonisation of rules. The Chair added that harmonisation requires a common implementation of rules and since much of the supervision will happen at national level, there is also a need for driving towards common outcomes in supervision on the ground.

A public representative stressed that regulatory certainty and calls for nimbleness need to be balanced. The right way forward is to develop more principle-based legislation, and setting the desired outcomes in terms of the key building blocks for the relevant sector in terms of how to manage risks and how to ensure investor protection. That should be the approach, rather than trying to address all issues through prescriptive rules in European legislation that also take a great deal of time to draft. The work of the European Commission on MiCA started in 2018 and will not be fully enforced until 2024, which is a very long time span during which the market will have significantly evolved. For example a long time was spent on categorising cryptoassets, but aspects such as initial coin offerings (ICOs) and large scale private stablecoins such as Libra are no longer as relevant. Since then decentralised finance (DeFi) and NFTs have developed but are not directly tackled in MiCA. This shows how quickly the market is changing and the need for the policy framework to be sufficiently open and flexible in order to keep up with evolutions. In addition there is a need to further adapt existing financial regulations to digitalisation and check whether regulations such as MiFID are compatible with MiCA for example.

The Chair mentioned that the adaptation of existing financial legislation to digitalisation is being worked on by the Commission as well as the consistency of these legislations with the digital finance framework. This is important to ensure that the opportunities that digitalisation brings can improve customer experience and the information that they are provided with.

Cryptoassets: are regulators on the curve?

1. Current state of the cryptoasset market and ongoing trends

Answering a question from the Chair about the recent downturn in the crypto market and the potential for improvement of cryptoasset valuations, an industry speaker acknowledged that crypto is currently in a 'bear market', which affects both investors and cryptoasset service providers (CASPs). The current market conditions are similar to a stress test. Several business failures have occurred, but these are isolated problems that have mostly affected certain decentralised finance (DeFi) platforms. Crypto remains an attractive investment opportunity. Bitcoin is a true scarce resource, and crypto offers diversification. The idea is not to substitute traditional assets for crypto, but to diversify by investing in crypto in addition to traditional assets.

A second industry representative noted that 'crypto winters' are inevitable in such an early-stage market and technology. This can be challenging for newcomers to crypto investment, but the latest downturn is an opportunity for more experienced market participants to consolidate their positions. There are three main lessons from the recent downturn. First, crypto markets are more correlated to the broader financial markets than previously thought. Two-thirds of the current downturn can be attributed to macro conditions and one third to crypto specific conditions. This reflects the maturation of the cryptoasset class and the breadth of adoption. Secondly, despite the sudden downturn since the peak of November 2021 and some sporadic dislocations of CASPs, the technology has proven resilient and most platforms have operated in a resilient manner. There has been an increasing adoption of stablecoins, particularly those that are well managed and well backed, which proves that the market is responding positively to improvements put in place by the main crypto players. At the same time, there has been a beneficial shake out of market participants and business models with poor risk management, such as some of the algorithmic stablecoins. Thirdly, the adoption of crypto continues. A partnership has been recently concluded between the speaker's firm, a major CASP, and a global asset manager to facilitate the provision of cryptoassets to institutional investors for example, showing a continued interest in the market for this asset class.

An official emphasised that monetary policy is one of the factors affecting the crypto market at present. The ongoing normalisation of monetary policy makes investors recalculate the risk reward ratio on certain assets and certain investors switch back to more traditional assets. There has been rapid development of the crypto market in several EU member states over recent years. In 2021 Europe emerged as one of the leading regions for DeFi. In Lithuania for example, the number of new CASPs coming into the market has grown from 8 in 2020 to 188 in 2021, with significant growth also observed at the beginning of 2022. This growth in the EU market is happening despite the fragmented regulatory landscape within the Union. When the European level Markets in Crypto-Assets (MiCA) regulation comes into force, that will be a solid basis for a pan-EU market to develop and for the EU to become a leading region for crypto. While some firms are trying to avoid regulation and exploit loopholes, others are seeking the certainty it offers.

A regulator observed that crypto is primarily a technological development and it can have different uses. So far this technology has mainly been used for developing investment assets, but this is not its only use case. When assessing the potential of crypto it is necessary to examine the different use cases of crypto technology and identify those that can bring most value to the market. The first industry speaker considered that the phase of speculation and investment through which the crypto market has first gone through is normal. It was needed to enable the industry to generate sufficient investment capacity and provide a basis for future innovation and growth. This should enable the industry to move into a second stage of evolution and develop larger scale payment and money transmission services and other financial services customers can benefit from.

2. Opportunities and risks from cryptoassets

2.1 Opportunities and future prospects

An industry speaker emphasised that crypto's potential is what makes it attractive. The speaker's company, a major CASP, is using the relative calm of the bear market to enhance their platform, improve consumer protection features and prepare for new innovations in the market. There are significant changes happening around the infrastructure of the crypto market, such as the Ethereum platform moving from proof of work to proof of stake for approving new transactions in September 2022, the so-called 'Merge', which promises to dramatically cut the energy requirements of the blockchain and help tackle scalability issues.

The industry speaker expected that new projects and opportunities supported by crypto technology will continue to emerge. A key future evolution is Web3, which will facilitate the exchange of value through the internet with no intermediaries or third parties. Such a technology can potentially bring more transparency and efficiency to financial flows and processes. Additionally, the transportability of title ownerships can be done through non fungible tokens (NFTs). This can open the way to a multitude of new use cases of crypto technology beyond

investments and payments leading to potential improvements in the way financial markets operate.

The Chair noted that during the energy crisis in the early 1970s with double-digit inflation there were discussions about allowing private currencies to compete with national ones. Similarly, the present context should support the development of crypto as a private currency, but this has not yet happened. The industry speaker responded that crypto is a medium of exchanging value. If crypto is properly supervised and regulated and follows a common set of rules across markets, there is no reason why it could not be used as a currency.

Another industry representative agreed that the use cases of crypto are manifold and will eventually cover a number of different applications, including use as a form of payment. In a digitised society, it is critical for citizens to be able to manage their wealth and their assets in a digitised form. Crypto provides that opportunity through the use of stablecoins. It is essential that policymakers allow this evolution to occur. Many developments are happening in the market such as the Ethereum Merge and venture capital is continuing to flow into crypto projects, which is clearly a positive sign.

2.2 Challenges and risks from cryptoassets and related regulatory objectives

A regulator explained that supervisors have long been concerned about the risks posed by crypto as financial assets. The EBA has issued many warnings to banks about the risks of holding these assets and recommending them to their customers as investments and also about their potential illegal use for money laundering. While crypto technology offers traceability and transparency features, the speed of transactions and the lack of AML/CFT checks until now, reinforced by the decentralisation of certain platforms and pseudo-anonymity used on some of them have also encouraged misuse. Warnings have also been issued by regulators to the retail customer base regarding the risks of fraud and the high volatility of these assets. These risks illustrate some of the important loopholes in the current regulatory approach that need to be tackled. In the future it is likely that there will be a shake up in the crypto market, as with any innovation, allowing a sorting out of the good and bad business models and products. The regulatory framework must ensure that the market converges towards the most beneficial use cases and that the more risky or less useful ones are limited or banned.

An official agreed that, as with many innovations, cryptoassets bring both opportunities and risks. It is up to policymakers and regulators to build a regulatory and supervisory framework that minimises the risks and fosters a sustainable development of the sector, leveraging the potential of the underlying technology.

Another official observed that the recent crypto crash has highlighted the basic failure of the market around some very fundamental requirements of prudential regulation and risk management. There were firms which, if not outright fraudulent, had little to no risk management in place. It is natural that some of these firms eventually failed, and there is no need to overreact to this. This may not have happened had they been following some basic risk management requirements.

3. Ongoing regulatory initiatives at the EU and international levels

3.1 The EU regulatory approach to crypto: Markets in Crypto assets (MiCA) and Anti-Money Laundering (AML) rules

A regulator explained that MiCA is in the final stages of adoption and will come into effect in the second quarter of 2023. It imposes requirements on CASPs and regulates the issuance of cryptoassets, identifying two main categories: asset referenced tokens, i.e. stablecoins that claim to be stable vis-à-vis other assets and are fully backed by a reserve of assets, and e money tokens, i.e. cryptoassets perceived as investments and unbacked stablecoins. Concerning asset-referenced tokens, criteria for evaluating their criticality to the financial system are due to be established and the most significant ones are due to be supervised at the European level, as well as their issuers. These criteria will cover different aspects, such as the total market capitalisation, the significance of cross-border activity, the importance for the payment system and the level of interconnectedness with the financial system, and will be further specified by technical standards. In addition to MiCA, the EU AML package has been updated to cover cryptoassets and it is expected that crypto will be within the regulatory perimeter of the new AML authority. The Transfer of Funds Regulation (TFR) information requirements are moreover being extended to transfers in cryptoassets. The combination of MiCA and the reviewed AML and TFR packages should contribute to creating confidence in the crypto market and fostering financial stability, while allowing the industry to continue innovating and growing.

Concerning stablecoins the regulator noted that some issues remain to be addressed as part of the implementation of MiCA. This includes ensuring that a stablecoin can be used without interfering with the transmission of monetary policy, which is a fundamental part of the payment system. If this is not the case, central banks will seek to ensure they can maintain a certain amount of control.

An official welcomed the political agreement on the MiCA framework and the updates to the AML package and TFR regulation. With such a bespoke regulatory regime, the EU has the potential to become one of the leading global jurisdictions in crypto. This will bring crypto into the regulatory perimeter, which has not yet been done in a major jurisdiction. The regime should provide a sound framework within which CASPs can develop new business models likely to bring added value to the market and this will enhance user protection and certainty in the market, as well as foster a level playing field with traditional finance.

The official emphasized that despite the progress being made on the EU crypto regulatory framework, an important caveat is that it will most likely only come fully into effect in 2025. This means that most of the industry will continue to operate for two more years under the currently fragmented and imperfect framework, period during which considerable growth is expected in the crypto segment. Lithuania has decided to anticipate this evolution with an enhancement of its domestic regulatory framework in line with the future MiCA and AML requirements, in order to provide the competent authorities with the ability to mitigate the risks from crypto

activities mounting in the market and enhance Lithuania's position as a regional fintech hub. The measures taken aim at increasing transparency, trust and investor protection. Capital requirements for CASPs have been raised; reputational requirements have been introduced, as well as more thorough customer identification procedures, including a prohibition of anonymous accounts. A public list of all CASPs operating in Lithuania has been established. However, the domestic regulatory changes do not go as far as MiCA in some important respects, for instance with regards to the establishment of a licencing regime for CASPs.

An industry representative commended the European authorities for the adoption of MiCA. Providing a single rulebook in Europe for the whole cryptoasset market covering 27 member states and 550 million consumers and providing a specific framework that aims to recognise the specificities of the crypto technology, rather than simply adopting technology neutral approach is a major achievement. In particular, the rules around CASPs are thoughtfully defined and should encourage crypto market players to request licences and build their operations in Europe around this new framework. There are however concerns around the rules for stablecoins, the emergence of which will be significantly restrained by MiCA. Europe has made a decision about store of value cryptoassets in MiCA which may be questionable at an early stage of adoption of these assets in the European market, given the importance of providing citizens with solutions for managing their assets in an increasingly digitised world. It is expected that the discussion around Level 2 standards will shed some light on the ultimate impact of the ruleset, particularly concerning stablecoins. This will require thorough assessment and dialogue between the relevant public and private stakeholders in the months ahead. Additionally, the FTR regulation has landed in a good place, though there will need to be further discussion on self hosted wallets and their implications for individual users.

Responding to a question about whether regulators are on the curve in the area of crypto, the industry representative stated that this is a difficult issue. One approach is to consider the vast amount of innovation occurring and expecting the authorities to regulate each increment of innovation as it happens. An alternative approach is for regulators to take proportionate action only when risks materialise and if there is an imperative for them to intervene.

Another industry speaker suggested that MiCA and the updated AML / FTR rules should be implemented at the same time. Otherwise, there could be different Know Your Customer (KYC) standards across markets, creating frictions for consumers and firms due to differences e.g. in onboarding processes. The rules for crypto should be consistent with those for the traditional financial system in order to achieve an interoperability between the two, since cryptoassets should gradually become part of the financial system and not remain as a parallel system. Additionally, it is important to remember that the FTR will apply to business to business (B2B) transfers as well as consumer to consumer ones. The rules for B2B transfers need to be clarified, notably concerning interoperability within the EU and at the international level, in order to be able to manage such transactions in an effective way under AML requirements.

An official considered that MiCA brings much certainty and clarity. The regulation makes an important distinction in particular between the tokenisation of real assets or existing financial instruments and truly novel or native cryptoassets, which is quite a new approach.

3.2 The regulatory approach to crypto in other key jurisdictions: Japan and the United States

An official explained that the Japanese regulatory framework for crypto was created in response to cases of hacking and the spread of speculative transactions. For several years, cryptoassets have also faced questions about anti money laundering and countering the financing of terrorism (AML/CFT). The basic ideas of the Japanese framework are similar to MiCA, but there are differences. This framework has increased the level of certainty and as a result, there has been less speculative trading, no significant 'crypto winter' and fewer service provider failures in Japan. There is nevertheless a constant evolution in the types of services provided by CASPs and the new technologies and services being developed by them, with which regulators and supervisors need to keep up.

In 2019, Japan introduced a regulatory framework concerning cryptoassets other than stablecoins in order to enhance user protection, including the protection of user assets and the provision of sufficient information to users. Cryptoasset exchange serviced providers, including custody service providers, are subject to regulatory and supervisory rules and are required to maintain proper internal control systems. Japanese CASPs are also required to put in place a proper segregation of assets and audited financial statements and to maintain system security in order to preserve client assets. Following several major hacking incidents, CASPs are required to manage cryptoassets deposited by customers in an offline environment, a so called cold wallet. In terms of information provision, CASPs are also 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.

Japan has also amended the law to provide a regulatory framework for money type stablecoins which are or claim to be linked to a fiat currency[1]. The main objective of these amendments, which will come into force in June 2023 are to mitigate financial stability risks, since stablecoins are susceptible to runs. To address these risks, only banks, fund transfer service providers and trust companies will be entitled to issue stablecoins. These institutions will be subject to specific requirements to ensure redemptions. Banks issuing stablecoins as deposits will be subject to prudential regulations and stablecoin holders will be protected by deposit insurance in the same manner as conventional bank deposits. Fund transfer service providers will issue stablecoins as claims on outstanding obligations and will be required to secure the obligation through either

1. Stablecoin intermediaries are subject to similar requirements to protect user assets as cryptoasset intermediaries. 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.

money deposited with official depositaries, bank guarantees or segregated safe assets such as bank deposits and government bonds. Trust companies will issue stablecoins as trust beneficiary rights and will be required to hold their trusted assets in the form of bank deposits only. Moreover, under the Japanese regulatory framework, tokens that do not meet the above requirements are categorised as cryptoassets and not money-type stablecoins. In this case, CASPs are subject to advertising solicitation regulations and are required to explain the risk of price fluctuations to customers, even though some of them may be labelled as stablecoins. They may handle these so-called stablecoins, but they must explain that their prices will not necessarily be stable. As of now, DAI is the only token, or so-called stablecoin, circulated in Japan.

Another official observed that the United States does not have specific legislation for the crypto space at this stage, and in an election year, it is unlikely that a comprehensive legislative package will emerge. However, the right pillars have been established to create the regulatory certainty that is needed in the crypto market. In 2015, the CFTC established that Bitcoin is a commodity under the CFTC's jurisdiction for commodity derivatives. In 2017, the first Bitcoin futures were listed, which were followed by Ethereum futures and other products. These are all regulated, listed on exchanges and managed by regulated entities. There have been debates about whether cryptoassets are securities or commodities, but given the very broad definition of commodities under US laws, if an instrument is not clearly a security, then it can most probably be considered as a commodity and fall within the scope of the CFTC. The CFTC has a broad anti fraud and anti manipulation authority over spot commodities, and Congress has given the CFTC the authority to provide direct regulation and oversight over certain spot products, including retail foreign exchange and retail leveraged commodity transactions such as precious metal transactions on margin using leverage. These are two areas where the CFTC can use its existing authorities to consider what else might be done to provide retail protections.

There are also several legislative proposals currently underway in the United States. One of these which has captured considerable attention is Senators Lummis and Gillibrand's Responsible Financial Innovation Act[2]. Regulation on digital assets has also been implemented by several states, such as the BitLicense, a business license for virtual currency activities created by the New York State Department of Financial Services. Finally, the regulatory authorities in the US, particularly the bank regulators, have a broad range of tools to use in order to provide certainty, clarity and user protection in the crypto sector with respect to banking activities.

Concerning stablecoins there is an ongoing debate in the US about whether a stablecoin is a specific cryptoasset or a technology wrapper around an existing type of currency or a financial product or service i.e. a central bank digital currency (CBDC), if it becomes available, or tokenised commercial bank money. There may be a wrapper around it but in effect this would still be in effect fiat currency or commercial bank money.

The US also believes, as the EU, that taking a technology neutral approach to regulation is essential. The US CFTC's principles based regulatory framework is in essence technology neutral. It is also important to have future proof or evergreen regulations because it is very difficult to anticipate every future technological development.

A participant invited the panellists to comment on the different ways to interpret cryptoassets – i.e.. whether they are a commodity, a security, a deposit - and how this influences the way they should be regulated in relation to deposit insurance, consumer protection, securities regulation and payment systems. An official suggested that the nature of financial instruments depends on how they are structured and this will determine the product's legal and regulatory treatment. This is the case for synthetics for example. While it makes sense to consider different alternatives, there is plenty of space within the securities and commodities regimes to cover all the various crypto financial products. In addition, if certain cryptoassets were to be treated as banking products, for example, that would require the regulators to consider monetary policy, bank runs, credit creation and the prospect of extending the US federal safety net over them.

3.3 Global consistency issues

An industry speaker stressed that a key challenge for the industry is the growing diversity of the regulatory approaches to the crypto space at the international level. Two different trends can be observed in the crypto industry as a result of this. First, certain companies are following a trend of avoidance, i.e. they wait until the last moment to adjust their processes or they operate from less regulated jurisdictions. Secondly, the more established companies are looking for certainty, i.e. obtaining licenses and following regulatory requirements in order to grow and reinforce user trust. The cross border nature of many crypto companies makes it crucial to move towards more regulatory consistency, predictability and interoperability.

An official emphasised that cross border aspects are very important for cryptoassets. A cross border stablecoin requires a solid regulatory framework in the home jurisdiction of the stablecoin and also in other jurisdictions. In addition, there must be a mechanism for cross border resolution and user protection. Until now the practical application of such principles has not been further considered because Japan was the only major jurisdiction to have a legal framework in place regarding stablecoins and other cryptoassets. As MiCA is progressing, now is the time for regulators and supervisors around the world to think more about the cross border aspects of regulation.

A regulator noted that the cross-border nature of these products requires addressing the cross border aspects of regulation. The number of jurisdictions with a stabilised regulatory framework for cryptoassets is still limited, but there is a need to start building a cross-border regulatory dialogue. It will require a forum involving national competent authorities from different jurisdictions and defining new ways of collaboration with other authorities, such as those handling AML and ICT risks.

2. Senators Lummis and Gillibrand introduced in June 2022 the Responsible Financial Innovation Act, a bipartisan legislation that would create a complete regulatory framework for digital assets that encourages responsible financial innovation, flexibility, transparency and robust consumer protections while integrating digital assets into existing law.

DeFi prospects and regulatory implications: what way forward?

1. Current market trends and opportunities associated with decentralised finance (DeFi)

1.1 Current DeFi market trends

The Chair explained that decentralised finance (DeFi) aims to replicate traditional financial activity in a decentralised manner without the use of intermediaries and based on distributed ledger technology (DLT) and cryptoassets.

Responding to a question from the Chair about how the current 'crypto winter' is affecting the DeFi market, an industry speaker explained that in the period preceding this 'crypto winter' there was significant investment and activity in cryptoassets and tokenisation, including DeFi. Many firms, including more traditional ones, were attracted to DeFi by the potential efficiency benefits of the technology in terms of e.g. automation and data distribution, and this has not changed. Some DeFi firms that were engaging in particularly risky activities experienced difficulties due to irresponsible lending practices and risk concentration but this increase in activity in DeFi also led to the development of new concepts and approaches in the crypto market. This also triggered discussions within traditional financial firms about how DeFi technology could be used to improve the structure certain securities markets for example.

Another industry representative agreed that, despite the focus in the press on the failure of certain DeFi platforms, there are many positive lessons to learn from the developments in this space and the knowledge about the opportunities and risks of engaging in DeFi activities is growing.

First, the technologies that underlie DeFi can widen the access to sophisticated financial products and services which have traditionally been the preserve of the wholesale markets. Historically it has been difficult for individual firms or small customers to participate in market making in deep liquidity pools pari passu with institutional traders for example, but DeFi offers that possibility. Automated market makers enable individuals to create sophisticated algorithms and quickly build deep liquidity pools. In addition, the decentralised peer-to-peer model of DeFi can apply to various forms of transactions that require an intermediary today (collateralized lending, interest-bearing deposits or investment portfolio management). This carries risks and brings new challenges for regulators and traditional financial institutions, but it also creates more choice. There are some obstacles to a wider participation in DeFi platforms, however, due to the difficulty to acquire the computer programming skills necessary to operate on DeFi platforms.

The other important aspect of DeFi is the speed with which scale can be built, the industry player noted. Commercial banks and public authorities will need to reimagine their roles in more open and scalable networks such as DeFi platforms. Traditionally, banks operate at the heart of their own closed network, but this role will change in the future. There are some 'crypto-DeFi maximalists' who believe in total decentralisation, but there will always be a need for scale and for some intermediation. The role of intermediaries will however need to be reimagined in this new environment.

Concerning the potential for DeFi to facilitate access to finance, an industry speaker observed that DeFi transactions are mostly fully collateralised or over collateralised, in the same way as options trades are executed on traditional platforms. While blockchain distribution can help financial firms to reach larger investor bases, it is not clear that the level of collateralisation required will widen customer access that much.

1.2 The interconnection between DeFi and traditional finance (TradFi)

An industry speaker explained that clients want a wider access to new assets and new liquidity pools in order to increase diversification and returns and at the same time solutions that are easy to use, that drive operational efficiency and that are resilient. To achieve the latter objectives, firms which are able to consistently deliver performance and scale with sufficient market integrity such as financial market infrastructures will need to play a role. This may add a layer of centralisation, contradicting somewhat the decentralised concept of DeFi. However, all DeFi platforms are run at present in a relatively centralised way, either by technology firms or by groups of developers who have the necessary knowledge and experience for running the platform and executing transactions.

Moreover, the concepts behind DeFi can help to address some areas in the market where there is a lack of infrastructure or where the infrastructure needs improvement, the industry speaker emphasized. They can also inspire traditional financial firms for the development of more efficient client solutions. The speaker's firm, a major market infrastructure, is working on a solution for some of the private equity markets in the US which lack strong infrastructure and secondary markets. These markets rely on siloed stakeholders for the issuance, trading and liquidity of the instruments involved. Driving more value for end clients in these markets requires a better distribution of data supporting quicker and faster decisions and a higher level of automation, ultimately driving efficiency. This entails bringing market stakeholders together on some form of infrastructure, which could be a ledger or a cloud based infrastructure. DTCC, for example, is developing a digital

cloud based infrastructure using APIs to interface with the public Ethereum blockchain. When this is live, it will allow clients to leverage blockchain to manage their assets in a different way. The solution's cloud based database provides an opportunity to increase resiliency, robustness and regulatory certainty. The technology is seven years into its lifecycle. As it matures further and certainty on the underlying infrastructure develops, it will be able to pivot into a more decentralised structure if needed.

Another industry representative observed that the level of interconnectedness between DeFi and regulated traditional finance (TradFi) has been limited by the lack of a clear regulatory framework for DeFi. However, the interconnectedness will almost inevitably grow because DeFi will increasingly fall within the regulatory perimeter. The next wave of DeFi growth will be very different from the current one. Until now the growth in DeFi and crypto more generally has come from the retail space. The next wave will be led by institutional money. The fiduciary responsibilities of larger asset managers and regulated banks have made them cautious about participating in crypto so far. As there is more discussion about regulating crypto and DeFi, this attitude is changing. Partnerships are developing between asset managers and cryptoasset service providers to provide institutional investors with access to cryptoassets and global banks such as Standard Chartered are working with the largest asset managers on the development of institutional custody products for cryptoassets. A growth of the cryptoasset market is expected as a consequence, as well as an increase in the interconnectedness between DeFi and TradFi and in the use of DeFi technology for traditional financial services.

An official also expected that the DeFi sector will continue to grow, as well as its interconnectedness with the traditional financial sector, leading to a progressive blending of DeFi and TradFi. This may however be limited by conduct issues and lack of risk management which have triggered the failure of certain crypto platforms at the outset of the crypto winter. The speed at which the sector addresses these issues will determine its capacity to grow, because building confidence is essential.

2. Main risks from DeFi

2.1 Specific risks from DeFi applications

A regulator explained that many of the risks associated with DeFi are present throughout the crypto space. These include conflicts of interest, custody, fraud, market integrity and market manipulation risks and the risk of bankruptcy of the platform, as demonstrated by some recent failures. Money laundering risks are also particularly important in the crypto sector because of the lack of AML/CFT (anti money laundering/countering terrorism financing) checks and the speed of transactions and they are increased in DeFi by the pseudo-anonymous and more decentralised nature of platforms. There is also significant layering risk[1] due to the complex set of activities in DeFi. The growing interconnectedness between crypto and traditional finance giving rise to contagion risk is a further issue.

The regulator suggested that one way to identify the risks which are DeFi specific is to divide DeFi into a set of layers, as IOSCO did in its recent report. Five main layers can be identified in DeFi platforms: a settlement layer, an asset layer, a smart contract layer, a user interface layer and a supply chain layer. The DeFi specific risks generally occur in the smart contract and the supply chain layers. The other layers are more generic to the crypto space. In the smart contract layer, the activity that has attracted most attention from a risk perspective is smart contract lending, which involves an automation of margining and an automatic liquidation of contracts if the collateralisation ratio falls below a given threshold. Collateralisation is indeed the basis of crypto lending because there is no credit assessment of borrowers. This mechanism creates contagion issues for lenders and close out risks for borrowers, when a contract is automatically terminated. These features do not disqualify DeFi from a risk perspective, but demonstrate that the DeFi ecosystem is providing financial services in a different way from traditional finance and with different risks. It is uncertain whether users fully understand these risks, but over time this knowledge should develop. In relation to the supply chain layer, there are also some DeFi-specific operational risks related to the use of 'oracles' for example that allow information external to the blockchain such as asset prices to be incorporated into the DeFi transaction flow. These are not fundamentally different in character from outsourcing risks that exist in traditional finance however.

More generally, DeFi raises specific governance questions related to the level of decentralisation of platforms, the regulator added. There is a spectrum of decentralisation and many DeFi platforms start as centralised projects in their development phase and intend to progressively evolve towards more decentralisation as the platform is deployed. In addition, there are certain elements of centralisation in most DeFi platforms such as the use of oracles. The level of decentralisation should be analysed when considering DeFi risks and smart contract arrangements in particular, because it is important to understand who holds the administration keys and governance tokens and whether they are held by a limited group of individuals who are responsible for the governance of the platform.

An official agreed with this assessment of the risks of DeFi applications and emphasized the risks from illegal

1. Layering is the process of making the source of illegal money as difficult to detect as possible by progressively adding layers of legitimacy to it. During the layering stage, the goal is to disconnect the money from the illegal activity that generated it. Generally, the more layers money passes through, the harder it becomes to connect the funds to criminal activity. The goal of layering is to make the process of tracking money through each layer more difficult to accomplish. Layering can include changing the nature of the assets, i.e. cash, gold, casino chips, real-estate, etc. Complex layering schemes involve sending the money around the globe using a series of transactions. The more countries the money enters and leaves, the harder it is to uncover the "dirty" source of the money – Source Dow Jones Compliance glossary.

activity and money laundering and terrorism financing, which are particularly important in DeFi, along with operational resilience and consumer protection risks.

A second official stated that central banks approach risk from a technology neutral perspective with no preference for TradFi or DeFi systems. However, it is important to evaluate DeFi risks closely because of the novelty of this activity and the lack of regulation and supervision. The risks specific to DeFi need to be considered, as well as how the traditional risks inherent in all financial activities materialise in DeFi. One difficulty is that DeFi is both an actor in the financial market and an infrastructure. DeFi applications also use alternative means of payment such as stablecoins, which requires some adaptations to the traditional approaches to supervision.

An industry representative agreed that certain aspect of the DeFi technology can exacerbate risks, but it is also possible to deploy the technology in a way which limits risks and preserves financial stability. Some DeFi features may also enhance the way institutional markets work. For example, the instantaneous movement of collateral and variation margin that happens on DeFi platforms can be used for live intraday risk mananagement, which in certain proofs of concept using FX swaps has reduced counterparty risk exposure by 80%.

2.2 Financial stability and contagion risks

An official considered that the direct implications of DeFi for financial stability are not particularly significant at this stage because it is still a minor activity. Nevertheless, these risks need to be considered because there is a potential for DeFi applications to favour overleveraging. Additionally, there is an element of procyclicality introduced by the specific features of lending in DeFi applications, which is based on the availability of collateral and not on a credit assessment of the borrower. The consequence of this is that there is more lending in buoyant cryptoasset markets and less lending when there are corrections, which may have financial stability implications. DeFi lending activities can also produce contagion risks. If there is a significant volume of lending through smart contracts, their automaticity may create a 'domino effect' in which all of the dominoes fall over at the same time.

The role of stablecoins in DeFi is also very important to consider, the official stressed, because almost all transactions performed on DeFi applications are set up and executed with stablecoins. Stablecoins are exposed to run risks and there is recent evidence of how disruptive stablecoins can be when an issuer fails to maintain convertibility at par value with fiat currency. This could be quite disruptive for DeFi and could create some contagion risk for other types of payments.

An official highlighted four main DeFi risks with financial stability implications. First, there is the direct exposure of financial institutions to DeFi and the related conduct, credit and liquidity risks. Secondly, smart contracts and automatic liquidation create a risk of amplification and volatility, which could spread into businesses and the markets that fund the real economy. Thirdly, there is risk to the payments channel. As their adoption grows, stablecoins will increasingly become a confidence channel, but their stability at par with fiat currency may be difficult to maintain unless they are backed by appropriate assets. Finally, there is a risk in terms of resilience. Since the great financial crisis of 2008, regulators have sought to build resilience in the financial sector ahead of crises rather than after them, in order to ensure that the sector acts as a stabilizer rather than an amplifier of risk in stress situations. Some aspects of DeFi suggest that it might be more of an amplifier of risks than a stabiliser. For example, the auto liquidation of loans based on smart contracts may generate procyclicality and volatility. In addition there are no credit checks and no management of credit risk since lending relies on over-collateralisation. This means there are generally fewer natural stabilisers, less use of judgment and fewer fire breaks in the DeFi system than in TradFi, which may raise financial stability concerns if DeFi were to grow in importance. Governance may be a further issue if decentralisation increases, as it may be difficult to identify who is responsible in a stress situation.

3. The regulatory approach to DeFi

3.1 The need for a specific regulatory approach to DeFi

The Chair asked whether the EU Markets in Crypto-assets (MiCA) regulation, which is the first holistic framework for cryptoassets, can address the risks outlined by the panellists and create a level playing field between DeFi and TradFi.

An official noted that MiCA currently does not explicitly address DeFi. MiCA seeks to regulate cryptoassets, including stablecoins, but it is based on a centralised view of the market in which transactions and activities are handled by cryptoasset service providers (CASPs). As a consequence, MiCA cannot be expected to tackle all of the issues associated with DeFi. However, MiCA demonstrates that cryptoasset products and activities can be addressed using a common and specific EU approach rather than trying to rely on existing regulations designed for other financial products. Similarly, the specificities of DeFi will require a different regulatory and supervisory approach. It is the right time to design this framework, because DeFi is still in its nascence. The objective to function in a decentralised way will however make it quite challenging to apply the usual regulatory and supervisory approaches, since there may be no single entity to which regulation can be applied.

A second official suggested that while it might seem like the traditional regulatory framework could address the risks posed by DeFi, since they are similar to those in TradFi – i.e. AML/CFT, consumer protection, operational resilience and financial stability risk. – doing so would be a serious mistake. The types of risks are similar, but they materialise in DeFi in a very different way. Taking AML/CFT as an example, it is clear that the channels through which DeFi applications favour illegal transactions cannot be controlled by standard Know Your Customer (KYC) requirements. Similarly, the problem of overleveraging in DeFi applications, which happens due to the possibility of using the same collateral for different

types of lending operations, cannot be addressed through the usual approach. The enforcement of regulation also needs to be adapted for DeFi because of its decentralised governance model. This means that the technology neutral principle 'Same activity, same regulation' is also not applicable to the specific problems posed by DeFi. Even the sounder concept of, 'Same risk, same regulatory outcome' may be difficult to apply to DeFi. There is a need for regulatory creativity. The case of the Tornado protocol[2] is a good example. As Tornado is not a legal entity, there is no legal entity to fine. It is not even a well established infrastructure, which means it cannot simply be closed down. The only solution is to target users of the application and try to prevent them from continuing to use it. Ultimately, there will have to be a specific regulatory regime for DeFi. In the future, this need will appear in many other policy domains beyond AML/CFT, which was the case in point regarding Tornado.

3.2 International policy approach and global coordination

An official considered that the decentralised nature of DeFi platforms makes them inherently cross-border and global. Therefore, regional or domestic approaches will be insufficient to capture the risks. There is a need to develop a global approach or at least global principles to address DeFi. There is still time to create a global framework before jurisdictions adopt their own approaches in order to avoid future harmonisation efforts.

A regulator outlined the content of the recent IOSCO report regarding the possible regulatory approach to DeFi. IOSCO felt compelled to take action on DeFi when it observed the mirroring or near mirroring on these platforms of more traditional financial products with low cost and high efficiency. It is impossible to address DeFi in isolation, however, because DeFi is part of the broader crypto space. Therefore, IOSCO decided to address the whole of the crypto space. IOSCO is intending to provide guidance on how to regulate crypto generally; on the similarities and differences between DeFi products and conventional financial products; and on how to supervise crypto activities. The aim is to complete most of this work if possible by the middle of 2023.

The regulator explained that IOSCO intends to take an outcomes focused approach, considering the principles that exist for securities markets at the international level and adapting them to crypto in a technology neutral way. There may also be a need for new standards in some areas if the risks are not covered by the existing standards. The guidance will focus on how common outcomes can be achieved through domestic frameworks and how to address particularly difficult cases. There is also a need for guidance from a financial stability, investor protection and market integrity perspective on specific DeFi products, particularly those related to the smart contract layer, which is the critical component of DeFi, Regulators must be able to judge whether DeFi products are suitably designed to be investment products for retail and institutional investors or whether some of them are closer to gambling instruments. Finally, there is a need to define how supervision can be conducted in an appropriate way on a cross-border level. When multiple jurisdictions will have developed regulatory frameworks, the question of cross border cooperation will become essential. Regulators will be encouraged to use the Multilateral Memorandum of Understanding (MMoU) designed by IOSCO to ensure the exchange of information between jurisdictions in a consistent way and allow the tackling of the more serious cross border issues such as criminal use.

Another official stated that the use of stablecoins in DeFi applications has strengthened the case for a regulatory response. The issuers of stablecoins are in the risk transformation business and therefore must be subject to some sort of prudential regulation. This might involve ad hoc prudential regulation for particular activities, which is the approach being taken by the UK. It might also be possible to treat the issuers of stablecoins as depositary institutions, which is the approach potentially favoured by the US regulators, although Congress is yet to express a view on this. Europe will be more flexible, as can be seen MiCA, and Japan appears to be following a similar approach to Europe. Ultimately, it is important for the regulatory response concerning stablecoins to be as internationally coordinated as possible. This effort should not only cover issuers but also the service providers offering related services such as wallet providers.

2. Tornado.Cash is a fully decentralized, non-custodial protocol that improves transaction privacy by breaking the on-chain link between the sender and recipients' addresses. To improve privacy, Tornado.Cash uses a smart contract that accepts ETH and other tokens from one address and allows them to withdraw to a different address. These smart contracts act as a pool that mixes all the deposited assets and generates a private key proving that you performed the deposit operation. Then, the sender can use this private key to withdraw the deposited funds into any address at the time of their choosing.
On August 8th 2022, Tornado.Cash was sanctioned by the U.S. Treasury's Office of Foreign Assets Control (OFAC) for its role in laundering more than $ 7 billion worth of virtual currency since its creation in 2019. These sanctions imply inter alia that all property and interests in Tornado Cash are blocked and that transactions by US persons or within the US that involve Tornado are prohibited. Source: US Department of the Treasury https://home.treasury.gov/news/press-releases/jy0916.

Data-led innovation: are EU data initiatives addressing the key opportunities and challenges?

1. Opportunities from the use and sharing of data in the financial sector

1.1 Opportunities for customers, corporates and the wider society

An industry representative noted that financial services is one of the most data-rich industries and the opportunities associated with using this data are huge, particularly in terms of product and service innovation. Creating seamless, digitised, just-in-time experiences for customers e.g. with 'embedded finance' concepts and providing real-time personalised services is becoming increasingly important. This is all made possible thanks to technologies such as cloud services and artificial intelligence (AI) and also data analytics. An important objective for cloud service providers (CSPs) is helping traditional and fintech entities to take advantage of the flexibility and scale of cloud for enhancing the way they use data. This means not just improving the efficiency of data recording and data management processes, but using the data to drive tangible business outcomes and improve customer service.

Sustainability is another area where these technologies can be put to use. The speaker's organisation, a major CSP, is helping companies to assess and optimise their data footprint through its platform, so that it is as carbon efficient as possible. It is also supporting companies in different sectors in achieving their carbon emission reduction objectives across their supply chain, with different analytical and geospatial tools.

Another industry representative agreed that there are many opportunities in the financial sector related to data use and sharing, notably for the development of new products and services. The financial industry has a great deal of data that it is not really leveraging. This includes know your customer (KYC) information, financial data and transaction data. This data should be put to use and customers willing to, should be able to share their data in a safe way with different providers, in order to get access to better financial instruments and services. Data could then like water, flow transparently from one institution to another, one regulator to another or one system to another. There needs to be a move away from the current approach of non-interoperable data locked-in by vendors to a more open system that may benefit customers.

A public representative observed that data is an opportunity for growth for European corporates and is a way for them to gain a competitive advantage in certain sectors within the global market. Data sets are core economic assets for the development of SMEs and start-ups in particular. The European Single Access Point project (ESAP) which will facilitate access to financial and non-financial company data should help to create an ecosystem for facilitating the financing of these companies. New technologies and data analytics can also help to tackle certain challenges the EU is facing. For instance, smart technologies can be used for tracking and limiting energy consumption.

A regulator agreed that it is important to consider, beyond individual consumer data, the availability and sharing of corporate information that can be supported by initiatives such as the ESAP. There is an opportunity with this project to design a system from the outset that ensures that the relevant information is provided in a standardized form, particularly concerning sustainability, where Europe has the potential to demonstrate thought leadership.

An official remarked that data access and sharing have become fundamental for many economic activities and public policy actions. At the height of the pandemic, leveraging a huge amount of real-time data was centre stage in establishing public policy answers and this helped to put in place responses that were more effective than during the 2008 financial crisis. Being able to process data as effectively as possible is also essential in the financial sector. Leveraging data can indeed help to improve existing financial products and increase financial inclusion to the benefit of citizens and corporates.

1.2 Risk management and supervisory applications

An industry representative remarked that there are also many use cases of data for risk management and regulatory reporting purposes. Regulatory reporting involves assimilating a huge quantity of data and bringing it together to produce regulatory filings. Technology can help financial institutions speed up the production of these filings and make this process more efficient and accurate. In some instances the time spent on the production of reporting can be divided by 4. A better leveraging of data can also facilitate access to information on banks' liquidity positions for example, which is very important in times of crisis from a financial stability perspective.

An industry representative highlighted that technology can also facilitate supervisory processes. There are many complaints from the financial industry about the burden and complexity of retrieving data from their systems and transferring it to different supervisors in formats that are not always interoperable from one supervisor to another. One solution is moving towards real-time supervision whereby supervisors can directly plug into the systems of financial institutions and retrieve the information they need. The technology for this to be possible already exists, i.e. technology handling reporting calculations and analytics and allowing a secure access for supervisors. A

collective effort from supervisors and the industry is needed to move such solutions forward.

A regulator noted that the transformations that data is causing in the financial sector have major implications for regulators and supervisors. ESMA has embraced the importance of data a long time ago, and is putting data at the core of all of its regulatory and supervisory activities.

First, ESMA endeavours to ensure that the policy and technical advice it provides notably for the European Commission is evidence-based and systematically based on data analysis. This was the approach taken for example in the reports issued in relation to transparency requirements for the MiFIR review and for recommendations concerning derivatives clearing. Secondly, the data collected from the industry is also used in the context of risk assessments. ESMA regularly provides the market, policymakers and other stakeholders with an EU-wide market perspective based on the data collected, detailing how capital markets are evolving and where potential risks are building up. This helps market participants to make informed decisions. Data is also used for assessments in specific areas or on specific issues. An assessment of whether EMIR data can be used to evaluate the leverage building up in the system was recently published for example, based on the Archegos case. A third area where reporting data is used is supervision for activities where ESMA has direct supervisory powers, such as credit rating agencies (CRAs) and trade repositories. The aim is for this supervision to be risk-based, outcome focused and data-driven, in order to ensure that supervisory efforts focus on where the most critical risks are perceived to be. All of the data in the market is looked at. For example, concerning CRAs, ESMA recently conducted an analysis looking at how CRAs are treating ESG in their press releases, which involved using natural language processing (NLP) techniques. ESMA also ensures that the trade repositories under its supervision provide good quality and accurate data, because of the critical importance of data for the proper functioning of the financial system and to avoid garbage in/garbage out effects.

To achieve this, there have been significant investments in skills at ESMA, the regulator emphasized, with the hiring of data scientists. ESMA has also invested in new systems in light of new responsibilities concerning data reporting service providers and a new big data platform has been implemented in order to support the analysis of transaction reporting, which generates very large volumes of data, and facilitate the provision of encrypted information to national authorities on individual transactions.

2. Expected impacts of EU data legislation and key issues to further consider

2.1 Objectives of the EU data framework and implications for the financial sector

A policy-maker noted that the political agreement on the Data Governance Act (DGA) was reached at the end of 2021, only one year after the Commission proposed the DGA, demonstrating the importance of this topic and the willingness of the co-legislators and different parties to move forward. The DGA was followed by the Data Act. While the DGA creates a governance framework for the sharing of data in a trusted way, including regulating the so-called neutral data intermediaries, the Data Act will regulate who can use what data and under which conditions. This is because through consultations and engagement with different stakeholders it was seen that the value of the data is not allocated fairly throughout the economy.

The policy-maker clarified the objectives of the Data Act, which is a far-reaching piece of horizontal legislation. The idea is to not have one-size-fits-all rules, but to lay down a basis on which more specific rules can be developed for certain sectors as needed, including for the financial sector. For example pricing provisions are drafted with the consideration of the interests of all parties. The Data Act is not creating a new legal basis for sharing data or for data ownership rights. Data should remain fluid so that many parties can benefit from it at the same time, possibly in different ways. In addition, the Data Act does not change the General Data Protection Regulation (GDPR) but builds on it, extending portability rights, which will concern all data and not only personal data. Finally, a broad definition of data has intentionally been taken in order to reflect the reality.

There are solid connections between the EU data policies and the financial sector, the policy-maker emphasized. The core benefit of the Data Act for the financial sector is improving the access that financial services companies, big or small, will get to data to use for innovation. The Data Act was announced in the European Strategy for Data which came out in 2020, roughly at the same time as the Digital Finance Strategy. The European Strategy for Data proposes to support the creation of data spaces in specific domains, including finance and this data space is now being developed by DG FISMA. The financial sector is also in the scope of the Data Act, so it will apply to financial services to the extent that there are no other more specific rules. For example existing reporting obligations will not be impacted by the Data Act.

2.2 Main priorities and issues to consider regarding EU data policies

A public representative noted that policy makers are trying to move quickly on new regulations concerning data and related technologies, because they realise their potential in terms of economic growth and addressing some of the crises that Europe is going through. There are four main priorities in this regard. The first priority is to ensure that these regulations benefit consumers and the industry at the European level, creating the best environment possible for these stakeholders and supporting growth and innovation. Second, these regulations should ensure high standards of consumer protection. Third, the regulations should be future-proof and help with tackling both the risks that currently exist and those that may come up in the future. Finally, there is the issue of consumer digital literacy. European consumers need to be appropriately educated so that they understand the importance of protecting their rights related to data.

There are several other questions to be considered in the elaboration of the European data policy framework, the public representative emphasized. First there is the risk that regulations may overlap or contradict each other. Sufficient emphasis needs to be put on ensuring that GDPR and the Data Act for example do not contradict each other, in order to avoid regulation heading in the wrong direction. A second aspect is the opportunity for the EU to remain in a leading position in terms of data regulation. The challenge for Europe is not only remaining the leader in terms of policy design, but also of implementation of these regulations in order to achieve competitive advantage in the market. There also has to be a fair, level playing field for all the sectors concerned by data legislation and also an objective to achieve consistency in these areas at the international level. The final challenge is ensuring that European companies' trade secrets are protected when it comes to data sharing regulations.

An official highlighted some key principles that should be taken into account in data regulation concerning the financial sector. The first is ensuring that stakeholders using digital financial services obtain adequate compensation for the data they share and provide. How the value of data is shared among stakeholders is of great importance in this perspective. The second principle is for customers to have control over their personal data, particularly the data which concerns their revenues and wealth. This is very important for building trust. Appropriate governance is the third key principle, and probably one of the main challenges concerning financial services, as governance principles in the financial sector are mainly established through pre-existing regulations and supervision, which need to be updated with requirements related to data. Finally there is the issue of defining what a fair commercial model for data sharing is and what the right incentive scheme is that allows data providers to cover their costs while providing appropriate systems and interfaces for handling the data. This is mainly a private sector issue but it has to be defined in a way that ensures consumer protection and positive outcomes for EU citizens, which is why regulators need to evaluate whether the outcome is adequate.

The official observed that digital identity could also play a key role in the development of digital financial services, which are largely dependent on trust and online safety. The use of an effective digital identity system is essential for protecting sensitive financial data, preventing fraud and facilitating access to digital financial services. There can therefore be positive effects for the industry, clients and also from a public policy perspective.

An industry representative indicated that there is a positive shift at the European level in the way data is handled in policy initiatives. Policy-makers and governments realise the value of data and recognise the need to ensure data privacy and the appropriate handling of data. A new approach to data privacy will be needed in the future, beyond GDPR, for a new generation of people who may have a different perception of data privacy issues and give greater consideration to the commercial value of their data. Europe can maintain its thought leadership in the area of data privacy and consumer protection by adapting its rules to this new environment. This dimension is missing somewhat in the present data regulations such as the Data Act.

Another issue not directly addressed in the Data Act is the broader question of how to encourage citizens to share their data in a post-Covid world where many citizens are concerned about authoritarian regimes and intrusions in their private lives, the industry speaker suggested. This requires building trust, which remains a challenge in the financial industry following the financial crisis.

Another industry representative noted that data has always been at the heart of the banking industry. Detailed records have always been kept by banks on customer identity, their transactions and the money that was lent for example. Banks have significant fiduciary responsibilities to their customers to keep their data safe, but also to innovate with it appropriately. They also need to be fully compliant across all the locations in which they operate. The difference now, is that all of those records are digital and they have expanded dramatically as the world has become more connected and digitalised. One important question is how to put power back into the hands of the customers regarding their data. Customers have been giving away their data for free to many providers and this data is not always kept as safely as it is in the financial sector. Their level of education about digital asset ownership needs to be improved.

A regulator agreed that the importance of consumer protection cannot be emphasised strongly enough. Whatever is defined in the EU regarding data should put the customer at the centre of the thinking and protect them. A further challenge is that the more data that is being used and the more data that is flowing around, the higher cybersecurity risks are. Beyond data privacy and data value issues, ensuring security around data is also essential.

3. Operational challenges related to data quality, standardisation and interoperability

An industry speaker emphasized that accessing data that is sufficiently normalised and clean is a major challenge in the financial industry. That is a potential obstacle to the leveraging of natural language processing, AI and machine learning technologies in particular. Using dummy data for training AI systems is possible, but to fully support data-led innovation better data standards are needed. In addition data standards need to be compatible with the formats that developers use. Standards that are defined by legislation are very limiting and do not correspond to the way that database developers look at data. There is a need to move away from a legislative approach to data standards to a more schematic approach and to open source projects using developer language.

An official agreed that standardisation is of great importance for the exchange of data. This is more of a technical ground than a regulatory one, but it is very structural.

A public representative observed that the European Parliament is aware of the need for standardisation when it comes to data collection, sharing or transfer. It is appreciated that, especially in the financial sector, it is important to have proper standards for reporting and transferring the data as otherwise the whole process is made more complicated and this will eventually affect consumer protection. Standardisation is part of creating a proper environment for the industry to develop and also for consumers to be best served.

A policy-maker agreed that standards are important. This is acknowledged in the Data Strategy, the Standardisation Strategy and the Data Act where there is a whole chapter on interoperability. For the financial sector, the importance of standards is also acknowledged in the Digital Finance Strategy. In the Standardisation Strategy, the Commission commits to advance the work on data standards and to work towards strengthening the global role of the European standardisation system.

An industry representative emphasized the importance of data standards for ensuring data quality. Having good quality data requires operational expertise for collecting and stocking the data appropriately, building the pipes to transfer it and regularly testing the systems, but adequate data standards defined in connection with the experts running these systems are also essential and they should be preferably applicable at the global level. These standards should be fairly easy to define for financial services, which are already a very regulated field, highly compliant and with a great deal of supervision. There should however also be the ambition to achieve a level playing field with other sectors and to bring e-commerce in particular into the customer-centric, free-flowing data space that is aimed for.

Another industry representative stressed the importance of interoperability and open standards for cloud services. There are two chapters to highlight in the Data Act legislation from a cloud service provider (CSP) perspective. The first of concerns cloud switching. The speaker supported the ambition of the Commission to empower customers to have the ability and the choice to migrate and deploy multiple different workloads on different clouds, or on premises if that is their preference. Achieving this requires operating in an open source ecosystem. For data to be successfully deployed in financial services, significant collaboration across the different stakeholders concerned i.e. different parts of the financial industry, supervisors, CSPs…is also needed. The second important chapter of the Data Act for a CSP perspective is the one concerning interoperability, which is about enhancing trust, and improving efficiency and data sharing. Customers do not want to be relying solely on one CSP. In moments of crisis, financial services companies, should have the power and choice to deploy their workloads where they need to. The Data Act supports an open source and open standards approach allowing flexibility, to ultimately avoid vendor lock-in which would not be good for the system.

A regulator agreed on the importance of setting appropriate standards in the financial sector, which need to be considered with a global perspective in the first instance. Agreeing at the international level on common identifiers is essential to facilitate the interoperability and usability of the information and to reduce reporting burdens. The approach to data also needs to be sufficiently agile, because technology is moving very quickly and there should be the capacity to adjust in agreement with all stakeholders. Interoperability is also important as it allows data sets to be connected. More and more data is needed from different sources to analyze issues in the financial sector and find the right solutions. Being able to connect the dots between information provided by the different entities concerned is critical for effectiveness in this space.

Digital operational and cyber-resilience: expected impacts of DORA and pending issues

1. Objectives of DORA and progress made with the legislative process

1.1 An increased focus on information and communication technology (ICT) and cyber risks

A Central Bank official highlighted that ICT and cyber risks have attracted increased attention from the financial industry and regulators in recent years. After the financial crisis, the focus was on financial and market risks and less on cyber risks and operational risks, but this situation is changing. Covid led to an increase in remote working and an expansion of digitalisation. As part of that process, outsourcing to ICT service providers, including cloud service providers (CSPs), has increased. Geopolitical tensions are also exacerbating cyber risks. As yet, there has been no major incident in the financial industry in the EU as a consequence of ICT and cyber risks, but that is not a guarantee that such a risk will not materialise in the future.

A public representative emphasised that recent geopolitical events, particularly the invasion of Ukraine, demonstrate how important cybersecurity is. Investment is needed, both from the industry and supervisors, to ensure that sufficient capability and competencies are available to tackle these risks. However, ensuring that the necessary resources are available will be a significant challenge.

An industry representative commented that the banking industry is a mirror of the economies that it serves and is dependent on the confidence of its customers. In the 80s and 90s, the biggest problems in the financial sector were due to credit and liquidity issues. These problems still exist, but IT and operational resilience risks have now become major potential threats. Banks have to operate as electric utilities nowadays, working permanently and with no outages to support an increasingly digitalised society and economy with operational financial and payment services. This involves processing tens of millions of transactions every day. Extremely high standards of operational resilience, mostly meaning technological resilience, are therefore needed. This involves a regulatory response as well as industry-driven initiatives. Although maturity and sophistication in the way financial services companies address ICT risks is increasing all the time, the pace of innovation and the range of issues that may go wrong increase just as fast. This is an area where it is easy to fall behind, which provides impetus to keep investing. Most financial firms are taking ICT and cyber risks very seriously. The smooth and effective responses by the financial industry to stress situations, such as Covid and the invasion of Ukraine, are also encouraging.

1.2 Progress made with the adoption of DORA and next steps

A Central Bank official stated that the EU DORA regulation (Digital Operational Resilience Act), aims to streamline the rules around ICT, third-party risk management, cyber-resilience testing and incident reporting. DORA also provides an oversight framework for non-financial critical third-party service providers (CTPPs) to the financial sector, which is a novelty.

A public representative emphasized the importance of cybersecurity which is being demonstrated once more in the context of the Russia-Ukraine war. There has been a great deal of engagement between the EU public authorities and many stakeholders in the elaboration of the DORA proposals, which have now been adopted. Guiding principles embedded in the drafting of the legislation include proportionality, future proofing and ensuring that Europe remains competitive and that innovation, creativity and R&D are not stifled as a result of DORA. DORA is therefore a balanced piece of legislation. Following the provisional agreement reached in May 2022 between the Council and the European Parliament, DORA will come to the plenary session of the European Parliament by November 2022. There will then be a two-year lead-in period for implementation. By late 2024 or early 2025, DORA requirements will become mandatory for all entities in its scope. It is hoped that there will be proper dialogue and discussion between the overseers and industry during this process, which will be a learning curve for both.

Responding to a question from the chair about the main areas of concern that have been tackled to achieve a compromise on DORA, the public representative commented that a first objective at the outset of the negotiations with the Council was to avoid a fragmented system, with different national competent authorities (NCAs) in charge of the oversight and different interpretations of the requirements. A reasonable compromise was found in terms of the oversight framework in particular, which should allow a consistent implementation of rules across the EU. Measures concerning CTPPs took up the largest portion of the time spent on discussing the legislation. Cloud outsourcing in particular has become an integral part of financial services and will continue to grow. A proper oversight of CTPPs, which are a limited number of massive global companies, such as CSPs operating globally, is clearly needed. The larger financial institutions can deal with major CSPs on a one-to-one basis, but smaller financial entities may not be able to. The aim is to ensure a level playing field in dealing with CTPPs for all types of financial players, so that the smaller ones are not disadvantaged.

A capacity for supervision to reach out into cloud services is also needed to ensure that there is integrity in the provision of these services, the public representative added. Cybersecurity is becoming a more prevalent concern and this is due to continue in the future. While it is widely accepted that cloud computing supports innovation and helps to improve customer service, it is also important to ensure that it does not create additional vulnerabilities in the financial system. The work on the Level 2 of DORA should aim at providing a clear and concise set of requirements that will allow a fast and compliant implementation, so that the financial industry can continue to innovate and improve customer service leveraging new technologies, while responding to its obligations in terms of security.

An industry representative agreed that achieving a minimum level playing field in how DORA applies across the financial sector is vital, because the sector is very interconnected and the overall system is only as strong as its weakest link. Level 2 standards must be promulgated quickly in a way that is implementable and enables progress. Standards should set a number of principles and minimum requirements as a safety net, because the detail of how to be optimally resilient will change all the time. Financial institutions should be able to set their own detailed standards of service and technological resilience in line with these principles and requirements.

1.3 Improvements expected from DORA

A regulator commented that DORA coming into force will be a significant achievement, even though there is still work to be done at Level 2. Standards already exist for addressing ICT and operational risks, but they are implemented differently across the EU which creates difficulties both for industry players and supervisors. Having a comprehensive framework for the entire European market with DORA will contribute to strengthening the resilience of the European financial sector. Three key features of DORA are to be highlighted. First, DORA provides an improved and harmonised framework for testing, which is essential. It is only possible to assess how resilient a system is by testing it. The testing needs to be thorough enough, identifying weaknesses that can be learned from. Secondly, it is welcome that DORA will be a lex specialis regulation, which means that it will prevail over more general rules, for example concerning reporting. This will help to streamline reporting and reduce the burden for the industry. Finally, the direct oversight of CTPPs will contribute to strengthening the supervision of ICT and operational risks in the financial sector. At present, the risks posed by CSPs are addressed by general oversight rules, which means that it is difficult to have a proper view of these risks, particularly when outsourcing to CSPs happens after several steps of outsourcing by different entities.

An industry representative stated that their company, a major CSP that services many European financial services organisations, shares the objectives of regulators on DORA. Achieving a high level of operational resilience and security is a key focus of their company as it helps to build confidence and trust in the cloud outsourcing operations they provide. Customers should be able to use cloud services in a secure way at all times and financial stability should also be guaranteed at market level. In addition, DORA is a major opportunity for harmonisation. Despite the EU level outsourcing rules established by the European Supervisory Authorities (ESA), there is significant fragmentation at the frontline level of supervision at present, creating obstacles for customers when they move to third-party providers. DORA should also help to create more transparency and trust by establishing a direct communication channel between third-party providers and the financial services supervisors.

A regulator commented that DORA will also provide significant benefits for regulated financial firms, allowing them to benefit from a more secure and harmonised framework instead of the existing fragmented approach, which will also contribute to reducing their regulatory costs.

2. DORA implementation challenges

2.1 Challenges faced by CSPs and different types of financial institutions

A Central Bank official commented that DORA will be successful if it is beneficial both to the public and to the private sectors. In answer to a question about potential concerns around implementation, an industry representative noted that Level 2 standards need to be brought out as soon as possible. Huge amounts of time and money are spent by the financial industry on digitalisation efforts and it would be extremely undesirable if part of that was wasted because players start moving in a direction that turns out to be incompatible with Level 2 standards or if they need to defer improvements because of delays in the publication of Level 2 standards. A second issue concerns the way proportionality is implemented. Experience as a practitioner over many years suggests that many cyber scares experienced in recent years are due to third-party suppliers involved in the process, rather than to the banks themselves. The regulation of third parties is therefore a crucial element of digital resilience. This is however challenging because not all of these suppliers are global players with a high level of professionalism. Proportionality is justified in the application of rules, but that should not lead to having a weak flank with some smaller providers.

A regulator noted that, for the largest banks and insurance companies, DORA will not constitute a real revolution, because these institutions are already subject to the existing guidelines drafted by the ESAs for the management of ICT and outsourcing risks, which constitute the core of the new DORA framework. DORA will however increase the level of harmonisation across Europe, requiring all institutions covered by DORA to reassess their practices and internal procedures and identify necessary adjustments, for example concerning the new European templates for information sharing. The time period for transition is also relatively short with a final deadline for 2025, which is a challenge. For the

financial and non-financial entities that are not already covered by digital operational requirements, such as the credit rating agencies or the insurance intermediaries, DORA will create a true shift of expectations in terms of practices and procedures. The proportionality embedded in DORA should however facilitate this process. The scarcity of skills in ICT risk management is also a key challenge for the private sector.

An industry representative noted that the main CSPs have been engaged with the co-legislators from an early point in the legislative process. This dialogue allowed the tackling of many issues, including those related to the proposal in DORA to move towards a pan-European, centralised approach to the oversight of CSPs considered as CTPPs. This is quite a new approach, since financial service supervisors will be overseeing technology companies for the first time and CSPs will be subject to a comprehensive oversight framework also for the first time. This creates a potential skills gap on both the supervisor and the CSP side. The industry representative's firm, a major CSP, is currently very focused on operationalising this new oversight approach with dedicated teams preparing for compliance with DORA. DORA is expected to have direct impacts on entities such as CSPs coming into direct oversight by the regulator, but also indirect impacts on how such entities will support new requirements for customers under DORA in the future.

The industry speaker added that while DORA is a technology-neutral proposal, it will primarily apply to cloud services in the first instance, so the specificities of cloud outsourcing, such as the multitenancy nature of these services, need to be appropriately taken into account in the requirements. All customers, financial and non-financial, are serviced from the same infrastructure. This means that the recommendations made by a financial services supervisor under DORA, e.g. around security or privacy protocols, will have to be implemented for all customers. In addition, during audits, a data centre cannot be switched off to test resiliency for one customer, because this will impact all customers.

2.2 Challenges for supervisors

A Central Bank official noted that the chairs of the ESAs had written a letter in 2021 expressing concerns about the practical implementation of DORA and making proposals about the oversight framework for CTPPs and the application of the proportionality principle in DORA, and asked what the main challenges for supervisors are expected to be.

A regulator confirmed that the implementation of DORA is a big challenge for supervisors. The three ESAs (EIPOA, ESMA and EBA) have been provided with some resources to address this challenge, but considering the workload, resources will still be very limited. The ESAs are working together on the implementation of DORA, sharing their knowledge, together with the European Systemic Risk Board (ESRB) and the Commission and also liaising with other authorities involved in ICT risk management. Existing guidelines that have already been produced in this area are being considered in order to avoid overlaps. There is an opportunity to deliver as a group on the oversight mandate, provided certain issues are considered. First, the timing is tight, so knowledge will need to be built progressively, which will also help to keep up to date with developments. Secondly, the approach to Level 2 requirements should be realistic, explaining the limits of the oversight that can be implemented and setting out what can be expected. A clear overview of how the governance system is expected to work is needed in the Level 2 requirements. It must be ensured that supervision adds sufficient value and is lean enough. A third issue is the availability of resources. 30 full-time equivalents (FTEs) are going to carry out the supervisory work at the European level, so prioritisation will be necessary. Finally, there is a need to train people. The help of the Commission in this regard is very welcome with the creation of a digital academy for supervisors. Experts from the market will also be sought.

Another regulator agreed that the public authorities will face challenges, in terms of resources and expertise, when providing supervision under DORA, which will cover a wide range of ICT services. DORA will involve all the supervisory authorities in charge of the financial supervision in Europe. All national and European authorities will therefore need to increase their competencies and expertise in the ICT risk field and pools of cybersecurity experts will need to be enriched. Where possible, resources that are already available should be used. The oversight of CTPPs is a particular challenge. The number of CTPPs is expected to be limited and the intensity of the oversight is meant to be adjusted strictly to need. However DORA will be a major innovation in this regard and a major project for the entire financial supervisory sphere in Europe.

The key condition of success is the adoption of collaborative approaches and lean management within the supervisory authorities, the regulator stressed. There are existing guidelines on ICT risk management and experiences in developing the single supervisory mechanism (SSM), the ESAs and the single resolution mechanism (SRM) should also be considered. There are already some resources and expertise in this area in the national competent authorities also. These competencies should be incorporated appropriately into the oversight framework. A system that can work as a single, smart and agile team across Europe will need to be implemented efficiently in a short period of time.

3. Consistency issues at the EU and global levels

3.1 Interactions across EU regulations

An industry representative noted that chapter V of DORA about the management of third-party ICT risk creates a significant overlap with existing outsourcing guidelines, which will need to be revised. How DORA will interact with other regulations addressing cyber-risk, such as the network and information systems (NIS) directive, also needs to be clarified. NIS creates a horizontal supervision that will apply inter alia to critical providers such as CSPs. There needs to be a precise cooperation of the

authorities under DORA and NIS. The final text resolves many of the issues of how cooperation will work in practice, but not all of them. There is also the question of how DORA will interact with forthcoming regulation, for example the Data Act. In addition, an EU cybersecurity scheme is under development, which will create a horizontal cyber framework applying potentially to financial players and CSPs in Europe, which is a further open question.

3.2 Global consistency of ICT risk management rules

An industry representative emphasized that global consistency is also very important in the area of ICT risk management. Sufficient European consistency should be ensured by the harmonised framework of DORA, the oversight framework of CTPPs and cooperation between the ESAs and the national competent authorities (NCAs), but DORA will regulate global technology providers and global financial firms together for the first time. There are similar trends in the APAC region and in the UK, with a proposal for a UK-style DORA under discussion. These elements need to come together to create a consistent framework. The Financial Stability Board (FSB) has a potential important role to play as a global standard setter in this regard.

A regulator highlighted the differences and similarities between DORA and the framework that exists in Switzerland. There are shared objectives in terms of operational resilience and tackling ICT risk events. There are three areas of focus in the Swiss framework when considering resilience of financial services companies, which are similar to those that can be found in DORA. The core requirement is that Swiss financial services companies need to map what they use, in terms of critical infrastructure systems, data applications and so forth, including their connectivity. The critical elements identified need to be shared with the supervisor so that a cross-sectoral view may be taken of where there may be reliance on common critical suppliers such as CSPs.

Secondly, operational risk management, in particular ICT risk management, needs to be integrated just like any other risk in the risk management practice. ICT risk must be recognised, mapped, analysed and mitigated and then monitored on an ongoing basis. Governance must also be clearly defined, i.e. who should decide on what, who does what and when. Effective governance is indeed essential in this space, particularly when it comes to dealing with incidents. Adequate supervision and inspection is also important. This requires planning and testing, but since it is not possible to test for everything that may happen in financial markets, there should be anticipation and scenario analyses carried out.

Thirdly, many of the issues related to digital operational and ICT risks are shared across the world and the industry. There is clearly a need for national and international cooperation, sharing of incident data and building up collective defences to cyber attackers. There is already a working level between the Swiss and the EU authorities on these issues, which should be continued and built on.

Finally, the regulator emphasized the importance of third-party risks. The fragmentation of supply chains is a natural way to create productivity by dividing up labour and this will not change. Therefore, it must be addressed from a risk management point of view. A useful principle from DORA, that is also applied in the Swiss framework, is technological neutrality. To the extent that the risks are the same, the same rules should apply. There is also a great deal of commonality on the more specific topic of outsourcing.

Digital Euro: objectives and challenges

1. The economic and digital contexts that triggered the digital euro project

A Central Bank official noted that, with the ever-growing importance of ecommerce and online platforms, there is an increasing shift towards digital payment. In addition, the expectations that money has to fulfil will change. The emergence of privately issued crypto tokens, such as Bitcoin and Ethereum, marked the beginning of the crypto sector. In order to contain the high volatility of such tokens, the idea of fiat backed tokens, known as stablecoins, emerged. The most prominent example of a stablecoin was a theoretical one: Libra, later called Diem. This prompted Central Banks to accelerate their research on Central Bank digital currencies (CBDCs), as was highlighted in comments by Jerome Powell.

2. ECB vision and objectives for the digital euro project

A Central Bank official reported that the euro system is investigating the digital euro. François Villeroy de Galhau recently summarised the reasons for Central Banks to develop digital currencies: maintaining accessibility and usability of Central Bank money; supporting monetary certainty and limiting the risks specific to external digital assets; supporting the strategic autonomy of the European Union. A retail CBDC could pose risks for the functioning of the current financial system, because CBDC could be used as a substitute for bank deposits. A digital euro could also encourage competition among banks and promote new services and business models. In 2021, the European Central Bank (ECB) governing council launched the investigation phase of the digital euro project.

2.1 Continuing to serve citizens with Central Bank money in the context of reduced reliance on cash

A Central Bank official stated that the digital euro, or any CBDC, aims to continue serving citizens with Central Bank money and to continue the coexistence of Central Bank money and commercial bank money. In the absence of CBDC, extrapolating the trends even in more conservative countries like Germany, there will be less reliance on cash. In five to 10 years, cash payments could even be the minority at the physical point of sale. Ecommerce is already crowded out by electronic payments.

2.2 Central Banks want to retain the commercial bank money and Central Bank money dual system in the digitalisation context

A Central Bank official stated that Central Banks aim to ensure that the convertibility into Central Bank money promise that is at the core of the definition of commercial bank money continues for citizens and firms, not only for banks. It is accepted that societal preferences and technology change over time. CBDC is less of a revolutionary idea than a conservative idea because it will maintain coexistence.

2.3 However, the concrete form of the coexistence of commercial bank and Central Bank moneys will become clearer as digitalisation increases

A Central Bank official noted that there are financial stability implications. If the Central Bank moves into this space, those already in the space will question how aggressive the move will be. Coexistence is easier currently because the habitats of bank notes and electronic payment instruments are not exactly the same. In a fully digital age, where everybody pays digital, there is a movement into the same habitat. There will need to be synergies but also some distinguishability to support the stability of the coexistence. The aim is not to expand the share, or the role of Central Bank money compared to commercial bank money but for a continued coexistence with no crowding out, although it is very difficult to target an exact replication in different countries or points in time. The aim is for the digital euro to be used regularly, in coexistence with commercial bank money.

3. The definition of use cases is complex

3.1 The ECB is halfway through the definition of users' requirements, which are progressing and should be stabilised within one year

A Central Bank official explained that the digital euro is being investigated through the Eurosystem project structure. The current investigation phase will take two years. At the end of the investigation phase, precise documents, such as user requirements and a vision of how to source the preparation, are produced. One year of the two-year phase is already almost gone. Good progress has been made and a lot of parameters have been specified. A lot of questions have arisen that were not anticipated. The governing council is then asked about the next step, which would be the realisation phase. That would start ideally immediately after the investigation phase, or after October 2023. That would typically take two or three further years. Then the ECB would be ready to issue, and the Council could decide whether to issue.

A Central Bank official stated that, as a member of the High-Level Task Force, they could confirm that the digital euro project is reaching the halfway point and there is reason for optimism.

3.2 Banks and payment service providers expect an added value digital euro, featuring payment services supplementing existing ones, such as programmable transactions linked with smart contracts, as well as automated compliance supervision

An industry representative stated that the digital euro must enable banks and payment service providers to build differential services compared to other current payment services. Programmability is one of the most promising opportunities for the private sector. Programmable CBDC could be the backbone for the implementation of smart contracts, allowing delivery versus payment in many transactions. For example, when acquiring a security, it would be possible to provide for the delivery of the asset and for the payment to be done in the same way. These new features could be introduced gradually, as users and authorities gain experience and confidence. For banks, the digital euro represents an opportunity to further develop embedded supervision, for example enabling public authorities to monitor the ledger directly in an automated way. The ECB should be ambitious when designing this digital euro, incorporating advanced features to ensure it is competitive, future proof and drives payment innovation.

3.3 Identifying customers' and businesses' needs is difficult and represents an essential challenge

An industry representative commented that how to best foster the adoption of the digital euro by customers is an important consideration. Interestingly, potential users do not fully understand the difference between the digital euro and the money that they already have in their bank accounts and use for their daily payments. Many of the use cases that today are being considered, such as P2P payments and point of sale payments, are already covered by other private payment solutions. For example, in Spain a P2P payment solution called Bizum is used by around 50% of the adult population.

A Central Bank official commented that customers and businesses must clearly express their expectations of the digital euro and needs. This is an important dimension of the current investigation phase. The Eurosystem has commissioned qualitative market research to that end, including through focus groups.

A Central Bank official commented that their institution and Banque de France were in alignment in this area. Data protection and privacy issues are another area of consideration.

3.4 The legibility of the respective added value of both existing payment means, and digital euro is an essential issue that will be settled only over time

A Central Bank official noted that a balance would need to be struck between a digital euro that is too successful and crowds out private solutions and one that is unsuccessful and does not generate sufficient demand.

A Central Bank official agreed that it is possible to be too successful. There are parameters available that would make it possible to be extremely successful in the means of payment area if there is legal tender status and a business model that strongly incentivises merchants to onboard. If merchants are attracted to the digital euro scheme, there will be possibilities, but coexistence is also needed. The aim is not to crowd out. Innovations such as programmability have been raised, but the fact that this use case has not been covered by commercial bank money suggests it may be premature. The project limited resources. It is not possible to solve all payment problems or have a payment instrument that is absolutely comprehensive. Focus on the core use cases will lead to the kinds of scale effects that money relies on. If the focus was on marginal use cases, the project would not be successful.

4. Beyond the priorities specific to the financial world expressed, fostering innovation capabilities in the EU, and being potentially leveraged by non-eurozone European Union countries are essential ambitions for the digital euro

A public representative stated that the digital euro is needed to foster the environment for innovation in digital finance in Europe. The ECB frequently reports back to the Committee on Economic and Monetary Affairs on the stage of the preparation of the digital euro. The digital euro could put the eurozone at the forefront of innovation. The digital euro has potential to assist even non-eurozone European Union countries to overcome currency issues. It is crucial that the key success factors for wide acceptance of the digital euro are clearly defined. There is the potential to create a new ecosystem for financial services innovators, whether from the fintech area or traditional financial services providers. Privacy and cybersecurity issues are a top priority. Assurance must be provided by ECB, the EU institutions, and politicians that the digital euro will be safe, will be secure, will guarantee the privacy concerns, will allow for further innovation and will solve some of the issues, including the issues of European payment infrastructure, in terms of sovereignty.

5. Although CBDCs counter big techs' digital currency initiatives, big techs may eventually be their first beneficiaries, at the expense, notably, of the EU strategic autonomy objective

An industry representative commented that it had already been noted that Libra was the key reason for the increased research into CBDC. The concern is that a big tech platform rolls out a non euro denominated stablecoin globally, which, in a very adverse scenario, could push the euro out of business and make monetary policy lose traction, impacting monetary sovereignty. The response to Facebook was clear. A global stablecoin is not going to happen and Central Banks embarked on

research into CBDCs. Stablecoins got a bad reputation overall, which is unfortunate, because the area of stablecoins is very diverse. After Libra, there have been number of unregulated stablecoins. Spectacular crashes of stablecoin earlier this year contributed to their bad reputation. Well regulated stablecoins that are full reserve, so fully backed by Central Bank money, can be issued by big techs, banks or other companies.

The backlash against Libra fits into a broader trend of backlash against big techs, for example the Digital Markets Act. The main concern regarding big techs is that a digital euro could end up strengthening them. It is not a stablecoin or a currency that gives big tech their lock-in power. Instead, it is big techs' ability to create a seamless payment experience, to integrate payments in their app and enable their users to pay for things, whatever the currency or method in the background, that locks in users. Big techs would immediately adopt a digital euro and ensure it was available throughout the EU, and perhaps outside the EU, for seamless payments. They would probably be able to do this faster and better than financial institutions.

A public representative stated that the key factors will be design and implementation. As previously noted, there is a risk that the adoption by non-EU global players will be faster than by some of the EU players. Therefore so much emphasis should be put on the innovation potential. Web3 and all the future applications that are to come should be part of the future vision for the digital euro.

6. Parallel infrastructure decisions are essential in the EU, if the digital euro is to contribute to the EU's goal of strategic autonomy, to backup existing payment means and to support smart contracts

An industry representative commented that the digital euro resides in the currency layer, not the infrastructure layer, which sits on top. Many of the goals of the digital euro should be realised at the infrastructure layer, not the currency layer. Reducing dependence on card schemes that are run by non-EU entities has been a longstanding goal, but those card schemes operate at the infrastructure layer. Adding a digital euro would not change that. In fact, the card schemes would likely be first to add the digital euro to their product offering. If the aim is to bolster strategic autonomy, a European payment scheme must be devised. Smart features, for example smart contracts, do not belong to the currency layer because a euro should be fungible. Smart contracts, programmability and conditionality belong on the infrastructure layer, not the currency layer. The infrastructure layer could apply to CBDC, but it could also incorporate existing forms of money. A goal that has not yet been mentioned in the current discussion is that a CBDC could be a backup to existing payment means. The backup should be to the infrastructure, not to the currency.

6.1 Disruption to the financial intermediaries' role and the introduction of unintended obstacles to the monetary policy are among the risks borne in mind when designing the digital euro

A Central Bank official commented that the digital euro could prevent a payment landscape that is dominated by the big techs from developing. However, a digital euro in itself, if badly designed, could work counter to the objective. That would be a major issue for Central Banks, which have financial and monetary stability in their mandate. There are two types of risk: the creation of disruptive effects for financial intermediaries and the creation of impediments in the conduct of monetary policy. The latter risk has been downplayed by the changing monetary stance and environment in recent times, because the risk was to conduct monetary policy in a context of negative interest rates. These risks are well understood by the Eurosystem and the analysis of them is part of the current investigation phase. There are three critical features that could mitigate these risks: holding limits, the remuneration framework and the distribution of roles between the Eurosystem and the financial intermediaries. An organisation to seek input from the market is being set up and contributions to this dialogue are invited.

A Central Bank official commented that parameter values do not need to be set during the current investigation phase stage. The only requirement is to identify the technical specification, so that it can be programmed in the next phase. In principle, both aspects should be included now. Allowance should be made for limits being imposed by making that part of the user requirements now. The ability to remunerate is also important because it provides some flexibility to policymakers. There could maybe be an area where there is flexibility on amounts but no attractive remuneration. Both aspects should be included in the requirements. Fabio Panetta has indicated to the Parliament an overall number of €1-1.5 trillion as a total volume that would be compatible with financial stability. That could then be insured through limits or other means. This provides an order of magnitude but there is no need to specify the parameters further at the present time.

6.2 The existing financial intermediary regulatory framework (prudential, AML) is an essential asset

An industry representative suggested that there is broad consensus that access to the digital euro should be provided through authorised intermediaries. The current two-tier model has proven successful. The private sector is best placed to manage its relationship with customers and to provide added value services. Banks are in a unique position to provide secure intermediation services, as they are already part of the Eurosystem payment systems, are supervised by the ECB and have the necessary expertise in know your client (KYC), anti-money laundering (AML) and consumer protection. The digital euro should be integrated into the existing banking apps and payment routes.

It has been argued that, in a digital economy, citizens should have access to public money, to avoid the risk of allowing them to only pay with private money. However, a commercial bank is fundamentally different from other

forms of private money and should be considered as more of a public-private partnership. The deposit guarantee schemes, resolution funds and prudential requirements are regulatory tools that are intended to protect customers. The digital euro should not be proposed as a safer form of money than commercial deposits, because that might pose a risk to financial intermediation. A digital euro would also not make sense if the objective was to provide a means of payment and not savings or investments.

6.3 The optimal distribution of operational roles will result from a partnership between Central Banks and financial intermediaries, with the aim of achieving a simple and cost effective user experience that is accessible across the whole euro area, in synergy with private sector projects

A Central Bank official stated that a partnership should be built with financial intermediaries, starting with banks, which are major players in the payments market. The current core payment system is built on cooperation and complementarity between Central Bank and commercial banks, or payment service providers, and between commercial bank money and Central Bank money. This should be central to the design of the digital euro. This should imply distribution of operational roles between the Central Banks and the private sector. A significant number of functions should be performed by the private sector intermediaries to ensure three objectives: a simple and economic user experience, distribution across the whole euro area and synergies with private projects, for example the European Payments Initiative (EPI).

7. Private digital money ecosystems and Central Bank digital currencies should coexist. MiCA is an essential regulatory contribution to this end

A public representative stated that, although stablecoins have a bad reputation, because they were not that stable, they may appear again. There are many projects that are able to drive further innovation in providing alternative financial services. The introduction of the public digital currency will complete the landscape. There is no competition between them because they are different by design, features and possibilities. These were some of the considerations when discussing and negotiating the upcoming crypto assets framework, known as the Markets in Crypto-Assets (MiCA) regulation. The rules on stablecoins are sometimes too strict. An ecosystem of private money should be able to coexist with other forms. Ideally, both private and public initiatives would work together to help the financial services in the digital area to grow.

A Central Bank official commented that MiCA is a good starting point for regulation. There will be ongoing monitoring and developments in that field of regulation. Discussion of the digital euro will remain relevant at Eurofi events for a number of years, until it is introduced.

Global infrastructures and cross-border payments: opportunities and challenges

1. Stablecoins deserve a specific building block in the G20 working programme

A central banker detailed three topics behind the evolution of cross-border payments. One is the G20 work whereby the Financial Stability Board (FSB) set up a large work stream of 19 building blocks. The second topic is the war in Ukraine and the potential risk for de-globalisation. The third topic is regulation.

1.1 With analysis complete, priorities are being determined

An official confirmed much of the ground clearing has been done. The real action is about to commence with many of these changes being implemented. G20 leaders approved the targets, which are ambitious but achievable, cover costs, speed, transparency, and access. The question now is how to get to these targets and which building blocks are most likely to be able to move the needle forward for implementing those changes.

All 19 of the building blocks are relevant, but not all of them will contribute as directly as others to achieving the targets. The results of analysing this will be communicated to the public in October, mostly likely covering payment systems, interoperability, and access, and operating an extension of payment services. It is understood, from discussions with the industry, that the legal, regulatory, and supervisory framework is still a major impediment when it comes to cross-border payments. Data exchange and the messaging standards also have to be considered.

1.2 The implementation phase and defining related priorities are always challenging

A Central Bank official stated there is a need to think carefully about how to involve the private sector. Policymakers and those trying to implement the roadmap need priorities.

The private sector is an essential part of this ecosystem. It ultimately has the expertise, skills, and knowledge, so it is not clear how it would be possible to proceed without its involvement. The targets were set a year and a half ago, and there is now a need to retrofit and determine whether, with the data that can be collected, those targets are credible or have to be revised. This requires granular, detailed information, which can only be provided through interaction with the private sector.

The public sector has to set clear priorities. If the private sector has to make investments, they need a clear landscape otherwise nobody will invest money. An intelligent use of the limited resources available means deciding what comes first.

1.3 Interconnecting existing infrastructure will add value

A Central Bank official noted one priority is to make better use of the technology and the infrastructure already present. However, many of the hurdles facing better cross-border payments are regulation and legal issues. There are about 60 fast payment systems working currently around the world, and the market is already trying to connect them. Those existing should be encouraged to connect across regions.

With ECB colleagues, the Bank of Italy last year carried out an experiment connecting TIPS with Buna. In one single link potentially, all European citizens could be linked with all citizens of the 16 countries covered by Buna. There is also thinking about whether something more global can be constructed so as to not rely on bilateral links. The Nexus proof of concept exercise aims to implement with the Monetary Authority of Singapore and the Central Bank of Malaysia.

1.4 Existing infrastructure will bring about improvements already in development

An industry representative welcomed the work since 2019 from FSB and Committee on Payments and Market Infrastructures (CPMI) on addressing the key challenges. It is clear there is a target of 75% of all cross-border payments that are reaching end beneficiary accounts within an hour. For access, the issue is providing optionality to customers, whether in the wholesale or retail remittance space, and fully transparent payments in terms of traceability and cost.

Since SWIFT gpi was launched a few years ago it has been able to measure and track payments. Across all SWIFT payments, 99% plus reach end beneficiary accounts within a day, 79% within six hours and almost half within five minutes. There is much that can be achieved with the current ecosystems or building blocks, because they provide not only a fast-forwarded route to the targeted levels but are also addressing the key controls that need to be considered in terms of compliance, AML checks and protecting data integrity end-to-end.

In terms of challenges, much is linked to the integration into domestic clearing systems when leg-out or leg-in payments get into the markets. This is all about harmonisation of data, opening hours and currency controls. They are key for the batch systems that some countries have not improved.

2. Efforts to improve cross-border payments at the global level highlight regulatory issues

An industry representative's suggested the most difficult barriers to get through are related to the legal and

regulatory context, and accessibility in particular in the cross-border context. A US bank has to access each Real-Time Gross Settlement (RTGS) where it settles. That is complexity from the legal and regulatory contexts in each jurisdiction, which are domestically driven.

Building block 9 concerns payment versus payment (PVP) processes and trying to enhance the way PVP can be rolled out. The main barrier to developing PVP processes today is the regulatory and legal acceptance of this cross-border exchange. The priority should be to look at that, knowing that the work being done, in particular on the operating hours of RTGS, on the facility to have standards being used, is very helpful and necessary but probably easier to remove than the legal and regulatory context.

In the context of being global it is important to have the capacity to have regulatory, legal, and political access to systems. Technical and operational issues can be resolved easily. The main problem is to have the capacity to interact with those countries and jurisdictions in a legally safe context and a safe regulation context.

3. Stablecoins deserve a specific building block in the G20 working programme

A central banker noted that stablecoins have a global ambition, and the regulatory question there is crucial. An official noted there is a great deal of work occurring in parallel to the cross-border payments work when it comes to stablecoins. Much has happened since the publication of the high-level recommendations of the FSB in 2020. The Basel Committee on Banking Supervision (BCBS) has done a great deal. In July CPMI and the International Organization of Securities Commissions (IOSCO) published guidance on the application of the principles for financial market infrastructures for stablecoins which clarify how the standards apply to stablecoin arrangements of systemic importance.

Stablecoins have different functions, which further complicates the way to look at them, but those stablecoin arrangements with a transfer function fall under the definition of financial market infrastructures (FMI). The guidance also lays out some of the specifics in stablecoin arrangements, and explains how the standards are to be interpreted. Many stablecoin arrangements rely on distributed ledger technologies, so the question is how to ensure governance. How risk management is to be applied to stablecoin arrangements, settlement finality and money settlement are also covered.

4. For retail payments existing international infrastructures often innovate

An industry representative emphasised creating a system that remains innovative, competitive, resilient and that delivers value will ensure the result is not a more siloed world. On the retail side, it is possible to send through Visa Direct effectively instantaneously to 180 countries around the world using multiple schemes, multiple payment systems and multiple messaging systems. The private sector is playing a role here.

With remittances the challenges vary by country. There is a very important issue about sending money back to Ukraine but an equally important issue to think about is the 4 million Ukrainian citizens living in the EU. They need access to banking services, and it can be asked if that is a remittance. Some of the issues are going to be around how digital identity and AML are thought about, and how European banks and financial institutions are enabled to give financial services to those refugees to make them consumers in that society.

Resilience must not be forgotten, because the trust and credibility in a payment system in the end relies on its availability, its security and the level of investment.

5. Understanding of each use case is necessary to identify challenges

A central banker noted that the ambition of the G20 work is to improve global payments for everyone. An official suggested the current panel shows how important it is to involve the private sector and to have all market segments involved. What are called use cases in the roadmap are retail payments, remittances, and wholesale payments. Targets are defined for all of these segments. The challenge is then to go into the detail. Consumer-to-business payments are different from person-to-person payments, which are not international remittances. Business-to-business payments are under the retail segment because the roadmap defines wholesale payments, financial institution to financial institution payments. With all these different views of market participants it is incredibly important to know where the challenges lie.

It is also clear that with such a huge programme there is no single solution to improving or enhancing cross-border payments. No single entity or set of entities, even if they are standard-setting bodies or global institutions like the International Monetary Fund or the Word Bank, can solve this issue on their own.

The G20 lays out the plan for the authorities and the authorities can give direction, but in the end, it will be key for the private sector to join in this effort. There have already been numerous interactions with the private sector over the past two years. There have been consultations on different reports like operating hours, whether the targets are reconciled and the key performance indicators to be established to measure these targets. There is an ongoing consultation on PVP.

The next stage of the programme is being moved into, and it is important to go beyond what has been done so far. The existing cooperation with the private sector should not diminish. A joint task force with SWIFT Payments Market Practice Group will define common elements for ISO 20022 for cross-border payments.

There is a task force on service level agreements and schemes. However, more senior people have to be brought in and the plan is to organise and host 'payment summits' under the chair of the FSB, bringing together C-level representatives from the private sector and also one level below with advisory groups with middle management.

In order to enhance cross-border payments, it is not only the G20 jurisdictions that have to be involved; many of the emerging markets and developing economies also have to be involved.

An industry representative noted that regulators have a tough set of balances to maintain, but incentives between the private and public sectors are relatively well aligned. Payments work at many levels, including the political, the technical and the central bank level. Those all need to be brought together, which can only be done by working with the private sector.

6. The implications of geopolitical deterioration

A central banker noted that the globalisation of payments relies on mutual trust. Any cross-border payment solutions involve both jurisdictions and therefore the whole idea of synergies, efficiency and openness rely on global trust, which has been lost to some extent since Russia's invasion of Ukraine and the sanctions in response.

6.1 Implementing sanctions without impairing the credibility of global systems

An industry representative's organisation only serves currencies not directly impacted by these geopolitical challenges. However, a very interesting question is raised on the necessity for trust and the capacity to exchange those currencies, even in geopolitically sensitive contexts.

It is important to learn the lesson of the way the Russian rouble has been disconnected from the system and whether that is the best way to do so in terms of infrastructure services. It is a real question to think about to see the extent to which there can be appropriate PVP again, so systemic implications are not created from the dysfunction of the settlement process and the infrastructure itself. It is a short-term risk if transactions which have already taken place cannot be settled. The capacity of the infrastructure to deliver a safe, resilient, and efficient service has existed and should be thought of independently of the trades going through the system.

The extent to which a strong infrastructure can be put in place which is legally stable, and which helps create a safe harbour to exchange goods is a real question to ask, knowing that if there is a necessity to disconnect some currencies or markets that can be done in a way that does not affect the capacity to have a safe, resilient, and efficient underlying process.

6.2 Preserving fundamentals in the context of increased fragmentation

An industry representative stated the work the G20 initiated, the advent of myriad initiatives, new technologies and new business models together with FinTech's getting into the space of cross-border payments were already trends. However, in the post-sanctions era there is a risk of increased fragmentation across the globe, as can already been seen happening. While fragmentation is a reality and the world is moving into a new era, the fundamentals built in terms of infrastructure have to be protected. That should even be put as part of the G20 objectives.

Resilience controls, data, end-to-end data integrity, compliance with different regulations and all of those cyber efforts are fundamental for coming out stronger, or at least positively, from this crisis. The alternative is additional fragmentation at the financial infrastructure level across regions and communities using different technologies. There is a common responsibility to think through how, with all of the optionalities needed as part of the objectives of the G20, it is ensured that this is part of the roadmap.

6.3 Cooperation between policymakers and the financial sector to preserve resilience

An industry representative's organisation suspended its operations in Russia. One reason was to ensure an orderly impact on individuals, but another was the difficulty the complexities sanctions present to a global organisation. Nonetheless, the international policymakers who worked through some incredibly difficult issues should be applauded. If there is anything positive to take away, it is the ability, both at a political and technical level, to work through this. If there is a way to embed that in the future for how to work together that would be immensely valuable, particularly between Europe and the US.

The geopolitical issues to reflect on are at retail level, which are the second order effects of fragmentation in this world. Some of it cannot be avoided. It has been seen in Russia and elements are seen in China. However, there is no need to make this worse. The cross-border work and the collective work of the G20 and other countries can be continued, with a vision for building on what has already been built over the last 50 years, rather than each country breaking away and there being more silos with an instinctive view that somehow that is safer. Demonstrably it is not; a siloed payment infrastructure will be less resilient. It will not work more hours of the year.

Equally importantly, siloed domestic infrastructure means it is not possible to protect against fraud in the same way. Unfortunately, fraudsters live around the world, and they go to the lowest common denominator. Unless there is data on where fraud is happening to be able to stop it elsewhere in the world, there will be more fraud. The same is true of cybersecurity. Data from around the world is needed to react in real time.

Instinctive reactions to localise as a way of addressing some of the challenges feared is concerning, and there are the second-order effects which create a more fragmented, less resilient, less protected system. What is already there should be held onto and driven forwards more quickly.

EU retail payment landscape: prospects and challenges

1. Challenges for integrating the EU retail payment market

1.1 Regulation, infrastructure, and schemes

A Central Bank representative explained that with legislation like Single Euro Payments Area (SEPA), the revised Payments Services Directive (PSD2) and the Digital Markets Act (DMA), legislators aim to foster innovation, fair competition, consumer protection and a single European market. The upcoming review of PSD2 is an opportunity to further strengthen the European payments market. The uptake of instant payment instruments remains below expectations. The solution level offers access to these instruments and provides convenient payment solutions to end users, but it is relatively fragmented. While there are some successful national solutions, big techs and international card schemes successfully deliver payment solutions for consumers across the continent.

An industry representative suggested the industry has done a considerable amount to support economies and people to develop growth and to create jobs. The payments industry supported people during the pandemic.

1.2 Competition enforcement

A policymaker explained that the European Commission has a role to play as a competition enforcer. The entry of big techs into payments initially brought innovation, choice and improved consumer experience to the European market. Since then, some big tech companies and their platforms may have become gatekeepers, reducing innovation and stifling the entry of new competitors.

In May 2022, the Commission launched a statement of objections against Apple for reserving near-field communication (NFC) technology on iPhones and iPads for Apple Pay. In the payments space, big techs are still largely card-based. This raises the question of whether they could be a competitive constraint on the traditional card-based model or rather another transmission grid for it.

1.3 Challenges for new payment solutions in the EU

There is a question about the space which remains for new non-card-based payment solutions. The Commission's role is to be vigilant in this setting to ensure that markets remain open and contestable, and for there to be a level playing field. The main challenge for start-ups in the payment market is how to develop an alternative pan-European non-card-based payment method that is attractive as a business model to merchants, banks and consumers.

1.3.1 Lifting limitations impairing competition

An industry representative confirmed there are significant limitations, as illustrated by the Apple case. Apple's policy limits, or at least heavily constrains, access to 20% of the European market. This means consumers do not have the free choice, as they should have, to choose between NFC and QR codes, which are an established technology. Any new solution will have to use QR codes because there is an ongoing inquiry into NFC. It should be the free choice of the consumer to choose whether they use NFC or QR codes.

1.3.2 Changing EU consumer's mind set

An industry representative explained their organisation is trying to build a European solution based on instant payments. The maturity of cards and the mindset this has created in the population are challenges in the market. Changes in payments take a long time and establishing something new is a question of market education. Cards are also ubiquitous. People will ask why they should change when the current solution works. Consumers know that merchants will accept their Visa or Mastercard. Any new solution must establish acceptance. If consumers have to find out whether a new solution is accepted, they will not use it because they do not want to be frustrated at the point of payment. That is about international acceptance. It is important to recognise that this process will have to happen step-by-step.

1.3.3 Demonstrating that new EU payment means are trustful

An industry representative remarked that new solutions need to address the challenge around fraud. Insecurity is the last thing that is needed.

1.3.4 Compensating for the absence of EU super-players

An industry representative stated the incumbent competitors in this space are super-players and there are no super-players in Europe. This is a challenge because these super-players come with financial means and market power. This issue must also be addressed.

2. Attractiveness of EU instant payments

2.1 Coverage of big tech and fraud

An official confirmed fraud is a key concern. When using instant payments, funds are transferred instantly. This is what consumers want, as shown by peer-to-peer marketplaces, which are not always run by big techs. There are also national marketplaces. It is not inevitable that big tech will run all these marketplaces. However, this is something the public should be wary of. As long as

fraudulent goods are not being sold, Europe should be content using instant payment solutions for peer-to-peer transactions.

2.2 Transaction opportunities

From the perspective of the public authorities, there is merit in helping to develop these schemes. There is a demand from consumers. From the business perspective for both small and large e-commerce firms, there is interest in improving cash management and facilitating systems of payment on delivery.

2.3 EU defragmentation and strategic autonomy

As this is a new technology with new use cases and new demands, the public sector and the co-legislators will hope that it spread out on a pan-European or multi-country basis. If it develops natively as a pan-European solution from the outset there is a chance this will help defragment the market. This is in the strategic interest of all European authorities. This has been undertaken with SEPA, and with the portability of bank accounts and the regulation of interchange fees in order to try to create a new integrated market. This would create a more sovereign market and would help authorities ensure that competition is fair.

2.4 EU data sharing

An industry representative noted there will be additional opportunities as PSD3 is considered. Banks could be required to connect to instant payment solutions and offer them to customers. There could also be further work on increasing the levels of data sharing and the ease of sharing data so that non-banks can compete with banks on instant payments. This would move Europe towards an open-finance type system. There will be a requirement for standardisation and harmonisation in order to ensure that the solution can work in all 27 countries.

3. Obstacles faced by the pan-EU instant payment scheme

3.1 Negative impacts of regulation imposing similar fees on domestic and cross-border payments

A Central Bank official stated that currently there are not enough market incentives for local players to offer SEPA instant payments. This might be an unintended consequence of existing price regulation of cross-border euro payments in the EU. As payments is an industry with strong network effects, the incentives will change if there is widespread deployment of instant payments in the eurozone in combination with a scheme or product that is also widely used.

3.2 Including non-euro countries remains an issue

There are questions about whether it is possible to interconnect instant payment systems, as has been done in Singapore with Thailand. Central banks are watching these developments closely. Even more interesting is the work being done by the European Central Bank (ECB) with the Riksbank on introducing a foreign exchange mechanism into the ECB's instant payment system (TIPS) allowing instant payments between the two currencies. The situation of countries outside of the eurozone must be taken into account in relation to EU regulation promoting the uptake of euro instant payments. If there is no demand there for euro-denominated instant payments, it does not make sense to force non-eurozone banks to invest in such payments.

3.3 Further efforts for critical mass

An industry representative stated one key challenge is the fact that this is a two-sided market: it requires merchants willing to accept a form of payment and consumers demanding to use it. The opportunity is the system. Some infrastructure has already been built. SEPA is already able to connect banks across the EU.

4. Lack of regulatory clarity, regulatory heterogeneity and uneven anti-money laundering (AML) legislation

A Central Bank official noted that currently the system involves a considerable amount of extra work due to EU payment legislation not being clear on key points and obligations. EU legislators need to do better if fast implementation is the goal.

The obligations and rights should be made clear as this will avoid the kinds of discussions that happened as part of PSD2, such as on third parties, which slowed down the implementation process.

Regulations should be simpler and easier to use. For many years there have been calls for the abolition of the E-Money Directive, which has outlived its usefulness. There is scope for regulatory arbitrage and endless discussions.

A Central Bank representative stated that it is strategically important that to work together on a pan-European solution in the payments market.

PSD helped create a single market. However, there are barriers that will have to be eliminated to boost the single market and create more opportunity and growth. There is not enough harmonisation, especially in with AML legislation. Whenever there is a new EU AML directive, there are questions around what changes to implement and whether due diligence policies and related measures should be adapted. There is a general framework, but the legislation is implemented in each member state which creates a large amount of additional work and is a pain point for the industry. It does not allow the market to create the openness sought. There is also a loss to the industry because best practice is not widely shared. There are many best practices that could be shared, managed, and implemented across the European Union.

5. The need for swifter adoption of new technologies an increased regulatory adaptability and efficient business models

5.1 Swifter adoption of new technologies

An industry representative noted another key element is how technology is applied in different jurisdictions. During the pandemic, several countries in the Middle East made changes to due diligence for payments and allowed much greater use of technology. European countries are still moving at different speeds. In the Nordics it is much easier to transact online, for people's identities to be verified and for them to undergo due diligence processes. There are some countries where these processes are still done using paper and everything must be sent two or three times. For instant payments, the requirements are worse. It is important to remember that technology can help to support the industry because due diligence and electronic KYC are even stronger when technology is leveraged. This can boost the market and increase consumer protection.

The traditional payments infrastructure was never built in Africa. Bank branches were not built everywhere; many countries had to skip a step and move directly to new technologies. Everyone in Africa has at least one mobile phone, and often they have the latest model that cannot be found in Europe. All these phones are connected to wallets with greater capabilities than people in Europe have today. In Kenya, for example, people use their wallets to pay for their laundry or for taxi fares, as well as to withdraw cash. There is more flexibility and less regulation outside Europe which creates increased levels of innovation. This could challenge the competitive advantage of the European markets.

5.2 Building an effective business model for instant payments

An industry representative noted progress has been made in open banking, as part of PSD2 creates the opportunity for non-financial institutions and payment service providers to offer instant payment solutions to consumers. It is easy to understand the opportunity for merchants: it is a cheaper form of payment for them to accept. However, there is also a need to convince consumers that it is a convenient way for them to spend their money. This will require the private sector to offer the solutions and find a monetary incentive to provide them.

5.3 Agile regulatory processes to catalyse innovation

An official noted less public involvement is required for the solution level. The public sector must continue to act as a catalyst for the solutions developed by the private sector. European authorities should continue to be vigilant about issues like that with Apple, both in terms of contentious cases and the development of new legislation.

The public sector can also play a role by enabling future new solutions. Public bodies should not make political or administrative choices in an attempt to foresee the future. There should be nimbleness when crafting legislation. Nobody knows whether crypto and distributed ledger technology (DLT) will be the backbone of future payment systems in 15 years, but they might be. There is a need for tools to help the private sector innovate, but this has to happen in a safe way. That is the aim of the Markets in Crypto-Assets (MiCA) regulation. There are a number of things in the legislation that will need to be reviewed. Given the long-term changes in payment systems and the fact that the technology is evolving in ever-shorter cycles, the process of crafting regulations will have to change.

5.4 Having the public sector take the initiative

There is sometimes a requirement for the public sector to step in. This should be done with a light touch and not too often. If there is ever a situation in which the payments market is dominated by American and Chinese big tech solutions, it will be of great benefit to have a European public solution to use as a platform to develop other forms of competition in Europe.

6. Regulatory improvements

6.1 The Digital Market Act

A policymaker noted that the DMA covers gatekeepers, and its provisions largely derive from antitrust enforcement. There is a close link between this regulation and the practice that has developed in Europe. The DMA will cover financial services and payment services offered by gatekeepers. There is an interoperability requirement. There are also several data-enabling provisions in the DMA which will stop gatekeepers from siphoning data from their ecosystem and preventing others from accessing their data.

6.2 Payment Services Directive and Open Finance

DG FISMA recently completed a public consultation on PSD2 and open finance. The principle of 'same risks, same rules' should guide the work. To create a level playing field, it will be essential to ensure that actors carrying out the same kinds of activities and creating the same risks are subject to the same type of regulation. This is an important question for traditional banks. The Commission is also considering an initiative on instant payments.

6.3 Consistent implementation of legislation and reactive supervision

The new AML package will include a regulation and create a European authority to implement. A digital euro would be an excellent complement to the diversified European payments landscape.

An industry representative suggested further harmonisation will move much of the legislation on payments from directives to regulation, but it will also create more harmonisation among the different sets of rules. Some elements of PSD are not completely aligned with the General Data Protection Regulation (GDPR) or elements of GDPR which are not completely aligned with the AML legislation, especially in relation to obtaining cross-border information. GDPR has been a great innovation in Europe, but it has also created challenges in complying with AML legislation.

There remain areas in Europe, and especially outside Europe, that require a physical presence to network. There

are still remote areas where people do not have access to financial means. It takes a very long time to register as an agent under PSD2. The host regulator has 90 days to provide a response. The process requires a firm to find a potential partner, undergo due diligence, wait 90 days for a response and then train the agent on how to offer the service, on AML legislation and on everything related to cross-border. On average, this takes six months. Many of these agents are not interested in waiting six months.

6.4 Possible unintended consequences on non-dominant players

An industry representative explained that from the perspective of a smaller and more niche player regulation is sometimes intended to address a market with dominant players. This can have unintended consequences which harm the smaller competitor. For PSD3 it will be important to focus on the existing non-dominant players in order to avoid unintended consequences such as the surcharging rules that allow them to be surcharged in certain circumstances in which a dominator players' products would not be. Focusing on such issues will ensure start-ups can continue to compete, make the case for merchant acceptance and encourage consumers to use their products.

6.5 Bank service accessibility

An industry representative opted de-risking is critical for the cross-border payments remittance industry. Many banks completely de-risk this activity. Many operators go out of business because they do not have any access to bank services. That is not because they are not respecting the rules or because they do not have a strong compliance programme; it is because banks prefer to de-risk completely and avoid future issues. This should be addressed with a measure that permits small operators and the remittance industry in general to secure proper access to banking services.

A Central Bank official called for the changes in the Settlement Finality Directive to allow some non-banks into payment systems as part of the G20 cross-border payments initiative, which is important for increased efficiency. Czechia is unique because it does not have an automated clearing house. All retail payments go through real-time gross settlement. There are several non-banks that would like to do this.

6.6 Clarity in EU regulation

A Central Bank official suggested that Czechia probably makes the most use of PSD2 due to the fact that a BankID solution was built on top of the PSD2 APIs.

7. Decisive success factors for Instant Payments in the EU

7.1 Moving towards a full payment solution

An industry representative suggested that everyone would agree that instant payments are a fantastic opportunity for the market because they are an opportunity to change the payments landscape. This has happened in other regions of the world. The uptake of Pix in Brazil is stunning. These technologies can transform markets. Europe should not miss this opportunity. Instant payments can address any use case. They can be used for commerce and P2P, but they can also be used for bill payments or anything else.

The payment means alone will not be the decisive factor. If only the means of payment counted, instant payments would already be successful. Instantaneousness is a nice feature, but it is not sufficient. The payment means must be taken to the payment solution level, and it must compensate for some of its weaknesses, such as the benefits of cards that consumers enjoy today. Instant payments do not offer guarantees or insurance services.

7.2 Articulation between instant payment and the digital euro

In some discussions, the digital euro is seen as unfair competition for instant payments. This topic requires a separate debate, but it is important to consider in the design of the digital euro.

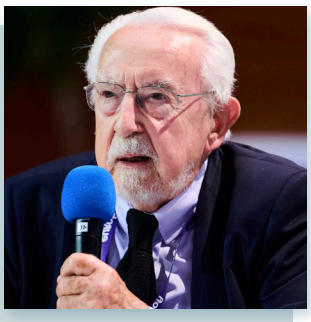
7.3 Leveraging the existing network of EU banks

An industry representative explained that their organisation can bring the distribution and marketing power of the banks, given the difficulties that exist and the challenges that must be addressed. The banks and the big acquirers are driving this project. They want this to happen and will put significant effort behind it. Somebody has to push this technology out to the market. The banks can also bring standardised integration for merchants, which does not exist across all of the national solutions. The banks can also address fraud. They also have a willingness to align with public authorities.

Particularly in combination with user-friendly value-added services, instant payments can bring benefits to both consumers and businesses. There is a need to create smart and convenient payment solutions, possibly based on instant payments, that can meet individuals' and firms' payment needs. Sound regulation is the key to fostering innovation, protecting consumers and ensuring healthy competition in the payments market. A regulatory initiative concerning instant payments is on its way, and the review of PSD2 will happen soon. While the public sector and the industry might take different approaches, they are united in seeking a prosperous retail payments market that serves the needs of payment users.

Exchanges of Views



Reviewing SGP and filling gaps in the EMU architecture

Jacques de Larosière - Honorary President, EUROFI

Klaus Regling - Managing Director, European Stability Mechanism

Alessandro Rivera - Director General of the Treasury, Ministry of Economy and Finance, Italy

Harald Waiglein - Director General for Economic Policy, Financial Markets and Customs, Federal Ministry of Finance, Austria

Klaus Regling (Chair)

Klaus Regling outlined that the task for the panel is to talk about how to fill the gaps in the monetary union, which is a broad subject. It is basically agreed that we want to make our monetary union work better, become more resilient and less vulnerable, but the difficult question is how to get there. We need appropriate economic policies, but that was not the subject of this panel.

The other question is how public decision makers can strengthen economic convergence among Member States and avoid fragmentation in the euro area. One key aspect for me is risk sharing, which is under-developed in the euro area. Risk sharing is an essential shock absorbing capacity of any monetary union. In the United States there are several quasi-automatic mechanisms for risk sharing that prevent the regional, cyclical and structural developments to lead to permanent fragmentation. First, a common tax and social security system; second, an integrated banking union and capital markets union; third, fiscal mechanisms that help in a crisis. In Europe, the common tax and social security system will not happen anytime soon. Therefore, it is all the more important to make progress on the Capital Markets Union, Banking Union and fiscal instruments. If there is no progress on risk sharing than the risk of fragmentation will remain present in the monetary union. Any progress on risk sharing would be good for growth and convergence, European sovereignty, and financial autonomy and for the international role of the euro.

Klaus Regling stated that in this context a credible reform of the Stability and Growth Pact is important to make risk sharing politically possible in the economic monetary union (EMU). The panel will address risk sharing more broadly, fiscal mechanisms for risk sharing and the Stability and Growth Pact (SGP). In terms of risk sharing more generally, why is there such a big gap in Europe versus the US. Is it a question of trust or a question of instruments and mechanisms?

Jacques de Larosière

Jacques de Larosière stated that it is not a question of instruments or mechanisms, but that the US is a country and the EU is 27 mostly diverging countries, each one trying to preserve its national regulations. That is the reason for the difference.

Klaus Regling

Klaus Regling stated that Jacques de Larosière's comment seemed pessimistic. Harald Waiglein was asked whether anything can be learned from the US example which is a successful example of risk sharing?

Harald Waiglein

Harald Waiglein agreed that something can be learned from the US. Risk sharing can have a stabilising effect but it is important to get the incentive structure in a risk sharing mechanism right. The Hamilton moment has been much quoted in connection with the Recovery and Resilience Facility (RRF) and NextGenerationEU. We have learned that the US was a failure over many decades, because when Hamilton first took on the debts of the individual states and made them federal debts the incentive that was set was that they could take on new debts and they would be bailed out again. This happened consecutive times over the next 50 years until the strict no-bail-out clause for states and municipalities was added. We do not have the strict no-bail-out clause for states and municipalities in the EU. The disciplinary effect is very necessary, because from that moment onwards the current union in the US started to work.

It is not possible to have mutualisation of everything. You can postpone the solution to a problem by throwing money at it, but the problem will likely become bigger. Money and mutualisation are only part of the answer,

they are not the full answer, because it is important to get the incentives right.

Klaus Regling

Klaus Regling agreed with Harald Waiglein's comments. Alessandro Rivera was asked whether he could see a trade-off between the public risk sharing that Harald talked about and private risk sharing and what the trade-off should be if we agree in Europe we want more risk sharing.

Alessandro Rivera

Alessandro Rivera stated that there is not any trade-off. There is a full complementarity between the public risk sharing and private sector risk sharing. When the monetary union was established, there was the assumption that the private sector and markets would be enough to perform the risk sharing function. The markets would send signals through prices while covering the funding needs. Market discipline did not work. The price signal was not there, both in good times and in bad times.

Alessandro Rivera suggested there has been a mistaken, brave assumption that short-term, volatile price signals can guide political decisions for making good choices for long-term policies. Short-term market signals call on politics to react with short-term responses that are often mistaken. It works the other way round that the policy framework has to provide to markets the signal that there is a stable institutional environment through risk sharing.

The framework the market called for that they can safely put money at work in risk sharing is that there is skin in the game from the public sector, the capacity for the institutions to react to shocks in the first place and provide resources, stabilisation and support where needed.

Klaus Regling

Klaus Regling agreed that markets do overshoot in both directions and so to rely only on those signals is not sufficient. He recalled that there has been some fiscal risk sharing via the EU budget since the beginning of the EU. The European Investment Bank (EIB) provides subsidised loans. The ESM has been doing public risk sharing since the euro crisis.

Harald Waiglein

Harald Waiglein returned to the comment made by Jacques de Larosière that a lot of this relates to harmonising rules as a basis for risk sharing, with social security being one prime example. To have a European social security system there would need to be agreement on standards for unemployment, when someone would need to take a job or benefits would be cut. These would need to be equal across Europe and it is a very heterogeneous system. Risk sharing would benefit some countries at the cost of others. Risk sharing cannot be to the benefit of just some and at the cost of others.

Harald Waiglein agreed that there has always been a fair amount of risk sharing, but it is debateable whether it is enough. Before the financial crisis hit, we inadvertently sent signals to the markets that it was safe to invest in European public debt, because there no difference in spreads before the financial crisis. The assumption was that this is safe. If that signal is given and the underlying structure is not safe at all it is actually more dangerous than not giving the signal and letting markets have the disciplining effect.

Klaus Regling

Klaus Regling agreed that there were problems before the euro crisis, but it was a market failure or a misunderstanding between public sector and private sector. Jacques de Larosière had been pessimistic about the possibility of the euro area becoming like the US. The panel was asked whether it would help to have a fiscal capacity for macroeconomic stabilisation in the euro area. That is one of the gaps. The other gaps are the banking union and capital markets union but let us leave that aside and focus on risk sharing here.

Jacques de Larosière

Jacques de Larosière stated that he did not feel his comments about the US and EU comparison were pessimistic. It is just a fact.

Jacques de Larosière did not believe that the EU can institute a stabilisation fund that will help the bad performers eternally without any condition, because this would be the end of the purpose and the work of the EU. To help those who have derailed, there is a fiscal capacity which is conditionality driven. The question should be whether a fiscal non-conditionality driven capacity is the missing element. One should be very sceptical about that for the reasons indicated by Harald Waiglein.

It is childish to think that everything will be alright if there is an EU fiscal capacity. If there are fiscal or public debt problems the market is going to tell us about problems. Alessandro was perfectly right in insisting on the importance of what the markets tell us in terms of trust and assessment. The basic thing is to let the market work. If that is not enough and we need some element of conditionality driven money, the European Stability Mechanism (ESM) is there for that.

Klaus Regling

Klaus Regling stated that in terms of what kind of fiscal capacity is needed, the ESM did a good job during the euro crisis with very tough conditionality. The EU budget has been very helpful over the last 60 years with very little conditionality, just transfers to promote convergence. The panel was asked what other type of instruments might be useful, and, looking to the US, whether there are recommendations for where Europe should move.

Harald Waiglein

Harald Waiglein stated that he was most tempted to look at the financial sector and the Banking Union. In terms of fiscal relations, the crucial element is the strict no bailout clause that has credibility in the markets. Everyone knows that when Detroit or Puerto Rico goes bust there will be no help from the federal government which means there is an element of market discipline we do not have in Europe. The Stability and Growth Pact rules do not provide for the full effect that one would have if engaged in the fiscal policy and markets were to react to your own currency. That gap has never been closed. We need to think about reforms, but it is not

clear that we can come up with something better than the SGP. 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. 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.

Klaus Regling

Klaus Regling noted that Alessandro Rivera wrote in the Eurofi Magazine about a broad definition of fiscal capacity, which is macroeconomic stabilisation on the one hand, but it also talks about financing public goods. Alessandro Rivera was asked if it is necessary to put it all into a central fiscal capacity and whether the EU budget is not the place to finance European public goods.

Alessandro Rivera

Alessandro Rivera advised that theoretically the two functions of stabilisation and funding of public goods could be separated. The two forms of public spending and intervention are closely intertwined. The lack of a stabilisation capacity relates to the largely pro-cyclical framework that we have as well as the underinvestment in terms of what is needed for funding public goods. This is one way where the two forms of support are connected. The EU budget has always had redistribution features. At the same time, the EU budget can be used for addressing divergence dynamics and risks of fragmentation through investment to public goods. The NextGenerationEU and Support to Mitigate Risks in an Emergency (SURE) tools have proved that the EU budget can be used effectively for a stabilisation function. These have introduced further redistribution capacity in the EU budget, providing financial stability and channelling the funds where they are more needed.

Alessandro Rivera had stated initially that there is no trade-off between private sector risk sharing and public sector risk sharing, but they are closely related and complementary. Conditionality has to be present in public sector risk sharing, but the kind of conditionality and how the governance works has to be discussed. The incentives have to preserve ownership and not to create unintended effects in terms of perception of choices imposed elsewhere that create political issues.

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.

Klaus Regling

Klaus Regling could see some convergence between Alessandro Rivera and Jacques de Larosière, who always wants conditionality. It can depend on the problem that is being addressed. During the Euro crisis it was impossible to avoid conditionality because the macroeconomic imbalances had to be fixed. The SURE programme was very different because the conditionality was very low as there were no imbalances to be fixed. That could be an approach there will be some consensus on here. Risk sharing cannot be discussed without mentioning the SGP, because a framework is needed to fit it all together otherwise political consensus cannot be reached.

Debt levels have grown over the last 10 years in all European countries, for reasons that are easy to understand. The panel was asked how countries can be convinced to add new mechanisms to risk sharing and how to get a credible stability pact as a framework to tie countries together.

Alessandro Rivera

Alessandro Rivera stated he will continue to argue for conditionality. Countries that are members of a monetary union are linked through so many different channels that focusing the policy recommendations needed by all those countries only on a debt, is a mistaken perspective. Debt may be seen as simply the sum of deficits of a year. If the deficit is reduced then there will be a lower debt at the end, but this is not the case. The more the countries' economies are interconnected, the more debt is part of an extremely complex set of relationships and causalities.

Public decision makers have to enlarge the perspective and look at how the rules are able to address all the relevant aspects of staying together in the monetary union. The conditionality applied so far has put a lot of emphasis on external competitiveness, but external competitiveness for each single member does not make much sense looking at the overall position of the euro area. The balance has to be found with correction all around.

Further steps should be taken towards monetary union because it is not a zero-sum game; it is a positive-sum game. The contribution is not simply mirrored by the net contributors. It is something that creates positive effects, not only in the beneficiary countries, but also benefiting the other ones in terms of macroeconomic dynamics, confidence of consumers and companies, and financial stability. The amount put in by the net contributors will be largely offset by the benefits that would return to them.

Klaus Regling

Klaus Regling stated that if EU public decision makers get this right everybody benefits and there will be convergence, more growth and a stronger financial sector. There is a macroeconomic imbalance procedure and it should be more symmetrical. The panel was asked how it saw the SGP and where progress can be made.

Harald Waiglein

Harald Waiglein stated that there are several layers of perception of the SGP. At the technical level EU Member

States probably agree on many things, if not on all. There is the symbolic element, in that it is a perception of either relaxation or toughening the pact that will influence the political debate and will determine how ministers will be seen in their own countries. It is also a symbolic debate and that is probably the most difficult element to overcome.

At the technical level, the SGP is very much an instrument to address moral hazard in fiscal policy, as the banking regulation is to address moral hazard in banking. The reform proposals that have been discussed so far fall short of credibility. There is the logic behind creating new exceptions for expenditure, but when addressing fragmentation, the single biggest risk is the reappearance of credit risk in the sovereign sector. The ECB is withdrawing support and now we see that debts still matter.

It is not clear whether the answer to that is creating new exceptions for expenditure and having longer adjustment paths, whether that is the message we want to send to markets. If there is a conviction that the NextGenerationEU will counteract those forces why there is widening of spreads just now.

Klaus Regling

Klaus Regling highlighted that a proposal from the European Commission may give the NextGenerationEU credibility. The primary objective in the end is debt sustainability. Jacques de Larosière was asked if using fiscal councils more is the answer.

Jacques de Larosière

Jacques de Larosière stated that it might be part of the answer, but not the whole answer. In order to have a system that will work for a long time it needs to be ingrained in the minds of those who are the actors of the system that there will not be a permanent flow of money to those who are in need because the way they have handled their public and general economic affairs. Without that in mind one could do whatever one wanted but will not be credible on the markets and the duration of the European system will be threatened.

Harald Waiglein had called it very rightly 'a problem of moral hazard'. Fiscal councils are not going to help with credibility on the moral hazard problem. It does not seem the fundamental answer to the question. A very independent fiscal board might be good for strengthening the credibility of the system, but it is not the answer.

For the Stability and Growth Pact to work there needs to be two things. First, a case-by-case framework where specific national problems are considered. This is better than a single number, because that is considered by the member in question as an arbitrary rule and arbitrary rules are eventually never abided by. Secondly, there needs to be a thoughtful analysis and explanation of the situation where both the Commission and the interested country would interact. Both a country in surplus and a country in deficit are to be considered. An Article 4 discussion is better than a percentage to apply.

In order for it to work, the actors have to have a sense of ownership. The Article 4 is going to introduce an element of rationality in the system in a more forceful and institutionalised manner. There would be a system that would be more tailor-made, more acceptable by each country. It may be naïve, and it may not work, but it would be better to be rational in this matter. We are going to give ourselves another year of suspension of the rules and relaxation, but that may not be wise because it is urgent to do this.

Klaus Regling

Klaus Regling noted that Commissioner Gentiloni today said that reaching an agreement is urgent.

Jacques de Larosière

Jacques de Larosière agreed it is urgent because the house is burning.

Klaus Regling

Klaus Regling thought it would be likely that the Commission followed Jacques de Larosière's advice of proposing a case-by-case approach although he would advocate a different approach.

Participant

An audience member highlighted that it has been a very striking discussion. The US system has been mentioned, but not the automatic stabiliser system. There has been one experience with the SURE system during the Covid crisis. The panel was asked if it took any lessons from how this was used well by member states or whether it is just a one-off related to Covid.

Harald Waiglein

Harald Waiglein stated that the Austrian view is that these are one-time measures, which has also been made clear by the legal Council service. Anything else would be against the treaty. The instruments were possible legally in special circumstances, but Europe cannot just continue using them. That is a legalistic answer.

The SURE instrument was important although it did not work perfectly, because there was one country that struggled to use the funds or make them available. When talking about the right incentives this is not the kind of mechanism. It is understandable why in an event like that there could be trouble establishing the right criteria and then implementing in a very short time span.

Alessandro Rivera

Alessandro Rivera stated that the treaty certainly had clear constraints of what can be done in terms of transfer to Member States. The EU has already introduced a strict no bail out clause for us. We have a starting point that is better than the one Hamilton had in the US. It is right that there are constraints, but it is also a matter of how those constraints are read and interpreted.

The constraint is that this kind of intervention can only be implemented to address temporary needs and shocks. It is necessary to understand and discuss what is meant by temporary. There was an interesting debate on how the whole green transition may be seen as something temporary in nature, but this may be stretching it too much. Certainly, with the EU budget there are limits and to make the right decisions one should not go through the lines and let them say something that is not

there. The ESM is an important tool and provides more flexibility even with the other constraints. The ESM can only intervene with loans and not grants.

It is interesting that SURE is one of the things that worked, regardless of legal issues and constraints. It has worked properly because it is a form of risk sharing. It can be said ex ante which country is going to receive, which may overcome the issue of moral hazard that was raised. This is not sending money to countries that had excessive deficits or other behaviours that are not fully compliant with the rules.

Klaus Regling

Klaus Regling thanked the panel for their contributions. While the word 'automatic stabilisers' was not used explicitly it is acknowledged they are an important part of the policy tools and so had been taken as a given.

Sanctions against Russia: impacts on the EU financial system

Alexandra Jour-Schroeder - Deputy Director-General, DG FISMA, European Commission
David Wright - President, EUROFI

David Wright

Ladies and gentlemen, here I have the pleasure of having with me Alexandra Jour-Schroeder, who is the Deputy Director-General in the Directorate-General for Financial Stability, Financial Services and Capital Markets Union (DG FISMA), a job I used to have up until 2010. There have been far better people since, and she is one of them. We are going to talk about a very serious subject here, which is the sanctions and the effectiveness of the sanctions regime being applied to Russia. Alexandra, just talk us through, first of all, the facts. Sanctions have not just been applied in Europe, but what have we done here in Europe to cut off the Russian financial system, and hopefully cause economic and financial damage to the aggressor?

Alexandra Jour-Schroeder

Thank you David for putting this subject on the agenda of this Eurofi meeting. It is indeed a very serious matter. Before we discuss the effectiveness of the sanctions, let me first give an update on the nature of sanctions the EU has imposed so far on Russia since 25 February this year. There are now a lot of different sanctions in place, first of all in the financial sector, of course, but also in other sectors.

All in all, we have now six packages of restricted measures plus some measures to ensure maintenance and alignment of issues discovered in the concrete implementation by the affected industries. This is the largest package on sanctions we have ever done in the EU. It is unprecedented, targeting Russia's financial system, as you said, but also high-tech industries, as well as politicians and the Russian elite. Numerous economic sectors are affected, but I will concentrate here on the financial one, and that has in fact been our prime target, although measures such as import/export bans, for example, are also very important.

The first sanction in the financial area is the prohibition of any form of lending to or buying of securities that are issued by certain Russian banks, state-owned enterprises, but also the government itself, including the central bank of Russia. It is not easy to estimate precisely the effects, but I would say that this measure targets more or less 70% of the Russian banking sector. A very prominent sanction is certainly the asset freezes on a number of Russian banks, but also Russian individuals, oligarchs and the elite. There has been a prohibition of any transactions with certain Russian state-owned enterprises. That also goes across different sectors. The EU has also prohibited to export Euro-denominated bank notes. We want to really cut off Russia from the EU financial system, but also from other official EU currencies beyond the euro.

Furthermore, rating agencies are no longer allowed to provide ratings to Russian companies. This is a very efficient sanction due to the requirement of ratings to get access to EU funds, which is now cut off. Then, there is the prohibition of all transactions with the Russian central bank. What was very prominent in the media is the exclusion of certain Russian banks from the SWIFT system. It was a measure that has been discussed at considerable length before it was adopted. There are now 10 key Russian banks that can no longer use SWIFT. And the EU has also prohibited large amounts of Russian money in EU banks above 100.000 EUR. All in all, it is a wide and unprecedented catalogue of effective measures.

David Wright

I think you said that the sanctions effectively cover roughly 70% of banking assets. Why is it not 95%? Should we be concerned about leakage here? Are the impacts and effects sufficiently severe? We have seen the price of hydrocarbons explode, and reports that, in terms of foreign currency, Russia is actually more or

less getting the same amount of income as it had before the war. My question is: do we need to go further?

Alexandra Jour-Schroeder

All the issues you mention are indeed very topical and the concern about leakages is certainly valid. We have this very much on our radar. If we impose sanctions, in an ideal case, it hurts the aggressor, but it should not hurt those who impose the sanctions. Therefore, what we wanted to do with the sanctions package was, first of all, not to include anything that would endanger European financial stability, while simultaneously cutting Russia off from their means to finance its military aggression in Ukraine. After we imposed the sanctions, the EU financial system has remained steady, stable and demonstrated resilience. The system continues smoothly to lend to the economy.

There is indeed the question: how far can we go in imposing sanctions that may hurt Russia even more than what we already have on the table? If you ask me today, 'Will there be more or will there be less sanctions?' My answer is that this depends a lot on the developments regarding Russia´s aggression against Ukraine. I would not exclude the possibility that there will be a new sanctions package. There are measures that could go further. In any case, this needs to be carefully assessed and needs to be agreed by all 27 Member States.

David Wright

Yes, I understand. Looking at the possible areas of leakage, as is the terminology, is the Commission concerned, for example, about the crypto markets, or Turkey and Dubai? What is under the spotlight here?

Alexandra Jour-Schroeder

We are very attentive about possible leakages. First, on crypto markets: There was indeed concern that Russia would immediately jump into those markets. We have considered and addressed the issue from day one by extending all measures I was just mentioning, such as the asset freeze, but also the prohibition on making funds or economic resources available to listed persons, to crypto assets. There is hence no loophole.

But let me say that this is the law in the books, but we also need determined and consistent application of the law in the EU. Nobody can ensure 100% that there are no leakages. But again, the rules are there, and they have to be applied, by economic and financial operators, and the Member States have to assume their responsibility.

David Wright

We have the problem here that no matter how tough the sanctions are in the US, EU and some other countries such as Japan, there are still a lot of countries in the world that are not applying these sanctions, so there must be some leakage. From a Commission perspective, are you seeing a shadow financial system emerging like the Russian SWIFT, possibly linked up with the Chinese SWIFT, because this, of course, would be evading the impact of the sanctions we want? Are you seeing a lot of collateral issues here that are weakening the impact of our laudable approach to the sanctions?

Alexandra Jour-Schroeder

First, on a possible shadow financial system, it is important to note that the use of other channels beyond SWIFT is only partly possible. It is costly and inefficient. It requires time to switch for other means to replace SWIFT services and it requires willingness and readiness of the international partner banks, for instance in China, to participate in dealing with the "deswifted banks" in alternative systems. As regards the Russian domestic financial messaging system, the use of this system by non-Russian banks is limited. Only very few banks outside of Russia are participants of the system and are usually subsidiaries of Russian banks. Considering these limitations, we do not see a concern with a system that could emerge as shadow financial system.

On international relations: we have a very broad international alliance of united countries that are applying sanctions on Russia. You mentioned already the United States. There is also the United Kingdom, Switzerland, and others, especially in the G7 context. The sanctions they impose are not always 100% identical, but they go very much in the same direction, so I think this is already very positive.

EU sanctions are not extra-territorial, and we have good reasons for that. EU sanctions can only apply if there is a link to the EU. What we are doing on a constant basis is reaching out to other international partners with which we have diplomatic channels to address possible circumvention. Again, one cannot avoid every leakage, but we use all means available to us, from diplomacy to technical measures, for instance by screening imports from other jurisdictions in the customs area.

David Wright

Just talk us a little bit through how it works inside the Commission organisationally. DG FISMA is in charge of the financial aspects, drawing up the financial parts of the overall sanctions regime, but the Commission's proposals have to be adopted by unanimity in the Member States. Can you tell us a little bit about how this is organised in the Commission? Presumably, it is through the President's cabinet.

Alexandra Jour-Schroeder

DG FISMA is not only in charge of the financial sanctions, but we assume a general coordination role that encompasses all other sanctions, such as sanctions in the trade and transport area, which prove to be very effective, for example with regard to the export ban of spare parts for the aviation sector. We therefore rely on the involvement of our fellow DGs. This cooperation is working very well.

There is always a steer in the Commission from the Secretariat General and the President's cabinet, because this is a very political issue. And indeed, there is always outreach to the Member States at a very early stage of the process, because it is in the end the Member States in the Council that adopt the sanctions by unanimity.

David Wright

Do you have an informal standing group with the industry to talk about how this is functioning and where the leakages could be and so forth?

Alexandra Jour-Schroeder

Exactly, it is absolutely vital to have close contacts with the industry, which is on the "frontline" in the application of sanctions. We meet regularly and constantly with industry stakeholders. We also receive a lot of questions. This is positive because it shows that there is a clear determination to apply the sanctions correctly. For the time being, we have drafted more or less 500 frequently asked questions and answers on all different topics, and we are developing this constantly.

We also work very closely with the Member States. We do this for the moment in a technical expert group, and Commissioner McGuinness plans to discuss the implementation of sanctions in the Member States at higher political level as the diligent implementation is such an important second step.

David Wright

Just clarifying a question here, does the coverage or scope include investment funds, private equity and insurance? Is everything included here, more or less, or is it focused on the banking system?

Alexandra Jour-Schroeder

It is mainly focused on the banking system, but this prohibition to lend or to buy from Russia includes all financial products, so it is comprehensive.

David Wright

Thank you very much, Alexandra, for clarifying how you are doing this work and the scope of it. It is obviously work that is of immense importance and very difficult. I think everybody recognises that. The Commission is doing the right thing in working closely with industry to make this effective, and hopefully the leakages or gaps that we have touched on can be closed off very much. All power to you.

Alexandra Jour-Schroeder

I would like to make one final point on the question whether the sanctions are really effective and have an impact on Russia. My clear answer is yes, whereas it is not so easy to quantify exactly the effect in the short term. Imposing sanctions is a medium- and long-term project. We see now that the sanctions are starting to bite, including the financial ones. That may even become more obvious in the future, because for the moment Russia still earns a lot from gas and oil deliveries, but if this stops, Russia will also have to borrow on the international financial market, and then the prohibitions currently in place are truly effective.

David Wright

Every success with your future work and thank you, Alexandra.

Alexandra Jour-Schroeder

Thank you.




Post-Brexit regulatory divergence: potential magnitude and impacts

Kristine Braden - Europe Cluster Head, Citi & Chief Executive Officer, Citigroup Global Markets Europe
Paulina Dejmek-Hack - Director for General Affairs, DG FISMA, European Commission
Richard Knox - Director, Financial Services International, HM Treasury
David Wright - President, EUROFI

David Wright (Chair)

David Wright noted that the Brexit referendum was held over six years ago and the EU-UK trade and cooperation agreement has been in force for over 18 months. The panel was asked to discuss the current state and magnitude of regulatory divergence between the EU and UK in the financial sector, how it may evolve and the potential impacts of this regulatory divergence post-Brexit.

Paulina Dejmek-Hack

Paulina Dejmek-Hack stated that Brexit is in essence a fragmenting event. There have been no immediate unexpected consequences or financial stability fallouts from Brexit, because financial industry players on both sides of the Channel were well prepared and had evaluated and anticipated the consequences for their businesses. Clearing, where the status quo remains, is a specific issue, due to the financial stability implications of a possible abrupt change of the current situation.

The discussion on the magnitude of divergence is somewhat misplaced. When the UK left the EU, the rules were the same in the UK and in the EU and, to a large extent, are still the same, since the UK had on-shored EU legislation. The UK has also embarked on a number of regulatory reviews, which will progressively be changing the UK regulatory framework. That is quite normal and inevitable and the same is happening in the EU, where reviews are undertaken to update the regulatory framework in order to better mitigate risks or adapt the framework to changes in the market. New legislations are also regularly brought in. Much work is happening in the Capital Markets Union (CMU) space for example, with on-going reviews of MiFIR and of the investment funds framework and new legislations being prepared such as the Listing Act and the Retail Investment Strategy.

Paulina Dejmek-Hack therefore expected regulatory divergence to develop over time, because regulatory changes will be happening on both sides of the Channel and issues will be approached somewhat differently in the UK and the EU. That is not surprising and is a natural consequence of Brexit.

At the same time, the EU and UK are facing common challenges, including climate change and digitalisation and the whole of Europe is facing the same complex geopolitical situation at present. There is also a great deal of multilateral international cooperation happening in the context of the FSB (Financial Stability Board), the Basel Committee, IOSCO (International Organization of Securities Commissions) and other international fora, leading to the creation of global frameworks for the financial sector that concern both the EU and UK.

David Wright

David Wright asked Richard Knox to outline the perspective from the UK on regulatory changes and divergence and what can be expected from the UK financial services bill that has been proposed and is now being discussed in Parliament.

Richard Knox

Richard Knox agreed with Paulina Dejmek-Hack's points about divergence. The UK will take forward regulatory change, as will the EU. These changes will not be identical because political systems and markets differ. The appreciation of divergence however partly depends on what is meant by divergence. The rules may not be exactly the same but may lead to similar outcomes. The question of interest to financial services firms is the extent to which differences in rules impact cross-border activity or create material frictions for the industry.

Richard Knox confirmed that there is significant regulatory activity going on in the UK in the context of the flagship bill on financial services. The second reading in Parliament started at the beginning of September.

When the UK left the EU, the UK on-shored thousands of pages of EU law, incorporating it into UK law. These rules are quite difficult to amend, because primary legislation is needed in most cases. In addition, the regulatory framework was significantly extended following the 2008 financial crisis, resulting in a great deal of granular detail in legislation. This was never intended to provide the long-term approach for UK regulation of financial services. It created a complicated patchwork of regulatory requirements with detailed EU provisions in UK law that can generally only be changed through a very time-consuming process of primary legislation.

What the previous Government determined and the current Government is taking forward is a bill that puts in place a new regulatory architecture for the UK. The Bill implements the outcomes of the Future Regulatory Framework Review, which assessed whether the U.K. financial services regulatory framework is fit for purpose in light of Brexit and several other initiatives such as the Wholesale Markets Review. The UK independent financial services regulators, i.e. the Prudential Regulation Authority (PRA) and the Financial Conduct Authority (FCA) will be given responsibility for creating firm-facing rules, with the related statute and the overall perimeter defined in law.

It is important to emphasise that the Bill is not actually changing the law. It will create the powers to put in place the new framework and then there will be a process for bringing all the law inherited from the EU into that framework and adapting it when needed. This will include a mechanism for democratic accountability which is comparable to the European system, where firm-facing rules are designed by the Commission and then adopted by the Parliament and the Council i.e. by political representatives. The UK is delegating the formulation of rules to independent regulators, but democratic accountability will be maintained by Parliamentary oversight and by ensuring that the regulators have broader considerations where appropriate, the underlying priority being an absolute focus on financial stability and market integrity.

David Wright

David Wright commented that the Treasury will be endowed with an oversight power and asked whether this would likely result in a call-back type of provision vis-à-vis the regulators or the Bank of England, or whether this was still under discussion.

Richard Knox

Richard Knox stated that this is the debate that is underway. Thousands of pages of law that were formulated by EU policy-makers and politicians are being given to independent regulators for review. The debate is about what the appropriate democratic input and accountability should be in that process given the fact that the UK will not have the same kind of direct democratic input as does the EU system.

There should be some mechanisms, probably by exception, as happens in some other jurisdictions. However, the UK system is also different from the US system for example, where the governance of the regulators changes with the political cycle, whereas the UK has a very independent regulatory system. How to ensure democratic accountability within the UK system is the object of the current debate.

David Wright

David Wright asked Kristine Braden about the consequences of a potential divergence of standards between the EU and UK over the medium to long term for a global bank such as Citi and if the regulatory cooperation happening at the global level is sufficient for alleviating potential issues.

Kristine Braden

Kristine Braden stated that, starting with the G7, the continued dialogue keeping the international system together is very much welcomed. Over time, there will likely be divergence between the EU and UK, as mentioned by the previous speakers. From the perspective of a practitioner, while it was in development for six years, Brexit has just started. There has been a first wave of asset moves from the UK into the eurozone, but the next waves are coming and this will continue over the coming years. There is probably still a 5 to 10-year process ahead, where infrastructure, asset classes, competencies and talent will be continuing to shift into the eurozone.

In the Brexit context, it is really important that international standards are maintained. Citi is for example running a broker-dealer in Germany. This currently involves interactions with 14 regulators, so having regulatory consistency is very important for running the operations effectively. It becomes much more complicated if the rule sets and/or capital requirements differ.

A second important aspect of Brexit is that activities are still spread out over the UK and the rest of Europe. As a result of that, it is really important not to add unnecessary layers of friction across the Channel. It is in everyone's interest to consider how to build the most competitive financial markets, because the ultimate aim is to support the economy. Both sides of the Channel will look to their own interests in the longer term, so banks need to be prepared for that reality.

David Wright

David Wright noted that a divergence in standards would have commercial implications for an international bank such as Citi and asked how they would respond and adjust to such differences.

Kristine Braden

Kristine Braden stated that the commercial implications of divergence and where it is most effective to carry out business are evaluated as a matter of course. At present, the EU is continuing to seek commonality across the EU through projects such as the Banking Union and Capital Markets Union (CMU) and there is a great opportunity associated with these projects.

The anti-money laundering (AML) regulation is also welcomed because it will enable their group to operate on a much more efficient platform within the EU. In a post-Brexit environment, EU objectives to create a more efficient internal market are welcomed. There is huge potential scale within the EU with the size of the economy

and the size of the population. However economies of scale can only be achieved if some of the internal frictions that exist within the EU are adjusted.

David Wright

David Wright noted that this debate is reminiscent of the transatlantic financial services dialogue that was happening with the US at the time the European Commission was building the first phase of integration of the Financial Services Action Plan. Both sides recognised that they did not want to have conflicting laws that would get in the way of free trade. That should also be the objective for the EU and UK. The aim must be to get the memorandum of understanding (MOU) that has been agreed between the EU and UK to function. It has been frozen for some time.

If there is a belief in open markets, there needs to be a discussion about how this is going to work. From an economic perspective, cooperation is good for the UK and the EU, but this has not yet been achieved due to political issues. David Wright asked the panellists for their views on how cooperation could be developed over time.

Paulina Dejmek-Hack

Paulina Dejmek-Hack noted that cooperation is indeed important, but there is a broader political context of the EU-UK relationship post-Brexit, from which financial services cannot be decoupled. It is uncertain how that broader political context will develop over time. For the time being, there are international frameworks and international fora where these financial regulation issues can be discussed between the EU, the UK and many other jurisdictions.

David Wright

David Wright noted that the UK had, and probably still has, a very substantial balance of trade surplus on financial services with the European Union. This would suggest a strong incentive on the UK side to resolve obstacles as fast as possible, rather than risking markets closing off. David Wright asked Richard Knox how progress can be made on these issues, leaving aside the politics.

Richard Knox

Richard Knox stated that the UK's view is that there are genuine benefits to cross-border activity. It is hugely important and has been for a long time, not just with the EU but with a whole host of other jurisdictions.

There are three important factors to consider in this context. Firstly, international multilateral cooperation is essential. The UK and the EU are active in this area and this has allowed the agreement on broad guardrails defining in particular how international capital markets and market infrastructures should operate. The UK is a global financial centre and needs to rely on other critical market infrastructures where they exist, whether in the EU, the US or elsewhere. Large international firms also need to organise their booking models and capital allocation with a global perspective. Departure from this would make the system much less efficient, with costs that end up being passed back to the real economy. That underpins many of the conversations in multilateral engagement.

The second point is that dialogue, particularly bilateral dialogue, is essential. An MOU is ready and the UK is keen to implement it to enable bilateral discussions between the UK and the EU.

The final point is that the rulemaking process that will happen in the UK will include industry consultation, as is currently the case in the EU, in order to take account of potential frictions and fragmentation that may be created by new rules or other impacts for the industry. The objective will be to try to minimise those impacts as they might potentially unfold.

David Wright

David Wright suggested that whether it is in the Basel process, the FSB, IOSCO's work, the International accounting standards, the more granularity that can be agreed at a global level, the less friction there should be when the EU and UK implement these international standards. The presumption resulting from Brexit was that the UK would be much keener on global rulemaking and that is turning out to be the case.

Kristine Braden

Kristine Braden emphasised Richard Knox's point on the need for continued dialogue with the industry. That is the most important objective from their perspective. Where there are frictions e.g. with various margining rules or capital requirements, it is vital that there is a conversation about where the differences are arising and whether they are actually achieving anything.

A second aspect that needs considering is the mandate of regulators. In the new UK framework there is the suggestion that regulators should be encouraged to foster the competitiveness of the industry. There is a similar idea in the Singapore model. This is an interesting position, because it can help to move the whole of the industry forward in the same direction. The European economy has the benefit of truly global corporations and financial institutions based within the Union. It is also in the interest of the EU to stay as globally coordinated as possible, so that its own economy has the ultimate benefit.

David Wright

David Wright asked what the Commission's views are on the competitiveness agenda, the regulatory competition agenda and the international regulatory agenda.

Paulina Dejmek-Hack

Paulina Dejmek-Hack agreed with many of the points raised by other speakers, in terms of the general ecosystem and frameworks needed for financial markets to flourish. When considering the CMU initiative for example, general regulatory objectives such as financial stability and investor protection are taken into account, but the competitiveness of the EU financial sector is also taken into consideration.

David Wright

David Wright summarised that the discussion showed that there should be as much regulatory convergence and supervisory cooperation as possible between the UK and the EU to minimise frictions and differences. That is to the benefit of everybody, firms, consumers and the broader economy. The message to the politicians is to start meeting on a regular and mature basis. That would be in everybody's interest.

Conversation with Odile Renaud-Basso

Odile Renaud-Basso - President, European Bank for Reconstruction and Development
David Wright - President, EUROFI

David Wright

Welcome to Odile Renaud-Basso who is the president of the European Bank for Reconstruction and Development. I have known Odile for many years. Just before you came, Odile, I was praising, among other things, the educational record of David Schwimmer from the London Stock Exchange, but I have to do the same with you, because you are a graduate of Sciences Po, you were at ENA, and also at the Harvard University John Kennedy School of Government. You cannot get much better than that.

You have worked and been the director of the Trésor in France. We worked in the Commission. We worked very closely at times in the Economic and Finance Committee, where you were vice chair. You have the most immense knowledge of international and European regulation over many, many years, and in your role today, we are going to discuss how you see Ukraine. Such a tragic situation. How is the EBRD looking at Ukraine? I think you have been one of the largest international investors in Ukraine. We have got an absolutely catastrophic situation. What are the short-term immediacies?

Odile Renaud-Basso

Thank you, David. It is a pleasure to be here, and it is a pleasure to have this conversation with you, and it is amazing to see the range of issues Eurofi is discussing now in this format with so many different people coming from various horizons.

What we see in Ukraine is, of course, a very, very challenging situation. I think we had all been impressed by the resilience of the country, the capacity to react and to resist, and to stand ground on the military side, but also on keeping the country going.

When the war started, and I remember it was exactly during the Eurofi conference in Paris six months ago, we did not know what could happen – whether the country could stand. Since then, we have seen a remarkable capacity of resilience of the country on the military ground, but also the functioning of the institutions, keeping the businesses and the banking sector functioning. We are talking to the Ukrainian authorities and our clients on a very regular basis, and they keep going and are doing everything to continue to work, to do business, and to support the country. The military situation remains the most important challenge. I am not a military expert, but I understand from many assessments that a likely scenario now seems to be that of a prolonged war? The perspective of a quick solution with a peace agreement seems more unlikely now. We will probably have to face a prolonged war with a huge toll on Ukraine, but also a huge impact on all the neighbouring countries.

What are we doing now? We continue to finance Ukraine. We have asked for some donors and shareholders support to share the risk with us, but we have decided to bear additional risk in Ukraine on our balance-sheet. This balance is a reasonable one given our unwavering will to show our solidarity and engagement to support Ukraine, while at the same time adhering to our sound banking principle. As you were saying, EBRD has been the largest institutional investor in Ukraine over the recent years. We used to invest around €1 billion a year in the country in the private sector and in some key infrastructure. We have also very much supported the reform agenda, with a specific EU-supported programme for reform and we are continuing to do that.

Our objective for this year is to invest more than €1 billion in the country, and we have received a lot of donors support from our shareholders. This is the case from the U.S. with $500 million of grants. When you look at the EU overall contribution, from the European Commission plus bilateral support from Member States, it will be the same order of magnitude. This is very important for us to be able to continue to support the real economy. The Ukrainian government revenues have shrunk, while public expenditures have increased, leaving the government with an important budget gap to fill. The IMF, the World Bank, and bilateral

contributions have brought budget support to bridge that gap – which is much needed to finance basic public services, to pay the pensions, to keep the government functioning. Beyond budget support, it is also crucial to support the real economy. This is exactly what the EBRD does: we provide much needed financing to key infrastructure (railways, electricity, gas), to private sector companies, in agri-business or in the pharmaceutical sector, and also, very importantly, to support trade finance, in order to facilitate export/import - all the more as banks and businesses are now very cautious.

David Wright

That is in the short term, but presumably you are scaling up and preparing for when this awful conflict ends. How are you doing that, Odile? Are you also working in areas such as with a clean piece of paper, looking at things like corporate governance reform, the rule of law? Are you looking at building a type of European NextGenerationEU (NGEU) programme once the fighting stops?

Odile Renaud-Basso

We are working both on immediate needs and on the longer-term reconstruction. There has been a lot of discussions since the beginning of the summer about the assessment of reconstruction needs. This is very important because it gives a perspective and it appears clearly that the challenges will be massive, so we need to get prepared. But it is also critical to keep supporting Ukraine now, because the more determined support we provide now, the more fertile ground will be for an effective reconstruction. If Ukraine's public infrastructure is not functional at all, then the cost of reconstruction will be much higher. Lots of efforts are still needed on what to do now. In view of the geopolitical and military situation, it does not seem likely that we will move from one phase to another, when we can say, 'Today we are at war, and tomorrow we will have a full-fledged peace agreement, and we can start from scratch.' It is now likely that we will have to start rebuilding some of the infrastructure, housing and municipal facilities, even while the war is ongoing.

To be frank, we must keep in mind that Ukraine has been at war with Russia already since 2014 – albeit over a limited part of the Ukrainian territory. Now, the situation is more uncertain with possible bombings over a much wider geography. But this is not a completely new situation, and we will have to deal with it. When thinking about the reconstruction, I think there are some key elements that we need to have in mind.

The first one would be the huge need for external financial support. That is not new, but that will be a massive effort, and external support will probably comprise quite a lot of concessional grant money, because the country will get out with a very shrunken GDP and a high level of debt, so there will be a major need for concessional support. Also, there needs to be a framework in order to bring the private sector into the picture, because when you look at the cost of reconstruction, the destruction and damages to infrastructure alone amount to over €100 billion. What will be key is to make sure the private sector contribute to the investments and activites there.

The second very important element is what you have mentioned: the reform agenda. We must not forget that Ukraine, before the war, was facing important structural challenges in terms of rule of law, good functioning of the institutions, fighting corruption. This has been a long-term agenda with progress, and sometimes some backtracking. This was something where EBRD have been very much involved with the IMF and all the international community was supporting this ongoing transformative agenda. I think this will be very important also post war to continue to address these structural challenges Ukraine was facing before the war and will be facing. In that respect, I believe that the prospect of EU membership and the process of being a candidate country will be a very important driving force in terms of reform. We can already see some decisions taken that have been long awaited – for instance the appointment of the head of the anti-corruption agency, which was something the European Commission pushed in the context of the candidacy status approval. There were some other steps taken, showing that, as it happened in Eastern European countries, the convergence towards the EU legal framework, and the acquis, will be a very important driving force for reform.

David Wright

That is a very interesting point. It just shows how powerful the forces of convergence are. I have one question here, Odile, about the post-war phase. You are going to have to coordinate with an awful lot of donors here – the IMF, the Commission, bilateral funds, EIB. How do you manage that? Is it like herding cats, with everybody scrapping? How do you break it up?

Odile Renaud-Basso

Ukraine before the war was a country where we had very good coordination among MDBs and within the G7. There were some challenges post-2014 with this huge reform agenda, so we were already working very well together, and I think this is still taking place now in the context of the war. All the MDBs have quite different, complementary sets of activities,. Of course, in the context of reconstruction and with the massive financial support which will be needed, close coordination and complementarity will be necessary. To achieve that, a more formalised coordination platform will probably be indispensable. The EU will have a central role to play because of the process of accession, but it is very important in our perspective to design an inclusive coordination. We see today the role played by the US, the UK, and Canada in providing support and being involved in supporting Ukraine, be it military but also financial, budgetary support. We will need to have a platform with all partners around the table.

David Wright

Is there a chef de file? Who is chef de file, or is everybody chef de file here?

Odile Renaud-Basso

The European Commission should of course have a central role. This will be quite natural given the

accession process of Ukraine to the EU. But any coordination will need to be inclusive and bring to the table all the key partners, because I think the support will need to come from all parts of the world. What will be very important in terms of coordination is the link between reforms and financing, so as to ensure that we are all pushing in the same direction in a consistent manner.

David Wright

How are you working with the private sector? Are you planning with the private sector for this massive reconstruction that is going to have to take place?

Odile Renaud-Basso

Not yet – I think it is a bit early. What we are thinking is how to prepare. We are still working with private sector clients, our clients in the country. EBRD's Board of directors approved two days ago an investment in a private equity fund in Ukraine with full support of our shareholders. It is quite a significant step forward and it is reassuring to see investors willing to work and invest in Ukraine – it is of course our duty to support them. What will be very helpful in the context of reconstruction is to work on ideas like pre-qualification of private partners in order to be ready to go very quickly whenever conditions are met in order to rebuild.

We also need to think about innovative products in the context of a post-war economic situation, and how a Bank like EBRD can work with clients. What kind of products should we develop in order to support private sector activites in the country and hopefully bring new investors? We can see that there is a huge interest for private sector investors from all over the world in the context of reconstruction, but of course, the risk will also be quite high. How to mitigate and deal with that will be one of the key challenges we need to work on now.

David Wright

Thank you very much, Odile, for being with us. We are reserving you, if I may, for Stockholm, and especially for Santiago de Compostela, where we will get some divine guidance, no doubt, on all of our files. You have a massive job ahead of you here among many others. We wish you every success, and we thank you for supporting Eurofi. Thank you very much.

Odile Renaud-Basso

Thank you, David.

Conversation with Bernie Mensah

Bernie Mensah - President of International, Bank of America

David Wright - President, EUROFI

David Wright

I have the pleasure, ladies and gentlemen, to be with Bernie Mensah, who is the President of International, Bank of America, a member of Bank of America's Executive Management team and Chief Executive Officer of Merrill Lynch, which is the largest subsidiary of the Bank of America. Bernie, first of all, I wish you a very warm welcome. It is great to have you here and thank you for your very generous support of Eurofi, which is greatly appreciated.

Now, we are going to talk about the transitional challenges we face in Europe and, particularly, let us start with the low carbon future and the objectives we have, such as net zero etc. Are we on the right track here? Are we making progress? Are the capital markets adjusting, do you think, or is it just a huge, long track ahead?

Bernie Mensah

Thank you, David. Thank you for having me and thank you, everybody, for taking the time to listen in. With respect to the transition, we are making progress, absolutely. I would say something like 15% to 20% of European and US listed companies had a net zero target barely a year ago and it is something like 70% to 80% now. There is great work going on in places like – for this audience – the International Sustainability Standards Board (ISSB), with Mr Faber etc. All of that is in place.

There are backward steps. I remember, when Covid hit, everybody thought, 'We will forget about all of our climate pledges'. We went through that. We now are in the middle of an energy crisis, so this is the real litmus test. Of course, in support of geopolitical aims, we probably have to use a little bit more fossil fuel than we might have expected to, but I am positive that, overall, we still have this on the agenda. We are making progress.

David Wright

I remember Xavier Musca, who is the Deputy CEO at Crédit Agricole – it must have been one or two Eurofis ago – said, 'It is just not clear to me what I can and cannot give credits to'. Do you feel that the standard setting is clear enough, that we are not going to end up with fragmented standards which will make your job nigh on impossible?

Bernie Mensah

We may do. We are not there yet and part of all of us and part of my taking the time to come today etc is to make the points that we are making around that fragmentation. As of today, we as an institution have set out what our targets are, who we finance, who we do not. We understand there has to be a transition. There should be. There is a whole question around a just transition for different communities, for different countries, for different industries. We are clear on that.

From where I sit, I would say let us have it measured very clearly and then investors, shareholders, various stakeholders can have an opinion or view on it. We set our parameters and we have a lot of input around that, whether it is on our own internal environmental and climate committee or whether it is on the regulator's. The regulators are undertaking stress tests and if the conversations get a little bit more difficult, that is a good thing.

As a banking industry, we should not be the tool or the execution mechanism for public policy. The politicians who, quite rightly, have the contract with our broader societies need to set the path and the pace and the direction. Otherwise, we continue to support our clients in various industries as best we can.

David Wright

Are you, as an institution, pricing credit now according to whether you see, let us say, a corporate client is taking all this very seriously? Is that beginning to happen?

Bernie Mensah

We are definitely taking it into account. I would not say we are pricing it, but we are urging our clients to have a view and we are saying, 'What is your plan?' We tend to deal with the largest clients globally. What we are doing is spending a lot of time with our more mid tier clients. In the US, we bank everybody, from the corner shop to the very largest trillion dollar companies.

Outside the US, it tends to be medium sized to large corporates and we spend a lot of time and energy and resources telling those mid sized companies that, 'This is what is coming down the pipe'. Forget about us; they might not be able to put their goods on Amazon, for example, if it is not green enough, or somebody will measure how green it is and decide if they want to buy it or not.

David Wright

The numbers that are going to be required for this transition to net zero just in Europe, let alone anywhere else, are absolutely massive. This is going to require, is it not, a public private understanding and partnership in order to get there? Do you see things in public, in the rules and regulations today, that hinder that? Are there changes that you think there should be – let us say to the Basel agreement or whatever – that will not help us here?

Bernie Mensah

Yes, you are absolutely right that it will be very expensive and will require an enormous amount of capital to be put to work. The interesting thing with Europe is that we do have the amount of capital and the savings, but it is deploying that and getting that to the right places. It is not just the public sector; it is the private sector, but importantly it is the markets as well and, David, we have talked about this.

Things like capital markets union, banking union, tools like securitisation are important. Europe has been an exporter of capital, by and large, over the last period of time. Now, you might say that negative rates and a bunch of other things means that savings are probably not being used as efficiently as they could and should. Over the next period of time, this is going to be even more important. A lot of slightly dry issues like banking union and capital markets union and rules on investing in securitised products etc, which make the markets more efficient, are doubly important going forward because we will need to harness all of that to go through what is equivalent in scale to another industrial revolution.

David Wright

Compared to six months ago when we talked, do you see progress on the banking union and capital markets union? Do you think there is enough dynamism in the process? Are international banks and investors really seeing the movements that they want to see? What is your feeling here?

Bernie Mensah

Not too much, but I would not blame anyone. In the last six months everybody has been focused, in this time zone, on the question of how we get through the winter. The conversation is slightly shifting to how we get through next winter and also the cost of that for a region that is a heavy industry based economy with a large energy input, and how competitive Europe is going to be if it is funding its industry on imported fossil fuels. That is what is in front of us and, frankly, it is perhaps more important than these things, but the conversation will slowly turn to that and when it does we all need to think through how the harnessing of these savings and market tools can be brought to bear.

Where the US had been a little bit of a laggard, you might say, the Inflation Reduction Act is something that, if people have not focused on, they should, because it is going to accelerate what is already an interesting renewables province. Often, the US gets a bad rap, but something like 20% of US energy is renewable – wind, hydro, solar. It is entirely market driven and it is the fastest area of new supply energy install capacity that is taking place there. That will tip over in the rest of the world as well.

David Wright

So Europe, I think rightly, and the European Union has claimed up to now a leadership on all of these sustainable development issues, including various measures such as taxonomy and all sorts of things like sustainable finance. Do you think the US is catching up, with the Biden inflation package? When the US puts its mind to things, it can go very fast. Do you think that political leadership in Europe is going to come under some pressure?

Bernie Mensah

I would not frame it that way. Europe has led with asking, 'How should we set the rules and what should the framework be?', and that has been really useful and very thoughtful, whether it is International Financial Reporting Standards (IFRS) rules and thinking through the consequences of border adjustment taxes, all of those things. That is the approach that Europe has taken and, through that, there is a lot of renewable activity and it is in the forefront etc.

Very broadly, in the US, that aspect of rules and regulation has not been at the front. It really has been the market. There have been tax incentives, no doubt about it, but it really has been the market solving things for itself. I would not say it did this quietly, but in the marketplace, it has come from less than 50 megawatts to more than 250 megawatts of renewable energy install capacity. It is just coming at it from slightly different directions.

It is important that we all make sure that that dialogue happens for global firms and others. It is expensive if the regulations do not land, broadly speaking, in the same place and, as senior regulators I was talking to today said, it can be some sort of equivalence. We do not have to set it up so that the rules are the same, but if they are recognised as being of equally high standard, then that is not a bad thing.

The US is engaged in how we look at things and what our rule making is and how we are thinking through

these things, and they will catch up with that, but it is not a zero sum game. That is good. Again, completely anecdotally, if you take the technology space, the venture capital (VC), deep tech, future tech technology space, which I think, personally, we will need to solve some of these issues, the level of activity around green energy and climate solutions, and the amount of money that is going into that through the VC industry in the US is huge. I expect some really interesting and I do see some really interesting scientific progress here, but there will probably be a little bit more there and their ability to commercialise it tends to be a little bit better as well.

David Wright

I think you are right that the US will go about this job in a different way, more using the market mechanisms, perhaps less on the disclosure standards and so forth. The key thing is that the broad principles are aligned and investors behave in the same way in both markets. There is no reason to think they will not.

I have just a final question, Bernie. You are a massive international bank. You work in London. You work around the European Union and here we have the Brexit fissure right in the middle. How do you look at all this? Is this something that worries you? Is it resulting in uncertainties? It looks like the new Chancellor of the Exchequer in the UK wants to press forward with some divergences with European rules. Are you worried about this?

Bernie Mensah

Brexit, what is that again? Can you remind what Brexit was again? I cannot quite remember. It is what it is. We are deep into it. Let me answer one aspect of it, because my background is in the markets and in trading. What we do, to state the obvious, as global banks, is to match savings with investments. Whether it is consumers or whether it is asset managers, there are pools of savings and we spend a lot of time trying to channel it to those that need those savings, such as corporates and others, and investments.

That task of moving that capital around the place to the best place – I would say so, because I am a banker – is really important and it is important that we do it efficiently. What happened five years ago made that less efficient and I always say capital is ideas. It is not so much capital. If somebody says they are going to put their capital in, it is their idea. It is their passion. They think that will work. They think that asset is cheap or expensive and it is really important that capital flows globally.

So over the next period of time, a huge amount of excess savings is going to go to fossil fuel countries and you are going to see European countries and countries like Japan running current account deficits for the first time. We need to make sure that we can cycle those pools of savings and capitals that have gone there into productive uses. Europe is in a transition of building out more autonomy around financial services and, as that transition happens, it is less efficient by definition.

We spend a lot of time trying to match the pools of capital. European savings are in the US. They are in the UK and so we just work to make sure that we can get that capital and those ideas in the right place to make it happen. Absolutely, it has been less efficient and, depending on policymakers, it could get even less efficient, more expensive, or less so. We need to find the best way to adjust around that.

David Wright

Thank you, again, Bernie for being with us.

Bernie Mensah

Thank you.

Conversation with David Schwimmer

David Schwimmer - Chief Executive Officer, London Stock Exchange Group

David Wright - President, EUROFI

David Wright

Ladies and gentlemen, I have the pleasure of having with me here David Schwimmer, who is the Chief Executive Officer of the London Stock Exchange Group in London. Before joining LSEG in 2018, he was at Goldman Sachs for 20 years, including being the Chief of Staff of the former president and COO of Goldman Sachs, Lloyd Blankfein. He has worked all over the world. He has degrees from Yale, Harvard and the Fletcher School of Law and Diplomacy. David, I think that is just about perfect.

We are going to talk about the capital markets situation in Europe. This has been the focus of most of our discussions this morning. David, how do you see things? We are seven years on from the first CMU project. Are we making progress? What are the things, in your view, that are really important to get right, and do you sense things changing in a positive sense?

David Schwimmer

First of all, David, thank you for having me here, and thank you to Eurofi. It is great to be here. If I may, let me just spend a moment or two on LSEG in the EU, because it is actually something that many people are not particularly familiar with. We are one of the world's leading providers of financial markets infrastructure and data on a global basis, and that, of course, includes the EU. We actually have people in 20 out of 27 EU countries, and that is across the trade life cycle. We provide equity trading. We provide FX trading. We have a clearing house outside the EU that gets plenty of attention in the EU. We have a clearing house in the EU in Paris, LCH SA, and we are a leading provider of data and analytics across the trade life cycle, again on a global basis.

From that perspective, we are a global business, and we view the EU as a critical market within the global ecosystem. We have 2,200 or more people across this market, so it is a big, important part of our business. We are very committed to it, which gets me to your question. Are we making progress? To a certain extent, yes, but we could have a long discussion, for example, with respect to capital markets union and harmonisation of insolvency and tax and governance regimes. I think that is going to be a long-term project. I think where there is an opportunity to make near-term progress, it is around competitiveness, and there are a number of things that we, the regulators and the Commission can do in this market to make it more attractive and competitive. That is where the near-term opportunity is.

David Wright

What are those measures, David?

David Schwimmer

Let me give you a few specific examples. I will start with an easy one, or at least one that I view as relatively uncontroversial, which is the European Single Access Point (ESAP). You mentioned that I was at Goldman Sachs for 20 years. As a young banker, I regularly used the Electronic Data Gathering, Analysis, and Retrieval (EDGAR) system in the US. It is not exactly the same as what ESAP will be, but it just makes sense to have unified and integrated access.

David Wright

A repository.

David Schwimmer

Exactly. That feels pretty straightforward. I would love to see the timeframe speed up on that. I think that in terms of the Markets in Financial Instruments (MiFIR) review and consolidated tape, that is an interesting one. There is a lot of focus on consolidated tape. I have some questions around the business case. If it were tied more directly to a best execution obligation, and if the EU best execution obligation were tied more directly to pricing, then you could see a very clear linkage for a business case for consolidated tape, particularly in equities. That is not how the EU regime currently operates, so I struggle a little bit with the business case there.

David Wright

On the tape, would you start with the bond market? Would you start with bonds and then equities, or would you do it the other way round? How would you do it?

David Schwimmer

I think arguably there is a better business case opportunity, given the lower level of transparency, in the fixed-income markets.

David Wright

Are there examples of where we can become competitive?

David Schwimmer

Another example is the Derivatives Trading Obligation (DTO). DTO implementation as part of Brexit had really unintended consequences. It sent the trading and clearing of credit derivatives to the US. It did not bring it to the EU. That was really not the goal there. I think there is an opportunity to tweak MiFIR to bring some of that volume back to the EU, which is clearly in the EU's interests. While we are on clearing, there was a big discussion about it just before this. I am not going to get into it in detail unless you want me to, but there is a clear opportunity to simplify and accelerate the supervisory timeframes there. Maybe the last point I would just touch on is EU benchmark regulation, where the third country regime needs some adjustment there and needs some fixing.

David Wright

What are you thinking of in terms of benchmarks?

David Schwimmer

I think we have not seen the kind of adoption in other markets where we could put in place an equivalence regime here. You would need to see a simplification of the requirements there and a focus on just the critical benchmarks.

David Wright

When we were talking before, you mentioned that it just takes too long in Europe to develop new products. Can you explain that?

David Schwimmer

Again, for those of you who were here for the prior session, I thought it was quite remarkable to see Daniel Maguire and Erik Müller agreeing on the need for speeding up the supervisory timeframe, and the example was referred to whereby if we want to roll out a new product in clearing, it can take us two to three years, whereas our competitors in Chicago can self-certify and get it done in 30 to 45 days. That is a dramatic competitive difference, so I think there is an opportunity in areas like that to make sure there is a single track or a single timeframe to really speed this up.

David Wright

Because they have a delegated authority to do that, subject to oversight, rather than the other way round.

David Schwimmer

Correct, and then the regulator can, of course, review it after the fact, but there is not a multi-year timeframe to get there.

David Wright

Those elements are clearly very important but let us think a bit more widely about tax and insolvency. Do you see these as major impediments in Europe to building a deep, liquid capital market?

David Schwimmer

In an ideal world, you would have resolution of those issues to move us more towards a true capital markets union. Given where we are, some of the national interests, and the timeframe on those, the focus and the opportunity near-term is on increasing and improving competitiveness, and we would like to see that in clearing, but we would like to see that in lots of other areas. There is an interesting fundamental or threshold question as to whether capital markets union means competitiveness or protectionism. We hope it means competitiveness.

At LSEG, we like to say, 'Open makes more possible', and that means giving the market participants access to the best-in-class, most competitive services and offerings. We have had this discussion in the context of clearing, but I think it applies in a lot of other areas, such as data across borders or cloud service providers. A number of these different topics are really important and implicate these issues, so when each of these questions comes up, I would like to see the various stakeholders ask that question. Is this about competitiveness and making us as competitive as we possibly can be and as attractive a market to do business, or is this about protectionism? Protectionism may feel like it has a short-term benefit, but over the long term it just drives capital and business away.

David Wright

I agree with you. I think the openness principle is going to be needed if you are going to fund the green and digital, and all these other major transitions in society. One thing I wanted to ask you, David, is about how the London Stock Exchange Group is now hugely important in terms of data. With the Refinitiv merger, data is a big part of your business and your turnover. Tell us a little bit about the green and environmental aspects of this. Are you seeing bigger demand for green-type data and sustainable investment data?

David Schwimmer

We are, and David, you are right that it is a significant part of our business. In terms of the provision of data itself, our data and analytics business is about 70% of our revenue, and then specifically with respect to sustainable finance, sustainable data, climate data and carbon data, it is a significant and growing area for us. Just to give you one specific example, there has been a great deal of discussion about how the different Environmental, Social, and Governance (ESG) ratings are inconsistent. We provide ESG scores as do others, but we also provide and have one of the leading content

sets of the data underlying what many companies use to form their ESG ratings. As companies and investors become more sophisticated on this whole issue, there is more and more focus on that underlying data.

We have a data set that goes back 20 years, with over 12,000 companies and 450 metrics across each company. I think we cover over 80% of the world's market, and that is growing. We are seeing more and more demand for that kind of data. If I may shift into the regulatory debate for a moment on this, it is also why we do not think there should be regulation or harmonisation of the ESG ratings. We think there should be standardisation of the disclosure, so that you can have higher-quality underlying data so that, again, as the markets and investors become more sophisticated on this, they have access to standardised, comparable disclosure and can make their own decisions.

David Wright

Let me send you a curveball. I think that is the right expression, but this is a slightly unfair question in a way. We have a new Prime Minister in the United Kingdom. We have a new Chancellor of the Exchequer, who apparently wants to push forward with creating a stronger competitive advantage in the UK. From your perspective, do you worry a little bit that the standards in the UK could diverge from Europe or vice versa? Should we not all be arguing here for regulatory cooperation, supervisory cooperation and common standards? Is that not the best thing for all of us?

David Schwimmer

Like you, we are not big fans of market fragmentation. We like consistency across markets. We like capital to be able to move across markets. We like regulatory and supervisory cooperation. The political winds will blow in the way that the political winds blow. I do not think we are going to see a race to the bottom. I do not think the markets want that. I do not think the regulators want that, and despite some of the political rhetoric, I do not think that the politicians want that. I think everyone here will continue to work with the various stakeholders on both sides of the Channel and hope that we can have as constructive an environment as possible.

Here we are six years post-Brexit. It still takes up a lot of noise and sucks a lot of attention away from other things that we all should be focusing on. I would love to see us in a position to move past it at some point soon, and to really focus on issues that can unite us better and that can help us deal with a challenging environment. Hopefully we can get on to other priorities soon, but I know it still does take up a lot of attention.

David Wright

Unfortunately, we have run out of time, David, but it is a pleasure talking to you. That was a very diplomatic answer, if I may say so, on that last question. Thank you very much for being with us and thank you for your support of Eurofi.

David Schwimmer

Thank you and thank you to Eurofi.

Conversation with Stephan Leithner

Stephan Leithner - Member of the Executive Board, Deutsche Börse Group

David Wright - President, EUROFI

David Wright

I have the great pleasure of welcoming Stephan Leithner, Member of the Executive Board of Deutsche Börse, with me. I want to say a very warm welcome, Stephan. We greatly value your support of Eurofi. To give a little bit of background, Stephan is responsible for pre and post trading and is chair of Clearstream. He has had a long career in the financial industry. He had previously been at Deutsche Bank, where he held various leading positions, and that working for McKinsey and at the Swiss Institute of Banking and Finance at St Gallen, where he obtained a PhD.

Stephan, we are going to focus on your views on the capital markets in Europe. I have heard you say that this is a really critical moment, and that capital markets union (CMU) is no longer optional. Why do you think that is?

Stephan Leithner

Thank you for inviting me, David. It is much appreciated. It is good to see you again after the work we did together around the CMU. Indeed, the criticality around our capital markets is not a new theme that we observe. On capital markets, time is of the essence in this geopolitical turbulent period.

We talked about Covid as a major ongoing challenge, but now the energy crisis is at the front stage in the current war context. As we are concerned with war in Ukraine, we already need to look forward to the rebuild and recover phase as the next challenge which needs to be funded. In fact, Clearstream is the single operator which has provided for international investors since a number of years access into the Ukrainian market to support and fund it. This shows that there are additional and necessary funding vehicles than public money which will not be sufficient to support Ukraine.

This applies more widely. There genuinely is an enormous financing challenge ahead of us but let me emphasise that what has changed in the last year can be explained in two dimensions. On one hand, the macroeconomic dynamics and the interest rate spread in particular, so I applaud the decided interest rate hike by the European Central Bank today. On the other hand, we need to recognise that that the recent outflow of liquidity from Europe to the US has been dramatic. In parallel, we observe a significant change, an emerging caution of investing in Europe. In fact, many international investors of sovereign and private actors wonder in light of the current circumstances about whether they still want to invest in Europe.

Having an efficient, non fragmented, safe capital market structure can therefore not be a 'nice to have' anymore. Enormous volumes but also the EU's competitiveness to keep investors interested in the European market are required. An argument which has been brought up is the EU's fragmented market, incentivising investors to rather seek the US market others. There is really an impetus now to act for the CMU.

David Wright

Just on the outflow of capital to the USA, don't we see this often during crises? The move towards the safe haven. Is this safe haven liquidity or do you think it is a permanent outflow liquidity? That would be my first question and the second one is that I think almost everybody in this room would agree with you about the time criticality of building the capital markets. Tell me how you see the leading German politicians. Do they understand this?

Stephan Leithner

Let me begin with your first question. It becomes very clear that what we see right now is more than just safe haven money. It is expressed by the underlying, very significant currency movements, which, if you balance it out, means that investment in US dollar in Europe has increased over the last six to eight months. Again, I am not making a judgment on the market, but the sentiment is that this journey may not be completed when it comes to currency adjustments. Therefore, what

we see is truly a much more fundamental move which is taking place and which represents a challenge.

The significant importance of a strong capital market in Germany is now more recognised than before. This is good news. At the same time, there are many other agenda items that have become very pressing. That is why the EUROFI event, like many others, turns out to be critical, because we need to keep reminding people and emphasise the point. Nobody can finance these enormous required investment needs, no government, not even those with lower indebtedness levels. In conclusion, the EU needs a functioning and efficient capital market.

David Wright

Just on that point, and I do not want to press you further about the German politicians, but do you think there is an understanding that these laudable green objectives and digital objectives cannot be financed in Europe without the capital market? Do people understand this?

Stephan Leithner

Yes. We have, in particular in the last 12 months, seen a very strong focus around sustainable finance being included in the capital markets perspective. That has been very positive. We recognise the achieved progress and welcome the European Commission's work since September 2020 from when on the work in the level-group has been translated into an action plan.

Unfortunately, the European Commission's work got stuck due to the complexity of the current taxonomy debate, but, nevertheless, underlying important progress has been made.

We need to tackle the interrelated nature of issues to build a stronger, more autonomous and resilient EU that can ensure long term economic success. In this context, it is critical that the EU gets some of its key legislative acts - also from the CMU Action Plan - right: the EU Listing Act, the MiFID II/ MiFIR framework, the EU's clearing strategy as well as the CSDR review and the post trade market is an important part where good progress has been made.. The MiFID/ MiFIR review certainly represent a major and central legislative piece of the CMU. Negotiations currently stall in the co-legislative process and that is regrettable as this legislation continues to be one the biggest shortcomings of EU financial market regulation. The misdevelopment of the last 20 years lead to moves away from transparent markets rather than moving to more transparency and more consolidation. That is clearly a missed opportunity. Looking forward, we are waiting urgently for the Listing Act.

David Wright

We have very little time left in this European political cycle. Effectively, the curtains will be drawn by April 2024, so there is not much time left. Besides, the first 9 months of a new mandate cannot be used efficiently as the European Parliament and the European Commission reorganise themselves. Do you think there is that sense of urgency in Germany to get things done? I say this about Germany because it is crucial that Germany is fully supportive of this.

Stephan Leithner

Yes, it is absolutely critical. I truly believe it as many current discussions display that urgency as for example the debate around the payment for order flow, market structure and functioning. The upcoming challenge of the current political agenda is how to prioritise some CMU topics vis à vis other topics, such as energy market debates or the sanctions debate.

Stephan Leithner

We should focus on the following three subjects on the MiFID discussion, which are critical. We observe a 15 year development towards a wrong direction compared to the positive intention that MiFID implied. This is an important overhaul opportunity. If the only outcome is a consolidated tape, then we have missed another big opportunity for bringing back more transparent markets.

David Wright

Tell us what you would like to see there, exactly.

Stephan Leithner

Let us take a closer look at the numbers. The transparent markets at this point are at the lowest point since the early 2000s. We are down to 27%. We are at the same level that systematic internalisers operate at, which is 28% of the market. There has been a fundamental change over the last years. Among the issues that are key, besides transparency around prices and the consolidated tape and how to make that practical, is really bringing back a strong sense of support to transparent markets. This refers to the volume cap discussions that are pending and the underlying supervision model that is there for different types of markets. That really needs to be tackled.

David Wright

In order to build deep, liquid markets in Europe, how important would you judge, for example, the need for a securitisation reform, which used to be multiples higher in Europe than it is now? Compared to the US, we are fractions of the size and this affects the competitiveness of the banking system. How important would you judge is the building of pan European pension systems? Again, the US strength around the 401(k) means massive levels of capital flow into the capital market. These are pretty important.

Stephan Leithner

Let us look at the context of Germany. The coalition in Germany has, in a very positive way last year, articulated the importance of emphasising private savings for pensions. Now we are in the middle of this year, it has been reiterated that one wants to get started and Germany is certainly a laggard from a structural respect on that topic. Even in smaller amounts, I am not too sure whether that initial funding wave can really happen, given the other priorities.

Therefore, your bigger topics – fundamental securitisation, market reinstitution, a real European approach to the savings markets – are critical. The question remains if we can progress in the next 18

months around on MiFID/MiFIR to ensure a functioning market structure and obtain the necessary trust by investors. Furthermore, the sustainability framework, where Europe is an innovation leader, needs to connect to global standards. The current major concern entails that the EU does not connect with emerging global standards.

May I just add as a third point that the European Commission emphasis on functioning, resilient and autonomous financial market infrastructure in Europe? We welcome the Commission's efforts to strengthen clearing activities in the EU and to explore measures that help to structurally boost EU CCPs' attractiveness and to address the substantial risk concerns around clearing of relevant products at non-EU CCPs.

For example, we support the idea to require EU-based market participants to maintain an active account with an EU CCP for the relevant products in scope, so as to avoid a reoccurring cliff-edge situation in the future and to demonstrate preparedness for the expiry of temporary equivalence in mid-2025.

It is a bit parochial when I talk about that but let me be a bit provocative. The gas dependence that Germany had on Russia was something that, for a long time, was ignored. If you, today, were to calculate the dependency of Europe on non EU entities in the financial market, the numbers would turn out to be higher than the dependence of Germany on Russian gas.

David Wright

We had an earlier panel, Stephan, on CMU this morning and I would not say sparks flew but we had two different views. One was that the key to building the capital markets in Europe is through the wholesale markets and there was an opposing view, a view that retail is vital. Where do you fit in here?

Stephan Leithner

In the longer term, there is no proper market without a proper retail market participation. That is a given. At the same time, making the wholesale market inside the EU really work over the next 18- 24 months is something that is critical and where we have a good starting point.

Let me give you a simple example. Europe, on the digital euro which is conceptually quite advanced. It is much further advanced compared to the US. However, the focus lies on retail. We could institute a digital European euro ad-hoc. There is already the TARGET Instant Payment Settlement (TIPS) system which the Banca d'Italia has put in place. It would give a large chunk of the wholesale market players immediate access to instant digital euro opportunities.

That is possibly an interim step, but it will build a wholesale market leg on the cash side that would instantly be world leading. In fact, we can do a lot on the wholesale side in a short period.

David Wright

The point that was made on the retail side by Bjørn from NASDAQ in Sweden was that they have a very successful model. It has worked quite well. Tax is an important issue, but it is not the only issue. Is that possible in Germany?

Stephan Leithner

We made a lot of progress in the last two or three years. Retail has picked up significantly. There are many 401(k) style savings plan volumes that have started to flow into the markets and the lesson learned from the Swedish and the Scandinavians more widely is that their institutional and retail combination through the pension funds is a very powerful tool. We can make a lot of progress here.

The trust of the retail investors is important. Remembering German history, investor rushed all to the Neuer Markt and then it unfortunately tanked. This time around, I do not think that history repeats itelf, but the trust around the topics of basic execution quality and best execution is very important. They need to be addressed in parallel to building underlying, attractive, tax efficient investment mechanisms. This item is however not doable within the next 18 months.

David Wright

The payment for order flow is quite a controversial subject, but it is, as I understand it, possible in Germany. What is your view?

Stephan Leithner

It certainly brought some difficulties in recent periods. The underlying balancing act is the one around best execution. This is the predominant principle which shall prevail. If we cannot give the retail markets a sense of confidence on best execution, a ban on the PFOF needs to be considered. If however it can be proven to that best execution applies within the model of payment for order flow, then that trust still needs to be built over time.

David Wright

I just wanted to ask you one thing, as a deep thinker about capital markets. One reads about younger people being keener to take risk in capital markets. This seems to be either cultural or it is simply too expensive to acquire a house these days. We didn't pay much attention to that generation, so they take a gamble. Are they a type of investors?

Stephan Leithner

In a personal sense, my son and my two daughters are like that. They are they are very interested in structural investments, and equally have a different attitude and openness. They have gained much more educational background. There is an entrepreneurial and investor momentum in Germany, and across Europe. That comes with not just founders and ventures and start ups, it also comes with a different attitude to financial investment.

From our clients as Clearstream in particular, we see the flows and, as I mentioned, we see also the structural background of where the flows come from. We observe that it is not just middle aged, high income families that have put in savings plans based on shares over the last two years or on funds and exchange traded funds (ETFs), but it is very much young people, who start with relatively small amounts. There is a genuine change that so far has not been disrupted by the market correction of the last few months.

David Wright

People would be very interested in your views on the trading in the crypto world. My very last question is where we are all going, towards instantaneous trading settlement, clearing settlement, payment and so forth? Is that the world we are moving to or not?

Stephan Leithner

I am distinguishing between crypto in the Bitcoin context versus what you allude to. I think you are referring more to the distributed ledger, as well as the automation that comes with tokenised securities. I truly believe we are heading in that direction. We, as Deutsche Börse, are investing intensively. We have shaped a framework around what we call D7, in which our clear intent is to move up to 80% of the German securities issuance activity into a framework that is fully digitised.

Now, admittedly, the balance of the number of issues is heavily biased to some instruments which are frequently issued rather than 80 year bonds by the government, which are not making up a large proportion of the number of issues. We believe there is a high impetus of creating fully digitised, tokenised securities in the frames that you describe and allude to.

We see strong interest from our clients, because in some of those markets where there is high issuance activity and high trading activity, they clearly benefit from the shorter settlement times.

David Wright

This refers to using blockchain technologies?

Stephan Leithner

Yes, this refers in particular to the tokenisation that is possible through the new regulatory frames in Germany – the eWpG(Gesetz über elektronische Wertpapiere) – and now in Europe as well as we move to the next wave of that regulatory frame. Tokenisation is the powerful engine that we are building on.

David Wright

Thank you very much, Stephan. It has been a pleasure talking to you, as usual, and I am sorry I threw a few unexpected questions at you.

Stephan Leithner

Thank you very much for having me.

Conversation with Xavier Musca

Xavier Musca - Deputy Chief Executive Officer, Crédit Agricole S.A.

David Wright - President, EUROFI

David Wright

Xavier, as Didier has said, is one of the leading figures in European policymaking for the last two decades. His career began in 1985. It is too long to mention all of it now, but he was the Director du Trésor en France in 2004 and became the Chair of the Economic and Finance Committee of the European Union (EFC), where I often listened to him and followed his advice from the Commission's side. He became the Secretary General of the Presidency in France in 2011 and is now the Deputy Chief Executive Officer of Crédit Agricole. I offer you a very warm welcome, Xavier.

We are going to concentrate on banking union issues and perhaps we can start with how you see the banking union. In June 2022, we saw some Eurogroup conclusions on banking union. Do they take us forward? Do they take us backwards? Are they fit for purpose, in your view? If they are not, what do you think is needed to move us forward on banking union?

Xavier Musca

Thank you very much, David. I am very happy to be with you today, with all our colleagues. The question you raise is a very important one and, indeed, I am very happy to speak my mind on this issue. I have seen recently a declaration from A. Enria mentioning that the fact that we have not a banking union is freezing €250 billion within the banking system that could be used for other purposes. Therefore, it is indeed a real issue, then, to try to tackle this question and to realise a true banking union, as it is also, in my view, a prerequisite for a true union of capital markets.

That has been the debate which occurred during the last meeting of the Eurogroup in June and I understand that there was an interesting proposal made by the Presidency, trying to create a consensus, putting on the table four ideas, four themes of negotiation. One was on improving the deposit guarantee schemes; one about the issue of realising a true, unified banking market; one about diversification of assets in banks' portfolios, and notably sovereign bonds; and the last one was on crisis management.

What this debate revealed was a profound disagreement among member states, despite the position expressed by the Commission and ECB, and the result was to retain only, of all these four themes, the last one, which is on crisis management. My view on that, to answer directly and bluntly your question, is that it does not signal any progress and, in my view, it is a distraction.

It is a distraction because, first of all, since 2011 2012, we have made a lot of progress in terms of financial stability in Europe, so the real need, the real urgency, is not to tackle this issue. Even though improvement could be envisaged, compared to the situation we had 10 years ago, a lot of progress has been made. Many countries have resolved their problems and we have to thank the banking sector itself but also the Single Supervisory Mechanism (SSM) and national authorities, notably in countries like Spain, Portugal and Italy, for what they have done. However, some of the rescues of banks have not fit with the orthodoxy, which was advocated by Europe, but the work was done.

I am not totally convinced of what the urgency now is to revisit this issue. On the other hand, are we making progress on the real issue, which is how we realise a real, unified market of banking services? We have made no progress and the fact that there is no progress signals the strong division among member states. That is my worry, and the real issue is this one.

There are other preoccupying signs. I have been very concerned to see that, when we look at the way we envisage to transpose into our legislation the Basel accord for the last part, there are a lot of people arguing for a solo approach. This is in my view, first of all, contrary to the Basel agreement, but above all this would reinforce the fragmentation of the banking system in Europe.

There is a clear contradiction between what is the declared ambition – to realise the banking union –

and the way the current legislation is implemented, reinforcing the division among the banking system in Europe. That should be a real political concern for all the reasons I mentioned. The real weakness of the European banking system is not supposedly the incapacity to deal with crisis, but rather its very poor profitability; its division; its lack of ambition; and its size, which does not fit with the size of its main competitors, notably American banks. I am sorry for being long, but your question was requesting maybe some development.

David Wright

Not at all, but, Xavier, how do we get out of this blockage? Are we in a situation where the member states are so divided on three of the four issues that you mentioned that, really, we cannot move forward? Or let me put it like this: if you were still the chair of the European Financial Committee (EFC), what would you be advising the Eurogroup to do? It is indisputable what you say, that we are just simply not moving forward in the key areas, so how do we break this deadlock, or can we not break it?

Xavier Musca

Well, I am now a banker and no more a civil servant, which is to a certain extent an easier situation, at least for answering your question. My first remark would be that I have read with a lot of interest what Enria has said on this issue. He said, 'Well, a possibility would be to encourage banks to change the status of the subsidiaries in foreign countries and to move towards branches'. But he immediately said, 'That needs at least a change in legislation', because when moving from a subsidiary to a branch you lose all the benefits of the previous contribution to the deposit guarantee schemes you have made and even this legal change would need some agreement.

I doubt that, in the current state of play, with the atmosphere we have now in Europe, this is feasible, and I would say there are other reasons for which it is very difficult: In a number of countries, banks have their own traditions; Some of their subsidiaries are not 100% held by the group; and so on and so forth. In any case, this option is blocked by the fact that it will also need a legislation.

I am not sure that the solution is in the hands of the banking system itself. The banking system, and notably the bank in which I work, has taken a different approach. If consolidation is not possible in the banking system, we will do consolidation in areas which are close to the banking system but which are not ruled by the same constraints – asset management, custody, consumer finance, etc. – in which the obstacles are less pregnant. That is the answer of the business, which to a certain extent accommodates part of the issue but not 100% and, indeed, does not address the real weakness in profitability of many banks in Europe.

The second issue is whether we are really going to progress, but I am not, to be honest, extremely optimistic. I remember that I participated in an informal Economic and Financial Affairs Council (ECOFIN) meeting. It was in September 2008, and it was just on the eve of the bankruptcy of Lehman Brothers, and the French presidency at that time proposed a programme to progress towards a banking union. To be direct, it was a complete failure and the progress we made was only realised after the crisis, when people realised that standing at the point where they were was not a solution and they had to make some progress. We had to be pressed by the crisis to make progress.

Nowadays, the situation seems calmer and indeed it is, and I really appreciate the fact that, as I said, the financial system is stronger than it was at that moment and, again, than it was more than10 years ago. It also means that the pressure on politicians to move on issues in which they see the political cost, but they do not really realise the economic cost for not moving is not creating the right momentum. I am sorry, David. If I were chairman of the EFC, I am not sure that I would be able to propose any smart solution. In any case, there is no smart, technocratic solution to a lack of political will.

David Wright

I have heard you say, Xavier, that you would like to see many more banks supervised by the SSM. Do you think this causes a fissure in terms of how the banking markets function? If that was the case, another fear or concern of yours is that you can have smaller banks who fail and have access to European funds when they are supervised nationally, rather than at the European level. How important is all of that?

Xavier Musca

You mention rightly that one of my fears is that this reflection on crisis management in fact opened the door to questions which should not be dealt with without taking into account the structure of the banking system itself. Today, we have two kinds of banks: those that are supervised by the SSM, and which contribute to the Single Resolution Fund, and those who are not contributing to this Fund in the same manner, and which are not supervised by the SSM. Blurring the difference between these two categories of banks is not a good thing. It can create political problems and, above all, inefficiency.

Extending the mandate of the SSM would be a real progress because having two kinds of supervision for different banks is not, in itself, something positive. We should move towards a clearer and simpler mechanism of supervision, which would be a federal mechanism as it stands for the big banks, and which is working quite well. I am surprised to see that, in the issues which were dealt with at the moment of last June EUROGROUP meeting, this idea was not really put on the table. We understand that some countries want to preserve certain banks and it is not a good sign, because they are not ruled by exactly the same constraints. It does not make the market more fluid and it creates possible discrepancy in terms of competition.

The idea of opening up, for example, the Single Resolution Fund for the resolution of banks which are not contributing to this Fund would create a real harm to the whole system and indeed, in any case, it is not the urgency. There is no huge problem we have to face in the months or years ahead – at least, I hope so –

and I am confident of the soundness of the financial system in Europe.

David Wright

I would like a final comment, perhaps, briefly, Xavier. We have the transition to the sustainable economy. We have the digital economy, and we have all the energy problems we have. I agree with you that at a political level, we do not seem to be able to galvanise the Council, the Parliament, the Commission to realise that these ambitions simply cannot be delivered without banking union and capital markets union. I wonder what we can do beyond using every technique that we can to convince the leaders of Europe that they have to move forward. Would you agree with that?

Xavier Musca

Yes, I agree with that and, as I said, I am even more concerned because I see some movements, notably through the Basel agreement and the way it will be transposed into our legislation, that can be harmful in this regard. Let us take, for example, structured finance. The way it will be treated is not favouring investment in real assets. It is very strange to see that when we encourage people to invest in the real economy, in energy plans etc, we are at the same time penalising the European way to finance these investments. We do not see the reasons why we are moving in that direction.

That is the usefulness of these meetings, and notably the usefulness of Eurofi, to take every opportunity to claim that, as you said, banking union and capital markets union are really needed. If we want to have a strong monetary union, it cannot be done without strong financial institutions and a true and united financial market in Europe. This supposes the sacrifice of some national interest for all the countries, which requires some political willingness from all parts. It is not there. It is our role and that is the thrust of my message, precisely to say that. Thank you.

David Wright

Thank you, Xavier, so much. It is always a huge pleasure for us to hear you.

Conversation with Jean Lemierre

Jean Lemierre - Chairman, BNP Paribas

David Wright - President, Eurofi

David Wright

A very warm welcome, Jean, Chairman of BNP Paribas, former Chair of the European Bank of Reconstruction and Development, and many important tasks throughout his career, such as Director of the Treasury. Thank you, Jean, for your support of Eurofi. It is invaluable to us.

We are in a very difficult situation. The commissioner has just said it is unprecedented times. In this situation we are in, and we heard from her about the amount of capital we are going to need, for example, to restructure parts of the energy system, it is obvious that the banking system is going to have to play an absolutely critical role here, leaving apart the digital, the green, the energy, and so forth. What is your feeling about this? Are we going to be able to do this? Is the banking sector ready for it? Take us to your thoughts.

Jean Lemierre

First of all, it is good to be with you once more. I agree on the list of challenges, but I would like to add one. The banking industry will continue to support the corporate sector and the economic activities in difficulty, whatever they are, and we can see it may happen through the price of energy. The job of banks is to stand with the clients to support them in case of difficulty, the way we did at the COVID time. Of course, we have to provide resources to finance energy transition and digital investment.

After the previous crisis, we had in mind that we would have, in Europe, a wider range of tools to address these questions. Notably, an efficient capital market union. It is still time to do a few things, hopefully on securitisation, but it means that the responsibility of the adjustment will on the banking industry.

Europe has not yet transformed its funding system with an efficient capital market. Banks will have to do the job. Of course, my simple conclusion to your question is banks must be able to do it, and we have made progress: the banking industry in Europe is stronger, and more efficient.

David Wright

Thank you, Jean. I think what you said on securitisation is interesting, and during today, I think we have heard a lot of support for some sensible and rational reforms to the existing community, the Acquis Communautaire. Securitisation markets are very low in Europe. I think there is a lot of support here to try to move that forward.

One point I wanted to put to you here is about the Basel reforms – are you worried that this could compromise the banking system's ability to provide massive amounts of capital? Are you worried that this is actually a negative factor?

Jean Lemierre

My point is the sense of urgency. We do not know what the price of energy is going to be in November or January; we do not know the impact on the industrial sector. What I do know is that the banking industry needs to stand ready to act if needed. This is not a time when we should open too many boxes. This is a time when we need to be focused and deliver.

To go back to your point, I think we can go through tensions. We can do it if everybody does their job in the proper way, understanding the challenge that we have. Let us implement Basel the European way, the way it has been agreed.

But the question is the sequencing – not of Basel, but of many other questions. There are views about taxation, or the green agenda. I can understand why, but we have to be very aware of the fact that, to be ready in times of crisis, we have to pay a lot of attention to the sequencing of what is done and decided.

The same message applies to securitisation. We shall not make massive progress on capital market union, but we can make progress on securitisation. Let us do

what we can do in good faith, rather than having long procrastination about to do or not to do. Let us do it step-by-step.

On the green agenda, this is the time to work on modalities: data systems, metrics, engaging with clients to understand what they do, and the way to deliver it. It will take time – we have to build up the system. There is no use in threatening about capital increases – let us do the job in the proper way, well-sequenced, with targets which have to be respected.

David Wright

Just the make the point, in terms of time, leaving aside the immediate urgencies of the energy crisis and so forth that the commissioner was outlining, but the fact is that the European political cycle finishes effectively at the end of quarter one, 2024. With the decision-making processes that we have in the European Union, there is very little time left, and then there is effectively a nine-month delay as the parliament renews, as the commission renews. In a way, it is the capital market's project, and the commissioner has made a lot of proposals, and there are more to come as the commissioner said, but there is very little time.

Jean Lemierre

Once more, we should not postpone what can be done. I am sure that on securitisation, there are pieces which can be decided and delivered. I see no reason why we do not do it at a time we need it to address the impact of a potential recession, to prepare investment for the future.

I am very grateful to you, David, because the Eurofi meetings are very useful to understand what can be done, and to try to split difficult debates into concrete steps. All the concrete steps will create a positive trend. This is what we need to do, and this is urgent.

David Wright

Jean, thank you. I think you are absolutely right, and I think that what you say about creating confidence in the European Union by moving forward, I am sure the commissioner agrees with that. International investors will notice what is going on, and that is a wall of money. There will be an expectation that we really can deliver these huge projects that we need. We have been having discussions earlier on about a lot of money leaving the European Union for the United States. Is this just normal safe-harbour money, or is it permanent flows of capital out of Europe? Any thoughts on that, Jean? It seems to me that it is quite an important point.

Jean Lemierre

Yes, it is. I say this quite often: Europe is a continent of savings. We have money. But it lacks the tools to mobilise the savings for its needs, and this is what we have to do together. Eurofi is not a place for lobbying; it is a place for action, and I hope that when we leave tomorrow, we will all have in mind that this is the time for action together. During the Covid crisis, the banking industry has fully supported the corporate sector. We shall continue to do it.

Six months ago, in Paris, it was the beginning of the war. Six months later, we see the challenges. I will go back to the remark I have made: if everybody does a proper job, avoiding overshooting, thorough views and ideology, we can do the job. That is exactly what we need to do in this room. The ECB has made decisions today; they were much expected, and they have been taken. We make decisions in the bank, and each of you make decisions, and if we are able to avoid mistakes and overshooting, altogether, we can go through this. I think the financial industry in Europe is strong.

David Wright

Jean, I think that is a very clear message that I am sure all of us agree with here, and again, thank you for being with us.

Speeches

Zbyněk Stanjura

Minister of Finance, Czech Republic

Speech at Eurofi Gala Dinner

Good evening, ladies and gentlemen, fellow speakers and distinguished guests,

First of all, I would like to welcome you warmly to the beautiful city of Prague. I am really glad that the Czech capital is hosting the EUROFI Financial Forum, which is an important event with a great tradition.

It is not overstating when I say that for these three days, Prague becomes the intellectual capital of the financial world, hosting the most respected speakers in the field. The organizers, David Wright, Didier Cahen and his team, deserve a lot of credit for that.

Thank you.

As you know, the Czech presidency has chosen an ambitious motto «Europe as a task: rethink, rebuild, repower.» As for the financial markets, I think that for now we should stick to rethinking rather than rebuilding.

Are there things that need rethinking? There certainly are. We have seen many interesting lectures in the last two days. But one topic stood out: It was the challenges brought to our everyday lives by the Russian brutal aggression against Ukraine, and Russia's economic war against Europe, based primarily on the weaponization of energy resources.

We are all now facing the consequences of this war: high inflation, rising rates, increased pressure on public finances, disruption of global supply chains. The rising rates may slow down the economy, reduce demand for credit and lead to a potential increase in non-performing loans.

Higher energy costs in the EU may damage the ability of European industrial companies to compete globally, and they may also affect the functioning of the EU economy, and lower the incomes of non-financial corporations and households.

The war and the two years of covid pandemic have clearly shown us how external factors can affect financial stability. And just how important it is to have a resilient banking sector. It is good news that the European banking sector is entering these uneasy times relatively strong, well-capitalized and with solid balance sheets.

When I look back at the developments in the EU banking industry since the previous Czech Presidency in 2009, much has been achieved. Not only has the financial sector been able to deal with the financial crises, but its overall resilience has increased, thanks to a number of reforms.

The Single Rulebook and the Single Supervisory Mechanism as well as the common resolution framework have been set up. In addition, the minimum requirement for own funds and eligible liabilities is gradually being developed, and the loan portfolio risks have been reduced. The number of non-performing loans has been lowered to less than a third over the last 8 years.

However, a number of long-term issues remain, such as the low profitability of the banking sector across the EU and the rising interest rates. And despite the overall improvement, there are still significant differences between the Member States' banking sectors.

In the light of what I have just said, I believe that the response to all these challenges must go beyond the banking sector itself. The regulators must play their role and continue to work on improving the resilience and stability of the financial and banking sector in the EU.

As a representative of the presidency country, let me assure you that we are ready to contribute and make progress, among others, in the proper implementation of the Basel III package, in the open initiatives of the Capital Market Union, and in the area of digitalization.

I look forward to working closely with other Member States and EU institutions to make the European banking and financial sector stronger and more resilient, and to fight financial crime with strict anti-money laundering rules.

Thank you for your attention.

Valdis Dombrovskis

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

Staying strong and building for the future in challenging times

Ladies and gentlemen,

It is a pleasure to be with you again at Eurofi's flagship event.

I remember clearly the last time that I spoke to you. It was in Paris, on February 24.

The day when Russia began its unprecedented aggression against a sovereign and independent country: its neighbour Ukraine.

The EU's response was swift and strong. We imposed a series of sanctions on Russia, its leaders and cronies, and on the aggressor's accomplice – Belarus.

We continue to provide political, financial, military and humanitarian support to assist Ukraine.

Just yesterday, the European Commission proposed a further €5 billion in macro-financial assistance loans to Ukraine as the second part of the exceptional package of up to €9 billion.

And tomorrow, EU finance ministers will discuss emergency financing under the same package, as well as options for financing Ukraine's long-term reconstruction.

After six months, Russia's brutal war raging on Europe's doorstep shows no signs of easing. It has brought dramatic changes to people's livelihoods and to European economies.

Instead of a solid recovery from the economic impact of the pandemic, we face surging energy prices and record-high inflation in a cost-of-living crisis.

Many people are struggling to pay basic household bills for food and energy, and winter will soon approach. Individuals and companies both face tighter financing conditions.

There can be no mistake about who is to blame.

As part of its illegal and unprovoked aggression against Ukraine, Russia is putting a deliberate stranglehold on energy supplies to EU countries.

While inflationary pressures were evident before its February invasion, Russia's cynical tactics have made the situation significantly worse.

We are entering a very different phase – economically and politically. And the uncertainty continues.

It is not clear how long it will last.

The EU has a war on its borders that has massive economic implications. Fortunately, our starting position was strong, also thanks to the well-coordinated policy response during the COVID pandemic.

Our focus now should be to preserve economic, monetary and financial stability, and to distribute the economic costs fairly. We should help to alleviate the hardship for vulnerable people who are struggling to pay their energy bills.

That also applies to companies that see their costs surge and have to close down, or lose out to rivals competing against them in other parts of the world.

This calls for policy action that is equitable and stays focused on reaching our long-term economic goals.

Fiscal support measures should be well targeted and temporary, not least because of sustainability concerns in some Member States. Neither do we want this support to conflict with the task of the European Central Bank of reducing inflation.

Fiscal measures taken now should remain compatible with our objective of reducing the EU's dependence on fossil fuels – especially on imports from Russia.

Overall, fiscal policy should be prudent.

So, for now, the fiscal policy priorities are clear.

But looking ahead, we need to make more progress on designing the EU's future fiscal rules. What is vital is that we have credible rules that ensure public debt sustainability.

This requires a combination of fiscal adjustment, reforms and investments.

The ideal combination can vary from one country to another.

But in all cases, a number of clear, common EU rules and objectives should be respected, not least in terms of debt sustainability.

In a nutshell, this means that there should be some leeway for Member States for determining their policies, within clear European boundaries. Logically, such leeway would come with stronger enforcement in the event of non-compliance.

Finally, simplification is essential.

The focus should be on a single operational indicator that is observable, like an expenditure benchmark.

All these factors will be reflected in the orientations paper for the review that the Commission plans to present later in autumn.

Ladies and gentlemen,

Most importantly, we must solve the immediate problem at its root. In the short term, this means ensuring a maximum degree of energy security, while finding ways to keep prices as affordable as possible.

This is the objective of the REPowerEU initiative: to help us reduce our dependence on fossil fuels and to move to a more reliable, secure and sustainable energy supply.

As vaccination was the key economic policy during the COVID-19 pandemic, energy security is the key economic policy now.

We are working hard to end the EU's dependence on fossil fuels and have already started to diversify our suppliers, particularly for natural gas imports. But this is only the first step.

As President von der Leyen has said, the current crisis is exposing the limitations of our electricity market design. Yesterday, the Commission outlined a set of immediate measures to address the surge in electricity prices.

These include proposals for:

- a mandatory target for reducing electricity use at peak hours
- a cap on revenues of companies producing electricity with low costs
- a solidarity contribution from fossil fuel companies in view of their unexpected profits.

We also propose a re-channelling of unexpected profits to support vulnerable people and companies to adapt, an update to state aid rules to allow Member States to provide liquidity support to energy companies – and a cap on Russian gas.

All this will be followed by a structural reform of the EU electricity market.

These and other issues will be discussed tomorrow at a meeting of the EU Energy Council.

Ultimately, however, we need to address weaknesses in our economic model more broadly.

This requires a wide range of structural reforms that boost our growth potential and resilience, building on the efforts that started under the Recovery and Resilience Facility.

I mentioned the need to preserve stability.

That also means addressing financial stability risks in the short term.

And for the medium to long term, this underscores something that I have mentioned many times to this audience: we need to complete the Banking Union and the Capital Markets Union.

These building blocks are essential to help our economy.

We need strong banks and strong financial systems to finance the reforms and investments that Europe needs for the future, and to create lasting sustainable growth.

It cannot all be done by governments alone.

To be slightly more optimistic, let's remember that before February 24, we were making good progress on the path to economic recovery after the impact of the pandemic and national lockdowns.

We now need to find ways to overcome the current crisis. And we will do so.

With coordination across the EU, with the right policies designed and implemented in each Member State, we can get through this turbulent time. We simply cannot afford to get the policies wrong.

Ladies and gentlemen,

Let me turn now to the importance of trade in the current geo-political context.

Europe's economic strength and competitiveness will also depend on its partnerships outside Europe. Joining forces with friends and partners around the globe is more important than ever.

We will continue to champion international cooperation and open trade while considering broader aspects in terms of our security, values, and interests.

And we will extend our trade agenda, pursuing new agreements around the world while deriving maximum benefit from existing deals.

Deepening the EU's engagement with key partners will not only strengthen our economic recovery and growth, and help fight inflation. It will allow us to support sustainable development more effectively around the world.

Open trade is also important for Europe to obtain the raw materials needed to make the Green Deal a reality. That means avoiding trade barriers, and looking at opening new markets for the import and export of green goods and services, as well as raw materials.

An active trade policy helps Europe to defend its place in the world, be prosperous and green the future. In short – Europe is open for business.

To conclude, ladies and gentlemen: as we enter a busy autumn, Europe faces a complex economic and political landscape.

I know that we can continue to rely on the support of Eurofi and its members.

As always, the financial sector has a vital role to play in developing our economy, both now and in the years ahead. Thank you.

Mairead McGuinness

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

Current challenges and on-going reforms

January feels like so far in the past. Because we were full of optimism.

We had managed a crisis, the pandemic, of enormous proportions. It hasn't gone completely but we managed it and we were coming out of that with a real sense of strong economic growth and vibrancy.

But if you look back six months ago, everything changed.

Russia invaded Ukraine and started war on the European continent.

So against that very sobering backdrop, it is more important than ever that we have a very strong European financial system to underpin the European economy.

And all of you here today in this room and in the margins of these meetings have a role to play to make that happen.

So I want to talk to you today about what we are doing, in the Commission and at EU level, to help us build that strong system together, from those big structural projects like Banking Union and the Capital Markets Union, to the very specific policies we're developing in areas like digital finance.

But maybe I'll start with a reflection on the economic outlook and the impact of Russia's war on Ukraine and in Ukraine.

This brutal invasion has obviously been horrific for the citizens of Ukraine.

It's also delivered a very heavy blow to the world economy, just as things were beginning to return, to get back on track.

In response to the invasion, the European Union imposed a set of severe economic and financial sanctions on Russia, alongside our international partners.

Overall the aim of our sanctions is to show Russia that its actions will not go unanswered – and to make it harder for Putin to finance his war machine.

These sanctions have inflicted very real harm on the Russian economy and its financial sector, with more effects which we will see over the medium term.

And I'll give a few examples.

The Russian Central Bank cannot easily manage its foreign reserves, and some of Russia's biggest banks have been removed from the Swift system.

Russian civilian aircraft are being deprived of spare parts from the European Union and the US, which could lead to planes being grounded.

The lack of access to foreign components from the EU and our partners is undermining Russian industry and manufacturing.

The financial sector is playing a vital role in implementing this sanctions regime.

And I know, we know this is very challenging work, because of the scale of the sanctions we have unveiled.

We very much welcome your feedback – as the people who are putting sanctions into practice – and in fact letting us know how they are working, and indeed when problems are arising.

We are working tirelessly to provide clarifications and ensure that implementation is consistent.

Because perseverance and determination are key to undermining the Russian war machine.

Now at the same time, we know that the financial stability impact of the war on the European Union should be manageable.

But this war is happening just across the EU's border, and we know that there are consequences for us.

The war is putting severe pressure on energy and food prices.

And that is setting the EU economy on a path of higher inflation and more moderate growth.

We're looking at over 8 percent average inflation in the European Union this year, and it varies between Member States.

And the Commission has revised its economic growth forecast downwards, to under 3 percent.

As we look to the winter, we need to prepare for what might happen in the energy sector in particular, and the consequences as we try to keep our homes warm and our businesses running.

The supply of Russian gas could be cut further – maybe even completely.

So I think to be very frank, we live in very difficult times. Extraordinary events have taken place and we are seeing the consequences every single day.

But we should also, in my view, maintain our determination and hope, even in these difficult times.

I'll remind us that the European Union does some of its best work during times of crisis.

In March, EU leaders adopted the Versailles declaration in response to Russia's invasion of Ukraine.

It builds on the idea of "open strategic autonomy", to ensure that Europe is more self-reliant and stronger on the world stage.

It's about reducing our dependencies as a continent and building a new growth and investment model for 2030.

That plan relies on having a robust economic base.

And a resilient financial sector is crucial to navigate these new, more uncertain waters.

Finance has a major role to play make Europe's economic base more resilient, competitive and fit for the future.

And for that to happen, we need to make progress on our big projects for the financial system: Banking Union and Capital Markets Union.

Europe's banking system has stayed resilient in a very challenging market environment.

We need European banks to keep supporting Europe's economy, especially small businesses.

We need our banks to mobilise investment for the big changes confronting us: digitalisation and the climate transition.

And to help us address the new challenges arising from war on European soil.

The stability of the sector owes a lot to the reforms implemented after the global financial crisis.

But we know those reforms are not yet complete.

Moving towards a complete Banking Union will bring more stability to the sector and foster its investment capacity.

And as you know, a work plan to complete the Banking Union did not emerge from the Eurogroup.

But the Eurogroup did reach agreement to proceed with fixing the second pillar of the Banking Union, reviewing the crisis management and deposit insurance framework.

In the Commission, we have already started to work on the legislative proposals to reform this framework.

It's vital that any failing bank can exit the market smoothly, while protecting financial stability and taxpayer money.

Beyond these legislative proposals, I'm convinced of the need for a European deposit insurance scheme.

The other big structural project for the European financial system is the Capital Markets Union.

The financing needs for the future, both public and private, are huge, and you've discussed that in the earlier conversation.

And those needs are only going to get bigger.

If we take the transition to climate neutrality, which will need huge investment in things like battery technology, renewable energy and housing insulation.

That task is now more urgent because we seek to end our dependence on Russian fossil fuels.

And that's why we've rolled out the REPowerEU plan – so RePowerEU will require extra investment of €210 billion between now and 2027.

We must build more efficient and integrated financial markets that can channel the investment that we need.

So when it comes to the Capital Markets Union, we have a lot on the agenda this year and next.

Including streamlining the rules for listing on public markets, and harmonising the rules on insolvency proceedings.

Next year, we will present new initiatives to help retail investors participate in capital markets.

And we will introduce a common, standardised, EU-wide system for withholding tax relief at source.

Since Brexit, we're seeing a new ecosystem of financial centres growing in the European Union, focusing on various aspects of financial services and playing to their own strengths.

This is positive, and we need to support this progress.

So we need to build the capacity of the European Union's financial sector, while also reducing the over-reliance we have on certain financial services outside the EU where that creates a financial stability risk.

And that's the case, for example, in the area of central clearing.

Before the end of this year, we will propose measures to make the EU clearing landscape stronger and to decrease our over-reliance on UK CCPs.

The Capital Markets Union is important to provide financing for the rapid changes in our economy.

We need the financial sector to power the digital transition.

But the financial sector itself is going through an unprecedented wave of digitalisation, accelerated by the COVID crisis.

We want to embrace digital finance and the new possibilities it offers.

But we need to make sure that this happens in the right way.

We need infrastructure to be resilient and secure.

We need to keep consumers safe and build trust.

And we need to safeguard financial stability.

And this is at the heart of our proposals – recently agreed by the European Parliament and Member States – to regulate crypto-assets and strengthen the digital operational resilience of financial companies.

We also need money to be resilient through this change.

Central banks around the world are preparing for the possibility of central bank digital currencies – to keep central bank money useable in a digital world.

The ECB is looking into the

possibility of a digital euro, working closely with the Commission.

A digital euro would provide a public money alternative to private digital means of payment.

And represent a safe, instant and efficient digital means of payment for all to use.

But there are many things that we need to consider.

Including how we maintain the privacy of users, how to safeguard financial stability, and how the digital euro might impact the private sector. Might it crowd out the private sector?

We would want the digital euro to co-exist with private solutions, and for payment service providers to have incentives to distribute the digital euro to users.

The Commission will propose legislation next year to establish the digital euro and regulate its essential aspects.

This would then allow the Council and Parliament to make their amendments.

And then the ECB would be able to issue a digital euro, if it takes the decision to do so.

So in conclusion, I think the cliché of living in unprecedented times is more than a cliché – it's an absolute truth.

But as I speak to many of you today, and listen in the margins, I think we are aware that we are resilient enough, even in very difficult times, to manage this process if we work together.

And for me that was the message and the lesson from Covid. In the beginning, we didn't particularly start well.

But immediately there was a recognition that this crisis was too big for any Member State alone, and we gathered together and did our work, and did it effectively.

And again, I would say that it is always in unprecedented times that the European Union shows what it is capable of.

And I believe that that will be the case now.

Unity is really important – it is our strength.

And it is exactly this strength and unity that will equip us for the future, that makes us more resilient and more capable than ever.

Thank you for your attention.

Klaas Knot

Chair, FSB & President, De Nederlandsche Bank

From thaler to tackle. On how to lift us out of the current crises

Hello everyone,

As a central banker, to be in the Czech republic is a special feeling for me. Do you know why? Because if it were not for Czech ingenuity the world would likely have looked quite different. And no, I'm not talking about essential Czech inventions such as mechanical pencils, sugar cubes or pilsner. I am talking about something the financial industry is much more fond of..... In a way, the seeds of our shared monetary history lay in the tiny town of Jachymov.

For it was there, at the dawn of the Renaissance, that the rulers of Bohemia started minting coins that would later serve as the prototype for all major Western currencies. With an image of saint Joachim on the front and the Bohemian lion on the back, the new currency was labelled as "Joachimsthalers" – which soon was shortened to "thalers". With the helping hand of the Holy Roman Empire, the thaler spread across Europe. From here it was just a matter of time before the Dutch brought the Leeuwendaler to New Amsterdam. And after New Amsterdam turned into New York, the Leeuwendaler turned into the dollar.

By passing through the Joachimsthalers from neighbor to stranger, our ancestors breathed life into our financial system. They relied on each other to spread their currencies across the globe. They relied on their currencies to improve their welfare and wellbeing. That interdependence still persists in our financial system today: we need strong, stable and sustainable finances to ensure and support welfare and wellbeing. This is a balancing act that requires all of us to weigh in. For there are many challenges that can disturb the balance.

When we now think of the most pressing financial challenges our societies face, the rapid revival of inflation stands out. The strong price increase for energy and commodities in particular has hit societies all over the world with force. Pushed past its point of inflection, inflation eats away at consumption and investment capacity and frustrates financial planning. In response, the ECB rallied to raise policy rates to calm down the business cycle and keep inflation expectations anchored. We will continue doing so until the inflation outlook has stabilized around our 2% target in the medium term.

This can however hardly be considered a walk in the park. First of all, some of the most important inflationary drivers are of an imported nature. This not only makes us collectively poorer as we spend more euros or koruna's abroad, but also makes inflation more complicated to control. Secondly, central bankers are having to walk a tight rope between controlling inflation and preserving financial stability. In the aftermath of the pandemic, debt levels and asset valuations peaked. Both make our system vulnerable to disorderly market corrections and cross-border spillovers.

Given these considerations, one might ask oneself what we can do. Recent analysis by DNB staff confirms that high inflation has been driven not only by negative supply shocks but - to a significant extent - also by positive demand shocks. With the tightening of monetary policy, European governments should be mindful not to implement generic fiscal support measures. Instead, targeted fiscal measures should focus on distributing support where needed most. This would also demonstrate our commitment to budgetary discipline.

But our interdependence goes much deeper. The early days of the pandemic serve as a stark reminder that - in our globalized economies - inward-looking policies almost always lead to a negative sum game. This means that financial institutions, businesses and governments should each consider the wider impact of their decisions. Each of us has a role to play when it comes to limiting the perils of cross-border spillovers. To maintain our balance, we rely on the international coordination of policymakers and industry leaders. Our teamwork determines the resilience of the real economy and, in particular, its financial system.

For the longer term, our response should focus on building more structural, more sustainable resilience. This can be done in many ways, but allow me to highlight a few important ones:

First, further integration of our banking and capital markets will strengthen our capability to withstand asymmetric shocks. This

– and only this – will help us to break definitively with the ghosts from the past Eurocrisis, withstand future shocks, and unlock the full potential our financial economy has to offer.

Second, we should push for the harmonization of international regulatory standards. A global level playing field minimizes regulatory fragmentation and allows for the most efficient allocation of capital. In practice, this means the EU should strive for the full, timely and consistent implementation of the Basel III accords.

Third, we should strive for more proactive use of macroprudential policy space. In times of relative ease, we should prepare the financial sector for when the tides turn. As they always do. Right now, macroprudential buffers in the Eurozone are not in line with the elevated levels of systemic risks. Uncertainty about the future should stimulate action rather than wait-and-see behavior. Partly, for this reason, the Dutch Central Bank recently announced the activation of the releasable Countercyclical Buffer.

Additionally, more dedicated macroprudential policy tools that address risks stemming from non-banking financial intermediation (NBFI) would be a welcome addition to our toolkit. For insurers, it is key that macroprudential concerns are well-incorporated in the regulatory framework so that authorities have the necessary tools to mitigate systemic risks, for example by reinforcing the financial position of insurers in exceptional circumstances. Moreover, the operationalization of already available tools, such as the leverage limit for open ended funds, would help address procyclical behavior.

However, our shared responsibility extends beyond the financial system and the real economy. Last February, the Intergovernmental Panel on Climate Change (IPCC) published its most alarming Assessment Report to date. Since then, the world has, once again, experienced its warmest summer to date. In Europe, we saw devastating wildfires, torrential rains and droughts. Water levels in some of our primary rivers, such as the Rhine, were so low that shipping was obstructed. Often in the very same places that suffered from the July floods in 2021, the costliest natural disaster in Europe since 1970.

More and more often, physical risks impact our supply chains. As a result, they aggravate already severe pandemic-related disruptions and increase price levels further. Climate risk is not something to worry about tomorrow, climate risk is something to worry about today. Especially because we did not worry enough yesterday.... In addition, research by DNB and our international counterparts shows that nature-related risks surrounding biodiversity also are in need of our attention. The green transition can no longer wait. We need to step up:

As Václav Havel put it: "Vision is not enough, it must be combined with venture. It is not enough to stare up the steps, we must step up the stairs."

The implementation of sustainable finance is our venture, our decisive step up the stairs. We must implement serious climate policies which take into account the negative externalities of carbon emissions. That means encouraging sustainable initiatives rather than subsidizing fossil fuels. That means incorporating ESG risks into our policies and business strategies. That means providing a wide array of sustainable and transparent financial products for our clients and partners. At the end of the day, renewables also remain our best bet to establish energy security.

Fortunately, the financial sector overwhelmingly supports the Paris Agreement and pledged en masse that they – that we – will do our part to establish a net-zero economy. While more is still needed, available capital should be put to maximum use. For financial institutions, this means implementing proper risk management policies to price in ESG risks. But for risks to be understood by the broader public, we also need common reporting regimes.

In this regard, I applaud the ambitious EU initiatives regarding climate disclosures. At the same time, financial institutions have voiced concerns regarding the different metrics that are currently being drafted between the Eurozone and standard setters such as the ISSB. Therefore, I would like to echo my previous message regarding the harmonization of regulatory policy. By designing internationally comparable climate disclosures from the start, we maximize their impact. This puts the industry in the best possible position to put their capital to work.

Just as our ancestors joined hands to create a strong financial sector by means of the Joachimsthaler, we now have to honor their legacy by keeping it that way. Today, a strong financial sector requires resilience and a transition to a balanced, sustainable economy. We do so together, but all in our own way, relying on our own strengths. As Madeleine Albright, daughter of a Czech diplomat, once said:

"The main thing is to remain oneself, under any circumstances; that was and is our common purpose."

In times of growing challenges to price and financial stability, there is great value in our combined effort. It is our European identity to come together and serve as a positive example for others. Once again, we have to transform our interdependence into collective action. We all have our role to play.

Thank you.

Pablo Hernández de Cos

Chair, Basel Committee on Banking Supervision
& Governor, Banco de España

Trust, digitalisation and banking: from my word is my bond to my code is my bond?

Introduction

Good morning, and thank you for inviting me to speak at Eurofi's 2022 Financial Forum, in association with the Czech Presidency of the Council of the European Union. It's a pleasure to be in Prague with you today.

While the transition from pandemic to endemic remains challenging and uneven across countries, much has changed since the previous Eurofi High-Level Seminar in February. The dual shocks of the war in Ukraine and resurgent inflation have darkened the outlook. Growth is losing its momentum.

Against this backdrop, elevated financial vulnerabilities will continue to test the resilience of the global banking system – with the challenges coming most notably from increased debt levels, stretched real estate valuations and links with non-bank financial intermediation. In addition, the ongoing digitalisation of finance and climate-related financial risks loom increasingly large in the risk priorities of banks and supervisors over the medium term.

So there is no shortage of topics and work for the Basel Committee; each of them would deserve a speech on their own. I should reassure you though that, given our time constraints today, I will focus my remarks on a single theme, namely, the digitalisation of finance.

Digitalisation of finance

Interest in technology-driven innovation in financial services continues to grow at an almost exponential rate. I counted almost a dozen sessions related to digitalisation that are taking place at Eurofi's conference this week. Topics such as fintech, cryptoassets, big data and artificial intelligence (AI)/machine learning (ML) may have seemed arcane a decade ago, but are becoming increasingly mainstream nowadays. This interest has been backed by significant investment. Total global investment activity in financial technology between 2018 and 2021 totalled almost $700 billion, with over 17,000 deals made during this period.[1] And these figures are likely to be an underestimate, as they do not include in-house investments by established financial institutions and big techs.

The spurt in interest and activity in financial innovation needs to be put into context, however. Finance and technology have a long and symbiotic relationship. Technology has been used in finance for more than 150 years.[2] The completion of the transatlantic telegraph cable in 1866 saw finance gradually shift from analogue to digital. This was followed by a second wave of technological innovations in financial services, starting with the advent of the automated teller machine in 1967. So today's wave of technological pervasiveness – including the emergence of new actors and channels for the provision of finance – is in many ways a continuation of this history.

I have previously discussed the Committee's work related to various aspects of financial innovation, including with regard to its impact on banks' business models and the prudential regulation of banks' exposures to cryptoassets.[3] The Committee is also pursuing a wide range of analytical and supervisory initiatives related to AI/ML, data governance, distributed ledger technology and operational resilience, which I hope to be able to cover in future speeches. So I will today provide a few reflections on two related themes that span the panoply of topics related to the digitalisation of finance.

Trust and banking

The first relates to trust and banking. The banking system exists on a web of trust. Indeed, the etymology of the word «credit» stems from the Middle French term for belief or trust.[4] Trust outranks virtually every other factor – including price and service quality – when it comes to consumers' choice of banks.[5]

Trust also forms the bedrock of cross-border supervisory cooperation and fuels the «soft law» nature of the Basel Committee's decisions, where members are committed to implement globally agreed standards in their domestic jurisdictions.[6] I would be remiss if I did not mention at this stage my trust in the European Union (EU) to implement the outstanding Basel III standards in a full and consistent manner, and as soon as possible.[7] As a Governor of a EU central bank, I would add that further delays and deviations to

implementing these standards would not only expose our banking system to additional risks and fragilities, but could also call into question the EU's commitment to global cooperation and, in the long run, weaken the trust that Committee member jurisdictions have in one another.

We also know that trust is fragile and can easily dissipate. The saga of bank misconduct practices following the Great Financial Crisis prompted a wide range of reviews and soul-searching about conduct and culture in banking, and highlighted the difficulty in restoring trust. We must never take it for granted.

The old adage of «my word is my bond» continues to be important today, but trust cannot and does not rely solely on words. Ethics and morals should be the primary foundation for instilling and preserving trust, but are (sadly) insufficient by themselves. A trustful and trusted banking system also depends on a scaffolding of regulatory safeguards, including with regard to conduct, safety and soundness, and market integrity.[8] Incidentally, this applies as much to banking as to other critical industries, including aviation, food and pharmaceuticals, to name just a few.

While these safeguards may impose some costs, these are vastly outweighed by the benefits of trust at both a micro and macro level. For example, in 1866, the inflation-adjusted cost of a return delivery of financial assets with Wells Fargo's iconic stagecoaches was more than $23,500.[9] Fast forward to today, and money can be transferred at a fraction of this cost and in a sliver of the time, in part due to the trust that we place in technological advancements in today's banking system.

At a macro level, it has been estimated that a 10 percentage point increase in the share of trusting people within a jurisdiction raises annual GDP growth by about 0.5 percentage points.[10] Moreover, in a globalised world, the benefits of trust spill over across borders: another study finds that an increase in trust by one standard deviation is positively associated with a 90 to 150% change in bilateral trade.[11] And, in the case of banking, these benefits are in addition to the direct impact of regulations such as Basel III, where the net benefits are estimated to be overwhelmingly positive to society.[12]

Why do I mention all of this? A narrative accompanying some of the emerging streams of financial innovation is centred around the concept of «trustlessness». This is often touted as a superior and more efficient model than today's system of banking, allowing individuals to transact in a quasi-pseudonymous manner, with trust being substituted by automated verification mechanisms.[13] «Trust me, I'm a coder» is almost a mantra in this world.

While such a vision may be conceptually appealing to some, it falls short of providing the robustness, seriousness and societal benefits from regulations, supervision and the rule of law. A trust-free banking system would essentially require society to place its faith in a set of codes and complex models, which we know from history can be subject to errors and model risk. Moreover, advances in financial technology bring with them greater risks to banks' operational and cyber resilience. Breaches in such areas could potentially weaken the fabric of trust in banking. The Committee's principles for operational resilience, finalised last year, aim to strengthen banks' ability to withstand operational risk-related events that could cause significant operational failures or wide-scale market disruptions. I strongly encourage banks and member jurisdictions to proceed with implementing these principles.[14]

Just as few would be willing to board an airplane that does not meet regulatory standards and that has not been inspected by qualified supervisors, I suspect that not many individuals would want to deposit their money in a banking system void of any regulatory and supervisory safeguards.

You may have noticed that I have been referring to «banking» and not «banks». What matters when it comes to securing trust in banking is not so much the specific entities involved, but rather the extent to which entities that provide banking services are subject to relevant regulatory and supervisory requirements.

It is why I chair the Basel Committee on Banking Supervision, and not Bank Supervision. And it is why the Basel framework has been designed in a way to provide sufficient flexibility for authorities to determine the appropriate scope of application.

As we continue to see the emergence of new banking channels, services and entrants, it will be important for authorities to continue to review the appropriate scope of the regulatory perimeter and the type of regulations to apply. This task, which will need to be pursued at both a domestic and global level, should ensure that activities with the same risks are subject to the same regulations. Indeed, the Committee's Core principles for effective banking supervision embeds such a notion.[15] And the Committee's recent high-level considerations on proportionality provide an additional lever for authorities that seek to implement the Basel framework for different types of institution in a proportionate manner and in a way that does not undermine financial stability or the safety of financial institutions.[16]

AI, models and judgment

My second and related observation is about the role of human judgment in banking.

As AI technology continues to evolve, it is changing the banking industry in a number of ways. Digitalisation is posing a number of risks to banks, including:

- *Disintermediation: This is when customers bypass banks and go directly to other financial service providers, such as*

online lenders. This means that banks lose out on revenue and customers.

- *Increased competition: There are new entrants to the market who are providing digital-only banking services. This increased competition puts pressure on banks to lower prices and offer more innovative products and services.*
- *Loss of customer trust: With the increase in data breaches and cyber attacks, customers are becoming more aware of the risks associated with digital banking. This loss of trust could lead to customers moving away from banks altogether.*
- *IT infrastructure: Banks need to have robust IT infrastructure in order to be able to provide digital banking services. This can be costly and there is always the risk that something could go wrong, leading to disruption for customers.*
- *Regulatory pressures: Banks are subject to strict regulation, which can make it difficult for them to keep up with the pace of change in the digital world.*

The text I just read (*italicised above*) was not written by me or any human being, but was instead entirely generated by an AI bot – Generative Pre-trained Transformer 3, or GPT-3, based on a few simple prompts.[17] I will leave it to you to judge the quality of both the drafting and the content of the text (and, dare I ask, how it compares with the rest of my speech), but I think it nicely highlights the advancements and promises of AI/ML. It is therefore not surprising to see growing interest by banks and supervisors in the use of AI/ML technology to increase operational efficiency and improve risk management.

But AI/ML also brings a range of risks and challenges, including the «explainability» of models. Understanding the outputs of models – including potential biases, limitations and robustness – is a key element of effective decision-making, risk management and supervisory oversight. Compared with traditional models, AI/ML models are more difficult to understand due to complex non-linear interactions among variables, making it more challenging to confirm their conceptual soundness. And the quality of modelled outputs are only as good as the inputs. Models can reflect biases and inaccuracies based on the data used, and potentially result in unethical outcomes if not properly managed. In a world with a seemingly ever-growing degree of uncertainty, the limitations of AI/ML models in anticipating and reacting to «unforeseen» and «unprecedented» events are likely to become of greater importance.[18]

The risks to banks from AI/ML are further exacerbated when model development is outsourced. As AI/ML deployment often involves the use of large data sets, interconnectivity with third parties, and the use of cloud technologies, it can also create multiple possible points of cyber risk. In addition there may be greater data governance challenges for banks given the higher volume, velocity and variety of data commonly used to support AI/ML models. I should note here that banks maintain the responsibility and accountability for appropriate due diligence and oversight when relying on third-party service providers.

To offer a simplistic example of the limitations of such models, when prompted to describe Eurofi, the GPT-3 bot generated a paragraph about Eurofi being the «perfect choice» for a «top-quality, reliable and affordable car», thanks to its «over 30 years of experience in the automotive industry»! While the generated text is entirely legible, its content is clearly incorrect – unless David Wright and Didier Cahen know something that we do not about Eurofi's activities!

Given the challenges associated with AI/ML, both supervisors and banks are assessing existing risk management and governance practices to determine whether roles and responsibilities for identifying and managing risks remain sufficient. As with other complex operations and technologies, it is important that banks have appropriately skilled staff, which can include model developers, model validators, model users and independent auditors. This is why the Committee published a series of newsletters earlier this year covering its work to date on AI/ML and third- and fourth-party risk management and concentration risk.[19]

Building on the discussions on the supervisory implications of the use of AI/ML so far, the Committee is working to develop further insights on this topic. Continuing discussions will focus on three areas:

- First, the extent and degree to which model outcomes can be understood and explained.
- Second, AI/ML model governance structures, including responsibilities and accountability for AI/ML-driven decisions including banks' third and fourth-party risk management and concentration risk-related arrangements.
- Third, the potential implications of broader usage of AI/ML models for the resilience of individual banks and more broadly, for financial stability.

Conclusion

Banking has always involved human relationships. The etymology of «bank» originates from the Late Latin for bench, referring to the place where money handlers sat in the market to transact in person.[20] While advances in financial technology that seek to enhance the efficiency, inclusiveness and quality of services should be welcomed, they will not replace the critical role of human judgment in banking and supervision. And they cannot substitute for the importance of ongoing cooperation among Basel Committee members with a view to safeguarding global financial stability.

Thank you.

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18. These limitations are not just limited to banking or finance. Consider the tragic limitations of AI bots in clamping down on terror and mass murder streaming on social media. In 2019, following the livestreamed terror attack in Christchurch, Facebook noted that the video did not trigger its automatic detection systems, because that would have required it to «provide [it] with large volumes of data of this specific kind of content, something which is difficult as these events are thankfully rare» (Lomas (2019)).

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Stefan Ingves

Governor and Chairman of the Executive Board, Sveriges Riksbank and Vice Chair of the General Board, European Systematic Risk Board (ESRB)

Issues in a high inflation environment

First of all, thank you for giving me the opportunity to say a few words. It is hard to say something completely original, given that most things have already been said this morning, but I cannot resist commenting on two messages from the earlier panel, which I take with me. One is 'moral hazard', and the other one is, 'It is all about equity'. Think about that, because you need to deal with both in the long run, which is much more important than most people think.

Now to where we are today. Central banks are in a dramatically different situation today compared to, let us say, just one or two years ago. Looking at the numbers, it is absolutely obvious that inflation is very high and also, unfortunately, broad-based. The inflation-target regime is now, for the first time in a long time, tested from what I would call the regular side. Inflation targeting was put in place in the mid-90s in many countries to avoid too high inflation, and we just did not envisage, in the early days of the inflation-targeting regime, that we would end up fighting too low inflation. But now we are back to where we are supposed to be when it comes to being a central banker and dealing with inflation.

Several factors contribute to the current surge in inflation, including the recovery from the pandemic, global supply-chain disruptions, and not least, the war in Ukraine. Of course, the current energy-price issues aggravate inflation and also weigh negatively on the growth outlook. Restructuring the European energy infrastructure is certainly possible, but that will take many years and in the short term there will be substantial transition costs. Earlier this morning, others commented on this, saying that there has been a change in terms of trade, so we are getting poorer, and we cannot escape from that. That is just a fact of life.

High inflation and higher interest rates have already reduced – and will further reduce – household demand. Weaker real growth, higher prices and reduced purchasing power make communicating the need for interest-rate hikes more difficult. People may think that central banks add to the burden by further increasing the cost of living: 'So why are you doing this to us?'

In addition, private debt has soared in many European countries - that certainly holds from my corner of the world. This has happened along with increasing asset prices for quite some time. In light of this, rising interest rates will this time operate in a completely new situation. As Klaas Knot already alluded to earlier this morning, it will mean that we will have to ask ourselves down the line whether macroprudential has done enough. We just do not know. I hope so, but I am not so sure, but time will tell. Going forward, we also need to keep in mind that the younger generation have, until now, never experienced neither inflation nor increasing mortgage rates. Over time this will of course lead to tensions, given that we have to do what is necessary to bring inflation down.

Another issue that is on its way to bubbling up to the surface is the fact that higher interest rates will also lead to large losses for many central banks. This can potentially affect public finances as well as increase the political risks of central banks. Furthermore, higher interest rates may also worsen public finances in heavily indebted countries. Coming from a small open economy, in addition to all of this, fluctuations in the exchange rate can also complicate the task, but we cannot change that. We just have to eat it and live with it. That is the way things are.

In all of this, balanced and clear communication on the part of central banks will be key. The present objective is to prevent inflation from becoming entrenched, while striving to avoid too negative a scenario for the real economy. While central banks can usually look through fluctuations in energy prices, that is currently not the case, because the inflation anchor is now in danger. What sums it up is this: In our case, the policy rate is at 0.75%, while the inflation rate is around 8% and probably heading up from there. Those two numbers do not add up. It is no harder than that.

Central banks will have to act even more strongly down the road if inflation becomes entrenched in wage and price setting. Most people have forgotten that issue today, but I am old enough to have memories from the 70s

and 80s. Then we went through those spirals with extremely bad outcomes when it comes to real wage development. So, we do have something to protect when it comes to getting inflation back to target.

Finally, as has also been pointed out and commented on by others, we need to try, at least as hard as we can, to have a policy mix that is reasonable. That means that policies should not counteract each other. Here, I am talking about monetary and fiscal policy. It is important that all parts of society do understand where we are heading, that we do not overpromise, and that everybody is ready to stand behind the inflation target.

In the future, changes will happen fast. I started out saying inflation targeting was put in place because inflation was too high, and then we ended up fighting to increase inflation for many years when it was too low. What that tells us is that it is important seize the opportunity to to strengthen the system in good times. Coming from a small, open economy, let me finally make the following comparison: It is like sailing on the high seas and, if you are in a small boat, you had better know how to sail. Thank you.

François Villeroy de Galhau

Governor, Banque de France

Mobilization of the Eurosystem against inflation

Ladies and Gentlemen,

I am delighted to be talking to you today at this Eurofi edition, although I very much regret that I cannot be in Prague in person today. I extend my warmest thanks to David Wright and Didier Cahen for organising this event. Let me first express my heartfelt sympathy to our British friends: the Queen brought a sense of duty and a sense of stability which will hopefully remain a powerful lesson in this very volatile period.

These are indeed times of extremely high uncertainty and difficulty. The European and French economies will face next year a significant slowdown, and we cannot exclude a limited recession. Let me quote, as I did some days ago in Jackson Hole,[i] two compatriots to give us some light: first, a philosopher – Voltaire – who said that "uncertainty is not a pleasant condition, but certainty is absurd"[ii]; second, an economist – Olivier Blanchard – with the following words "monetary policy must be closer to art when it is frequently confronted to new, poorly anticipated and poorly understood, contingencies"[iii]

Well, between art and science, how did we deal yesterday with the present uncertainty?

We decided to frontload on our monetary policy normalisation. We did it because inflation is too high, but especially core inflation at 4,3%: there is for sure a significant energy and supply component in the euro area inflation; but it is also becoming broader and more domestic, and this is the field where we have to act. And second, we clearly show our determination to bring inflation back to 2% in the medium term: this is not only our target, it is our commitment towards European citizens; our will and our capacity to deliver on our mandate cannot be subject to any doubt whatsoever.

That said, yesterday's significant move sometimes raises two questions:

- what about the next move? Let me be clear: we have our hands completely free. Nobody should speculate that this will be the magnitude of the next step – we did not create a new "jumbo habit"–; nor that we simply must emulate other important Central banks. We obviously go in the same direction as them, but not necessarily at the same speed or with the same final level: because the nature of inflation has its differences on both sides of the Atlantic, the monetary answer has its differences too.

- and this brings a second frequent question: what about the destination of the journey? Frankly, it's too early to tell: we know the final rate of inflation, 2%; but we don't know yet the « terminal interest rate », or the policy rates that will ensure a timely return of inflation to our target, while seeing no reasons for increased expectations on these. Let me rather give some light on the first part of the journey, the normalisation till neutral rate; for sure it's unobservable, but this one can be estimated, in the euro area at below or close to 2% according to me. I sometimes use a simple metaphor: as long as it is about lifting off the accelerator, we have to act for sure, in a determined but orderly way, and we should be there by the end of the year. Afterwards, the question could come of pressing the brake, and tightening if needed: but this part of the journey remains today an open question, and will deserve further assessment and reflection, in due time.

Let me only stress one last and obvious point of yesterday's decision: it marks the return of interest rates in positive territory. This historical step brings with it multiple dimensions that need to be revisited: on our operational framework, on our TLTRO operations, on our remuneration mechanisms of bank's reserves. This is a matter that, as Christine Lagarde said yesterday, we will take up without delay.

May I add that with a long view, monetary policy cannot be the only game in town? Europe also needs to solve its supply constraints and challenges, and this refers to two structural policies: first, energy transition, starting with the revision of the too volatile pricing of electricity; second, better training and employability of the labour force. We cannot remain in many European countries including France with so severe labour shortages while still being above 7% unemployment.

As a conclusion, let me quote a famous Franco-Czech writer, Milan Kundera: "The novelist teaches the reader to comprehend the world

as a question. [...] In a world built on sacrosanct certainties the novel is dead". For us central bankers, only one thing is certain, but it is key: we will do everything in our power to fulfil our price stability mandate. And like in good novels, we will bring it through many uncertainties to a successful end. Thank you for your attention.

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Sabine Mauderer

Member of the Executive Board, Deutsche Bundesbank

Climate change and geopolitical shifts: Accelerating the sustainable transition

1. Introduction

Ladies and gentlemen,

Having just arrived from Germany, I'm enjoying the pleasant, slightly cloudy weather in Prague. It is very different from what we have experienced over the summer. This summer has been hot, unbearably hot – with temperatures reaching 40 degrees Celsius or higher. Scorching heat coupled with little to no rainfall has caused an unprecedented stress on water levels.

Two-thirds of Europe is subject to a drought warning or alert, according to the European Drought Observatory.[1] This could be the worst drought in at least 500 years.

The severe rainfall deficit is increasing the risk of fires. The wildfire in the Bohemian Switzerland National Park was terrible, the smell of smoke even reached as far as Prague.

Of course, such weather extremes are not entirely new, but their magnitude and frequency are frightening. It shows: The climate change is not a future problem. The climate crisis is at our doorstep.

In addition to the human tragedy, the proliferation of extreme weather events has economic consequences. The European Council estimates that the financial losses caused by extreme weather and climate-related events exceeded 487 billion euro in the EU (European Union) 27 over the last 40 years.[2] On average, only around 23% of the total losses were insured.

And it is widely understood that climate-related extreme weather events will become more frequent. Without mitigating action, they could result in even greater losses going forward.

2. Time to act – more reasons

Ladies and gentlemen,

There is simply no time left to hesitate or delay. We need to pull together and speed up the green and sustainable transition. Even more so now that the Russian war in Ukraine is having global ripple effects. It has sent food, energy and commodity prices soaring across the world.

In Germany, the year-ahead price for electricity reached a high record at the end of August. Prices briefly rose to 1,000 euro per megawatt hour. Before the war, they rarely rose above 100 euro. Overall, the World Bank expects global energy prices to increase by 50 percent on average in 2022.[3]

And, in a recent analysis, the World Bank estimated that the energy shock could lower global output by almost 1 percent by the end of 2023.[4] We are now paying the price for our longstanding dependency on fossil fuels.

To dampen the impact of high energy prices, many countries have introduced price caps or other subsidies. However, it is important to not dilute the price signals completely and to not create misdirected incentives.

In addition, an adequate carbon price remains a key political tool on the road to climate neutrality, with a clear steering effect. Of course, it is important to keep an eye on the social balance. But for this, policymakers have other, more appropriate instruments.

Policymakers in Europe are rushing to find alternatives to Russian gas, too. In Germany, for instance, coal plants are being reactivated amid debates about extending the life span of the remaining nuclear power plants. But neither coal nor nuclear power are the silver bullet for energy security. Due to low water levels, we have seen instances where coal could not be shipped and nuclear reactors could not be cooled down.

There is no simple solution.

Rather, we are dealing with a multidimensional problem. Thus, the situation might even worsen in a non-linear way. It's time to speed up the renewable energy transition to become independent and less vulnerable.

Greening the energy sector won't be enough. Moving carbon-intensive industries towards a low-carbon future is at the heart of the transition.

We have to get the entire economy on track for net zero. Along this road, policymakers are called on to set the right incentives for investment in the climate- neutral transition.

3. Financing the sustainable transition

There is no doubt that decarbonising our economies will be costly. The European Commission, for example, estimates that additional investments of around 350 billion euros per year

will be required up to 2030, just to convert the energy system.[5] But delaying the sustainable transition will cost us more. To reach our goal of net zero greenhouse gas emissions by 2050, the public and the private sector must pull together.

Of course, targeted public spending is needed. National and European funding programmes could be a vehicle through which companies and private individuals receive grants, loan reduction and guarantees for sustainable projects. This would mean the public sector assumes some of the risk, but the private sector has to pitch in as well. The real economy itself will have to invest a great deal. Banks, capital markets and institutional investors stand ready as funding partners. The financial sector has a key role to play in mobilising the badly needed investments.

However, again and again, we have seen that investors struggle to identify what qualifies as sustainable or green – and what does not. This ambiguity leaves the door open to greenwashing. Investors need to be certain that their money is actually contributing to the transition. Transparency is key for aligning investment with net zero objectives.

4. Enhancing market transparency

High-quality climate-related data are crucial for aligning capital flows with low- carbon transition pathways. There is, however, room for improvement regarding the quality and quantity of data. Acknowledging the need for better data, the global Network for Greening the Financial System (NGFS) has recently launched a new data directory.

It serves as a central catalogue of available climate-related data sources and supports stakeholders in finding the sources relevant to them. The data directory facilitates access to these data and, importantly, it is available to the wider public. Currently, the data directory contains more than 700 links to relevant data sources. In this way, the NGFS is helping to identify existing data gaps.

Similarly, the NGFS widely recognised scenario analyses also contribute to greater transparency. They not only allow us to put a price tag on delayed policy action. They also highlight how transition and physical risks would leave a mark on the world economy.

Moreover, regulatory ambition to enhance transparency has increased in recent years. At the EU (European Union) level, promising steps are being taken to enhance corporate sustainability reporting. EU (European Union) rules require large firms and financial institutions to disclose the environmental and social impacts of their activities – namely the Corporate Sustainability Reporting Directive (CSRD) and the Sustainable Finance Disclosure Regulation (SFDR).

In addition, EU sustainability reporting standards are currently being developed. These should ensure consistency of reporting rules and are envisaged to become part of the CSRD. The European Financial Reporting Advisory Group (EFRAG) has been tasked with drafting them. A first set of standards is expected to be adopted by October 2022.

While those steps are laudable, it is important to bear in mind complexity and practicability. Aligning disclosure standards globally must take priority. Building on and contributing to international standardisation initiatives will be vital.

In this regards, the newly established International Sustainability Standards Board (ISSB) can play an important role in creating global coherence in sustainability disclosures. Close cooperation between the EFRAG and the ISSB will be essential to harmonising data metrics for climate-related data.

Though consistency is the unambiguous goal, it will also be about balancing interests across jurisdictions.

The new standards should be ambitious and in line with the Paris Climate Agreement, at the very least. Thus, the concept of double materiality is an important aspect. Companies should be required to report on how sustainability issues affect their business, and on their impact on the environment and society.

Another example is the Common Ground Taxonomy. It compares the green taxonomies of the EU and China and identifies commonalities. Harmonised standards and frameworks are key for more transparency.

Globally aligned disclosure standards have benefits ...

... for investors by ensuring consistency and comparability

... for companies by reducing reporting burdens

Broadly accepted reporting standards are enablers to the transition.

5. Transition plans – from commitment to action

Let's get down to the heart of the transition. I am looking at you – the representatives of companies and financial institutions. Your action matters.

Indeed, more and more businesses and financial institutions are committing themselves to reaching net-zero emissions. It is important to now put words into action. This includes making your climate pledges verifiable.

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 so as 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 commitments and actions are aligned. This, in turn, would help to mobilise investment and ensure that the funding actually contributes to decarbonising the economy.

Investors increasingly expect businesses to disclose how they are managing their transitions to net zero. Government action will also be crucial in influencing corporate behaviour.

The United Kingdom has taken encouraging 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.

In the EU, the disclosure of transition plans is also under discussion. It is part of EFRAG's proposal for EU sustainability reporting standards. Companies covered by the CSRD should thus anticipate having to disclose their transition plans in the near future. However, publishing net zero transition plans early – before they become mandatory – could give institutions a head start.

6. Conclusion

Ladies and gentlemen,

Let me recap. We are facing unprecedented challenges. The question is not if but how our economies will change. The sustainable transition makes sense: environmentally, economically and politically. We need all hands-on deck. You are at the heart of the transition. With your expertise and dedication, we stand a good chance of succeeding.

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Caroline D. Pham

Commissioner, U.S. Commodity Futures Trading Commission

Money and Life, the Metaverse, and Everything

Good evening. It is my great pleasure and honor to be here at EUROFI Prague. I wish to thank David, Didier, and Marc for organizing this important event. Eurofi was launched more than 20 years ago during a time of great change and consolidation—in the middle of the launch of the common currency—designed for more efficient payments and price transparency, bringing its own promises and challenges. Now, perhaps it's no surprise that many are exploring the promises and challenges of virtual currency.

I also wish to thank the Czech Presidency of the European Council for hosting us in Prague. It is an opportunity for central bankers, finance ministers, regulators, and other policymakers to come together with key leaders to discuss the world's most pressing issues and potential solutions. It is in times of great challenge that it is more important than ever to remember that connection to others is one of the most defining characteristics of humanity. Throughout all my exchanges with policymakers, both domestically and in Europe and Asia, I am struck more by the commonalities we share, and not so much by any differences. I'm so pleased to be here, to reconnect with many, and to make new connections with you all.

It is fitting that we are looking into the present and future of banking and markets, including the further digitalization of finance. We should remember our past as we imagine the future, particularly as we continue what's been called a "150-year revolution" of financial technology.

Last year was the 100th anniversary of the premiere of Karel Čapek's play here in Prague that first used the word "robot." Today, we see much in financial technology that would have seemed science fiction not too long ago.

As you may know, I used to work in regulatory strategy. Now that I have returned to the public sector, it seems only appropriate that I share some thoughts on a regulator's strategy for what may well be the next chapter in the digitalization of finance—science fiction come to life, the metaverse.

In approaching this topic, it is my hope to raise some key questions—what is the metaverse? Why do we care? What should we do as policymakers? that will spark ongoing dialogues and provide one approach to addressing the opportunities and risks to not only the financial system, but perhaps even society and community itself.

Before I proceed, I'll say now that these are my views and do not reflect those of the CFTC or any other Commissioner.

The metaverse is here now

The metaverse is here now. Corporations, venture capital, and private equity have already invested more than $120 billion into the metaverse space in the first five months of 2022.

I would like to share some statistics. A recent McKinsey & Company report found that some 95 percent of business leaders expect the metaverse to have a positive impact on their industry within five to ten years, and 61 percent expect it to moderately change the way their industry operates. The report also found that the industries most likely to be impacted by the metaverse include consumer and retail, media and telecommunications, and healthcare—and those industries are also among those already undertaking metaverse initiatives. These are major mainstream consumer brands, beyond large technology companies like Meta (formerly Facebook), Microsoft, Apple, and Alphabet (Google).

In the near term, the metaverse may generate up to $5 trillion in impact by 2030—if not more. High potential consumer use cases include e-commerce, and high potential enterprise use cases include banking, discrete manufacturing, professional services, retail, telecommunications, media, and process manufacturing. The examples beyond the financial sector show the value proposition in the real economy. Major corporations and others have invested significantly, and I note that one of the top corporate capabilities they're focused on to deliver these metaverse strategies is legal, risk, and compliance. This isn't all the Wild West.

I believe that studies like these show that the metaverse is far more than speculation on crypto assets—it is "the real business of the virtual world." Some describe

the metaverse as the next iteration of the internet, something we are immersed in, a three-dimensional version. I also find compelling the vision of the metaverse offered by some that focuses on the ability to have a unique identity coupled with an economy.

The metaverse may very well be our next life: a life where the lines between our physical and digital lives are increasingly blurred, where we seamlessly switch or exist in layered experiences simultaneously, which ultimately creates a new dimension to society and community. It could even materialize a "network state" of the minds, not the lands.

We've long seen conceptions of the metaverse in the realm of science fiction. William Gibson's Neuromancer described people connected to what he called cyberspace almost 40 years ago, and Neal Stephenson's Snow Crash imagined the metaverse a few years later. And more recently, the movie Ready Player Onepresented an immersive virtual reality world called the Oasis.

In some ways, online gaming is a preview, a "proto-metaverse," of what's in store. Online video games provide experiences of digital, interactive worlds involving identities and economies. I expect some parents here agree: not only is the metaverse here, but they wish their kids would spend less time there. And gaming is already big business. I was surprised to learn that gaming is larger than other subsectors of the entertainment industry like movies and music, with more than three billion users globally and a total value of more than $200 billion.

The metaverse or not

I would distinguish the idea of the metaverse from Web3. In my view, what's been considered Web3—a decentralized internet of ownership where users can own, monetize, and utilize their data to their own benefit, enabled by blockchain, digital assets, and smart contracts—isn't a necessary condition or required for the metaverse. But Web3 could unlock more of the open metaverse's potential. That is why I believe we must be forward-looking and deliberate in addressing the policy issues of Web3 and digital assets in order to protect users but not inadvertently derail our next life. The great debate over crypto may be only a waypoint on the journey to the metaverse.

As a side note, it's also my view that augmented reality (AR) or Virtual Reality (VR) is not required to experience the metaverse. When I was in Seoul earlier this year for Korea Blockchain Week, I saw the metaverse with my own eyes on a regular screen. AR/VR is an enhancement right now.

What happens when life goes digital?

Look further into the future and ask what happens when more of our lives, financial and otherwise, become digitized in the metaverse. The top five metaverse activities that consumers are excited about are social, entertainment, gaming, travel, and shopping. The top five enterprise use cases that companies are already implementing in the metaverse are marketing, employee learning and development, business meetings, events or conferences, and product design (digital twinning).

The public sector is also exploring use cases in the metaverse. Dubai's Virtual Assets Regulatory Authority (VARA) is the first regulator in the metaverse, establishing a headquarters in The Sandbox platform. Seoul is the first city government that is set to join the metaverse with a virtual Seoul City Hall, plaza, and civil-service center and announced a five-year "Metaverse Seoul Basic Plan" in order to provide "civic freedom, participation, engagement, and communication," and South Korea's Ministry of Science and Information and Communication Technology recently released a consultation on eight ethical principles for the metaverse ecosystem: authenticity, autonomy, reciprocity, respect for privacy, fairness, data protection, inclusiveness, and accountability.

In financial services, use cases include marketing, infrastructure, and new products and services. Potential opportunities in a future metaverse that embodies a next life could include multicurrency cash management for native metaverse wallet owners; servicing, like virtual real-estate mortgage origination and warehousing; funds and investing services for metaverse projects; enhanced customer engagement like unique loyalty experiences; but also potential financialization of everything through the use of digital assets in the metaverse, which may present unique challenges for financial regulators.

Metanomics and utility

One aspect of the metaverse will be facilitating use and engagement through digital assets sometimes called utility tokens. These have sometimes been defined as digital tokens that provide digital access to a good or service, are available on blockchain, and that are valid within a particular economy. These are things, not financial instruments. Put differently, just because you can financialize something doesn't mean that it is always financial in nature. Real economy examples of true utility tokens—not fraudulent ICOs—show that they can be far more than just speculative financial instruments.

If utility tokens are the key to accessing much of the utility of our next life in the metaverse, we must be open minded and embrace possibilities in ways that do not stifle innovation, while still protecting against misconduct and abuse.

Gaming once again provides a way to understand these tokens. As a kid, I remember going to the arcade at the mall and buying tokens to play the games. I wasn't an investor in the arcade—I was using a fungible good the arcade sold to access the games. Today's games have a lot more features. And you can spend money for more things than just playing the game or extra lives. But the essence is the same.

Another example of what are essentially utility tokens that we have today are transit rewards points. Those of us who traveled to Prague by air may have been members of a frequent flyer

program, building points that may be used towards future flights or services. Perhaps more befitting of Web3, an airline recently sold blockchain-based tokens for use in purchasing charter flights and related services.[1] These tokens did not offer any rights to the profits of the company, but rather only a more efficient and faster way to obtain the services.

In the EU's MiCA Regulation, and the regulatory frameworks in Switzerland, Liechtenstein, Dubai, and others, utility tokens or usage tokens are distinct from other categories. For our part, the CFTC's regulatory framework is relatively asset- and technology-neutral. Our focus on principles-based regulation, customer protections, market integrity, risk management, price discovery, and transparency has worked well for our markets for decades in part because it is flexible enough to allow for innovation and change while ensuring strong protections are in place.

Metaverse and policy

There are key areas that need to be further developed and matured to achieve the full metaverse and its potential for engagement, community building, self-expression, and commerce. They include technology; commercial infrastructure; privacy and identity; workforce of the future; and regulation, tax, accounting, and social infrastructure.

As these areas are developed, one question in particular stands out: how do regulators address the development of solutions and services to support virtual worlds that are globally accessible, but may be required to adhere to local jurisdictional requirements and rules in commerce and payments? Luckily, this question is not a new one, as it is a further extension of how regulators have approached globalization and past technological innovations that enable cross-border activity.

Just as regulators have had to tackle the digitalization of finance, so too must we look ahead to the future and the increasing digitalization of life. In many ways, much of our life involves transactions. Some say that the foundational layers of the metaverse—the "enablers"—are security, privacy, and governance; identity; and payments and monetization. These are issues that are very familiar to financial regulators, financial institutions, and new entrants like fintechs. You could say that money is life.

Some of the other critical issues for policymakers to consider include open access to the metaverse; competition and promoting innovation; intellectual property rights; commerce, monetization and distribution models between stakeholders; promoting diversity, equity, and inclusion; securing user safety and awareness; and ensuring data privacy.

The metaverse also has broader societal implications. Relevant stakeholders will need to define a road map toward a metaverse that is ethical, safe, and inclusive. This likely will include rules relating to data privacy, security, ethics and regulatory compliance, physical health and safety, and equity and fairness.

Because metaverse development is still in its early stages, I believe a principles-based approach to emerging policy issues appropriately reflects the need to anticipate and adapt to issues and risks quickly. I also believe it is imperative for regulators to proactively engage with the private sector, and ensure the responsible development of products and services that have embedded protections.

A regulator's strategy for the metaverse

As I have previously said, I believe that the way to get things done is to get all the information, learn as much as possible, and then find pragmatic solutions. Just as business leaders need to identify a strategy for the metaverse, I believe that it is incumbent upon regulators to do the same. I believe that we must learn more about the metaverse, assess the policy issues, create expertise and resource, connect with other policymakers, and establish a regulatory approach that is fit-for-purpose with each of our singular legal structures and authorities. Throughout all this, we must ensure global cooperation and coordination, because the metaverse is truly a world without borders.

The internet's emergence led to the profusion of social media, mobile connectivity, and cloud computing. The emergence of the digitalization of finance has led to what a few decades ago would have been the realm of science fiction: using pocket-sized supercomputers to make and receive near-instant payments across the world. And today's technologies may put us on the verge of a metaverse of real-time, immersive, massively multi-person content, experiences, and connections, potentially with a financial transaction layer powered by Web3. We could be moving from crypto and blockchain as a wrapper on value to a wrapper on reality.

If the metaverse is too big for companies to ignore, then it is too big for regulators to ignore as well. If the metaverse is, at the very least, another iteration of our current life, all current regulatory issues will iterate there as well. And this digital layer imposed on our physical layer may bring new issues as well.

And if the metaverse is truly our next life, we can't avoid it. It's better to face it head on and build in now the protections we will need. But we can't be so shortsighted that we foreclose the future by regulating the technology out of existence.

Karel Čapek's play coined the term robot but also anticipated key concerns of systemic risk posed by technology. There's no guarantee that new technologies such as AI or the metaverse will follow Isaac Asimov's 1942 Three Laws of Robotics by default, especially the Zeroth Law: A robot may not harm humanity, or, by inaction, allow humanity to come to harm. For that, it will take careful observation, foresight, and nimbleness from policymakers and regulators.

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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 policy and the macroeconomic and industry trends affecting the financial sector**
- **A workplan organised around 2 major international yearly events, supported by extensive research and input from 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.

Our work is organised mainly around two yearly international events gathering the main stakeholders concerned by policy work in the financial sector and macro-economic developments impacting the sector for informal debates. Research conducted by the Eurofi team and contributions from a wide range of private and public sector participants are provided as input to the debates and allow an effective structuring of discussions. The output of these discussions and assessments provides a comprehensive account of the latest thinking on trends and issues affecting the financial sector and the policy actions needed for addressing them.

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 80 European and international firms, covering all sectors of the financial services industry and all steps of the value chain: banks, insurance companies, asset managers, market infrastructures, payment platforms, technology firms, 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 policy developments in the financial sector, the macro-economic environment and the implications of industry trends such as digitalisation and sustainable finance. 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, UK, Japan, China...) and international organisations. 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 macro-economic and monetary developments affecting financial services, vulnerabilities in the financial sector, key industry trends (digitalisation, sustainable finance...) and on-going financial and digital policy initiatives. This research allows an effective preparation of the debates during the annual meetings and provides input for the discussions. Four main documents are published twice a year on the occasion of the annual events. These documents are widely distributed in the market and to the public authorities and are also publicly available on our website www.eurofi.net:

- **Regulatory Update:** policy notes and background papers on the latest developments in financial policy and on macro-economic and market trends affecting the EU financial sector
- **Scoreboards:** key facts and statistics on the economic performance of EU countries and the impacts of fiscal and monetary policies
- **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 each conference on on-going trends, regulatory initiatives underway and how to improve the functioning of the EU financial market.

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