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Monetary policy: truth or prejudice?

Note written by Jacques de Larosière & Didier Cahen

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

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

As the Eurofi Monetary Scoreboard demonstrates, pushing too hard and too long on the monetary pedal has severe negative consequences: the lasting excessively accommodative monetary policy over the last decade has enhanced incentives to borrow more, increased financial leverage and undermined financial stability. It also discouraged governments from undertaking structural reforms since borrowing "cost nothing" and undermined growth potential. Thinking that monetary creation can solve the problems arising from excessive debt is an illusion. In other words, supply-side obstacles cannot be overcome by throwing money at problems or by using cyclical policy instruments. Yet this is what has been done too often by pursuing lax fiscal, monetary and economic policies that will inevitably pose systemic risks to financial stability and therefore to future growth. Actually, the huge monetary and accommodative fiscal stances of the last decades have not led to sufficient productive investment or growth. Persistent low or negative interest rates induce a fatalistic mindset that lowers, not raises, propensity to invest. Under what J.M. Keynes called the "liquidity trap", investors play safe by placing savings in very short-term instruments rather than deploying them over longer term when low interest rates bring them inadequate returns for higher risks.

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

Formerly attempting to "look through" what they considered to be "transitory" higher inflation, many Central Banks across Advanced Economies responded late and slowly. Inflation must remain the priority of central banks despite the vulnerabilities they have created over the years.

Since the resurgence of inflation, a number of approximations and untruths have emerged.

- **"The war in Ukraine with its consequences on energy prices was the main factor in the return of inflation".** However, this is not the case: in January 2022, inflation in the Eurozone was 5.1% and has been above 2% since July 2021 – well before the outbreak of the war in Ukraine – since when it has been rising.
- **"The high levels of inflation since February 2022 are mainly the result of the supply shock (bottlenecks in production chains, rising commodity prices)"**. The situation was in fact more complex because demand, driven by expansionary monetary and fiscal policies, ran up against the long-standing structural problem of inelasticity of the productive capacities, which is largely due to insufficient productive investment over the last decade.

  Instead of stimulating money creation and public debt, it would have been better to undertake structural reforms capable of increasing productivity, labour participation and thus potential growth. The mistake that has been made for a very long time is to believe that the deficiency in potential growth lies mainly in the insufficiency of demand, whereas this deficiency was and remains above all a problem of supply. When monetary policy is too lose, it damages aggregate supply.
- **"Since we had a partial view of the causes of inflation last year (oil price rises, the exit from Covid and the war in Ukraine), we thought that it would be transitory"**: in fact, the rise in the price of commodities was only supposed to be a shock limited in time. This was to forget that a significant rise in energy and food prices inevitably spreads throughout the economy. Moreover, given that the inelasticity of the productive capacities largely explains the inflationary problem, the shock could not be transitory because it is the supply side that is in question and the insufficiency of investments cannot be corrected overnight.

This explains why core inflation – excluding changes in energy, food and other volatile components – remains very high in the US and Europe. In March 2023, core inflation reached 5.7% in the euro area and 5,5% in the US in February 2023.

Moreover, the costs of decarbonisation are expected to increase with the rise of renewable energies, the increase in the price of carbon, the upward pressure on the prices of precious metals (lithium, cobalt, nickel, etc.) needed for the equipment required for the energy transition (electric batteries, etc.), which should contribute to making inflation structurally higher.

It is therefore necessary not only for monetary policy to normalise but also for governments to undertake reforms to encourage productivity instead of pursuing expansionary fiscal policies which often seek to preserve household purchasing power, but which thereby accelerate inflation and thus complicate the action of central banks.

- **"The evolution of monetary aggregates does not impact on inflation"**. One thesis, particularly in the US, tends to show that the Fed's easy money policy has not led to an increase in bank lending insofar as the banks have maintained their reserves with the central bank instead of granting credit to the economy. Nevertheless, the truth of the Quantity Theory of Money is not denied. What is difficult is to establish precise links between the evolution of the money supply and inflation (the velocity of money is volatile, investment and savings decisions are motivated by multiple factors…).

But just because these relationships are difficult to formulate does not mean that reality does not exist. The simple fact that we continue to be interested (albeit insufficiently) in the evolution of credit shows that quantitative theory cannot be ignored. Indeed, the increase in the money supply (M3 or M2) is strongly determined by the evolution of credit (a large part of M3 is the counterpart of bank credit), so indirectly it is indeed a money supply problem that is at stake.

In any case, central banks have not been very interested in the explosion of credit over the last 20 years and their permanently accommodating monetary policies have contributed to the real estate and stock market bubbles which have accentuated social inequalities.

The willingness to use the monetary weapon continuously to stimulate the economy has led to the vulnerability of the financial market which now dominates the economic cycle.

- **"Inflation reduces debt and should be tolerated at levels above the 2% target"**: in the short term, inflation does reduce debt. But we need to look at the longer-term consequences of sustained high inflation: lenders are being mislead, which is detrimental to the future of savings and investment. A prolonged period of inflation has never been shown to result in a revival of investment and strong economic growth. To base a system on the plundering of some would, in fact, represent a major social danger. Inflation is a surreptitious tax, not voted by Parliament, which hits the poorest first. Its persistence increases social risks and the development of populism.

- **"Monetary conditions have tightened in the eurozone since July 2022"**. But this is not the case in real terms. It is true that central banks have raised their policy rates by 350 basis points in the euro area between July 2022 and March 2023, and by 475 basis points in the US between March 2022 and March 2023. Nevertheless, real interest rates in the euro area are more negative than they were before the war in Ukraine. It seems difficult to fight inflation with such a debt premium.

The ECB bases its policy not on realised and observable inflation but on the expectations of economic agents. Market expectations seem reassuring. They are of the order of 3% over 3 years, which, with nominal rates of 3%, suggests that the ECB has reached the neutral zone.

However, there is a risk in relying on these expectations. Just because inflation expectations are limited does not mean that they are accurate. These expectations are always subjective and rarely based on a rational forecast of future price increases.

The investors interviewed are often tempted to play down their expectations in order to reduce or hide the disadvantages that could arise from too much inflation. Having suffered only a part of the losses caused by the rise in rates (central banks having borne a third of them), investors even if they feel relatively "serene", want to stop the rise in rates. Investors are also influenced by the emblematic centrality of the 2% target, as created by central banks.

- **"The transmission of price inflation to wages has been moderate so far"**, we were told.

We see that in the fourth quarter of 2022, labour costs rose by 5.7% in the euro area compared to a year earlier. This is more than twice the historical average of 2% recorded between 2014 and 2019. The higher inflation becomes, the greater the risk of significant wage increases or even a return to indexation.

- **"The reduction of the balance sheet of central banks should be normalised at a very slow pace"**.

However, the rise in medium and long-term interest rates, the fall in inflation and the return to an economy where interest rates are the result of the supply and demand of capital, would move away.

A recent ECB publication[1] has shown the drawbacks of the excess liquidity that has built up (commercial bank reserves placed with central banks). This trend in high

1. I. Schnabel, "Quantitative tightening: rationale and market impact", 2 March 2023.

reserves can only increase as nominal rates rise. Hence the need to reduce the Eurosystem's balance sheet.

The mistake of the Quantitative Easing policies carried out was to buy long maturity securities financed by short term money which maximises the risk of market reversal and leads central banks to keep on their balance sheet a legacy that dissolves only in the long term. This strategy explains the magnitude of the losses recorded and to come by central banks.

In monetary theory, it is better to use the purchase of short securities (punch effect) as already demonstrated by the economist Bagehot[2].

- **"When a country has little private debt, the consequences of monetary easing policies are less penalising thanks to the low debt and the solidity of the balance sheet of private actors".** This is true but according to the BIS, if the debt of non-financial companies alone was only 80% of GDP in June 2022 in the US, in the euro zone it was 108.5% (in France 164.7%, an absolute record). This excess of private corporate debt in Europe is a factor of increased fragility in the event of a rise in interest rates.
- **"Positive real interest rates would be nightmarish".** It can also be shown that they would force over-indebted states to reduce their deficits and debts; savings would no longer be taxed but remunerated and medium and long-term investments would be encouraged because they would be remunerated. Zero or very low interest rates foster the "liquidity trap" as Keynes taught: they push households to choose increasingly liquid forms of savings and to move away from long-term investments whose risk is not properly remunerated.
- **We have been told again and again that the banking system was well regulated and supervised. But it is a fact that some US regional banks, especially those with less than $ 250 billion in assets, have been exempt from international prudential constraints since 2018 and are vulnerable.**

Central banks have pursued an unprecedented policy of monetary accommodation for some twenty years. With the QE and the monumental securities purchases that have been made, the value of the assets purchased by the issuing institutions has surged while interest rates have been lowered, and then maintained, at zero when they were not nominally negative.

In such a situation, the risk is to believe that rates will remain low indefinitely. If you believe this, the danger is that rates will go up again one day or another, which mechanically leads to a loss of value of the assets accumulated. If one has accumulated such fixed-rate assets while turning a blind eye to the possibility of a rise in rates, one risks very heavy losses on the depreciated assets.

Central banks have deliberately accepted this interest rate risk without bothering to hedge it. After all, these banks are not subject to regulation and the huge losses they are potentially about to incur do not seem to worry them much.

But the same cannot be said for private sector financial institutions: they are responsible for their own financial health and risk bankruptcy. And for those that might be tempted to ignore this risk, regulation would put them on the right path.

Generally accepted regulations state that:

- In a portfolio intended to be traded, the bank has to to record these securities at their market value ("mark to market"); in the event of a rise in interest rates, additional capital will automatically compensate for the potential loss thus created.
- If the bank decides, on the contrary, to keep its portfolio without trading it, by classifying it as "held to maturity", then the transactions will be resolved at the maturity of the securities in the portfolio without loss; in this case, it is logical not to impose additional capital requirements.

But it should be remembered that if the bank decides to sell even a small part of these securities, the entire portfolio would have to be reclassified as marketable and thus accounted for as mark-to-market. **This reclassification, although mandatory, was not required of the Californian banks, which gave a false impression of solidity to banks that had begun to dispose of their impaired assets without having to incur a capital charge for the losses already recognized.**

European banks, on the other hand, strictly applied the rules in question.

The Basel regulation goes even further in the treatment of interest rate risk.

According to the IRRBB ("Interest Rate Risk on the Banking Book") on how to deal with interest rate risk in the banking sector as adopted in Basel in 2015 and duly transcribed into European law (with entry into force in 2019), ALL portfolios – on the assets as well as on the liabilities side – held by banks (regardless of their classification) should be permanently subject to an interest rate sensitivity calculation.

The result of these calculations must be treated either by an adjustment of the equity capital (*Pillar 2*), which encourages to cover the risks by hedging (interest rate swaps).

2. The Bagehot rule ("Lombard Street" 1873) is that the Central Bank must, in a crisis, "lend freely against good collateral and at high rates".

It should be noted that this very protective regulation has not been formally mandated by the US regulator, either in the large systemic banks or in the smaller or regional institutions. As a result, the management of interest rate risk is not subject to systematic reporting that would allow supervisors and market analysts to monitor the risks incurred in a harmonised and efficient manner. The risk of quickly rising interest rates has not been included in the US stress tests either.

It is clear that **there are considerable differences in the regulatory and supervisory systems on both sides of the Atlantic. As the financial world is open, such disparities pose a real systemic risk that should be urgently identified and addressed.**

- **"Some believe that central banks are schizophrenic".** Indeed, with one hand they are taking back liquidity (reducing their balance sheet) but with the other hand the Fed is giving liquidity back to the banking system to avoid the withdrawal of deposits by banks affected by the rise in interest rates and the inadequacy of the management of this risk

Are these two approaches contradictory? It all depends on how the banks use the additional liquidity. If, as we have reason to believe, the banks keep this additional liquidity in the form of deposits at the Central Bank without transferring it to new loans, the operation is neutral from the point of view of the credit to the economy.

Therefore, it is possible to conceive of a restrictive monetary policy with increasingly high nominal interest rates and, at the same time, the granting of financial aid to banks in difficulty.

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It is imperative to revive productive investment. Therefore, long term interest rates should no longer be determined by central banks. QE has been used and abused to reduce artificially long-term yields while this should be the result of demand and supply on the financial markets.

A gradual, but determined, return to a more traditional and sensible monetary policy is of the essence. It should:

- Restore the oversight of credit expansion.
- Reintroduce symmetry in monetary policy and not stimulate continuously.
- Not give the market a form of free insurance against possible losses; moral hazard has pleagued the system, upset the risk-reward relation and encouraged short term speculation.
- Be more careful on the risk of fiscal dominance; having created money to buy some 70% of GDP in the euro area, the central bank is getting so deeply involved in fiscal affairs that its independence is questionable.
- Should refrain central banks from the temptation of being "popular" and having too many goals (green, social inclusion...) that are not at the heart of their primary mission which should be monetary and financial stability.

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The fear of the reappearance of spreads in Europe should not dominate the decision-making process of the monetary policy. Indeed, sooner or later, structural spreads – based on the past accumulation of fiscal and structural deficiencies – in Europe will appear on the markets. The ECB is certainly concerned with moderating "excessive" market rate differentials between European countries. But central banks do not have an obligation to forever erase all traces of interest rate differences in the appreciation of the markets. The elimination of all spreads would be difficult to reconcile with the Maastricht Treaty, as some member states – known for their fiscal discipline – place greater emphasis on the objective of monetary stability (believing that the ECB should not monetise public debt).

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

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

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

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

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

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Ultimately, the paradox of the euro is that a single currency and 27 national economic policies coexist without a strong cement of coordination. Ultra-accommodating and asymmetric monetary policy has been used to overcome this paradox, but the price of this permanent rescue is costly. It is essential to ensure convergence of fiscal and structural policies. An intelligent revision of the Stability and Growth should help to resolve these contradictions and thus make the euro sustainable.

For a more dynamic economy in the Eurozone

Note written by Jacques de Larosière & Didier Cahen

A monetary union does not by itself create economic convergence. This Scoreboard underlines that the eurozone is a currency area comprising heterogeneous countries with a low level of federalism (their productivity levels, productive specialisation, level of fiscal deficits and indebtedness, and level of labour force skills being very different).

As we have observed, many Member States have relaxed their macroeconomic discipline over the last twenty years and those who played the card of fiscal vigilance turned out to be the winners. The Covid-19 crisis has exacerbated these existing heterogeneities across EU Member States. In this context, it is important that the implementation of Next Generation EU is a success.

It is an illusion to try to solve the structural problems of our economies by prolonged increases in public or private debt or by using money creation. Yet this is what has been too often tried by pursuing lax fiscal, monetary and political policies that inevitably pose systemic risks to financial stability and therefore to future growth. It is not because budget deficits are monetised that they disappear. In addition, the quality of a state's signature is an essential element of confidence that shall be preserved at all costs for the country's future.

But as long as it is not sufficiently understood, especially in highly indebted countries, that over extended debt is a source of under-competitiveness, the economic situation in these countries will continue to deteriorate and it will be all the more difficult to make progress in the construction of an economic and financial Europe. Indeed, the intensity of fiscal and economic divergences between EU countries makes it more difficult to define in Europe a common interest, encourages a policy of "every man for himself", creates a climate of mistrust between Member States which hinders any progress in terms of public and private risk sharing and weakens the euro zone.

It is economic growth that eventually solves indebtedness issues. The only way of promoting robust growth in the EU is to implement ambitious structural reforms in all Member States.

If Europe and the euro zone are to correct their growth disadvantage in relation to the United States and China and not be relegated to the rank of second-rate powers, a considerable investment effort in research and development, in industrial equipment, in decarbonisation, in digital technology, in improving equity financing, the education system and the skills of the population, in promoting selective immigration of "people" who can occupy sufficiently skilled jobs, will therefore be necessary

We must understand that our future – noninflationary – depends on the elasticity of supply, and thus on sufficient investment and a well-trained force. Anything that encourages savings to into liquid investments at the expense of long-term choices must be fought.

As explained by Jacques de Larosière in his latest book, "one day we will have to understand that the narrowing of the output gap between potential and observed growth cannot be reduced to the mere fight against the restoration of production chains, but requires the activation of all the sources that ultimately constitute our eco system: productive investment – penalized for 20 years by lasting very low interest rates – , the development of training, the recovery of the share of wages in income, the revitalization of competition... To revive productive investment, refrain from administratively setting ("or guiding" the market) long term interest rates and accept to let the market remunerate savings in the medium and long term according to supply and demand without which there can be neither productive investment nor productivity gains".

Monetary policy can erase spread differentials but cannot address structural issues and notably the lack of confidence and the persistence of structural discrepancies, which explains the limited capital flows from North to South. Europe benefits from a large pool of savings which could contribute to finance long term investments and especially those related to the green and digital transition, provided that such savings are not taxed but remunerated. However, these savings leave the EU and finance the rest of the world (in particular the United States).

This is notably due to the interest rate differential between the US and Europe (risk taking is more rewarded in the US than in Europe), the limited financial flows between the eurozone countries and the insufficient number of investment projects. These limited cross-border capital flows in the euro area highlights the lack of a genuine Banking Union and integrated financial markets as well as persistent doubts of some investors in Northern Europe about the solvency of states and companies in other countries.

If the divergence of interest rates between the two sides of the Atlantic continues to increase in favour of the United States, the problem of transfer savings to higher interest rate areas could have very negative consequences for Europe.

The result of a too slow monetary normalisation in the euro area, in a context of persistent and very high inflation – HICP inflation is above 2% in the euro zone since April 2021 and increased to 6.9% in March 2023 and core inflation has continued to increase, reaching 5.7% in March – would be an acceleration of inflation and low growth (productive investment would continue to fall as we have seen over the past 20 years in periods of very low interest rates).

Consequently, the eurozone has to embark on the right course: fighting inflation, which requires vision and courage, more fiscal responsibility and more supply reforms geared to increase productivity, as well as steps to complete the Banking Union and implement the Capital Market Union. But this move can only be envisaged if sufficient discipline starts reversing the trend of ever-growing economic heterogeneities across Member States.

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

To be viable, the eurozone needs:

- **To combat very high and persistent inflation without further delay by gradually returning to positive real interest rates.** As the 2022 annual economic BIS report reminds us, the most pressing monetary policy task is to restore low and stable inflation and to sustainably rebuild monetary buffers. Higher rates will also reduce central banks remittances to the governments. The reappearance of spreads should not dominate the decision-making process.
  It is usual in times of high inflation to increase nominal and real interest rates to avoid further increases in demand. The recommendation is therefore to continue to raise interest rates and gradually move to positive real interest rates. This would only not be the case if the economy were in a deep economic crisis with rising unemployment or a risk of deflation, which is not the current situation (nor the one that has prevailed since the beginning of the second quarter of 2021, when inflation returned strongly). Real interest rates in the euro zone are much more negative than they were before the war in Ukraine. It seems difficult to fight inflation with such a debt premium.
  We must not allow ourselves to fall into the trap of schizophrenia, *i.e.*, to believe that if we fight inflation, we will worsen the financial crisis by introducing less growth. On the contrary, we can continue to curb inflation by raising interest rates and at the same time provide liquidity to banks that need it. The money creation that would result from this injection of liquidity is not of the same nature as QE because it would not contribute to the credit dynamic.
- **National budgets under control in all parts of the Union.** No responsible state can be expected financing durably current public deficits generated by other eurozone members of the Union that do not follow the rules of the Union. The future – and notably the solution to market fragmentation – depends on a consolidation of present weak fiscal positions (primary surpluses) and a shift towards quality of expenditure and investment. We do not need more redistributive expenses. We must rein them in and allow adequate space for public investment.
  We have to recognize that the shift towards more productive investment will require substantial political effort because presently public investment only accounts for some 4% of GDP while current – non-productive expenditure – represent almost all public expenditure. As much as we need to fight against unproductive spending, we can encourage the financing of infrastructure spending (including research) that can be financed by debt. The revision of the Stability and Growth Pact is of paramount importance in this respect. Postponing discussions on the revision of the Pact delays the solution, exacerbates tensions within the market (due to the lack of benchmarks) and only complicates the resolution of problems that are likely to become even more acute.

- **Domestic structural measures towards enhancing business dynamism increasing growth potential should be encouraged and monitored.** We have seen that the economic and financial model based on monetary abundance, the non-remuneration (taxation) of savings, the financialization in response to structural insufficiencies, the systematic short-termism, and the increase in the – essentially speculative – valuations of financial assets, does not meet the needs of our society. These needs require long-term investments, a response to climate and digital challenges, an adequate return on savings and salaries. Without such a reorientation of our policies, it seems difficult to achieve the "common good" and to correct the major current imbalances.

  Reducing output gaps cannot be ensured just by subsidies to the labour markets. This requires more substantially to increase the productivity of the system, which necessitates more competition and long-term investment. Making Next Generation EU a success is therefore essential and should contribute to boost potential growth.

  Last but not least, it is necessary to refrain from fixing administratively ("or directing" the market) long-term interest rates and to accept to let the market remunerate medium – and long-term savings – according to supply and demand – without which there can be no productive investment or productivity gains.

- **An active banking and integrated capital market in Europe.** In sum, members of the Monetary Union must act together to make it work, and not behave as passive individual bystanders hoping that things will turn out fine. Ultimately, the fate of euro will depend on the political will to achieve genuine cooperation within the euro area.

Addressing sovereign debt challenges in the European Union

Note written by Didier Cahen

Excessive debt is a source of crisis. Examples abound, such as the European sovereign debt crisis (2011-2012) that would not have occurred if public debt in several EU countries had not been so high.

Even before the Covid and the energy crises, global debt was at an all-peacetime record. Indeed, the continuation of very low interest rates during the past two decades has pushed many advanced countries to implement active fiscal policies and economics agents to borrow more.

Monetary policy and the resulting credit expansion in the 2000s played a major role in preparing the great financial crisis of 2008. Since then, many advanced countries have continued to increase their recourse to public debt encouraged by lasting very low – end even negative – interest rates and eventually to ask future generations to bear a large part of the costs that the present generation refuses to assume.

In such a context, global public debt in advanced economies has grown by 30% between 2007 and 2019, according to the World Bank. In the euro area, the aggregate government debt-to-GDP ratio in the same period rose from 65,9 % to 85,9% – one-third more debt compared to the pre-crisis level.

The Maastricht Treaty specifies reference values for the general government sector of the various EU Member States: 3% of gross domestic product (GDP) for the government deficit and 60% of GDP for government debt (the Maastricht criteria). But in 1998, a political logic replaced the accounting reading of the debt situation. Indeed, Belgium and Italy – two founding countries of the European Union – qualified for entry into the euro zone with a public debt ratio of 117% and 115% respectively. Since then, Europe has accepted that the debt is rising inexorably in many Member States.

In the euro area, the divergence in public debt levels is a major concern. While the negative interest rates ensure the sustainability of European countries' public debt in the short term, the absence of structural reforms to gradually reduce this public debt would lead to economic decline and call into question the future of the euro zone.

In the face of the over-indebtedness of certain countries, it is necessary to gradually get out of the current excess of debt by questioning public budgets, giving priority to expenditure for the future and to undertake structural reforms, which have been postponed for too long, but which are the only way forward.

1. The Euro area and the EU are characterized by significant public and private debt divergences across Member States

This note focuses on the issue of public debt sustainability in EU countries. To do so, it is necessary to take into account the main figures of private debt in these countries (non-financial corporations and households) and thus to have data on the total debt of the Member States. Public and private debt levels differ greatly across Member States.

1.1 Public debt to GDP ratios differ widely across Member States

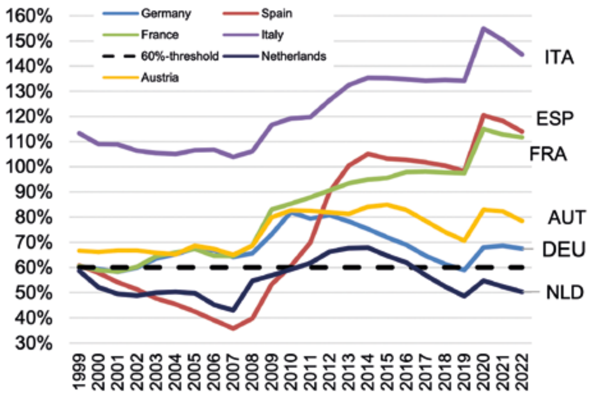
At the end of 2022, public debt vulnerabilities reach a very high level in a small set of mainly large European countries.

Despite the different reforms which took place after the sovereign debt crisis (European semester, Six pack, Two pack, Treaty on stability, coordination and governance in the Economic and Monetary Union), the public debt ratio has continued to grow steadily in significant countries of the euro area (*e.g.* France, Italy, Belgium, Spain) and is approaching 120% of GDP or even more in certain Member States *(see Chart 1*). Credit to public sector, % of GDP)[1]. On the contrary, countries such as the Netherlands, Germany or Austria have been able to maintain a ratio of public debt to GDP of around 60% or even less[2].

In 2022, 14 countries in the EU have a public debt to GDP ratio below 60% (Estonia, Bulgaria, Luxembourg, Sweden Denmark, Lithuania Latvia, Czechia, Ireland,

1. Between 2008 and 2022, gross public debt to GDP ratio increased by 38.2 percentage points in Italy, 42.5 pp in France, 20 pp in Spain and 11.6 pp in Belgium.
2. In Germany, gross public debt to GDP ratio increased by 1.7 pp between 2008 and 2022, and by 3.9 pp in the Netherlands.

CHART 1.
Evolution of Gross Public Debt to GDP ratio in Major Eurozone Economies, %



Source: EU Commission ; Data for 2022 are projections taken from the EU Commission's Automn forecasts of November 2022

Romania, Netherlands, Poland, Malta, Slovakia), according to the EU Commission. However, three countries have a public debt of more than 115% of their GDP: Greece (171.2%), Italy (144.6%) and Portugal (115.9%). France and Belgium also have a high public debt (respectively 111.7% and 114%) well above the average of the 27 countries while Germany and the Netherlands respect 67,4% and 50,3%.

12 EU member countries would have a public deficit below 3% of GDP in 2022, according to AMECO's November 2022 forecast. Four would have a budget surplus, namely Denmark (1.8%), Cyprus (1.1%), Sweden (0.2%) and Ireland (0.2%). The deficit is not expected to exceed 2% of GDP in Luxembourg (-0.1%), the Netherlands (-1.1%), Finland (-1.4%), Croatia (-1.5%), Lithuania (-1.8%) and Portugal (-1.9%). Estonia (-2.2%) and Germany (-2.3%) are expected to have a deficit below 2.5%.

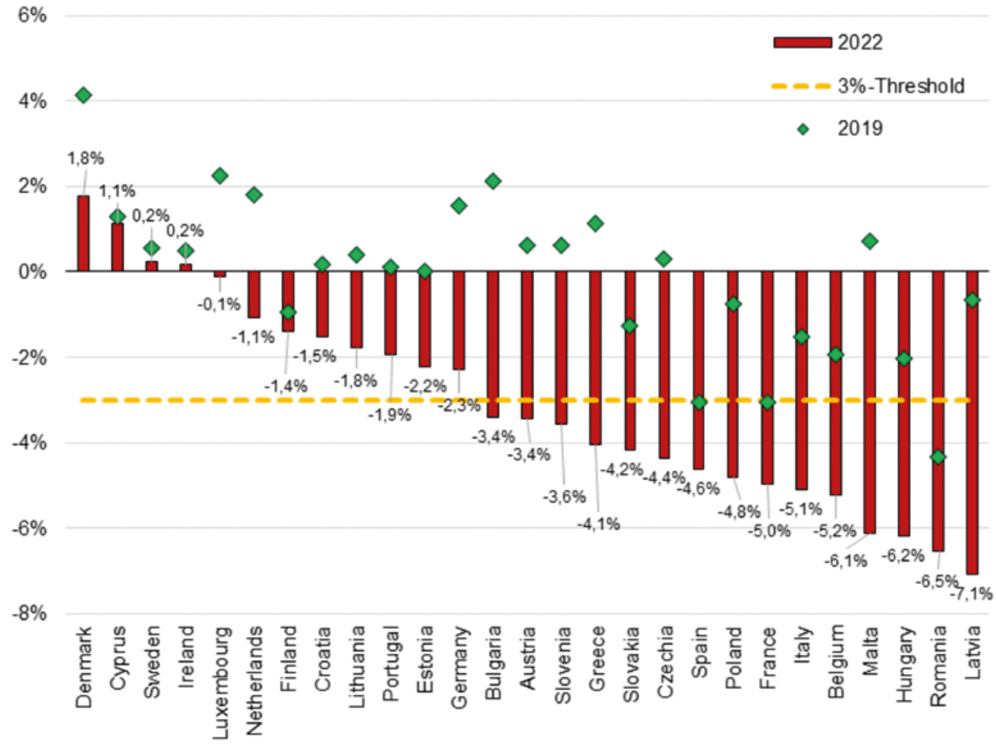
Of the remaining 15 member states with deficits above 3% of GDP in 2022, 3 would have deficits below 4% of GDP, including Bulgaria (-3.4%), Austria (-3.4%) and Slovenia (-3.6%). 5 countries would have a deficit between 4 and 5% in 2022, including Greece (-4.1%), Slovakia (-4.2%), the Czech Republic (-4.4%), Spain (-4.6%) and Poland (-4.8%). The rest of the member countries are expected to have a deficit above 5% of GDP in 2022. Among them are France (-5%), Italy (-5.1%), and Belgium (-5.2%). It would exceed 6% in Malta (-6.1%), Hungary (-6.2%), and Romania (-6.5%), and exceed 7% in Latvia (-7.1%).

1.2 Private debt also differs across EU countries

Private household and Non-Financial corporate debt has also strongly diverged across EU Member States during the past years.

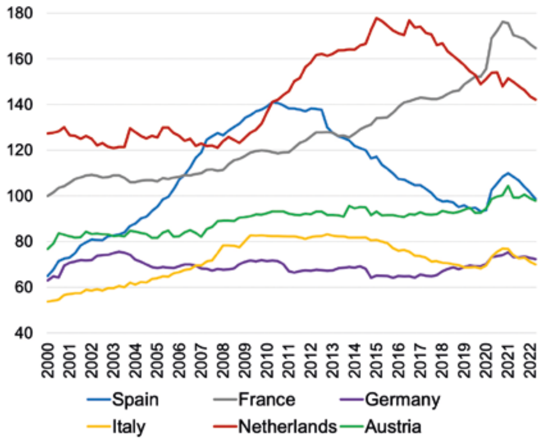
In France, private debt (households and non-financial companies) has increased from 181.1% of GDP in 2013 to 231.2% in June 2022, according to the BIS.

CHART 2.
Total Budget Balance in 2022, % of GDP



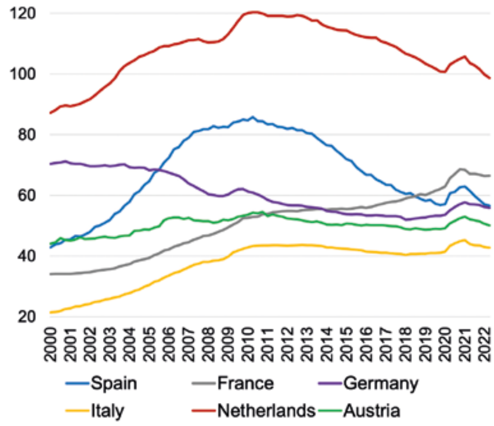
Source: European Commission (Autumn Forecasts of November 2022)

CHART 3.
Credit to Non-Financial Corporations (% of GDP)



Source : Bank for International Settlements

CHART 4.
Credit to Households ((% of GDP)



Source : Bank for International Settlements

By contrast, it fell significantly in Spain (from 202% to 155.3% over the same period following the deleveraging of companies and the deflation of the real estate bubble); it also decreased in Italy (125% in 2013, 112.8% in June 2022) and increased slightly in Germany over this period (124.3% in Germany in 2013 and 128.3% in June 2022).

Although the level of French private debt remains lower than that of the Netherlands in Q2-2022 as share of GDP, it should be noted that the latter decreased by 39.4 points compared to 2013 in the Netherlands, while it increased by 50.1 points in France during this period. In Belgium, the ratio increased by 8 points.

1.3 Global debt challenges in the European Union

By analysing the levels of public and private debt relative to GDP in the main euro area economies in Q2-2022, several groups of countries stand out.

A first group includes Germany and Austria, which both display a low level of public debt (67.4% of GDP in Germany and 82.8% in Austria in Q2-2022 vs. 94.3% in the euro zone) and private debt (128.3% of GDP in Germany and 148% in Austria versus 167.2% in the euro zone) compared to other euro area countries.

A second group contains countries where the public sector is highly indebted, unlike the private sector, which is weakly indebted compared to the euro area average. These include Italy, Spain and Portugal, which are among the countries with the highest public debt ratios in the euro area (resp. 150.1% of GDP in Q2-2022, 116%.4% and 123.3%), while the level of private debt is below the euro area average (resp. 112.8% of GDP, 155.3% and 161.5%).

Conversely, the level of Dutch public debt is one of the lowest in the euro zone (50.9% of GDP), while that of the private sector (240.9% of GDP) is among the highest. This applies to both non-financial corporations and household debt.

Finally, France and Belgium both display the highest public debt (113.3% of GDP and 106.9%) and private debt (231.2% of GDP and 199.8%) compared to the main Eurozone Member States.

2. The divergence in public debt levels across Member States is a major concern

Fiscal coordination is needed in a monetary union. The reason stems from the fact that the Union European is not a state and that negative externalities – stemming from questionable national fiscal policies – should be taken into account and avoided. The European Monetary Union has a single monetary policy but no common fiscal and economic policy. Therefore, the need for fiscal coordination.

The comparison of the ratio of public debt to GDP between France and Germany, which is natural given the place of these two countries in Europe, is striking: 67.4% for Germany in 2022, compared with 111.7% for France, whereas these two countries were at the same level, around 65%, in 2007.

In 2022 the total public expenditure in relation to GDP was 49.5% in Germany but this ratio reached the European record of 57.0% in France.

While the European average in percent of GDP was 167,2% in Q2 2022, the level of private debt reached 231.2% for France and 128.3% in Germany *(see above).*

These economic divergences make it more difficult to define in Europe a common interest, encourage a policy of “every man for himself”, create a climate of mistrust between Member States which hinders any progress in terms of public and private risk sharing and weakens the euro zone.

Without Franco-German understanding, it is impossible to imagine a Europe capable of competing economically with the other great powers. France's fiscal and economic weaknesses have become an economic and political handicap that prevents it from influencing its German neighbour.

France urgently needs to undertake fiscal measures (reduction of public spending in relation to GDP, achieving a primary surplus) and structural measures to increase productivity and potential growth and eventually regain the path of economic convergence with German and regain a credibility capable of relaunching economic, financial and political Europe.

Some may think that fiscal discipline is no more indispensable because of the persistence of low interest rates. This is a profound misconception: interest rates will not stay negative in real terms for ever and the markets are already showing this. And to base a fiscal framework on the assumption of indefinite low interest rates and monetisation of public debt is not consistent with the functioning of our monetary union.

If this fiscal drift were to continue, we would end up making the virtuous countries pay for the slippage. This is the definition of a non-cooperative game where most players try to avoid their obligations by shifting the cost to those who observe them. If this were the case, the logical result would be an inevitable, major, new crisis of the euro zone.

3. How did we get here?

3.1 Between 2000 and 2007, most eurozone countries met the Maastricht fiscal criteria, except for Italy and Greece

Before the subprime crisis, with a few exceptions, budget deficits were relatively limited. Thus, in the period preceding the crisis (2000-2007), the budget balance was, on average, positive in Ireland (1.4% of GDP) and Spain (0.4% of GDP). It was negative in Austria (-2.2%), Germany (-2.5%), France (-2.7%) and Italy (-3%), but only in Greece (-6.4%) did it exceed the Maastricht criterion (3%).

When the crisis broke in 2007, Spain had a budget surplus of 1.9% of GDP and its public debt was only 35.8% of GDP. In 2012, its debt reached 90%. In Ireland over the same period the debt to GDP ratio rose from 23.9% to 119.6%. In the meantime, the sovereign debt crisis[1] has hit these two countries in particular and governments have been forced to intervene.

3.2 Fiscal heterogeneities across EU Member States have increased between 2013-2019

In 2019, the Netherlands and Germany, after several years of efforts to reduce their public deficit and debt, brought back their public finance in line with EU fiscal rules. Indeed, between 2014 and 2019, they ensured an average public surplus of 1.2% and 0.04% of their GDP, respectively. Such fiscal efforts allowed them to gradually reduce and stabilise their public debt, at respectively 59.6% and 48.7% of GDP in 2019, from 81.1% and 66.7% in 2013. Austria also made such efforts over that period, contributing to reduce its public debt burden by nearly 11 pp to 70.5% of GDP in 2019.

By contrast, during the post-Global Financial Crisis period, the public debt ratio of Spain, Italy and France has kept rising. Between 2012 and 2019, France increased its public debt in relation to GDP from 90% to 97%; Italy's one jumped from 126% to 136%, and Spain's rose from 86% to 95%.

The continuous rise of public debt-to-GDP ratio in these three Member States is mainly due to the accumulation of yearly fiscal deficits. As shown in Chart 5, the average deficit of France and Spain exceeded 3% of GDP, the threshold of Maastricht fiscal rules, between 2014 and 2019. Unlike Italy, these two countries have not delivered any primary surplus, since 2002 for France and 2008 for Spain. Between 2014 and 2019, their average primary deficit reached 1.5% of GDP, while Italy secured a primary surplus at the same period of 1.4% *(see Chart 1 in Annex)*.

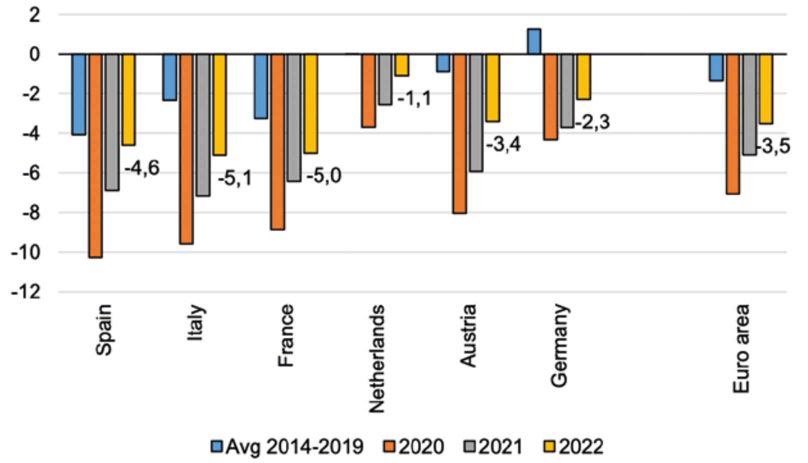
Chart 2 in Annex illustrates the cumulative change in the debt ratio and the various components that contribute to it in the four main countries of the euro zone from 2007 to 2021.

Over this period (and despite the extraordinary expenses linked to the pandemic in 2020 and 2021 which have greatly increased the primary imbalances in all countries), only Germany and Italy maintained a primary surplus which contributes to limiting the increase in the debt ratio. In France and Spain, the increase in public debt is mainly explained by recurrent primary budget deficits reflecting the structural imbalance in public finances in these two countries.

3.3 The Covid crisis has exacerbated these fiscal heterogeneities

Following the Covid-19 crisis, monetary and fiscal policies have been more active than before, widely contributing to the shock absorption. The ultra-accommodating monetary policy during the Covid crisis allowed the shock of the pandemic to be absorbed by protecting household living standards, facilitating the financing of public debt and providing companies with the necessary funding.

CHART 5.
General Governement Budget Balance, % of GDP



Source: Eurostat, EU Commission's Automn Forecast (November 2022)
Notes: Labels relate data for 2022 ; data for 2022 are taken from the EU Commission's forecasts of November 2022

But it has encouraged states to allow economic divergences between states to widen: France's public deficit in 2020 and 2021 has risen to 15.5% of GDP compared to 8.1% in Germany.

The aggregate government debt-to-GDP ratio rose by around 12 percentage points between 2019 and 2021 for the euro area, and 10.2 percentage points for the EU, reaching respectively 97.2% of GDP in the euro area and 89.4% in the European Union according to Eurostat.

Divergences of fiscal performance across euro area Member States have widened between 2019 and 2021. Five EU Member States still saw their public debt exceeding 110% of GDP in 2021: Greece (194.5%), Italy (150.3%), Portugal (125.5%), Spain (118.3%) and France (112.8%). Spanish debts jumped by 20 percentage points between 2019 and 2021 to reach respectively 118.3% of GDP in 2021. It increased by 15.4 percentage points in France, and 16 percentage points in Italy, to reach respectively 112.8% of GDP and 150.3% in 2021.

By contrast, nineteen EU countries kept their ratio below 75% of GDP in 2021. Among them, Germany, the Netherlands, and Finland had their public debt compared to GDP hovering respectively at 68.6% of GDP, 52.4% and 72.4% in 2021.

The public debt-to-GDP prudently increased during the same period by 3.9 percentage points in the Netherlands and 9.7 percentage points Germany, to reach respectively 52.4% of GDP and 68.6% in 2021.

3.4 The divergence in terms of fiscal and public debt between the Member States has not increased with the war in Ukraine but the public debt-to-GDP ratio has stabilized at elevated levels in many EU countries

Economies of the European Union are affected differently by the war in Ukraine; inflation pressures have also intensified but divergences in terms of public deficits and public debts have not increased across Member States notably thanks to very negative real interest rates.

However, the economic policies chosen to deal with inflation are a further source of divergence. While France is subsidising household purchasing power through the deficit in 2022, other countries, such as Germany and Italy, have allowed prices to rise. Thus, France's lower inflation has as a counterpart a lower reduction of its public debt compared to GDP.

In such an economic context, for 2022, the ratio should have reduced marginally in France from 112.8% of GDP in 2021 to 111.7% in 2022, according to the EU Commission (Autumn Forecast). It should have fallen by 4.3 pp in Spain (from 118.3% to 114%) and by 5.7 pp in Italy (from 150.3% to 144.6%), according to the EU Commission.[3]

3.5 The ECB's ultra-accommodative and asymmetric monetary policy since the European sovereign debt crisis (2011–2012) and the lack of fiscal discipline have led to excessive public debt in some EU member states

Lasting zero or even negative interest rates have been a disincentive for many member States to undertake structural reforms. Moreover, the Stability and Growth Pact has not been enforced for the majority of the time over the last two decades.

3.5.1 The very accommodative monetary policy in the euro area over the last 20 years explains to a large extent this public debt overhang

In fact, with lasting interest rates at ultra-low levels, debt service costs were at post war troughs during the past ten years. The debt burden has never felt so

3. Spain and Italy experienced higher inflation and nominal growth in 2022 than France, given the measures to freeze energy prices in that country. The decline in public debt to GDP in Spain and Italy is all the more significant than in France, where the primary deficit of 3.2% of GDP in 2022 was much higher than in Spain (-2.4%) and Italy (-1.1%).

light as during this period. Thus, governments were under no pressure to reduce their debts. Negative interest rates encouraged them to borrow more and has disincentivised fiscal discipline.

3.5.2 In Europe, the fiscal rules of the Stability and Growth Pact have not been obeyed by many large economies of the EU (France, Italy, Spain...[4]) which has contributed to their over-indebtedness

Furthermore, in the EU, the rules of the Stability and Growth Pact (SGP) have, most of the time, not been respected by many large economies of the EU (*e.g.* France, Spain, Italy, Belgium) since their implementation in 2002 *(see Chart 4)*. In those countries, gross public debt has continued to rise since the EU sovereign debt crisis (2011-2012). Such a dynamic is due to the accumulation of yearly large public deficits. The sanctions originally provided by the SGP were never implemented. In other words, Europe does not have the instruments to impose fiscal discipline.

4. The very low long-term interest rates of the last few years allow the sustainability of the public debt of European states in the short term, but the absence of structural reforms to gradually reduce this public debt would lead to economic decline and compromise the future of the euro zone

4.1 The sustainability of a public debt is linked to the confidence of creditors

It depends on several factors:

- The total amount of public debt and its maturity,
- The potential growth and income available to the borrower to meet its debt obligations,
- The average interest rate on the stock of debt issued by the government compared to the capacity to tax the economy,
- The primary budget balance which will increase the debt in the case of a deficit or reduce it in the case of a surplus: the higher the debt, the greater the primary surplus required
- The percentage of debt held by non-residents[5],
- The nature of the expenditure financed by this debt (infrastructure and social expenditure having different effects on long-term activity).

4.2 A government's public debt appears sustainable when its average interest rate is lower than the growth rate of GDP in value terms

The public debt-to-GDP ratio, growth and interest rates determine the stabilising primary balance and the capacity to stabilise the public debt.

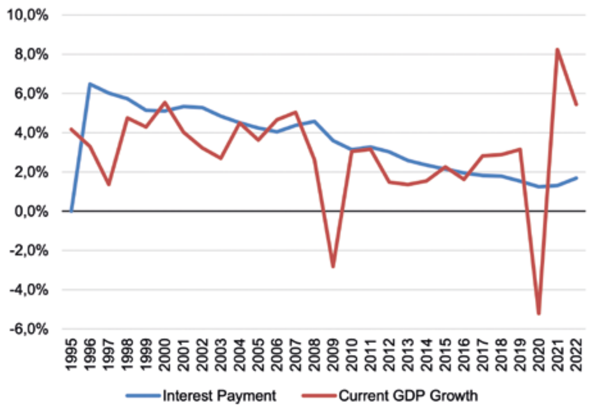
For the public debt-to-GDP ratio to be stable, the primary government balance as a % of GDP must be equal to (r - g) × D/Y, where r is the average interest rate on the sovereign debt[6], g is economic growth, and D/Y is the public debt-to-GDP ratio.

For example, with a level of debt to GDP of 120% and a gap (r-g) = 1.1, which is the average gap observed in France between 2000 and 2020, the stabilising primary balance would be 1.32 % of GDP[7].

When the interest rate is higher than economic growth, *i.e.* with (r- g) > 0, there is a debt snowball effect. The debt is self-sustaining due to the accumulation of interest charges, and a primary surplus is needed to stabilise it.

In the case where (r-g) < 0, the primary public balance stabilising the debt is negative.

CHART 6.
Average interest rate on public debt (r) and current GDP growth rate (g) for France



Source: FIPECO via J. Arthuis, « Commission pour l'avenir des finances publiques – documents préparatoires » (March 2021); EU Commission (Automn Forecasts of November 2022)

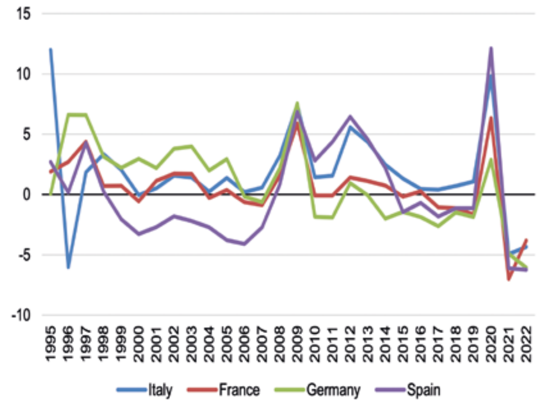
4. In 2019, 16 of the EU members (including Germany and the Netherlands) had a public debt/GDP ratio below.
5. Foreign ownership is a stronger constraint for the borrowing state.
6. This is the ratio of interest payment for the year compared to the level of debt at the end of the previous year.
7. See Commission pour l'avenir des finances publiques – Documents préparatoires, March 2021.

To stabilise the public debt, a primary balance must be generated equal to the product of the debt at the end of the previous year and the difference between its apparent interest rate and the growth rate of GDP in value. This primary balance is the stabilising primary balance.

A few elements about the dynamics of r-g in France, Italy, Spain and Germany in recent years are worth noting:

- With the exception of Italy, r - the interest payment expressed as a % of total debt – was overall lower than nominal growth between 2014 and 2019 on average for France, Germany and Spain, whereas the relationship was positive between 1999 and 2007 on average for the first two countries. Spain enjoyed much higher nominal growth than the other members (7.7% vs. 4.2% in France and 2.5% in Germany), during this period (1999-2007).
- Compared to Germany, France and Spain, Italy suffers from relatively low nominal growth for a relatively high debt burden, which is the source of a positive r-g over the entire 1999-2022 period. Already prevalent in 1999-2007, this dynamic worsened in 2014-2019, with the deterioration in nominal growth (4% on average between 1999-2007 and 1.8% between 2014-19), which the fall in the interest payment was unable to offset (5% between 1999-2007 vs. 3% between 2014-2019).
- After a sharp rise in 2020 following the collapse of nominal growth, r-g has become negative again since 2021 for the four member countries, to the point of reaching historically low levels since the creation of the euro zone. This dynamic continued in 2022, given the exceptionally high nominal growth due to inflation, while interest charges barely increased.

CHART 7.
Average interest rate on public debt (r) compared to nominal growth (g), across key EU Member States, Percentage points



Source: EU Commission (Automn Forecasts of November 2022)
Notes: r = total interest payment over year t divided by the debt stock at the end of year t-1; g = nominal GDP growth rate at year t

CHART 8.
Average interest rate on public debt (r) compared to nominal growth (g), across key EU Member States, Percentage points

	r - g, percentage points			
	Italy	France	Germany	Spain
Avg 1999-2022	1,7	0,4	0,4	0,1
Avg 1999-2007	1,0	0,6	2,3	-2,8
Avg 2014-2019	1,1	-0,4	-1,9	-0,6
2021	-4,8	-6,9	-4,9	-6,0
2022	-4,3	-3,8	-6,0	-6,2

Source: EU Commission (Automn Forecasts of November 2022)
Notes: r = total interest payment over year t divided by the debt stock at the end of year t-1; g = nominal GDP growth rate at year t

The table above shows that the level of r-g was much more negative in Germany than in France in 2022, because, compared to the France, Germany supports a lower debt service cost (r) for a higher nominal growth (g). In 2022, interest payment, calculated as the ratio between the amount of interest paid and the stock of public debt of the previous year, amounted to 1% in Germany, against 1.7% in France. Nominal GDP growth was 7% in Germany, compared to 5.5% in France. The GDP deflator (measure of core inflation), twice as high in Germany (+5.3%) as in France (+2.8%), contributed to explain this nominal growth differential between the two countries in 2022.

Between 2014 and 2019, r-g was also weaker in Germany than in France for quite similar reasons. Germany benefited from lower debt service costs than in France (1.7% of public debt on average in Germany vs. 1.9% in France). Also, nominal GDP growth was significantly higher in Germany than in France (3.6% in Germany versus 2.4% in France on average). The latter resulted from a higher real GDP growth (+1.8% in Germany vs. 1.5% in France) and a higher GDP deflator in Germany (1.8% in Germany vs. 0.8% in France).

4.3 The very low interest rates of recent years help reduce debt-servicing cost for the most indebted States in the euro zone in the short run

The very low or negative long-term interest rates of the last ten years in the eurozone countries still ensure the sustainability of the public debts of these States: they allow them to have larger public deficits without increasing the level of debt.

However, it is far from certain that the interest rate on the debt will always remain lower than the growth rate, unless central banks abandon their objective of fighting inflation, which would then pose other difficulties (economic stagnation, risks of social movements, inflation hitting the poorest, etc.).

In a context of high inflation in the countries of the euro zone, we note that growth rates in value terms are nevertheless low while long-term interest rates are rising. It is therefore urgent that the most indebted Eurozone countries secure primary budget surpluses. This is all the more important as r-g seems likely to remain positive for a long period. Indeed, the next few years are likely to be marked by positive nominal rates and low growth rates, which will gradually deteriorate the solvency of the debt of these countries unless they make efforts to control their public deficits and carry out reforms capable of increasing their potential growth.

Otherwise, sooner or later investors will decide that such debt levels are unsustainable and drive Eurozone debt spreads much wider.

4.4 Is inflation a solution to reduce public debt?

It is often said that inflation would be an effective way to reduce public debt ratios. It is true that It is theoretically easier to stabilise or reduce public debt when inflation is higher. Indeed, the higher the inflation, the higher the GDP in value terms, which tends to lower the debt/GDP ratio. However, the debt must not increase faster than GDP under the effect of the primary deficit and the interest burden.

But one should be careful with this argument. After the wars, inflation was high, and this helped to reduce public debt ratios. But now central banks have a clear inflation target which should lead them to raise their interest rates and reduce their balance sheets in the coming months. For inflation to become a tool of reducing public debt rates again, central banks would have to change their inflation targets, which would raise other structural problems: Lasting high inflation slows down economic activity. It makes the future more uncertain for economic agents and discourages them from investing. Moreover, if it is higher than that of the main trading partners, inflation reduces the competitiveness of companies in relation to their foreign competitors. Lastly, inflation increases social risks and the development of populism. It is a factor in increasing inequalities between households – it hits the poorest first – because the ability of economic agents to preserve or increase their purchasing power and their assets in periods of high inflation varies greatly.

4.5 A change in the nature of budgetary expenditure is required to address the financing challenges related to the climate transition: from unproductive to productive goals

The climate challenge implies the substitution of decarbonized energy for fossil and polluting energy. To achieve this substitution, it is necessary to release additional public resources to make the necessary ecological investments more financially viable.

This implies another substitution in overindebted countries: replacing unproductive public spending (financing current deficits) with public spending that incentivizes the financing of the ecological revolution.

A special treatment for growth-enhancing expenditure, on the occasion of the revision of the Stability and Growth Pact to be finalized in the coming months, would not be helpful. It comes from the illusion that public financial means are not scarce. Actually, it is a matter of refocusing the priorities. Unproductive public spending needs to be replaced by productive public spending.

It would be a grave mistake to push the extreme fiscal limits in the present situation. Investment-friendly rules – such as a golden rule to protect public investment implying a separate capital account – will lead to add borrowings to already overindebted countries fostering potential risks to debt sustainability.

This fiscal substitution has nothing to do with austerity. It is not a question of reducing public support for the economy. On the contrary, it is a question of increasing it by redirecting the public expenditure towards productive energy related investments. It is about defining financing mechanisms that benefit from a state guarantee in order to encourage households or SMEs to make green investments.

NextGenerationEU is a powerful ecological lever provided it is rapidly implemented. Indeed, this European plan proposes European financing (grants and loans) to the States insofar as the latter commit to implementing the proposed structural reforms defined in the framework of the European Semester.

4. 6 Lasting negative real interest rates and high public deficits (>3%) and debts (<90/100%) are synonymous with a decline of productive and public investment

The economic consequences of high sovereign debt

In its Economic Bulletin (Issue 3/2016), the ECB explains the significant economic challenges raised by high government debt.

First a high government debt burden makes the economy more vulnerable to macro-economic shocks and limits the room for counter-cyclical fiscal policy. For instance, a rise in long-term interest rates may reignite pressures on more vulnerable sovereigns, thereby triggering a sovereign risk re-pricing. Second a high government debt entails the need to sustain high primary surpluses over long periods, which may be difficult under fragile political or economic circumstances. Indeed, high primary surpluses are difficult to maintain under adverse economic conditions.

Third theoretical and empirical literature suggests that high government debt burdens can ultimately impede long-term growth. Indeed, several studies suggest that beyond a threshold of 90%-100%, public debt has an impact on growth performance. However, it is important to analyse the nature of the expenditure financed by this debt, as infrastructure and social expenditure do not have the same effects on long-term activity. In any case, productive investment and public investment have declined in the most indebted countries during the last decade.

Lasting loose monetary policies discourage productive investment and growth

Net public investment in the euro area during the 2011-19 period was the lowest of the advanced economies, with the exception of Japan. Before the global financial crisis (2008), public investment levels were at around 4% of gross domestic product (GDP) in the euro area. But, according to F. Panetta[8], after the sovereign debt crisis, public investment tumbled by more than one percentage point. When accounting for the depreciation of capital stock, net public investment fell from about 1% of GDP in 2010 to around 0% in 2013. It hovered around that level until 2019 and even turned negative between 2014 and 2017. Euro area governments invested around € 500 billion less in the 2011-19 period compared with the 2000-09 pre-crisis period.

Negative or very low interest rates are supposed to encourage productive investment, which has been in decline for more than 10 years. However, the reality is quite different. it has been shown that negative interest rates discourage savers, particularly in Europe, from investing in the long term and encourage them to hold on to their liquid assets. A saver is not going to finance a risky investment if it does not bring him any return!

If interest rates remain negative in real terms, it is to be feared that investment will not pick up again. How can savers be encouraged to invest in future projects that carry a certain amount of risk if they receive zero return, or even a tax, on the money they invest?

4.7 Increasing public spending and public debt in over-indebted European economies inevitably leads to economic underperformance and to the questioning of the existence of the euro

The Eurofi Macroeconomic Scoreboard shows that:

- The most indebted countries of the euro zone had also achieved the lowest productivity growth performance in the past two decades.
- The most indebted EU Members have experienced the highest unemployment rates in the EU since 2007, as Spain (14,8% in 2021), Italy (9,5%) and France (7,8%).

Large deficits and high levels of debt and deficit have not been conducive to growth, especially in Europe. Indeed, the most indebted countries, (*e.g.* France, Italy) have achieved the lowest growth performance of the eurozone since 2013[9].

The most indebted countries on the eve of the Covid-19 crisis have been the most severely hit in terms of output shortfall in 2020. Likewise, the most indebted EU Members have experienced close to double-digit level of unemployment rate since 2007, as Spain (14.5% in 2019), Italy (9.9%) and France (8.5%). Despite their significant deficit, the three countries are among those with the highest share of long-term and young unemployment rate. EU countries with the highest level of government expenditure as percentage of GDP (*e.g.* France, Belgium) are also those with the least competitive firms. Such levels of public expenditures have been reached at the expense of productive investment.

By contrast, the EU countries that have best managed their public finances after the Global Financial Crisis and the EU Sovereign crisis (*e.g.* Germany, the Netherlands, Austria) are those that have suffered the least from the Covid-19 shock. At 4.2% of GDP (Germany) and 4.3% (the Netherlands), their 2020 public deficit has remained mainly below the euro zone average of 7.2%. Those countries also record among the lowest unemployment rate within the euro area, with 3.2% for the Netherlands and 3.5% Germany as of June 2021[10].

4.8 Thinking that monetary creation can solve the problems arising from excessive debt is an illusion. Despite Quantitative Easing policies, the fiscal constraint remains

Between March 2020 and June 2022, central banks and notably the ECB have been carrying a primary role in public debt monetisation, as they purchased a large share of new public debt issuances[11]. In sight of the massive debt purchases, central banks have de facto become the agents of fiscal policies. This "fiscal dominance" that is still taking place puts in question the independence of central banks and is a major disincentive for governments to engage in structural reforms.

8. P. Panetta, "Investing in Europe's future: The case for a rethink", Milan, 11 November 2022.
9. See the Eurofi Macroeconomic Scoreboard, April 2023.
10. According to Moody's Analytics Economic Indicators (can be found at https://www.economy.com/indicators).
11. Refer to the Eurofi Monetary Scoreboard: 64% of French debt issuances have been bought by the Eurosystem in 2020. The figure reaches 79.8% in Germany, 70.1% in Spain, 74.5% in Austria, 101.3% in Italy, 98.5% in the Netherlands.

Central bank purchases of public debt do not change the total indebtedness of the state. It prevents interest rates from rising in the long term, but it cannot be permanent or it will become inflationary and create asset bubbles.

Prudent fiscal policy sustains credibility, not monetization

The idea that States can compensate for everything by exposing their balance sheets is unfortunately a fantasy. Indeed, it is not because budget deficits are monetised that they disappear. Despite the QE and its possible magnitude, the budget constraint remains. Analysts and rating agencies continue to examine ratios and make judgments about the quality and sustainability of public debt. This point should not be taken lightly: rating changes are an important element of an issuer's "signature" and a key factor in the decision to buy securities by private investors, especially non-residents. As they are very sensitive to the rating, they still play a decisive role in the demand for public securities offered for issue.

Considering that these judgments voiced by the markets actually do not matter, because the central bank will always be there to buy, is doubly inaccurate: the central bank will not always be able to buy everything, as we shall see below, and the quality of a state's signature is an essential element of confidence that must be preserved at all costs for the country's future.

The resumption of the monetisation of an increasing share of public debt stock and new issues in case of increasing financial fragmentation in the euro area would eventually promote financial instabilities and could lead to a loss of confidence in the currency.

The ECB cannot absorb all public debt forever

If some national central banks are theoretically free to monetise the entirety of their states' public debt, the same cannot be said of the ECB, which is governed by an international treaty that prohibits the monetisation of public debt. Similarly, the idea that central banks purchasing public securities could cancel their assets in order to reduce their states' debt to zero is, in the European case, legally impossible. The subsidy to the states that would be implied by the cancellation of public debts is not compatible with the Maastricht Treaty, which prohibits the monetary financing of Treasuries.

We cannot pretend that money creation can exempt our societies indefinitely from having to face the question: "who will pay?". Do we seriously believe that unlimited issuance of sovereign securities will never come up against a fundamental questioning of the markets as to the solvency of States?

What we need is more long-term investment to cope with the challenges of reduced labour and the green and digital transition

This will not be achieved with more distribution through budgets or more money creation. It will only be possible if structural – supply side oriented – reforms as well as a normal remuneration of risky investments are made possible. This combination requires a reining in of excessive current public expenditure (*i.e.* fiscal normalisation), alongside a qualitative shift towards reasonable public investment.

As long as we do not understand notably in indebted countries (France, Italy, Spain etc) that excessive debt is a source of lack of competitiveness, the economic situation will continue to deteriorate in these countries. Only domestic structural reforms can resolve structural issues and increase productivity and potential growth.

It is an illusion to try to solve the structural problems of our economies by a prolonged increase in public or private debt. Yet this is what we have tried to do by pursuing lax fiscal, monetary and political policies that pose systemic risks to financial stability and therefore to future growth.

If we continue to live on the illusion that fiscal stimulus can "replace" monetary stimulus, we will have two negative results:

- Fiscal dominance because fiscal stimulus cannot co-exist with high rates.
- A financial crisis because excessive leverage always leads to it.

Furthermore, if this fiscal drift were to continue, we would end up making the virtuous countries pay for the slippage. This is the definition of a non-cooperative game where most players try to avoid their obligations by shifting the cost to those who observe them. If this were the case, the logical result would be an inevitable, major, new crisis of the euro zone.

5. It is economic growth that eventually solves indebtedness issues

A monetary union does not by itself create economic convergence. The eurozone is a currency area comprising heterogeneous countries (their productivity levels, their productive specialisation, the level of fiscal deficits and indebtedness, the level of labour force skills are different) with a low level of federalism. The Covid-19 crisis has exacerbated these existing heterogeneities across EU Member States[12].

Monetary policy can erase spread differentials in the euro area but cannot relaunch capital flows from the North to the South. Indeed, since the EU sovereign debt crisis, Member States with excess savings (Germany and the Netherlands in particular) no longer finance investment projects in lower per-capita-capital countries (Spain, Italy, Portugal, Greece).

This is notably due to the interest rate differential between the US and Europe (the risk is better remunerated in the US than in Europe), the limited financial flows between eurozone countries and the insufficient number of investment projects. These limited cross-border capital flows in the euro area reflect the persistent doubts of investors in Northern Europe about the solvency of states and companies in other countries, as well as the lack of a genuine Banking Union and integrated financial markets.

Adequate remuneration of risk, implementation of structural, supply side-oriented reforms and sustainable fiscal policies are essential to promote a return to healthy growth in overindebted countries.

Remuneration is a key driver for contributing to sustainable growth

The world – and the euro area in particular – should move gradually and cautiously towards monetary normalisation, in order to avoid cliff effect. The market – the supply and demand of capital – must be gradually be reintroduced in the determination of medium and long-term interest rates. This would be a step to a more productive post-pandemic period of higher growth and productive investment.

Raising long term potential growth is of the essence to solve the indebtedness issue.

Fostering a sustainable path to stronger growth is essential. This requires structural reforms and sustainable fiscal policies designed to deliver a flexible and competitive economy. Lost competitiveness due to postponed reforms in many EU countries in particular has led to the deterioration of the potential growth which cannot be improved by cyclical policies. Monetary policy cannot do everything: only domestic structural reforms can resolve structural issues and increase productivity and growth. The Next Generation EU package, if well implemented, should be useful in this respect.

France and Italy notably are suffering from a supply problem, due to the decline in industrial production capacity, the deterioration in cost competitiveness, the low level of labour force skills and the low level of potential growth, especially in Italy. When demand increases in France, this increase in demand mainly leads to an increase in imports and not in domestic production. Increasing fiscal deficits in these countries could only lead to a noticeable rise in interest rates that may threaten fiscal solvency and dampen private sector demand.

In such a context, France urgently needs to rebalance its public accounts in order to reduce the excessive level of tax and contributions which are detrimental to the competitiveness of French companies. What is needed is a reduction of public expenses, which represented in 2022 57,9% of GDP compared to 48,7% in Spain or 49,5% in Germany (as illustrated in the following graph) and not a lesser increase. In other words, 56% of GDP in France is used to finance administration and redistribution expenditures. This represents an 8-to-9-point difference with the European average. This is a burden for economic players, because public spending has to be financed by taxes and social contributions that are 8 points of GDP higher than in the other countries. This additional tax and social burden explain the de-industrialisation of France over the last forty years. Moreover, in a monetary union, Member States cannot devalue our currency in order to regain competitiveness vis-à-vis our neighbours. There is no other way than to lower taxes if we want to restore sufficient profit margins so that companies can invest. France suffers from chronic under-investment, at least in industry.

Italy, for its part, needs to increase its potential output and reduce public debt, which represents a major potential source of financial spill over for the rest of the euro area. Italy's public debt is very high and financing needs are large. After increasing by 20 percentage points of GDP in 202, Italy's public debt declined somewhat in 2021 nearly to 150 percent of GDP. Further sustained and significant reduction in the public debt ratio is needed to safeguard debt sustainability. As mentioned by the IMF in its Article IV report (August 2022), "key risks stem from a disappointing growth trajectory, a sharper increase in financing costs and materialization of large contingent liabilities… Reaching a primary surplus of 2 percent of GDP no later than 2030 is required. It would create room for priory investments in education, digitalization, and the energy transition while also reducing public debt to around 130% of GDP in 2030, with further reduction thereafter".

12. See J. de Larosière, D. Cahen & E. Krief, Eurofi Economic Scoreboard, February 2022.

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Growth will be the only way to handle the debt problem. In over indebted countries, governments must take corrective actions to ensure a path to primary fiscal balances and reduce unproductive and inefficient public spending. No illusions should be held over the capacity to stimulate demand in these countries.

However, some economists explain that global secular stagnation[13] was and is driven by deep structural factors lowering interest rates for safe assets that neither Covid nor inflation have done anything to reverse: demographic evolutions lead to a longer retirement. This induces people to save more for their retirement. Consequently $r < g$ should remain the prevalent regime for some time to come. In such an environment of lasting very low interest rates, governments should be encouraged to take on more debt in order to finance the public spending that is necessary for the future.

Given the uncertainty about inflationary expectations and the growth rate, and if we include in the reasoning the need for investments in order not to miss the ecological and digital turn, believing that the r-g equation will be permanently negative seems more like a risky bet than a certainty:

Indeed, the truth is that investment needs are increasingly high, especially those related to then green and digital transition – the EU Commission estimates them at 650 billion euros per year until 2030 – and should change the medium – and long-term interest rate situation. The permanence of secular stagnation is not guaranteed, and fortunately it is so.

Furthermore, those who support the thesis of the permanence of negative r-g, what assumptions do they make about quantitative tightening and its impact on long-term interest rates? This subject and more generally the normalization of monetary policy, is passed over.

While it is true that the secular decline has led to a decline in interest rates for structural reasons, many economists often forget that the hyper-accommodating monetary policies conducted since the great financial crisis of 2008 – and in particular the Quantitative Easing policies (QE) – have exerted downward pressure on medium and long-term interest rates, which would not have been as low over the last 15 years without these massive securities purchases.

Moreover, the gradual setting of rates by the market and no longer by the central banks would lead to a better remuneration of savings. Fiscal deficits will have to be reduced in such a context, structural reforms will be encouraged, share buy backs will have to decline investment would be favoured.

It is also important to understand that if fiscal policies were to remain expansionary, central banks would have to tighten monetary policies even further to curb inflation and reduce inflationary expectations exacerbated by this fiscal stimulus.

Olivier Blanchard[14] recognized that there are many reasons why investment might become stronger and increase r. "Geopolitics suggest that defense spending, a form of investment, may go up. Reshoring and friendshoring, for security or other reasons, may imply both higher investment and possibly lower growth as some of the benefits of trade are lost. The fight against global warming will increase green investment, while at the same time potentially slightly decreasing growth. All these may lead to an increase in r – g and thus reduce the room for fiscal space and the use of fiscal policy".

In such a context, in order to ensure the sustainability of their public debt, countries with large budget deficits (*e.g.*, >3%) and excessive debt (*e.g.*, >100% of GDP) must achieve and maintain a primary surplus to be defined and monitored in the context of the current review of the Stability and Growth Pact.

A recomposition of public finances focusing on the nature of spending is therefore urgent and essential in highly indebted European countries. The climate and digital transition will indeed have a significant cost for the public finances of states. But this effort must be undertaken by redirecting current expenditure (unproductive) towards investment expenditure (productive). Reforming the Stability and Growth Pact is an urgent necessity and has to take into account this objective[15].

Only productivity enhancing, and supply side-oriented reforms can foster productivity and growth, neither negative real rates, nor QE.

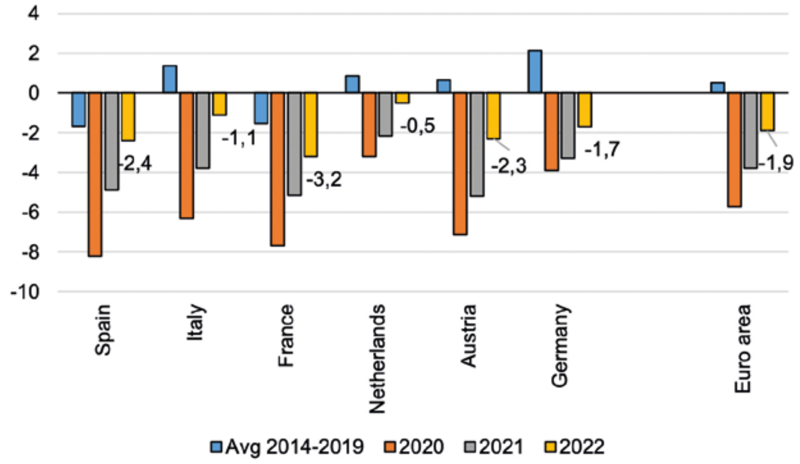
13. For those who support this analysis, the steady decline in real interest rates observed over the past 40 years is the result of excess savings compared to low investment and high demand for risk-free assets, leading to a lower equilibrium rate.

14. O. Blanchard, "Secular Stagnation is not over", PIIE, 24 January 2023.

15. J. de Larosière & D. Cahen, "Reforming the Stability and Growth Pact" – February 2022 (available in the Eurofi Regulatory Update – February 2022.

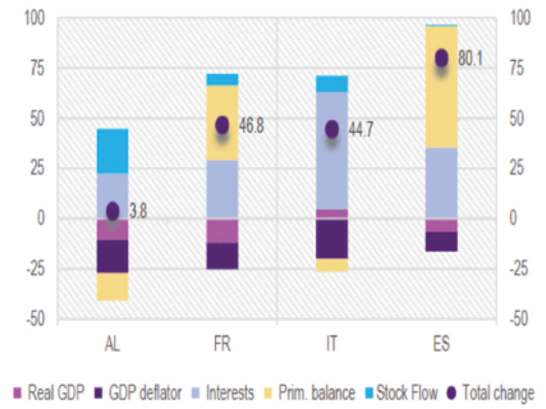
Annex

CHART 1.
General Governement Primary Budget Balance, % of GDP



Source: Eurostat, EU Commission's Automn Forecast (November 2022)
Notes: Labels relate data for 2022 ; data for 2022 are taken from the EU Commission's forecasts of November 2022

CHART 2.
Change in the level of Gross Public Debt to GDP ratio between 2007 and 2021, breakdown by components



Source: J. Castillo, « Italy once again in the eye of the storm», Special Report, Natixis Economic Research, June 2022

TABLE 1.
Credit To Non-Financial Private Sector, Public Sector, Firms and Households % of GDP

	General Government			Private Non-Financial Sector (a + b)			Non-Financial Corporations (a)			Households (b)		
	2008	2013	Q2-2022	2008	2013	Q2-2022	2008	2013	Q2-2022	2008	2013	Q2-2022
United States	66,1	96,2	113,4	168,8	150	155,1	72,5	67,5	79,5	96,3	82,5	75,6
United Kingdom	50,8	85,3	101,3	184,8	166,3	150,2	90	77,8	66,3	94,8	88,5	83,9
Japan	145,1	194,3	233,6	163,8	159,5	187,4	103,6	98,2	118,5	60,3	61,3	69
China	27,1	37,3	75	111,9	170,8	220,3	93,9	137,5	158,7	17,9	33,3	61,6
Euro area	69,8	93	94,3	157,2	163,3	167,2	96,5	101,8	108,5	60,7	61,5	58,7
France	68,8	93,3	113,3	164,2	181,1	231,2	116,2	125,6	164,7	48,6	55,5	66,5
Germany	65,8	78,2	67,4	129,9	124,3	128,3	70,1	68,8	72,3	59,8	55,6	55,9
Italy	106,2	132,5	150,1	116,5	125	112,8	77,5	81,7	70	39	43,3	42,8
Spain	39,7	100,5	116,4	214,2	202	155,3	131,6	124,3	98,7	82,6	77,7	56,6
Netherlands	54,7	67,7	50,9	234,7	280,3	240,9	123,2	164,1	142,2	111,5	116,3	98,7
Austria	68,7	81,3	82,8	142,5	146,5	148	90,5	95,6	97,9	52	51	50,1
Portugal	75,6	131,4	123,3	206,3	220,1	161,5	117,4	134	97,8	88,9	86,1	63,6
Belgium	93,2	105,5	106,9	192,1	205,1	199,8	142,2	148,7	139,3	49,9	56,4	60,5

Source: Bank For International Settlements

Reforming the Stability and Growth Pact

Note written by Jacques de Larosière & Didier Cahen

European fiscal rules, as enshrined in the Stability and Growth Pact, are currently suspended to allow governments to fight the economic fallout from the pandemic. Under current plans, these fiscal rules will be enacted again in 2024 and the EU Commission should put forward its legislative proposals on the future economic governance framework in April 2023.

This subject is far from simple. The rules of the Stability and Growth Pact have become difficult to interpret let alone implement.

Behind this difficulty, it must be understood that the subject is complex, not least because of the heterogeneity of the economic and financial situations of the Member States which has been increased by the Covid-19 crisis.

The purpose of this note is to propose principles for the revision of the Stability and Growth Pact and in particular more individualized rules for each Member State, less dependent on abstract figures and at the same time more rigorous so that the new EU fiscal framework becomes more effective.

1. An EU and adapted framework for a common discipline

1.1 Why do we need fiscal discipline in a Monetary Union?

Fiscal coordination is needed in a monetary union The reason stems from the fact that the Union European is not a state and that negative externalities – stemming from questionable national policies – should be taken into account and avoided. The European Monetary Union has a single monetary policy but no common fiscal and economic policy. Therefore, the need for fiscal coordination.

The purpose of EU fiscal rules should be to reduce the risk of debt crisis related spillovers across Member States, by making sure that each country's debt remains sustainable. In the event of a crisis, no responsible state should ever accept financing current public deficits generated by other members of the Union that do not follow the rules of the Union.

If all countries ensure the sustainability of public debt, national debt crises that threaten the existence of the euro would be avoided and confidence among Member States would be boosted.

Sound public finances are essential for growing out of debt. They represent an important safeguard to the single monetary policy and keep away monetary policy makers from being under pressure to guarantee government solvency. As Mr. Nagel recently stated[1], "the higher the level of public debt becomes, the greater the pressure on central banks to maintain favourable financing conditions in order to prevent the state from experiencing a solvency crisis".

In addition, fiscal and economic divergences between EU countries make it more difficult to define in Europe a common interest, encourage a policy of "every man for himself", create a climate of mistrust between Member States which hinders any progress in terms of public and private risk sharing and weakens the euro zone.

Some may think that fiscal discipline is no more indispensable because of low interest rates. This is a profound misconception: real interest rates will not stay negative or ever and the markets are already showing this. And to base a fiscal framework on the assumption of indefinite low interest rates and monetization of public debt is not consistent with the functioning of our monetary union.

1.2 The increased heterogeneity of the economic and financial situations of the Member States

At the end of 2022, public debt vulnerabilities reach a very high level in a small set of mainly large European countries.

Despite the different reforms which took place after the sovereign debt crisis (European semester, Six pack, Two pack, Treaty on stability, coordination and governance in the Economic and Monetary Union), the public debt ratio has continued to grow steadily in significant countries of the euro area (*e.g.* France, Italy, Belgium, Spain) and is approaching 120% of GDP or even more in certain Member States. On the contrary, countries such as the Netherlands, Germany or Austria have been able to maintain a ratio of public debt to GDP of around 60% or even less[2].

1. J. Nagel, "Current challenges facing the European Monetary Union", London, 22 March 2023.
2. In Germany, gross public debt to GDP ratio increased by 1.7 pp between 2008 and 2022, and by 3.9 pp in the Netherlands.

In the euro area, between 2007 and 2019, the aggregate government debt-to-GDP ratio rose from 66 % to 83.8% – one-third more debt compared to the pre-crisis level. In France, the public debt ratio compared to GDP has increased even more from 64.5% to 97.4% of GDP between 2007 and 2019. In Italy the public debt ratio has grown from 103.9% to 134.1% and in Spain from 35.8% to 98.3%. However, by contrast, in Germany public debt has decreased from 64.2% in 2007 to 58.9% in 2019.

Except for few countries, the fiscal rules of the SGP have not been obeyed particularly for large countries (*e.g.*, Italy, France…).

The economic consequences of the current Covid-19 crisis have worsened the situation. They have increased the heterogeneity of fiscal performance across euro area member states. The aggregate government debt-to-GDP ratio rose by around 12 percentage points between 2019 and 2021, reaching respectively 88.1% and 95.6% in the EU/EA in 2021, according to Eurostat.

Between 2019 and 2021, fiscal divergences rose further in terms of public debt-to-GDP. In average, the public debt of each EU Member State deviated by 37.3 percentage points from the EU aggregate public debt level in 2021, up from 35.2 percentage points in 2019[3].

in 2022, 14 countries in the EU have a public debt to GDP ratio below 60%[4] according to the EU Commission. However, three countries have a public debt of more than 115% of their GDP: Greece (171.2%), Italy (144.6%) and Portugal (115.9%). France and Belgium also have a high public debt (respectively 111.7% and 114%) well above the average of the 27 countries while Germany and the Netherlands respect 67,4% and 50,3%.

In such a context, it would be rational to propose that each member country should outline a specific path for reducing its public debt which would take account of specific local parameters (level of savings, economic potential…) and debt sustainability but it should be up to EU Institutions to discuss and formally validate these plans notably to avoid any asymmetry of treatment between small and large countries.

1.3 Structural problems need to be addressed by structural reforms; a qualitative change in budget expenditure is also required: from unproductive to productive goals

A proactive fiscal policy to "substitute" for a dwindling monetary policy would be a great mistake. Fiscal or monetary stimulus will not necessarily enhance potential growth. Indeed, the huge monetary and fiscal stances of the last decades have not led to investment or higher growth. There is no automatic substitution effect: less monetary expansion offset by more fiscal deficits.

Fiscal deficits – if they are increased above their huge present levels – will only be possible if monetary policy and interest rates remain accommodative. One of the most concerning consequences of accommodative and low rates for long policies has been precisely the marked reduction in real terms of global productive investment over the last 15 years: lasting low interest rates do not foster, by themselves, more productive investment[5]. What they do – notably in the EU – is to encourage savers to keep their financial assets in liquid instruments and not to channel them in securities geared to long term investments[6].

What we need is more long-term investment to cope with the challenges of reduced labour and ecology. This will not be achieved though more distribution through budgets or more money creation. It will only be possible if structural – supply side oriented – reforms as well as a normal remuneration of risky investments are made possible. This combination requires a reining in of excessive current public expenditure (*i.e.* fiscal normalization), alongside a qualitative shift towards reasonable public investment.

If we continue to live on the illusion that fiscal stimulus can "replace" monetary stimulus, we will have two negative results:

- Fiscal dominance because fiscal stimulus cannot co-exist with high rates.
- A financial crisis because excessive leverage always leads to it.

1.4 Distinguish between legitimate and abnormal fiscal heterogeneity

A rule adapted to certain circumstances may not make sense in another context. Over the years, attempts to pre-program all possible contingencies have led to excessive complexity while Member States have not wished to give the Commission effective powers to adapt the rules to specific situations.

To work on this complexity, first it is critical to understand what could be called the "legitimate heterogeneity". If Greece is on one side and Germany the other, the structures, histories and capabilities are different. Homogeneity will not be attained because

3. Indeed, five EU Member States still saw their public debt exceeding 110% of GDP in 2021: Greece (193.3%), Italy (150.8%), Portugal (127.4%), Spain (118.4%) and France (112.9%). By contrast, seventeen EU countries kept their ratio below 75% of GDP in 2021. Among them, Germany, the Netherlands, and Finland had their public debt compared to GDP hovering respectively at 69.3% of GDP, 52.1% and 65.8% in 2021.
4. Estonia, Bulgaria, Luxembourg, Sweden Denmark, Lithuania Latvia, Czechia, Ireland, Romania, Netherlands, Poland, Malta, Slovakia.
5. See Eurofi Economic and Monetary Scoreboards, April 2023.
6. Long-term investments do not produce returns consistent with the risks involved in such projects. So, savers act rationally and prefer to keep liquid banking accounts that are easily mobilizable. This is the "liquidity trap" feared by Keynes which is particularly severe in European countries that do not have the risk appetite for equity that characterizes US markets.

of a 3% rule or a 60% rule. It is thus important to distinguish between legitimate heterogeneity, which is, in many cases, the product of history, and "abnormal" heterogeneity, which is the incremental heterogeneity that has been created by public action or inaction. This has to be analysed carefully. If abnormal heterogeneity is detected, it can be worked on, not necessarily to erase it in a couple of years but to start working gradually on that element.

1.5 Better internalize the European framework in domestic systems

We need to recognize that the present system of sanctions has not been observed because the figures and norms were considered as externally imposed. As Tuomas Saarenheimo, President of the EU's Economic and Financial Committee, pointed out during an exchange of views at a Eurofi Seminar in April 2021, it would not make much sense to go back to a disciplinary system based on sanctions. The purpose should be to introduce into the European mechanisms an intelligent view of the priorities to be implemented on a State-by-State basis. That is the real challenge.

The framework seems more important than the precise rules, if 'rules' means a set of numbers. A set of numbers in itself is not going to solve the credibility problem for the framework. What will be helpful is finding ways for countries to better internalise the framework in their domestic systems. This by definition would be better than pretending to apply sanctions.

Promoting transparent discussions on fiscal issues between an independent EU fiscal authority and each Member State is a right approach. Having a dialogue like the one at the IMF for article IV would certainly be a progress. Socratic discussion leads to a quantum of realism and is a better approach than having a few arithmetical rules that will never be applied.

Those who advocate a return to numerical rules should recognise that there has been very little compliance with these rules. Making them more binding seems illusory because countries have never really accepted them as their own. This makes an Article 4 type of discussion seem preferable as it is more easily internalised in national policies. The conclusions of these economic discussions will be more difficult for countries to contest than an arbitrary figure. However, this new system must be well supervised *(see 2.8)*.

A fiscal-stabilisation facility should also be added to this new EU fiscal framework so that, in exceptional circumstances – when, for instance, the Commission declares that a country is in exceptional circumstances and there is a reason to activate the escape clause – additional fiscal space from the European side is made available to the country. These are all elements where it will not be easy to find a consensus in the Eurogroup.

2. The gist of a common framework

The approach would be to achieve a mechanism that is sufficiently adapted to the problems – by definition different – of each of the Member States, by establishing common standards under European supervision in order to achieve credible and realistic debt-reduction trajectories and build fiscal buffers to face new unexpected challenges.

2.1 A case-by-case framework

Macroeconomic circumstances and the debt dynamics are different for every country. Sustainability of public finance very much depends on country specific factors (level of potential growth of savings and taxes, type of government…) and equal treatment of EU Member States does not necessarily mean "one-size-fits-all" rules.

The revised common framework should define, on a State-by-State basis and in a medium-term perspective, the realistic budgetary guidelines which best reflect the particular national and Community interests.

Each state would have to explain its orientation by focusing on its own priorities. The European authorities (European Commission, ESM) should regularly monitor the implementation of what would reflect the common understanding on these issues.

This is important because the markets are guided more by dynamics than by absolute numbers in determining country spreads. Because monetary policy will not always be there to buy all the new sovereign issues, it will be imperative to reassure the markets by gradual fiscal normalization policy.

From this point of view, the updated fiscal rules should include special monitoring of the primary balance by prohibiting primary deficits for over indebtedness countries with lasting excessive fiscal deficits *(see below)*.

2.2 A set of rules adapted to each problem (expenditure, primary balances, debt)

Some countries rely too much on public expenditure, which then deteriorates all their fiscal situation. A precise rule on the reduction of public expenditure – and not on the growth of public expenditure – is therefore necessary. Otherwise, the overburdening of taxes and contributions on businesses will continue to penalize those countries because they will remain above the threshold of competitiveness gap.

It should be suggested that countries with excessive government spending compared with average of the euro area, will need to focus on significantly reducing this particularity – and not just increase them in line with potential growth – with a well-established and monitored nominal spending rule. Such a rule could be the following: "Any country that exceeds "the average normal" of public expenditure to GDP in the eurozone would have to eliminate the difference in a period of 5 years or less". This would be a specific constraint to be monitored at the EU level.

It is indeed problematic to reach 55% of public expenditure on GDP (before Covid) when the European average is 8 to 10 percentage points lower. In this respect, a country like France, which holds all records of public spending relative to GDP, devotes only a small amount of resources to productive public investment. Absorbing 55% of GDP to finance the "end of the month" is much more dangerous than if much of it were spent on public investment. Such a situation is incompatible with future growth and requires more active treatment. The new European mechanism will have to take this into account.

A ceiling on public expenditure growth, in such situations, would be inappropriate and contribute to maintain – and even increase – fiscal and competitiveness heterogeneities across Member States.

2.3 Primary fiscal balances

The countries with large fiscal deficits (>3% for instance) and over indebtedness (>100% of GDP for example) should achieve and maintain a primary surplus to be defined and monitored by the EU Commission or the independent EU fiscal authority *(see 2.8)*.

Primary fiscal balance should become a quantitative benchmark to support the EU reformed fiscal framework as well as the comparison of the ratio of public expenditure to GDP with the average for the euro zone.

2.4 Keeping the 3% of GDP deficit rule – a minimum ratio in normal times – is a reasonable option

The 3% deficit rule is already very tolerant. It is a hard-to-challenge safeguard in "Normal" periods. It is sufficient to stabilize the economy during downturn. It has proven to be a good fiscal anchor and should be kept.

This is a minimum ratio not to be exceeded: in the case of a country's nominal growth of 3% per annum, with a deficit of 3%, the public debt of that country is stabilized.

2.5 The 60% of GDP debt rule: toward a country specific debt adjustment speed

A recent ESM paper[7] states that "Keeping the 60% reference value and assuming a 20-year horizon to achieve it would necessitate unrealistically high fiscal surpluses for several countries. For example, Portugal would need a primary surplus of close to 2.5% of GDP on average for the next 20 years despite a significant decline in debt service costs since the 1990s[8]. The required primary surplus would be even higher for some other countries, which risks causing countries to adopt inappropriately tight and unsustainable policies". This paper also proposes to raise the debt limit to 100%.

As already explained above, the debt ratio compared to GDP varies greatly from one Member State to another. We think that it should be "personalised" on a case-by-case basis, depending on available margins and debt sustainability. Mr P. Gentiloni followed this same logic when he said that the proposed reform of the Stability and Growth Pact by the Commission would set individual debt goals for each country, adding that the Commission should be given more effective instruments to enforce fiscal rules.

In any event, if the proposed new rule on reducing public expenditure for countries that deviate from the euro area average were adopted and implemented, and if primary surpluses were also respected, the 60% debt-to-GDP rule would become less important.

2.6 Public investments should not be excluded from a country's s deficit and debt calculations

There are huge public spending needs, given new investments for the green and digital transitions, education, healthcare[9]. But a special treatment for growth-enhancing expenditure would not be helpful. It comes from the illusion that public financial means are not scarce. Actually, it is a matter of refocusing the priorities. Unproductive public spending needs to be replaced by productive public spending.

It would be a grave mistake to push the extreme fiscal limits in the present situation. Investment-friendly rules – such as a golden rule to protect public investment implying a separate capital account – can lead to excessive borrowing and weaken the link between fiscal targets and debt dynamics, fostering potential risks to debt sustainability. In addition, as stated by the ESM paper, "creative accounting and

7. O. Francová, E. Hitaj, J. Goossen, R. Kraemer, A. Lenarčič, and G. Palaiodimos, "EU fiscal rules: reform considerations", ESM Discussion Paper 17, October 2021.
8. "This is an illustrative exercise, and the surplus quoted is different from that implied by the existing debt rule. Debt dynamics could evidently vary over time and for example, require higher consolidation efforts, at the start with higher debt levels. Structural measures of the primary surplus may lead to different outcomes, and possibly showing even higher adjustment needs".
9. The Commission estimates that the additional private and public needs related to the green and digital transitions will be nearly 650 billion per year until 2030. The green transition alone accounts for €520 billion per year.

the reclassification of unproductive expenditures as investments to circumvent rules could challenge monitoring and enforcement, alienate the targets from the numbers and reduce transparency".

We need strong fiscal positions to face the challenge of infrastructure investments and ecological policies. The last thing we need would be to deteriorate current imbalances budgets. The future depends on

- a consolidation of present weak fiscal positions (primary surpluses) and
- a shift toward quality of expenditure and investment.

With the amount of liquidity created in the past years, we do not need more redistributive expenses. We must rein them in and allow adequate space for public investment.

2.7 The quality of public spending and composition on public finances must be given more importance than its quantity

Fiscal policy should ensure a composition of public finances that is both growth-friendly and sustainable. We have to recognize that the shift towards more productive investment will require substantial political effort because presently public investment only accounts for some 4% of GDP while current – nonproductive expenditure – represent almost all public expenditure.

In this perspective, putting in place early warning mechanisms to prevent unsustainable public finance trajectories would be required. Indeed, a country whose share of public expenditure reaches record levels in relation to the European average should be subject to special discipline.

The fact that money has been thrown at the problems for years has worked against supply-side policy. In order to reduce the unused margin of the economy ("output gap"), it is necessary to deal not only with the stimulation of demand, the reduction of unemployment but also to increase productive investment and productivity gains, which have been the orphans of this story.

In an extreme case, stimulating demand does not translate into increased production, but leads to a widening of our trade deficit if a country does not have an efficient production system. In this respect, the quality of public spending is becoming an absolute imperative: as much as we need to fight against unproductive spending, we can encourage the financing of infrastructure spending (including research) that can be financed by debt.

2.8 An effective fiscal surveillance and enforcement process

The specific rules that would emanate through each country from the discussion undertaken at the EU level must be internalized in domestic frameworks and these rules should be a condition for the presentation of the national budget to the national parliament.

As mentioned in 1.5, in the absolute, if one wanted an ideal system, promoting transparent discussions on fiscal issues between an independent EU fiscal authority and each Member State is a right approach. Having a dialogue like the one at the IMF for article IV would certainly be a progress. Socratic discussion leads to a quantum of realism and is a better approach than having a few arithmetical rules that will never be applied.

An independent fiscal authority, comprised of economists of economic and academic backgrounds, would therefore add credibility. The proposals to entrust an independent European Budget Committee with responsibility for defining the concept of sustainability as well as the debt target and growth assumptions seem excellent. It could help each country top fix its personalized standards; it would be free to establish the fundamental macroeconomic assumptions behind the national budgets with the assistance of academics.

In the face of the difficulties of such a system or the opposition that would inevitably arise, one should be able to count on the European Commission to fulfill this role in an independent manner.

In this perspective, each Member State would define a specific path for reducing its public debt and this politically independent EU institution should discuss and validate these plans. A dialogue would be needed between the economists of the Commission and the national authorities. If the country understands that the measures are reasonable, enacting those prescriptions becomes easier. Increased confidence and trust between the economists in charge of this supervision and the national authorities would improve enactment and application of the system.

It would then be appropriate to set up a supervisory body (including economists) that could independently monitor the effective implementation of national budget programs and on which the Commission could rely. This high-level group would strengthen the credibility of the exercise. The composition of this fiscal entity should be governed by the principle of independence. Political difficulties could interfere there: Domestic fiscal choices are domestic and political issues. But, if political factors make comprehensive fiscal action at the level of the Union impossible, the problem is a lack of belief in a true European Union *(see 1.5)*.

If it is considered that the use of such a quasi-academic body is not realistic and raises too many difficulties, then the ESM could be used as suggested by Mr Nagel in a recent communication[10]. The ESM would thus participate in the Commission's dialogue with Member States and would be in charge of supervising the implementation of national budgetary trajectories for the countries of the Euro area.

The Union is based on a cooperative game of all its members. If a country decides to ignore the EU fiscal framework and continue to sink into debt and deficit – which it believes to be its national interest, then it is deliberately out of the game. The sanction is that it can no longer be taken seriously by the Union because it has turned a blind eye to the negative externalities it creates.

In other words, the penalty is the loss of credibility and its ability to participate actively in the Union and its modes of cooperation and of course, a country that embarked on this type of path would be labelled as such (name and shame).

Transitional aspects

In 2023, there will not be many countries with a deficit below 3% (11 according to the Autumn 2022 Commission forecast). Several will have deficits close to 5%[11] and should need one or two years to reduce them to 3%.

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As long as it is not sufficiently understood, notably in indebted countries (France, etc.), that excessive debt is a source of under competitiveness, the economic situation in these countries will continue to deteriorate. Only domestic structural reforms can resolve structural issues and increase productivity and growth. It is an illusion to try to solve the structural problems of our economies by prolonged increases in public or private debt or by using money creation. Yet this is what has been too often tried by pursuing lax fiscal, monetary and political policies that inevitably pose systemic risks to financial stability and therefore to future growth.

When the house is burning (when deficits and public debt are increasing in certain countries), we must not postpone the arrival of the fire department (absence of European rules and endless discussion on the economic governance of Europe). This is the reason why an EU agreement on the reform of the economic governance framework needs to be achieved in the coming months.

It is important to understand that if fiscal policies were to remain expansionary, central banks would have to tighten monetary policies even further to curb inflation and reduce inflationary expectations exacerbated by this fiscal stimulus.

Moreover, as public debt ratios worsen, the problem of debt sustainability becomes more acute.

Historically, a negative "r-g" ratio (where r=interest rate, g=economic growth rate) does not eliminate sustainability problems. Indeed, the growth rate and the interest rate are not independent of the level of indebtedness. The higher the level of indebtedness, the higher the market interest rate and the more fragile the economy. Hence the extreme caution that must be attached to the question of risks to debt sustainability in Europe. It must be understood that money creation and the purchase of public securities will not always be able to solve this problem. The Maastricht Treaty contains limits on the monetary financing of the Treasury, and opinions on this issue are far from unified.

Since the pandemic hit in 2020, the general escape clause of the Stability and Growth Pact has been applied and the Commission motivated the Member States to pursue an expansionary fiscal policy. Reacting to the economic consequences of the Russian invasion of Ukraine, the European Commission postponed again the renewed enforcement of its fiscal rules by a year, to 2024. However, the problem of excessive public deficits and indebtedness of some EU Member States constitutes the central explanation for the financial fragmentation within the eurozone.

Without an effectively implemented European fiscal framework, it is not possible to resolve this issue and thus to reduce the growing heterogeneity in terms of budget and debt between the virtuous states (Germany, the Netherlands, Austria, Portugal, etc.) and the others (Italy, France, Spain, etc.).

As we have observed, these fundamental problems have been with us for nearly 20 years and were not created by the war in Ukraine or the Covid crisis. The war in Ukraine exacerbates these problems but is not the cause.

By renewing the suspension of European fiscal rules once again in May 2022, policy makers believed that they would have an easier time later. In reality, postponing has solved nothing, and only complicated the resolution of problems that are likely to become even more acute.

10. J. Nagel, "Current challenges facing the European Monetary Union", London, 22 March 2023.

11. In 2023, According to the Autumn 2022 Commission forecast,
- 7 EU countries are expected to have a deficit of 5% of GDP or more, namely Romania (-5%), Slovenia (-5.2%), France (-5.3%), Poland (-5.5%), Malta (-5.7%), Belgium (-5.8%) and Slovakia (-5.8%).
- 9 countries are expected to have a deficit between 3 and 4.5% of GDP. These include Germany (-3.1%), Italy (-3.6%), the Netherlands (-4%) and Spain (-4.3%).
- 11 EU countries are expected to have a deficit of 3% of GDP or less in 2023. The deficit is expected to be between 2 and 3% of GDP for Croatia (-2.3%), Finland (2.3%), Bulgaria (-2.8%) and Austria (-2.8%). The deficit is expected to be between 0 and 1% of GDP in Portugal (-1.2%), Luxembourg (-1.7%) and Greece (-1.8%).
4 countries are expected to record a budget surplus, including Cyprus (+1.1%), Ireland (+0.8%), Denmark (+0.5%) and Sweden (+0.2%).

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Experience has shown that many States had not complied with the Pact. The following lessons must be learned:

- Rules are needed.
- They must be “personalized” (country by country).
- The methodology used must be indisputable.

Of course, all of the above could be completely unimplemented, as was the case with the old rules of Stability and Growth Pact. The sanctions originally provided for were never implemented.

If this drift were to continue, we would end up making the virtuous countries pay for the slippage. This is the definition of a non-cooperative game where most players try to avoid their obligations by shifting the cost to those who observe them.

If this were the case, the logical result would be an inevitable, major, new crisis of the euro zone.

Developing and strengthening EU capital markets

2

Capital Markets Union: progress made and future steps

Note written by Marc Truchet, Eurofi

1. Objectives of the Capital Markets Union (CMU) initiative

The Capital Markets Union (CMU) initiative was launched in 2015 with the objective of developing and further integrating capital markets in the EU in order to (i) diversify the financing of EU enterprises, particularly the most innovative and fastest growing ones and (ii) provide savers with improved long-term investment opportunities, while better connecting savings to productive investment across the Union. At the macro-level, the CMU also aims to preserve financial stability and enhance the resilience of the EU economy by fostering a geographical diversification of funding sources, strengthening private risk sharing across the EU and reducing the reliance on bank financing, which has in the past led to an excessive concentration of risks on bank balance sheets.

The importance of channelling savings towards the EU capital markets for Europe's continued prosperity and strategic sovereignty has recently been re-emphasized in an op'ed article published by the Presidents of the European Council, European Commission, Eurogroup, ECB and EIB[1] who also stated that bank financing and public investment will not be insufficient to provide the investments needed for the green transition, boosting technological competitiveness and diversifying supply chains[2].

Capital markets are indeed essential to fund fast-growing and innovative businesses due to their capacity to finance immaterial assets and projects with a long term perspective and disperse risk across a wide range of investors, thus completing the financing provided by banks. In addition studies have found that capital markets may reallocate funds towards less-polluting sectors more efficiently than more traditional financial activities and provide stronger incentives for carbon-intensive sectors to develop greener technologies[3].

The importance of the CMU together with the Banking Union for enhancing the open strategic autonomy[4] of the EU and strengthening confidence in the euro has also been stressed in the Communication on CMU published by the Commission in November 2021. Developing deep and liquid capital markets within the Union and enhancing the attractiveness of European capital markets to domestic and foreign investors is also important in a post-Brexit context, where frictions with the UK are due to increase.

2. Capital markets remain under-developed and fragmented in the EU

2.1 The size of capital markets relative to GDP is lower in the EU27 than in the US and UK

It is a well-known fact that EU capital markets as a whole remain quite under-developed compared to those of other major economies such as the US or the UK when considering their size relative to GDP. Although structural differences (*e.g.* in the pension systems between the EU and US and in the way capital markets and banks have evolved historically in each region) mean that the US cannot be considered as a direct benchmark for the EU, the comparison with the US shows that the development potential of EU capital markets is still significant, particularly in the retail space and for the financing of SMEs[5].

At the end of 2021, EU securities markets where about half the size of those in the US in percentage of GDP and also smaller than those of major economies such as Japan, China and the UK. The total of EU27 debt securities and public equity markets represented 233% of GDP compared to 449% for the US, with the main difference coming from public equity markets which amounted to 81% of GDP in the EU compared

1. See "Channeling Europe's savings into growth" – Op'ed article – 9 March 2023.
2. In addition, the op'ed article stresses that the role of public investment is mainly to incentivise a crowding-in of private investment and give policy directions, rather than provide the bulk of the financing.
3. Source: Bruegel "Europe should not neglect its Capital Markets Union" June 2021.
4. The concept of open strategic autonomy, meaning in effect non-dependence on foreign jurisdictions or players, has progressively expanded from the security and defense dimension to many other areas, such as energy, healthcare and, with the UK exiting the EU, to the financial services.
5. Measured by criteria such as the availability of retail pools of capital for investment in capital markets, the access of non-financial companies (NFCs) to capital…, which are significantly lower than the US (*see 2.3*).

to 227% in the US. In addition while public equity markets significantly grew in the US between 2015 and 2021 (from 137% of GDP to 227%), this was much less the case in the EU27 (81% compared to 61%)[6].

The smaller size of EU capital markets is in part due to their lower liquidity and competitiveness (*see 2.3*)[7]. Other key differences with the US are the more limited amounts of venture capital (VC) and private equity (PE) funding invested in the EU and also the lower number of IPOs, which lead to a reduced availability of capital for innovative and growing companies[8]. For example, the biggest EU VC firm was 3 times smaller than the 10th US VC firm by money raised over the last decade (2010-2019)[9].

These average EU figures also mask strong contrasts between different parts of the Union. Indeed the size of capital markets relative to GDP is quite high in the Nordic countries (around 360% in 2021), with a balanced proportion between public equity and debt securities markets. In a second group of Western European countries including France, Germany, the NL, Belgium, capital markets are smaller but still around 250% of GDP (albeit with a higher proportion of debt vs equity relative to GDP than in the first group).

Thus, although there is a margin of progression in the whole of Europe, the deficit in capital market financing is mainly concentrated in Southern European countries, with the exception of Spain, and in Central and Eastern Europe (CEE). Capital markets represent respectively 208% and 82% of GDP in these two regions and equity markets are practically inexistent in the CEE region and quite limited in Southern EU countries. In addition, the size of capital markets remained stable in CEE and Southern European countries relative to GDP over these last few years, whereas they progressed in the rest of Europe.

Another difference between the EU and the US in terms of capital markets is the much more limited size of securitisation issuance in Europe. The EU market grew to 800 Bio € in 2008, but has since constantly decreased to reach 230 Bio € at the end of 2021 despite the introduction of a reviewed framework, whereas the US market significantly grew during the same period from around 1 Tio € in 2008 to more than 3 Tio in 2021.

2.2 Capital market funding and investment remain limited in a large part of the EU

At the micro level, the structures of EU household financial assets and business funding confirm the under-development of EU capital market sources of finance.

During the 2015-2020 period, on average, EU households held 32% of their financial assets in securities directly or via investment funds compared to 51% in the US, according to figures from a recent CEPS study[10], to which should be added part of the 33% of financial assets held via insurance products and pension funds[11]. In total it can be estimated that around 55% of financial assets are held directly or indirectly in securities in the EU by households compared to more than 70% in the US[12]. The proportion of financial assets held in currency and bank deposits is also significantly higher in the EU (31%) than in the US (12%). In addition, while EU household capital market savings grew during the pandemic, they have decreased in 2022, practically going back to pre-pandemic levels (around 104% of GDP) according to recent AFME figures[13], as economic uncertainty has increased.

The situation in terms of retail investment moreover varies to a large extent across EU member states. In the Nordics and NL, securities and pension fund based assets are the largest categories of financial assets. Currency and deposits in these countries represent less than 20% of financial assets, a little over the US proportion of 12%. Whereas in many Southern European and CEE countries, bank deposits and savings accounts represent between 35 and 50% of household financial assets. The CMU indicators also show significant variations across member states in terms of % of financial assets invested in securities via investment funds and insurance products (15 to 80%)[14].

As for non-financial companies (NFCs), although it is difficult to have a fully clear and up-to-date

6. Figures from 2020 show that the EU-27 average stock market capitalisation amounted to 52% of GDP in EU-27 in 2020, compared to 116% in the UK and more than 190% in the US. In 2019 % were similar for the EU and UK, but were closer to 150% for the US.- Source World Bank database. Capitalisation represented by the outstanding listed shares issued by domestic firms.
7. The lower perceived attractiveness of the underlying firms and economies in terms of investment return also play a role.
8. Source CEPS "Time to re-energize the EU's capital markets" Nov 2022.
9. Source Banque de France "CMU: unleashing Europe's potential" Speech by F. Villeroy de Galhau Nov 30th 2021.
10. Source CEPS "Time to re-energize the EU's capital markets" Nov 2022.
11. When considering the breakdown of assets held in pension products, it appears that in the US the proportion of pension fund assets held in equity and mutual funds is higher than in most EU countries: nearly 60% of assets in the US compared to an average of 20 to 40% in the EU, the remaining part being held in bonds (20%), short term debt and real estate. Source Eurofi Regulatory Update February 2022 – Retail investment: opportunities, challenges and policy proposals.
12. This proportion is in line with the CMU indicator of 'intermediated retail investment by households' published by the Commission, which shows that around 58% of households' financial assets were held directly or indirectly in securities in 2020 in EU.
13. Source AFME CMU Key Performance Indicators 5th edition November 2022.
14. Source: CMU indicators – European Commission July 2022 – Indicator 21 Intermediated retail investment by households measuring the Sum of volumes of investment funds and claims against insurance and pension funds held by households relative to the sum of volumes of both and cash holdings and deposits.

picture of their funding situation compared to other jurisdictions from current studies, the available data shows that the capital market funding of NFCs in the EU is significantly lower than in the US and UK. An IMF report from 2019 evaluates the share of listed securities at 28% of the funding structure of EU NFCs[15] compared to 47% in the UK and 69% in the US[16]. Loans (bank and non-bank loans) represent around 35% of the financing of NFCs in the EU, according to the IMF report, compared to 20% in the US[17]. Another report from the OECD also shows that debt securities amounted to 12% of NFC debt financing in the Euro area in 2019 (the rest being loans) whereas this share is of 65% in the US. A further indicator is the share of the EU in the global equity market capitalisation of listed shares which accounted for 10% of the world's total in 2022, down from 18% in 2000[18] and below its share of the world GDP (16%).

This relatively low level of capital market funding of NFCs in the EU is due to a combination of supply and demand factors including the complexity and cost of listing, the current taxation bias in favour of debt and also the lack of appetite of entrepreneurs for listing due to the potential impacts on the governance of their firm. Indeed while it is estimated that the equity funding gap in Europe among NFCs amounts to € 300-600 billion[19], the CMU indicators published by the EU Commission in July 2022 show that on average only 11% of SMEs consider that equity funding is relevant for them, with a few exceptions such as Sweden, where this figure reaches 50%. In addition there are practically no SMEs declaring that they need equity and that equity is not accessible to them in 2021, except in a certain number of CEE countries[20].

Capital market funding is moreover impacted by the underlying economic situation and the volatility of markets. AFME statistics show that the funding of NFCs derived from capital market sources grew to 14.1% in 2021 from 11.3% in 2019[21], but has decreased in H1 2022 to 9.4% with the lowest share since 2012. The increase in 2021 is due in part to a higher number of IPOs and greater PE / VC investments in 2021[22], which have now tended to decrease due to higher economic uncertainty and market volatility.

In conclusion, while EU capital markets are generally under-sized compared to some other world economies relative to GDP, the situation differs significantly across the EU with two main groups of countries: the Northern and Western European countries[23] that represent around 60% of the EU's GDP, where capital markets are relatively developed and continue to grow, and the CEE and most of the Southern European countries where they are significantly under-developed or practically non-existent and tend to stagnate.

2.3 EU capital markets are still fragmented, despite harmonised regulation, limiting their liquidity and depth

In addition, there is a persistent fragmentation of EU capital markets, despite the efforts made to harmonize rules and integrate markets with the implementation of EU securities legislations such as MiFID, EMIR and CSDR, and TARGET2Securities harmonisation efforts[24]. This fragmentation reduces the liquidity and depth of EU capital markets and leads to differences in the cost of capital and access to capital market instruments across the Union. Combined with the under-development of capital markets in the EU, fragmentation raises financing costs for issuers and reduces the cost-efficiency of risk and capital allocation for market participants, as well as potential long term return for investors, in comparison to other markets at the global level.

A first indicator of fragmentation is the high level of home bias in equity and debt detention in the EU. Figures from the July 2022 CMU indicators published by the Commission show a home bias[25] – *i.e.* a detention of domestic assets – of 85% at EU level for equities (down from 90% in 2015) and 69% for debt (stable). For equities, the home bias ranges between 75% and 95% across member states but is more variable for debt (from 30 to 95%).

15. To which should be added around 35% of unlisted securities compared to about 15% in the US.
16. Source IMF staff discussion note "A Capital Market Union for Europe" September 2019.
17. The market funding ratio of the European Commission CMI indicators (July 2022) – indicator 1 – evaluates that around 50% of NFC funding comes from corporate bonds and listed shares in 2020 with significant divergence across member states (10 to 60%). This indicator focuses on listed shares and corporate bonds relative to bank loans, leaving out non-listed shares and non-bank loans.
18. Source AFME CMU KPI 2022.
19. See Eurofi Financial Forum Prague Summary September 2022 – Listing Act and DEBRA: prospects for equity markets.
20. Source: CMU indicators – European Commission July 2022 Indicators 13 SME use of equity and indicator 14 SME equity financing gap.
21. AFME CMU KPI 5th edition November 2022. This indicator quantifies the proportion of total finance for NFCs which is provided by equity and bond issuance as a percentage of the total funding received by NFCs (*i.e.* new loans plus equity and bond issuance).
22. An increase of equity holdings by insurers was also observed during that period.
23. the Nordics, France, Germany, NL, Belgium, Spain.
24. See Eurofi Summary High Level Seminar 2021 Lisbon. The ECB's high-level indicators suggest that in quantitative terms the increase of cross-border transactions in the EU has not been significant over the last few years. T2S cross-CSD settlement data as a proxy seems to be stagnating at around 3% of T2S's total turnover recently. Data on CSD links shows a similar picture to general ECB security settlements. Holdings via CSD links seem stable at around 21% of securities outstanding with no increase since the Central Securities Depositories Regulation's (CSDR) introduction or the T2S go-live. When looking at the cross-border issuance of securities, quantitative data from the eligible asset database suggests that securities' cross-border issuance across national CSDs is stable at relatively low absolute levels.
25. The home bias indicator included in the CMU indicator toolkit represents the share of domestic investment relative to the EU investment *i.e.* the difference between the actual and the optimal share of foreign equity in EU investors' portfolios under assumption of perfect integration.

A second indicator is the cross-border distribution of investment funds. Although the number of UCITS available for sale to retail investors in at least 2 member states is increasing in the EU[26], a report of February 2022 from the European Court of Auditors (ECA)[27] on the investment fund single market showed that funds are mainly distributed in their domestic market, even if they are registered as cross-border. Nearly 70% of funds held in the EU continue to be focused on domestic markets and are sold by domestic asset managers. Part of these are "round-trip" funds which are notified for cross-border marketing but are only sold domestically, making the actual cross-border marketing of funds more limited that notification figures may suggest.

A third indicator is the fragmentation across national lines of the EU trading and post-trading infrastructure. The EU counts 27 national stock exchanges plus some regional exchanges, 17 CCPs and more than 30 CSDs compared to 2 to 5 main players of each category in the US, and although some consolidation is driven by the main trading and post-trading infrastructure groups in the EU, the underlying markets remain separate to a large extent with differing rules, order books, etc. This having been said the 4 main exchanges (Nasdaq Stockholm, Deutsche Börse, Euronext Paris and Amsterdam) represented nearly 70% of EU market capitalisation and more than 60% of the capital raised through IPOs in 2021, showing a significant level of concentration of European markets in some key financial centres. The clearing market particularly for government debt and derivatives is also relatively concentrated in a few CCPs.

As part of its CMU KPIs AFME[28] also monitors the level of integration of EU capital markets in a holistic way taking into account different factors including the cross-border issuance and holdings of debt and equity, FX trading volumes and cross-border PE investment and M&As. This composite indicator shows that intra-EU integration of capital markets has stagnated over the last few years. The level of integration is relatively low (with cross-border volumes lower than 25%) for all criteria except the cross-border issuance of debt, which is above 90%.

2.4. The competitiveness of EU capital markets also shows significant potential for improvement

An additional element to consider is the competitiveness of the EU capital market ecosystem. This is an important factor for retaining investments in the EU and also attracting investments from outside the EU. Competitive markets indeed facilitate the cost-efficient allocation of risk and capital by market participants and reduce the cost of access to capital.

Competitiveness is driven by several elements including: the availability of local pools of capital; market liquidity[29]; and the ease of access of local NFCs to capital (public markets and PE/VC capital).

Based on these criteria and also taking into account the level of digitalisation of EU capital market ecosystems and their capacity to support new trends such as the green transition, AFME has elaborated a composite indicator that shows that the overall competitiveness of EU capital markets has slightly improved over the last few years (2018-2022), but it remains significantly lower than the US and UK. The largest gaps with the US are in terms of availability of pools of capital (notably the amount of household savings invested in capital market instruments and pension funds) and access of NFCs to capital market finance, while with the UK, the key difference is in terms of market liquidity, due in particular to the role currently played by the UK as a global hub for derivative and FX markets[30]. AFME data also suggests that EU corporate bonds are less liquid than US ones *e.g.* with less daily trades.

In terms of market liquidity, the situation appears to be generally stable in the EU over the last few years, according to the data available. While a significant part of the trading activity on EU equities, particularly on-venue, has shifted to the EU following Brexit and the implementation of the EU share trading obligation, the impact on liquidity for the overall European equity ecosystem (EU, UK, Switzerland) of these evolutions is "non-conclusive" according to AFME assessments, due to the current fragmentation of the EU trading market across venues and jurisdictions[31]. The liquidity of government bond markets has also decreased over the last few years for the main EU member states[32].

26. Source European Commission CMU indicators – July 2022 – Indicator 30: cross-border UCITS measuring the number of UCITS available for sale to retail investors in at least two member states.
27. Source ECA Report on Investment funds – EU actions have not yet created a true single market benefiting investors – February 2022.
28. Source AFME CMU Key performance indicators – Fifth edition – November 2022.
29. Liquidity refers to the efficiency or ease with which a security can be converted into ready cash without affecting its market price. One first dimension of liquidity is market depth. A market is deemed deep if there is a large flow of trades on a frequent basis with a persistent willingness to trade by market participants. A second dimension is market breadth *i.e.* the consistency with which liquidity is distributed within asset classes. A third element is tightness *i.e.* bid-ask spreads, measuring the difference between the price market participants are willing to pay and the price at which they are willing to sell, approximating the financial cost of completing a transaction.
30. According to the BIS the UK is the largest hub for FX and derivatives trading at the global level, intermediating 38% of global FX trading and 46% of global derivatives trading, which participates in the development of global liquidity pools in the UK.
31. Compared to the previous situation where significant equity volumes were traded in the UK, which is by definition a more integrated market.
32. Possibly due in part to the accommodative monetary policy used over the last few years.

For corporate bonds it is more difficult to conclude, but trading appears to be concentrated in a relatively small amount of bonds and on the first days of trading after issuance.

The CMU indicators of the European Commission confirm the stability of most liquidity indicators (market breadth, bid-ask spreads...), except for the market breadth of SME shares, which grew in 2021 probably thanks to an increase of the number of IPOs.

AFME also evaluated, as part of its CMU KPIs, the integration of EU capital markets with the rest of the world (ROW), measured by the % of cross-border issuance and holdings of debt and equity, FX trading volumes and cross-border PE investment and M&As. According to this indicator, the level of integration of the EU capital markets with the ROW has remained relatively constant over the last 20 years. Most components of the EU capital market ecosystem have a level of integration with the ROW lower than 20% except for M&A activity. Integration with the ROW is also significantly lower than the UK, which is one of the most interconnected capital markets in the world, due in particular to the large flows of FX transactions and interest rate derivatives intermediated in the UK.

3. Progress made with the CMU initiative and latest proposals

3.1 Legislative and non-legislative actions implemented in the context of the CMU initiative (2015-2020)

Following the launch of the CMU initiative, two CMU action plans including legislative and non-legislative measures were adopted successively in 2015 and 2017 and are now in force, although part of the measures are only starting to apply in the market.

The initial CMU Action Plan published in September 2015 set out 33 actions including measures to relaunch securitisation, facilitate the cross-border distribution of investment funds, optimise prudential calibrations related to capital market activities, simplify prospectuses, etc.[33] Following the mid-term review of the CMU, a new set of measures was proposed by the Commission in 2017, covering additional objectives such as the strengthening of the powers of the European Supervisory Authorities (ESAs), the development of fintech, the promotion of sustainable finance, the facilitation of SME listing, the provision a new Pan European Pension Product (PEPP) framework and support for the growth of local capital markets[34].

Despite the significant enhancement of the EU capital market legislative framework that these two action plans led to, the general feeling in 2020 among market stakeholders was that much remained to be done to further develop and integrate EU capital markets and make the CMU a reality. There was also the perception that the implementation of CMU was too slow to address rising financing needs in the EU[35]. This prompted the Commission to set up a High Level Forum group (HLF) to make proposals for relaunching the CMU.

A new set of measures, presented as potential 'game-changers' for the CMU were proposed by the HLF in 4 areas: the financing of EU businesses, market infrastructure, retail investment, the internal market. These proposals have since been integrated by the Commission in the new CMU action plan published in September 2020 and endorsed by the Council, which is currently being implemented (*see 3.2.*). The HLF also suggested a stricter monitoring of the overall CMU implementation timetable, on which progress has been made with the publication and regular update by the Commission of indicators to monitor the progress of the CMU[36]. A further proposal of the HLF was to seek an upfront tripartite institutional agreement between the Commission, the Council and the Parliament on the main components of the CMU action plan proposed. This was not achieved as such, but political support for the CMU has been demonstrated since in many European Council and Euro Summit statements, as well as in the recent op'ed article published by the Presidents of the European Council, European Commission, Eurogroup, ECB and EIB[37] referred to previously in this note.

In parallel, efforts are being made to develop local capital markets, for example through the Technical Support Instrument (TSI)[38], whereby the EU provides

33. These include measures to develop securitization and covered bonds, improve Solvency II calibrations, prospectus and investment fund rules, facilitate the cross-border distribution of funds and also some non-binding measures regarding withholding tax and insolvency proceedings.
34. The actions proposed in 2017 to support the development of local capital market ecosystems included: the provision of technical support to Member States through the Technical Support Instrument (TSI) or previously the Structural Reforms Support Programme (SRSP) and the establishment of a CMU Working Group by the Vienna initiative to promote the diversification of investment finance in the region. The Commission proposed to establish a comprehensive EU strategy in 2018 on steps that could be taken at EU level to support local and regional capital market development across the EU.
35. A first reason for this perception is that EU capital markets have not significantly grown since the launch of the CMU, as shown by the figures above, except non-bank funding through debt securities and retail investment to a certain extent during the Covid-19 crisis. Secondly, there has been frustration among many market stakeholders with the protracted implementation of the two first action plans and the lowering of the initial ambitions of certain proposals such as those concerning the ESAs' operations or securitisation, showing a disconnect with the strong political commitment to CMU expressed by the Council in particular.
36. See CMU indicators – European Commission July 2022.
37. See "Channeling Europe's savings into growth" – Op'ed article – 9 March 2023.
38. Previously known as the Structural Reform Support Programme (SRSP).

technical assistance to certain EU Member States for reforms that include the development of their capital markets. Actions are also undertaken by the IFIs[39] such as EIB, EIF, EBRD to support the development of local capital markets and SME funding in particular. A report of the European Court of Auditors (ECA) however pointed out in 2020[40] that a comprehensive strategy for the development of local markets is still missing and that the European Semester is not used to its full potential to foster capital market reforms. The TSI is demand-driven and tailor-made at the request of individual Member States and therefore leads to piecemeal action, but these actions could be the basis for more coordinated initiatives at the regional or EU level aiming to grow local markets. The work undertaken in the context of the Vienna initiative on the financing of innovation is an example of a regional initiative that may further support the development of capital markets.

3.2 Objectives and legislative measures proposed in the new CMU action plan published in November 2021

The Commission published in September 2020 a new action plan for completing the Capital Markets Union (CMU) based on the recommendations of the HLF report, which is being progressively implemented (*see detail of the proposals in the Appendix*). The objective of the Commission is that these new measures should all be adopted by the end of the current legislature in 2024[41].

This new action plan has a more specific focus on developing SME financing with the proposed Listing Act aiming to simplify listing requirements for companies wanting to raise funds on public markets and with the setting up of a European Single Access Point (ESAP) to public financial and sustainability-related information on EU companies. The further engagement of retail investors is another important objective of this action plan, with the ELTIF review facilitating access of retail investors to these funds and a Retail Investment Strategy proposal due to be published before the summer of 2023. The action plan also aims to enhance the structure and transparency of EU securities markets with the review of MiFIR[42] and the functioning of the alternative investment fund market with the AIFMD review. It moreover sets out stronger ambitions than the previous action plans for EU capital market integration, addressing in particular the fragmentation of insolvency regimes, albeit in a targeted way.

There is also the objective with this new action plan of correcting some existing measures with the improvement of instruments that have not delivered all the benefits expected in the previous stages of the CMU, such as ELTIF funds, a review of insurance[43] and banking prudential requirements[44] impacting long term investment and the Listing regime completing previous measures to facilitate SME listing. Non-legislative tools are also being developed to improve pension provision and retirement savings in the EU (pension auto-enrolment, pension dashboards and best practices for the enhancement of pension systems)[45].

The Commission has moreover made proposals to strengthen EU capital market infrastructures with the review the Central Securities Depositories Regulation (CSDR) in March 2022 aiming to increase the efficiency and safety of securities settlement in the EU[46], followed by proposals to strengthen EU central clearing in the Union published in December 2022. Finally the Commission has proposed with the Debt-Equity Bias Reduction Allowance (DEBRA) a new mechanism aiming to rebalance the costs of debt and equity financing for non-financial corporations[47], in order to achieve higher equitisation levels and discourage excessive debt accumulation[48].

39. International financial institutions.
40. ECA Special report – CMU slow start towards an ambitious goal November – 2020.
41. For an update on the proposals made see for example Keynote speech by Commissioner McGuinness at AFME – 17 November 2022.
42. Proposals include the implementation of a consolidated tape, the restriction of payment for order flow and dark trading, measures targeting systematic internalisers, the improvement of transparency measures.
43. As part of the review of Solvency II, the Commission has made proposals to amend the insurance legal framework in order to further promote long-term investment by insurance companies, without harming financial stability and policy holder protection. These proposals concern notably the appropriateness of the eligibility criteria for the long-term equity asset class, the risk margin calculation, and the valuation of insurers' liabilities, with the aim of both avoiding undue pro-cyclical behaviours and better reflecting the long-term nature of the insurance business.
44. In the context of the CRR/CRD review, the Commission moreover made proposals in terms of prudential treatment for banks aiming to avoid undue impacts from the implementation of Basel III on long-term SME equity investments by banks and on banks' and investment firms' market-making activity.
45. A first step was the publication in November 2021 of a report on best practices in the area of pension auto-enrolment, which is a mechanism that automatically enrolls individuals into a supplementary retirement savings scheme unless they explicitly opt-out, in order to ensure more adequate retirement income. In addition, the Commission is working on the development of pension dashboards aiming to support Member States in the improvement of their pension systems and on the identification of best practices for the implementation of individual pension tracking systems at domestic level, aiming to provide citizens with an overview of their future retirement income.
46. The CSDR review proposal aims to facilitate the cross-border provision of CSD services and improve certain requirements notably by simplifying the CSD passporting regime and improving the settlement discipline regime.
47. The proposed mechanism combines a tax allowance on new equity with a limitation of interest expense deductibility.
48. The combination of a tax allowance on new equity with a limitation of the deductibility of interest expenses to a period of 10 years also aims to limit the budgetary impact of this measure for member states' budgets. Under DEBRA, a notional interest rate allowance would be granted on new equity for a period of 10 years, based on the yearto-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 currencyspecific 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%.

However this proposal is still at a standstill following the temporary suspension of negotiations on the proposal by the Council in December 2022.

4. Questions and priorities for the future stages of the CMU

The CMU has been built as a long term initiative addressing a broad range of drivers for the development and further integration of EU capital markets in terms of supply, demand and infrastructure. A step-by-step and iterative approach has been adopted for its implementation in the continuation of efforts undertaken over the last 20 years to harmonise the European capital market regulatory framework[49].

While significant progress is being made in the improvement of the EU legislative framework applying to securities markets with the implementation of the successive CMU action plans, many stakeholders consider that the CMU is moving too slowly in the achievement of its objectives and that effective progress in the market is still limited. The slow pace of the CMU has recently been pointed out in the op'ed article published in March 2023 by the Presidents of the European Council, European Commission, Eurogroup, ECB and EIB who stated that 'Europe has been too slow for too long in building the CMU'. Many stakeholders from the financial industry and the authorities have also suggested on the occasion of panel discussions organized by Eurofi in recent years that CMU should be streamlined going forward and refocused on a more restricted number of essential areas or objectives around which a stronger dynamic may be built. Some also consider that the focus put on further harmonising and integrating capital markets inferred by the concept of building a 'union' and recently reaffirmed in the op'ed article[50] is misguided to a certain extent, because according to them the main problem of EU capital markets is their small size and lack of depth and liquidity and not their level of integration which has progressed, notably thanks to common regulation[51].

Identifying the key priorities to focus on in the short and longer term to develop EU capital markets remains challenging however, given the breadth of potential issues to address and the magnitude of the gap in terms of capital market finance compared to other jurisdictions, particularly in certain parts of the EU.

Some stakeholders suggest that the further development of wholesale markets should be given the priority in Europe because it is those markets that drive the growth and liquidity of capital markets, from which retail customers may eventually benefit and because EU wholesale markets are already much more integrated than retail ones. The importance of enhancing the competitiveness of EU capital markets and their attractiveness to EU and non-EU investors and of fully connecting EU markets to the global ecosystem[52] and to international capital pools is also often emphasized in this context in order to increase trading and investment volumes in the EU[53]. This would involve in particular prioritizing the further harmonization of legal and fiscal rules, the rationalisation of market structure and data provision and the further unification of supervision at the EU level.

Others argue that the development of EU capital markets should focus first on key economic priorities of the Union, such as the funding of SMEs and the growth of retail investment, which would eventually contribute to the well-functioning and liquidity of the overall market including wholesale markets (*e.g.* through retail investments in pension funds or insurance-based products)[54]. The importance of sustainable investment for driving capital markets is also frequently pointed out, as well as the need to develop private pensions with the ageing of the population[55].

A further idea regularly expressed is that capital markets cannot be developed in isolation in the EU, due to the current importance of bank financing, and that there is a need to build synergies and complementarities between the different components of finance (*i.e.* capital markets, banking, insurance, pension funds etc. and also public funding). This means understanding how each type of financing

49. These initiatives include the Financial Services Action Plan action plan for a single financial market (FSAP) in particular which put forward measures for establishing a single market in wholesale financial services, making retail markets open and secure and strengthening the rules on prudential supervision, which was followed by the implementation of key EU capital market frameworks such as MiFID, EMIR, CSDR and also the AIFMD directive and ELTIF regulation, the reviews of which are mostly incorporated in the current CMU initiative.
50. See op'ed article 9 March 2023. "The EU has already taken some decisive steps in creating a Single Market for capital. Still, we need to step up our efforts and our ambitions to remove remaining barriers to cross-border finance and allow for deeper harmonisation. This includes more aligned insolvency laws, more easily accessible financial information, simplified access to capital markets, particularly for smaller companies, robust market infrastructures, and more integrated capital markets supervision".
51. See for example Eurofi Views Magazine April 2023, From Capital Markets Union to Capital Markets Growth, R. Buenaventura.
52. *e.g.* in the clearing space.
53. Several actions in the latest CMU action plans published by the Commission may support this objective, including measures to improve the time to market of new product launches (*e.g.* in the clearing space), increase market transparency or the visibility of EU businesses such as the European Single Access Point (ESAP) or reduce disincentives to trading on EU markets (*e.g.* amending certain trading obligation rules).
54. See Eurofi Financial Forum Prague Summary – September 2022 – CMU: what can be done in this political cycle?
55. These latter objectives however face challenging issues such as the need to define effective sustainable finance guidelines and the importance of national prerogatives in the pension space.

may best contribute to the funding of different types of companies at different stages of development and tackling potential gaps (*e.g.* regarding innovative companies, scale-ups etc.). This also requires ensuring that rules applying to different financial activities do not disincentivize capital market financing – considering for example the impact of prudential rules on the role of banks as providers of liquidity and insurers as investors – and enhancing supervisory convergence within and across financial sectors.

Another debate is whether CMU-related legislations sufficiently emphasize the objective of developing long term investment – *i.e.* investment on the basis of the fundamental value and expected cash flows of assets – as opposed to shorter term investment focusing more on changes in market price[56]. Some observers consider that the real-time consolidated tape proposal for example, which is one of the main points of the MiFIR review may support more the latter objective.

The different CMU action plans set out since 2015 cover the main areas and drivers mentioned above to a large extent. A question going forward however, is whether the CMU should focus more on certain of these priorities to make decisive progress more quickly in terms of capital market growth and preserve the momentum of the CMU initiative. A second question is whether more specific actions would be needed to support adequately key strategic objectives of the EU such as the green and digital transitions and the EU open strategic autonomy agenda, in order to better materialize the added value of CMU, in a context where bank financing and public investment will be insufficient to support these objectives. A further question is whether CMU actions should not be more differentiated for Member States where capital markets are less developed and where the first objective may be to support and coordinate efforts to develop local markets, building on the existing TSI actions and those undertaken by the IFIs[57].

Appendix: Measures proposed following the September 2020 action plan

Legislative proposals published in November 2021

In November 2021, the Commission published **a first set of four legislative proposals** for implementing the September 2020 action plan, which are currently being reviewed by the co-legislators[58].

- **Setting up of a European Single Access Point (ESAP)** to public financial and sustainability-related information on EU companies and financial products in a digitally useable format
  - The ESAP will build on existing information channels and be developed, operated and governed by ESMA. Its objective is to make SMEs in particular more easily accessible and visible to both EU and international investors such as business angels, venture capital and private equity funds.
  - The Council agreed its common approach on the proposal in June 2022 and the ECON Committee report on the ESAP proposal was published at the end of 2022 opening the way for the start of the trilogues.
- **Improving the European Long Term Investment Funds (ELTIF) framework** in order to channel long-term financing to SMEs and long term infrastructure projects by making it easier for asset managers to operate and market ELTIFs and facilitating access to ELTIF funds for retail investors in particular, while maintaining high investor protection standards.
  - The ELTIF review proposes a broadening of the scope of eligible assets and investments and a reduction of certain fund rule limitations to allow fund managers to benefit from greater flexibility in the design of ELTIF investment strategies and portfolio compositions. A reduction of the investment threshold and the introduction of an additional liquidity window redemption mechanism were also proposed for retail investors.
  - The Council adopted its General Approach on 20 May 2022. The ECON Committee report was voted in June 2022 with a provisional agreement reached in October 2022. ELTIF should come into force at the beginning of 2023 now that the co-legislators have reached an agreement.

56. See for example ECMI policy brief n°33 How to make CMU work January 2023, which suggests that the latter approach focusing more on changes in market price (momentum investment) may be to a certain extent disconnected from underlying asset values and proposes introducing a minimum proportion of investment on the basis of expected cash flow within professionally managed portfolios as a condition of cross-border access to the European capital market.
57. Indeed many of the CMU actions may only have a limited impact in the member states where capital markets are very limited and where a first objective may be to develop multi-source financing combining capital market financing together with more traditional financing sources such as bank and public financing (possibly supported by NGEU). TSI: The Technical Support Instrument is the EU programme that provides tailor-made technical expertise to EU Member States to design and implement reforms. European IFI (International Financial Institutions) include the EIB, EIF and EBRD.
58. See for example Clifford Chance EU Capital Markets Union: an overview of key developments in 2022 – July 2022.

- **Enhancing the Alternative Investment Fund Managers Directive (AIFMD)** in order to better integrate the EU Alternative Investment Funds (AIFs) market, improve companies' access to diversified forms of financing, strengthen investor protection and enhance the ability of fund managers to deal with liquidity pressure in stressed market conditions.
  - The changes proposed include: the introduction of common minimal rules regarding loan-originating funds[59]; a harmonisation of liquidity management tools (LMT); a clarification of the rules on portfolio management delegation; measures to facilitate the use of depositaries on a cross-border basis[60]; and measures to remove reporting duplications and to facilitate access to relevant data by national and EU authorities. In addition the UCITS directive will be updated to reflect the changes made to the AIFMD where necessary[61].
  - The draft report of the ECON Committee was tabled in May 2022, and the vote is scheduled in Committee on 30 November 2022. The Council agreed on its general approach in June 2022
- **Reviewing the MiFIR regulation** in order to improve transparency and the availability of market data, improve the level playing field between execution venues and ensure that EU market infrastructures can remain competitive at international level.
  - The MiFIR review proposes the introduction of an EU-wide consolidated tape for shares, bonds, exchange-traded funds (ETFs) and derivatives based on close to real-time data and covering all trading venues aiming to improve the overall price transparency and provide investors with easier access to trading data. Secondly, a restriction is proposed on payment for order flow[62], as well as clarifications of the limitations on dark trading, reviewing current volume caps, waiver and deferral rules. Obligations for systematic internalisers relating to the publication of firm quotes and the matching at midpoint are also reviewed. Other proposals include the removal of the open access obligation for exchange traded derivatives[63] and an adjustment of the scope of EU share and derivative trading obligations[64] and aligning trading and clearing obligations for derivatives in order to increase the competitiveness of EU financial markets.
  - The draft report of the ECON Committee was presented in Committee on 19 July 2022 and the vote in Committee is scheduled on 31 January 2023. The Council reached a general approach on the MiFIR review in December 2022 on which negotiations with the EU Parliament can start.

Additional proposals published in December 2022

The Commission published in December 2022 an additional package of three legislative proposals for consolidating the CMU, building on the September 2020 action plan.

- **A Listing Act** aiming to simplify listing requirements for companies, particularly SMEs, wanting to raise funds on public markets by cutting unnecessary red tape and costs. The proposed amendments include: (i) the simplification of the documentation that companies need to produce and the streamlining of the scrutiny processes by national supervisors; (ii) a simplification and clarification of certain market abuse requirements; (iii) measures to encourage the production of more investment research, particularly for SMEs; and (iv) the creation of multiple vote share structures allowing the founders to retain sufficient control of their company after listing, while protecting the rights of the other shareholders.
- **An initiative on corporate insolvency** aiming to reduce fragmentation and make rules regarding value recovery more predictable for creditors. Proposals include (i) the harmonisation of specific aspects of insolvency proceedings across the EU[65]; (ii) the introduction of a simplified regime for winding down micro-enterprises; and (iii) the requirement for Member States to produce an information factsheet on the key elements of their national insolvency laws in order to facilitate decisions by cross-border investors.

59. *i.e.* the direct lending by AIFs to companies. These rules will allowing them to operate cross-border and addressing potential risks related to this type of lending.
60. The possibility for National Competent Authorities to allow AIFs to appoint a depositary situated in another Member State; measures to allow depositaries to obtain the necessary information for their oversight duties when fund assets are safekept by a CSD.
61. For instance on LMTs, delegation and reporting.
62. Whereby retail brokers forward the orders from their clients to a limited number of traders in exchange for compensation.
63. In order to improve legal certainty and suppress disincentives for exchanges to create innovative financial products. Open access provisions for exchange-traded derivatives indeed reduce the attractiveness for exchanges to invest in new products as competitors may be able to get access without the upfront investment, according to the Commission.
64. The proposal would refine the perimeter of the share trading obligation (STO), which requires that the majority of trading in shares takes place on trading venues or systematic internalisers, to clearly limit it to EEA ISINs. This would clarify that the exemption to the STO for shares which are infrequent, irregular or ad hoc applies to EEA shares. In addition the proposal would introduce a possibility to suspend the derivatives trading obligation (DTO) for certain investment firms that would be subject to overlapping obligations when interacting with non-EU counterparties on non-EU platforms.
65. For example concerning rules on the preservation of the insolvency estate, creditors' committees to ensure a fair distribution of recovered value among creditors, so-called "pre-pack" proceedings and the duty on directors to timely file for insolvency.

- **Proposals to strengthen European clearing** including measures to (i) simplify procedures for the launching of new products and the changing of risk models by introducing a non-objection approval for changes that do not increase risks for CCPs; (ii) enhance the framework for clearing commodity derivatives by requiring margin models to be more transparent, improving CCP participation requirements to be met by corporates and broadening CCP eligible collateral; and (iii) require market participants subject to a clearing obligation to clear a portion of products deemed of substantial systemic importance through active accounts at EU CCPs.

Proposals planned for H12023

Further proposals are due to be published during the first semester of 2023, covering other aspects of the September 2020 CMU action plan:

- **A Retail Investment Strategy is due to be published in H12023** following assessments conducted in 2021 and 2022 on the key issues to tackle with regard to retail investment[66]. This proposal is expected to focus more specifically on how financial products are distributed and the handling of inducements, on financial advisors and how suitability and appropriateness assessments are conducted and on the information that investors receive, particularly in a digital environment.
- **An Open Finance framework** aiming to allow data to be shared and re-used by financial institutions for the creation of new services[67] in different sectors of finance including capital markets. This proposal intends to provide a level playing field for existing and new entrants and will build on the work undertaken in the context of the upcoming Data Act and the on-going evaluation of the Payment Services Directive II (PSD II). In addition, the Commission will propose a supervisory data strategy to improve data standardisation and sharing in order to enable supervisors to efficiently collect and use the data they need to perform their tasks, which involves a modernisation of EU supervisory reporting.

The publication of proposals concerning withholding tax procedures and securisation had been anticipated, but it is unlikely that these will be proposed in the coming months:

- **A targeted legislative proposal regarding with-holding tax procedures** which hinder cross-border investment with late refunds and high costs.
- **A way forward on securitisation** on the basis of input from the ESAs. A report was published by the Commission in 2022 on how the securitisation regulation is working that concluded that the regulation generally works well, but that targeted improvements should be made, notably on the proportionality of certain requirements.

66. A consultation was conducted by the Commission between May and August 2021 aiming to identify the main issues to tackle in the Retail Investment Strategy and the MiFID II, IDD and PRIIPs reviews with regard to retail investment. More focused assessments were conducted in 2022 by the Commission and the ESAs on suitability and appropriateness assessments, disclosures, inducements, product complexity and digital channels.

67. Provided that customers agree to it and subject to data protection rules and clear security safeguards.

Strengthening EU clearing: key issues and way forward proposed

Note written by by Marc Truchet, Eurofi

1. Central clearing has grown in significance since the 2008 financial crisis

Central counterparties (CCPs) have become key components of efficient and stable capital markets. They play a major role in the stability and safety of highly interconnected capital market ecosystems, allowing a centralised netting of risk exposures and a reduction of counterparty risk[1] and also improving the visibility on position concentrations and counterparty credit risk exposures. CCPs also help the financial ecosystem to withstand potential market stresses and economic shocks by mitigating contagion risks and facilitating a more effective hedging of risks. CCPs moreover provide significant efficiency benefits, thanks to the netting of risk exposures and the possibility of using collateral for the clearing of different operations, which are amplified by scale and network effects[2]. CCPs also allow counterparties to maintain a single net exposure to the CCP instead of a complex network of bilateral exposures to individual counterparties.

The role of central clearing has grown significantly with the implementation of the G20 2009 commitments set out following the 2008 financial crisis, which mandated the central clearing of all standardised OTC derivative contracts in order to increase transparency in the OTC derivative market and mitigate the systemic risks generated by these transactions. Between 2008 and 2020, the share of derivative contracts that were centrally cleared rose from 50% to 83% and reached 91% for certain asset classes such as interest rate derivatives (IRD)[3].

In parallel derivative markets have also grown significantly over the last two decades. The global aggregate size of the over-the-counter (OTC) and exchange-traded derivatives (ETD) markets grew from € 78 trillion to € 528 trillion between 1998 and 2020, in terms of notional amounts outstanding. The OTC segment accounts for 90% of that, of which interest rate derivatives (IRD) make up the vast majority (80%).

The mandatory clearing of standardized OTC derivative contracts was implemented in the EU through the EMIR regulation adopted in 2012, which also regulates more broadly the operations of CCPs. The financial stability risks from the possible failure of a CCP, in a context of a growing importance of these infrastructures in the financial system, were also tackled with the CCP recovery and resolution regulation and an enhancement of supervision.

2. Key challenges and areas of improvement concerning central clearing in the EU

CCPs based in the EU and the UK have demonstrated their continued resilience over the last few years, notably during the stress events of 2020 and 2022. However the issues created by Brexit and margin procyclicality remain to be fully tacked and new challenges are emerging in the clearing space.

2.1 Reliance of the EU on UK-based central clearing for euro-denominated derivatives

The reliance of the EU27 on UK-based CCPs handling a significant part of euro-denominated derivatives[4], became a subject of heated debate between the EU and UK, following the decision of the UK to leave the EU. UK-based CCPs indeed play a key role in the clearing of euro-denominated derivative contracts (and also derivatives denominated in other currencies such as the dollar). In the first half of 2021 for example, 91% of all euro-denominated interest-rate swaps (IRS) trades were cleared in the UK[5]. Following Brexit, a temporary recognition was granted to UK-based CCPs (LCH, ICE and LME) due to their importance for the EU financial system. It was extended in 2022 until the end of June 2025.

1. The use of derivatives involves the posting of margin – typically in the form of cash collateral – as a performance guarantee. CCPs guarantee the performance of transactions and contracts by interposing themselves between the parties to a trade through the legal operation of novation, collecting guarantees and becoming the buyer to every seller and the seller to every buyer.
2. Due to network effects, the more users join a CCP, the more value each of them derives from its service in theory. A larger number of users increases netting benefits, increases risk diversification potential and the possibility of using portfolios of collateral for the clearing of various obligations and also reduces transactional and operational costs due to economies of scale.
3. See CEPS 2021, "Setting EU CCP policy – much more than meets the eyes.
4. More than 30% of all OTC derivatives are denominated in euro and other Union currencies.
5. See Capital Markets Law Journal 2023, "CCP supervision after Brexit: from extraterritoriality to a model of shared control". IRS are the largest component of the IRD market. UK-based CCPs also clear about 97% of notional US dollar IRD.

The EU authorities emphasize the potential financial stability risks for the EU posed by the large amounts of euro-denominated contracts cleared in the UK and the possible implications this may have in terms of conduct and transmission of the EU's monetary policy. Although this issue may be addressed to a certain extent by aligned standards and close supervisory cooperation in normal market conditions[6], the EU authorities are concerned by the difficulty for EU regulators and supervisors of handling appropriately financial stability risks for the EU in a crisis situation, with such exposures and with detailed requirements potentially diverging over time. As noted by ESMA[7], in times of crisis, changes to the eligible collateral, margins or haircuts decided by the CCP or the UK authorities may negatively impact the sovereign bond markets of one or more Member States, and more broadly EU financial stability, if they do not fully take into account EU needs. Disruptions in key markets relevant for EU central banks' monetary policies may also hamper the transmission mechanism of those policies. The objective of building a robust and competitive clearing capacity in the EU that remains open to global financial markets via equivalence decisions[8] has therefore been highlighted as an important objective of the EU open strategic autonomy agenda.

For their part, the UK authorities have been stressing the fact that derivative markets are cross-border by nature and the financial stability benefits of cross-border clearing. In their view, resilient cross-border CCPs, such as those established in the UK, support a wider netting of positions across counterparties, currencies and products, leading to a significant diversification of risks and also greater efficiency through economies of scope and scale, which may increase incentives to hedge risks. The UK also considers that after having on-shored the EU clearing legislation and having aligned resolution rules with FSB guidance, UK-based CCPs follow equivalent standards to EU-based ones that can be enforced through close cooperation between the EU and UK authorities. Changes have also recently been made to the statutory objectives of the Bank of England in terms of regulation to ensure that the impacts of the UK's decisions on financial stability in other jurisdictions are adequately taken into account.

2.2 Margin procyclicality issues

The procyclical effects of margin requirements and the possible spill-over of risks to the wider financial system are a second issue that is currently being reviewed by the EU authorities and global standard setters.

An increase of margin requirements in stressed market conditions may indeed lead to a higher demand for cash collateral, amplifying liquidity and volatility issues in other parts of the financial system. For example, some observers consider that the increase in haircuts that was applied to certain government bonds in cleared repo transactions during the most acute phases of the sovereign debt crisis of 2011 increased tensions on these sovereign debt markets[9]. Some studies have also suggested that the increase in variation margins on derivative contracts held by euro area insurance companies and pension funds at the outset of the Covid crisis contributed to significant outflows from euro-denominated money market funds (MMFs) used as sources of liquidity by these firms[10]. During that period, margin increases on the derivative positions held by investment funds amplified the liquidity issues that these funds were already facing due to significant redemptions, leading to sales of securities that had adverse impacts on the underlying markets[11].

EMIR includes a certain number of measures that aim to mitigate the effects of margin procyclicality (requirement for CCPs to monitor regularly the level of margins according to market conditions, anti-procyclicality (APC) margin measures…). These measures helped to alleviate the effects of recent market stresses, but also showed some limitations in terms of their level of granularity and the consistency of their implementation across the EU. An initiative was launched in 2022 by ESMA aiming to fine-tune these tools and improve their consistency. Work is also underway at the international level led by CPMI-IOSCO and the BCBS to review margining practices, following an assessment by the FSB of the March 2020 market turmoil.

6. A number of initiatives have been implemented to address the mismatch between the international dimension of derivative clearing and a supervisory approach that remains essentially local: on the regulatory front, with the PFMI (Principles for financial market infrastructures) international standards and on the supervisory front with the creation of global supervisory colleges.

7. See ESMA report of December 2021 – Assessment report under Article 25(2c) of EMIR.

8. The Commission has adopted CCP equivalence decisions for more than 20 jurisdictions and concerning more than 40 third-country CCPs – Source European Commission Communication – A path towards a stronger EU clearing system – 7 Dec 2022.

9. See "Repurchase agreements and systemic risk in the European sovereign debt market" HAL, 18 February 2020.

10. Together with bank deposits, repo agreements etc. See "Interconnectedness of derivatives markets and MMFs through insurance corporations and pension funds", ECB Financial Stability Review, November 2020.

11. See "The impact of derivatives collateralization on liquidity risk: evidence from the investment fund sector", ECB Working Paper Series N°2756 December 2022. Liquidity risk manifested itself in the March 2020 coronavirus related market turmoil, when market volatility and margin calls rose dramatically, including for non-bank financial intermediaries. Facing liquidity squeeze from both margin calls and redemptions, euro area investment funds sold securities worth almost € 300 billion in the first quarter of 2020, which amplified the adverse market dynamics. The report also notes that despite this episode and an increasing collateralization in derivative markets, investment funds' holdings of liquid assets continued to decline after March 2020 and reached the lowest level since 2013 at the end of 2020.

2.3 Challenges from energy and commodity derivative markets

Some challenges from energy and commodity derivative markets were brought to the forefront with the energy crisis triggered by the Russian invasion of Ukraine.

Commodity derivatives allow firms of the energy sector such as energy producers, suppliers and distributors to manage risks of volatile prices and offer long-term fixed price contracts to customers. Most of the trading in energy derivatives is conducted on regulated (futures) markets and is centrally cleared via CCPs established in the EU and regulated under EMIR[12]. In most cases, energy companies access CCPs via a clearing member, but some large energy companies access CCPs directly.

With the sharp rise in gas and electricity prices initiated in 2022, EU energy companies have been exposed to substantial margin increases and liquidity pressures. They have been required to post higher amounts of cash collateral to CCPs, as margin calls have risen in line with prices in order to guarantee the performance of derivative contracts, resulting in liquidity strains for these companies. ESMA's assessments also showed that in certain markets these liquidity issues led some energy companies to reduce hedging activities, potentially increasing risks in the market[13]. This prompted calls to review the rules governing margin requirements in the energy derivative markets and also for energy companies to enhance liquidity management in order to be in a position to meet margin calls in stressed conditions[14].

The impact of a possible energy price cap or market correction mechanism on CCP clearing is a further issue that is being assessed. A mechanism impacting price formation may indeed have negative implications for the energy futures market in terms of margin requirements and liquidity, according to some market stakeholders, potentially increasing risks in the market.

2.4 Emerging trends related to technology and climate change

Some new trends and impacts from technology and climate change are also emerging in the clearing space.

New technologies such as blockchain and artificial intelligence (AI) create potential opportunities and challenges for central clearing. First, the technologies underlying crypto and decentralised finance (DeFi) – *i.e.* blockchain, smart contracts, tokenisation… – and AI have the potential to improve significantly the efficiency and risk management of clearing activities *e.g.* with mechanisms allowing an immediate settlement of transactions or an automatic liquidation of positions, allowing a reduction of counterparty risk. These technologies could eventually change the value chain and the way clearing services are provided *e.g.* potentially integrating clearing with the trading and settlement layers or even doing away with the central counterparty function. The potential impacts of these evolutions in terms of price formation and of the ability of financial markets to absorb supply or demand shocks will however need considering in particular[15]. Cyber-risks, which may increase with more digitalisation of clearing activities, are another issue that is due to be addressed with the implementation of the Digital Operational Risk Act (DORA). Blockchain technology moreover supports the creation of new assets such as cryptoassets, related derivatives and tokenised assets, the clearing of which may produce new challenges for CCPs and their supervisors due to risk profiles that differ quite significantly from traditional financial instruments.

Climate change is a second trend that may impact CCPs in different ways over time. First in terms of physical risk to the operations of CCPs, their counterparties and service providers. Secondly in terms of the availability and adequacy of collateral. Thirdly, climate change could make it harder for CCPs to appropriately calibrate their risk models and identify possible future stress scenarios in a context where most models have a backward-looking approach to risk calibration based on historical data.

3. EMIR 2.2 review and assessment of third-country CCP risks

3.1 EMIR 2.2. review: changes for third-country and EU CCPs (2019)

A review of EMIR (EMIR 2.2) was adopted in 2019, focusing mainly on addressing the risks from the exposure of the EU to UK-based CCPs, following Brexit. EMIR 2.2 established a dedicated CCP Supervisory Committee (SC) within ESMA[16] in charge of supervising third-country CCPs (TC CCPs) that

12. See European Commission: Letter from DG FISMA to ESMA September 2022 – Response to the current level of margins and of excessive volatility in energy derivatives market.
13. See ESMA's response regarding the current level of margins and of excessive volatility in energy derivatives markets 22 September 2022.
14. In addition emergency measures were put in place in some Member States to alleviate market stress such as public guarantee schemes.
15. See "The future of clearing" Focus of the World Federation of Exchanges by Klaus Löber June 2022.
16. The CCP SC is composed of three independent members, the relevant national authorities and the national central banks of issue and reports to the ESMA Board of Supervisors.

are systemically relevant for the EU and enhancing supervisory convergence for EU-based CCPs.

For TC CCPs, EMIR 2.2 introduced a tiering of CCPs depending on their systemic importance for the financial stability of the EU and its member states. Non-systemic TC CCPs (Tier 1) are allowed to continue to provide services in the EU under the supervision of their home supervisors after being recognised by ESMA. Systemically important TC CCPs (Tier 2) have to comply with most EMIR requirements[17] and potentially additional requirements imposed by the relevant central banks of issue (CBI)[18] and are supervised by ESMA through the CCP SC. This is in effect a shared supervision between the UK and the EU authorities, which notably involves exchanges of information on the activities and risks of the CCPs concerned and the possibility for ESMA to conduct investigations and inspections if needed. To avoid an excessive burden on the CCPs potentially subject to a double set of rules, EMIR 2.2 introduced a concept of comparable compliance in Article 25, which is an equivalence assessment that is entity-based rather than jurisdiction based (as for traditional equivalence). In addition, ESMA can also propose to the European Commission, after having consulted the ESRB and the relevant CBIs, to not recognize in the EU a TC CCP or some of its clearing services that may be considered of 'substantial systemic importance' in the EU *i.e.* too systemically important to be located outside the EU.

For EU CCPs, in addition to national CCP supervisors who remain in charge of the supervision of the CCPs established in their jurisdiction, EMIR 2.2. introduced a more pan-European approach to supervision. The objective of the ESMA CCP Supervisory Committee is to promote supervisory convergence, bringing together in a single forum the different national competent authorities and central banks concerned by the supervision of EU CCPs. EMIR 2.2 has also strengthened the role of colleges of supervisors and central banks of issue in the supervision of CCPs.

3.2. Assessment of the challenges from UK-based clearing activities (2021)

In January 2021 the Commission set up a working group including representatives from the ECB, the ESAs and the ESRB to explore the opportunities and challenges from a potential transfer of derivative clearing activities from the UK to the EU. The discussions at the Working Group showed that a combination of different measures to improve the attractiveness of clearing, to encourage infrastructure development, and to reform supervisory arrangements were needed in the EU to build strong and attractive central clearing capacity in the years to come.

In parallel, ESMA conducted a comprehensive assessment of Tier 2 CCPs established in the UK and the risks they may pose to the financial stability of the EU and its member states. This assessment led to the identification of three clearing services considered to be systemically important for the EU, particularly in times of stress, due to the size of exposures of EU market participants, interconnections between these services and the EU and the lack of alternative services in the EU: interest rate derivatives denominated in euro and Polish zloty, short-term interest rate futures and credit default swaps denominated in euro[19].

ESMA did not recommend to derecognise these services or the CCPs providing them, considering that the costs for the EU would outweigh the benefits[20]. A non-recognition would indeed imply a range of costs and risks for EU counterparties including transfer costs, costs of breaking netting sets (reduced netting efficiencies, higher amounts of collateral…), potential additional costs and risks of a 'basis' developing *i.e.* a price difference between two CCPs offering clearing for the same product[21], significant competitive disadvantages for EU clearing members and risks related to the potential shift of EU clearing volume to another third-country. Potential benefits would only materialise if positions are transferred to EU CCPs and may include the reduction of dependencies on the UK and a facilitation of risk management (increased ability of the EU authorities to access information in a timely manner and to intervene effectively during a crisis situation) and resolution planning (early intervention powers to guard EU financial stability).

ESMA proposed instead measures to be considered by the EU institutions for reducing and mitigating the risks posed by these services. These include the implementation of appropriate incentives for reducing the exposure of EU participants to Tier 2 CCPs, the expansion of ESMA's supervisory and crisis management toolbox particularly regarding cross-border systemic risks and a revision of the framework for comparable compliance regarding Tier 2 CCPs[22].

17. Tier 2 CCPs need to comply with the prudential, organizational, conduct, reporting and interoperability requirements of EMI.
18. The CBI may for instance impose the submission of additional information, requirements to address temporary systemic liquidity risks, the opening of an overnight deposit account…
19. On 22 March 2022, ESMA amended the recognition decisions and tiering determination decisions in respect of the 3 recognised UK CCPs (ICE Clear Europe Ltd and LCH Ltd as Tier 2 CCPs and LME Clear Ltd as Tier 1 CCP) to extend them temporarily until 30 June 2025.
20. See ESMA, "Assessment report" under Article 25(2c) of EMIR of LCH Ltd and ICE Clear Europe Ltd, 16 December 2021.
21. Bases can develop between two CCPs if there is a different composition of market participants, with more or less directional portfolios, and different market flows across the two CCPs. Empirical data shows that bases change over time, can be volatile and are unpredictable. See ESMA assessment for further detail.
22. This includes the clarification that ESMA may retain supervisory powers over Tier 2 CCPs for EMIR requirements for which the Tier 2 CCP has been deemed comparably compliant.

4. Proposals for strengthening the EU clearing ecosystem (December 2022)

Following a consultation led in 2022 on proposals to increase clearing capacity in the EU and strengthen the supervision of clearing activities[23], the Commission made proposals to amend EMIR in 5 key areas, aiming to enhance the attractiveness of clearing in the EU and make EU CCPs more resilient. These proposals were published in the context of the action plan set out in December 2022 to complete the Capital Markets Union (CMU), taking into account the key role that CCPs play in supporting the development of safe and efficient capital markets.

These proposals are due to be assessed by the European Parliament and Council in the coming months, with the objective that they should be adopted before the end of the current legislature (Q2 2024) by the co-legislators. They will also be discussed during the April 2023 Eurofi Seminar in Stockholm and some initial views on these proposed expressed by a range of public and private sector representatives can be found in the April 2023 edition of the Eurofi Views Magazine.

4.1 Acceleration of procedures for approving new activities and simplification of equivalence assessments in low risk situations

CCPs need to be able to respond to developments in the markets and economic circumstances dynamically in order to contribute to financial stability and to maintain the competitiveness of EU CCPs. The industry has been complaining for many years about approval processes for launching new clearing activities and products in the market and implementing model changes considered to be unnecessarily long and burdensome[24], which increases costs and may put the EU at a disadvantage compared to other jurisdictions.

The introduction of new procedures and standardised applications that the authorities involved in EU CCP supervision should follow to approve new activities or services and changes in risk models has been proposed, with the objective to reduce the delay for obtaining approvals to a few weeks. A new shorter procedure for launching new activities and services that do not materially change the business model of a CCP will also be introduced. The aim is to encourage EU CCPs to broaden their product range in order to meet the demand of their clearing members and clients.

The Commission is also proposing to simplify equivalence assessments under EMIR when the risks related to clearing in a third country are particularly low, with a more proportionate equivalence framework and cooperation mechanisms with foreign supervisors better tailored to the magnitude of risks posed by CCPs located in third countries.

4.2 Requiring EU market participants to clear a portion of substantially systemic products through active accounts at EU CCPs

The Commission has been encouraging EU market participants since the UK's decision to leave the EU to reduce their excessive exposures to CCPs established in the UK in light of the potential risks in a stress scenario. Shifts of clearing activity to the EU have been observed in some areas such as euro-denominated repo, as well as the development of EU-based clearing activity by the private sector (*e.g.* with the creation of an alternative liquidity pool for euro denominated IRS by Eurex and the development of credit derivative swaps (CDS) clearing services by LCH SA), but the overall transfer of clearing activity to the EU has been limited so far.

In its December 2022 proposals, the Commission reasserted the objective of increasing clearing capacity in the EU and strengthening the EU clearing ecosystem, in order to alleviate the risks from an excessive exposure to UK CCPs and a possible interruption of the access of EU market participants to UK CCPs, while maintaining EU markets open to other jurisdictions. The legislative proposal recommends that EU market participants subject to a clearing obligation should be required to clear through "active" accounts at EU CCPs a portion (to be defined) of the products that have been identified by ESMA as of substantial systemic importance. To complement this measure, the amendment of the Capital Requirements and the Investment Firm Directives has also been proposed in order to enhance the monitoring and treatment of the concentration risk that may arise from exposures to CCPs[25].

4.3 Adjusting the UCITS and Solvency II Directives to reflect the risk reducing nature of central clearing

Banks benefit from a preferential prudential treatment when they clear at an authorized EU CCP or a recognised third-country CCP in order to acknowledge the reduction in counterparty credit risk that central clearing entails. This approach has not been fully

23. The objective is to ensure that the EU clearing ecosystem remains safe and resilient and support the CMU and open strategic autonomy objectives of the EU.
24. Currently, it can take up to 2 years for an EU CCP to get the supervisory approvals necessary to start offering a new clearing service.
25. The objectives of the measures proposed is to incentivize supervised entities (credit institutions and investment firms) to reduce excessive concentration risks by, for example, diversifying/scaling back their exposures. To the extent that a competent authority will consider that the actions taken by an entity it supervises are insufficient to reduce that risk, it will be able to impose supervisory measures.

mirrored in other pieces of financial legislation such as the rules on counterparty exposure limits for derivative transactions in the UCITS Directive, creating inconsistencies. The Commission has proposed amending the UCITS Directive and the money market fund (MMF) Regulation to better reflect the risk-mitigation role of CCPs authorised in the EU or recognised by ESMA.

A second issue highlighted in the December 2022 proposals concerns insurance companies wishing to become direct CCP members. At present under Solvency II, the CCP-related exposures of insurance companies wishing to become direct CCP members can be subject to higher capital requirements than where insurers act as indirect clearing participants. These higher capital requirements are a disincentive to using these new direct access models. This issue is due to be tackled in the context of the forthcoming revision of the relevant Solvency II Delegated Regulation[26].

4.4 Enhancing the cross-border supervision of EU CCPs

Developing the EU clearing ecosystem may lead to additional risks within the EU due to increased clearing volumes. In addition, recent market stresses (*e.g.* in the energy and MMF markets) have demonstrated the interdependencies among different types of economic actors in the clearing space and the externalities of clearing activities for the wider financial system.

A more holistic monitoring and control of clearing activities and interactions among market participants has been proposed to address these risks, as well as an improvement of the level of information on the relationships and interdependencies across the entire clearing chain and the liquidity issues that different market participants may experience due to margin increases.

The Commission also considers that the EU supervisory framework must be reinforced, to ensure the authorities work together effectively on the ground both at the national and EU levels, share knowledge and insights and develop a common supervisory culture, particularly to handle emergency situations, in the interest of the different stakeholders concerned. Building on the new supervisory and coordination roles of ESMA regarding CCPs in EMIR 2.2, the Commission communication proposes: i) establishing joint supervisory teams for certain tasks; ii) allowing ESMA, through its CCP Supervisory Committee, to coordinate common responses to emergency situations on the basis of up-to-date information; and (iii) facilitating the monitoring by EU authorities, such as the ESAs, ECB, ESRB and the SSM, of cross-border risks to the EU throughout the clearing chain.

4.5 Strengthening the framework for clearing commodity derivatives

Following the pressures on liquidity that some energy companies experienced in 2022 because of higher margin calls linked to rising energy prices, some emergency measures were proposed for energy derivatives, including (i) an increase of the threshold to € 4 billion, below which non-financial counterparties will not be subject to margin requirements on their OTC energy derivatives and (ii) a temporary broadening for one year of the list of eligible assets that CCPs may accept to cover their risks on energy derivatives markets; these may be extended *e.g.* to uncollateralized bank guarantees for non-financial companies (NFCs) acting as clearing members and to public guarantees for all types of counterparties[27].

In addition to these emergency measures, the Commission proposed increasing the transparency on margin models in order to allow all participants in the energy markets, including producers, suppliers and distributors, to get a better understanding of their potential liquidity needs when clearing centrally, particularly in situations of stress. Clearing members will moreover be required to explain to their clients how margin calls work and provide simulations under different scenarios building on the tools that EU CCPs provide to simulate the behaviour of margin models.

The legislative proposal amending EMIR also strengthens the requirements for non-financial firms participating in a CCP, in order to avoid that undue risks spill over to other clearing members. The proposal also takes into account ESMA's recommendations to amend the methodology to determine the clearing threshold, making it easier to implement and more predictable. It also requires ESMA to review and clarify the conditions for a transaction to be considered a hedge and therefore not count towards the clearing threshold.

26. Some observers have suggested that measures are also needed to support the direct access to CCPs of EU pension scheme arrangements that are due to come under a clearing obligation in June 2023. This could potentially increase liquidity in the EU market, but pension funds need to be able to convert their securities into cash in order to face margin calls. This requires a proper functioning of the repo market at all times at reasonable pricing conditions or the availability of other collateral transformation services. See Eurofi Summary Prague September 2022 "Strengthening EU clearing".

27. In its response to the Commission letter regarding the current level of margins and of excessive volatility in energy derivatives markets (22 September 2022), ESMA emphasized that any potential policy measures should avoid transferring risk from the energy sector into the financial sector and that a holistic view needs to be taken in terms of risks and costs. With this in mind, ESMA recommended clarifying the conditions under which different types of collateral can be accepted (EU bonds, commercial paper) and temporarily extending acceptable collateral to commercial bank guarantees backed by public entities and uncollateralized commercial bank guarantees under certain circumstances (see ESMA RTS Emergency measures on collateral requirements. 14 October 2022).

4.6 Further engaging the EU public authorities in the central clearing ecosystem

In order to increase clearing capacity in the EU, the Commission encourages in the legislative proposal public entities and authorities in the EU such as public debt management offices, which are currently exempted from EMIR derivative clearing requirements, to centrally clear their positions at EU CCPs, when the products sought are available.

Secondly, the Commission invites national public authorities to assess national accounting rules applying to hedging in order to remove or alleviate any obstacles to transferring exposures from third-country CCPs to EU CCPs and eliminate any uncertainties as to how certain national rules may apply.

Thirdly, the Eurosystem central banks are invited to address some operational issues that may hinder central clearing in the EU. A first issue is the operating hours of TARGET 2 which are considered to be too short, leading EU CCPs to call some margins late in the day in foreign currencies such as the US dollar rather than in EU currencies. This creates difficulties for CCPs that have to find ways to invest the US dollars received in the repo market and for clearing members and clients who need to have the necessary amounts of US dollars available to meet the margin calls. This could be a concern particularly in times of stress when CCP margin calls can occur late in the day and are of varying amounts. A further issue relates to central bank access policies for CCPs regarding deposit and liquidity facilities, which could be further harmonized across the Eurosystem.

Open finance opportunities and challenges

3

Open finance: opportunities, challenges and policy implications

Note written by by Marc Truchet, Eurofi

1. Objectives of open finance and main use cases

1.1 Objectives

Open finance (OF) refers to the sharing of personal and non-personal customer data held by financial sector intermediaries and other data holders with third-party providers for the purpose of providing a wide range of financial and information services[1]. It is an extension to a broader range of data (credit, savings, investment, insurance, pensions) of the Open Banking concept which focuses on payments and the sharing of bank account data[2].

The main objectives of OF are (i) to offer individual consumers and businesses that consent to share their financial data an improved range of financial products and services leveraging the potential of data-enabled innovation in finance and (ii) to increase competition in the provision of financial services to the benefit of customers and of the overall financial system[3].

In the EU, OF concepts were first implemented in the payments area and for bank accounts in the context of the revised Payments Service Directive (PSD2) adopted in 2015 and currently under review. PSD2 inter alia requires that payment service providers (mainly banks) open up their customers' current account data to authorised and regulated third parties in order to enhance competition in the payments market and create incentives for further digitalisation. These rules apply to the accounts of individual customers and also businesses.

PSD2 has led to the emergence of new payment service providers (payment initiation services) and also new information services aggregating payment account data (account information services), provided by banks and fintechs that interact with payment accounts mainly through application programming interfaces (APIs). New account information services supplied by PSD2-entities for individuals include services offering an overview of the different current accounts held by a given customer and budget planning apps[4]. For businesses, open banking applications include SME financial dashboards and scoring systems using in-going and out-going payment history to assess loan applications.

The development of open banking solutions in the EU has been significant with more than 350 account information and payment initiation service providers authorised[5] following the implementation of PSD2, but market penetration is lower than expected for the time being with open banking touching less 5% of customers in 2021[6]. The objective with open finance is to further leverage the potential of data sharing and data-led innovation in finance with a wider range of services provided and a review of the regulatory framework, taking into account the lessons learned from the implementation of the open banking provisions of PSD2.

1.2 Examples of open finance use cases

Open finance broadens the open banking approach to almost all financial services including banking and savings accounts, investments, insurance and pension products. This wider sharing of financial data and interconnection of accounts supported by APIs[7], possibly combined with data analytics and artificial intelligence (AI), may bring value to retail and business customers in many areas of finance beyond payments such as investment and financial advice, pension preparation, mortgage and credit, insurance…

Examples of use cases of open finance include: dashboards, financial management and wealth management tools consolidating information on different accounts and products; product and supplier comparison tools; credit-worthiness and insurability assessments using a wide range of financial data; financial services and insurance imbedded in online sales or information processes (*e.g.* banking as-a-service, insurance as-a-service); data collection processes from multiple sources to support onboarding, loan, mortgage or insurance applications; sharing

1. See definition for example in: Consultation document, Targeted consultation on open finance framework, European Commission, 2022.
2. Beyond open finance there is the possibility of expanding the scope of data sharing into open data, applying the same principles to other types of data beyond financial data, including those from telco, utilities, IoT, e-commerce platforms and social media for example.
3. OF may also contribute to more effective supervision by the direct provision of regulatory information potentially on a real-time basis.
4. These services allow consumers to have a global view on their financial situation and to analyse their spending patterns, expenses, financial needs in a user-friendly manner.
5. See EBA chairperson keynote speech at the Money Live Summit, 8 March 2023.
6. See Com. McGuinness keynote speech at event in European Parliament "From open banking to open finance" 21 March 2023.
7. The APIs that are being used under the PSD2 and are essential for connecting different financial applications could be expanded for this purpose.

of in-vehicle data to help insurers provide more customized policies; handling of insurance claims; suptech solutions offering supervisors access to prudential, product or consumer information on a real time basis... See Appendix 1 for further detail on potential OF use cases.

2. Main benefits and opportunities of open finance

2.1 Benefits for customers

Open Finance may contribute to improve the financial products and services offered to individual consumers and businesses and also enhance customer experience in different ways.

OF solutions may in particular: (i) provide consumers with access to more tailored financial services and insurance products better suited to their needs and profiles and provide more choice; (ii) empower consumers to make more informed financial decisions with an aggregated view on their financial situation, the forecasting of possible future scenarios and information on how products and services may match their needs; (iii) make it easier for consumers and businesses to compare prices and product features and switch products or providers; (iv) support more effective creditworthiness or insurability assessments based on a wider range of data, enabling certain customer segments or specific customer needs to be better served; and (v) improve the provision of financial advice based on a more holistic view of the financial situation of customers[8].

The access to and sharing of data potentially in real-time supported by OF may also allow financial institutions to streamline certain data collection and processing activities (*e.g.* related to credits and mortgages) to the benefit of their customers and enable the transferability of customer profiles among financial providers to facilitate *e.g.* on-boarding and suitability assessments.

2.2 Opportunities for financial services providers

The easier access to larger customer datasets supported by OF also creates new business opportunities for financial service providers, both newcomers and incumbent firms.

First, OF creates opportunities for new service providers such as fintechs, that will be able to offer new services based on the data sharing and aggregation possibilities offered by OF in the areas inter alia of investment and financial advice, pension preparation, mortgage and credit, insurance...

As far as traditional banks and insurers are concerned, OF will introduce new forms of competition, but should also bring about new opportunities to better serve existing customers and attract new ones. OF solutions may indeed enable banks and insurers to improve their offering and develop cross-selling opportunities, by integrating services from third parties seamlessly through APIs in the range of products they offer. In addition, the possible consolidation in one place of customer financial data thanks to OF (including accounts, loans, payments, investments, insurance policies...) should give banks and insurer a more holistic view of the financial situation of clients, allowing them to offer new financial management and insurance services and improve the advice that their advisors currently provide for their customers[9]. The potential streamlining of data collection processes via OF infrastructures may also contribute to enhancing the efficiency of a number of processes such as credit applications, on-boarding, AML verifications, claims management... Expanded access to a customer's financial history could also facilitate decision-making in bank lending processes or the provision of more effective wealth management services or insurance policies.

3. Possible risks and challenges from open finance

Open finance can potentially bring about many changes in financial value chains and the existing market structure, creating new opportunities and also some challenges for customers, financial firms and supervisors.

3.1 Potential customer risks from open finance

The implementation of OF solutions creates new risks or increases some existing risks related to data sharing and the technical infrastructure supporting OF[10] and also to a higher level of disintermediation in OF ecosystems.

The exposure of customers to data privacy and security issues may increase with OF. The risk that customer data may be used without sufficient consent or may be inappropriately used could be amplified by the more complex and active data

8. See: Open Finance Feedback statement, FCA, March 2021; Open insurance: accessing and sharing insurance-related data Discussion paper EIOPA 2021.
9. See The future of open finance: empowering consumers in a connected ecosystem, BCG, April 2021.
10. See in particular FCA Open Finance Feedback statement March 2021; Open insurance: accessing and sharing insurance-related data Discussion paper EIOPA 2021.

sharing chains used for supporting OF, also creating potential concerns in terms of customer trust. The increased sharing of personal data in an OF context may also increase the vulnerability of customers to financial crime, fraud and scams, as well as to operational ICT[11] risks such as API security risk and cyber-risk.

Consumer protection issues may also emerge as a result of a higher level of disintermediation in the provision of financial services in OF ecosystems. OF may indeed allow the development of more sophisticated product comparison tools, advisory tools based on data aggregation and imbedded financial services that may replace part of the role currently played by traditional financial intermediaries and advisors, potentially creating risks for customers if these applications generate over-simplified information or mis-leading recommendations.

The data-driven nature of OF-based services and the possible use of sophisticated data analytics and AI in this context, may also expose OF customers to the risks usually associated with these techniques *i.e.* biases concerning certain customer profiles, errors due to out-of-date or incomplete data or unfair price optimisation practices, potentially leading to customer discrimination or exclusion issues or over-charging in some cases.

3.2 Challenges for financial firms and supervisors

The financial firms and third-party providers operating in OF environments also face a certain number of specific risks and challenges. First, operational risks relating to API use; interoperability issues between different types of systems and applications including legacy systems; an increasing complexity and dependency in the interconnectedness with third-parties; greater exposure to cybersecurity risks; and a possible shortage of skills for operating such environments. Secondly, competition risks, if OF leads to asymmetrical access to and sharing of data between financial institutions and third-party providers or to an unfair sharing of costs for setting up and running APIs and OF services; or if barriers hinder the access of newcomers to APIs and OF applications due to insufficient proportionality in the calibration of rules or proprietary standards.

Supervisors also face new challenges and risks with OF due to the cross-sectoral nature of OF ecosystems, the reliance of OF ecosystems on API-based interconnected infrastructures and also possible changes in the financial market structure driven by OF (greater fragmentation of financial value chains with the emergence of specialised providers, possible development of new types of platforms aggregating financial services from multiple providers or combining financial activities and ecommerce or information provision activities…)[12]. This may require new competences and changes in the current financial supervision approaches (*e.g.* to tackle risks involving multiple interconnected players operating under different financial frameworks, more complex data governance and API related issues…).

While OF could have some implications in terms of financial stability (*e.g.* due to a higher level of interconnectedness among financial service providers; or the possibility for customers to move more of their money in real time making the monitoring of liquidity positions harder), it is unlikely that OF will rapidly reach a scale sufficient to create a significant stability threat for the financial system.

3.3 Implementation challenges

Moreover, the uptake of effective OF-based services and products may be hindered by operational challenges and standardisation issues. Insufficiently standardised data and API interfaces are an obstacle to the development of OF, leading to insufficient interoperability in OF ecosystems. This may include the standards used by non-financial companies that operate within or interact with an open finance ecosystem such as car manufacturers for the use of in-vehicle data for insurance purposes for example. Technical challenges related to the maintenance of the API infrastructure of OF ecosystems with a sufficient level of security and the management of interfaces with the legacy infrastructures of incumbent financial institutions also need considering.

The investment required for setting up OF systems and platforms (including technology costs stemming from the implementation and connection of APIs; the costs of standardising and digitising data; the costs of improving cyber-security and fraud detection; additional compliance costs and OF business development costs) is an additional challenge, requiring a detailed assessment of the potential business impact and feasibility of OF use cases and an adequate sharing of costs along the OF value chain.

11. Information and communication technology.

12. OF may indeed have significant impacts on existing financial value chains and the financial market structure over time if it develops in the market. A greater fragmentation of financial value chains can be expected from OF with the emergence of OF service providers focusing on certain steps of the value chain or providing specific services. OF and the use of APIs could also favour new forms of platformisation in the financial sector, leading to more concentration in certain areas of the financial ecosystem, with the development of non-bank providers aggregating best-in-class financial services from multiple providers or multi-activity or e-commerce platforms embedding multiple financial services in their sales processes. See for example Speech by Denis Beau, Banque de France, From open banking to open finance, 24 March 2022; White paper by BCG and Innovate Finance, Unlocking the potential of open finance in the UK, March 2023.

4. Main issues to consider regarding a possible open finance framework

4.1 Objectives of an EU open finance framework

The European Commission is planning to propose an open finance framework by the end of H1 2023 in order to support the sound development of OF applications in the EU. A review of PSD2 is being conducted in parallel to strengthen the framework applying to payment service providers with an enhancement of security and customer protection requirements, a strengthening of enforcement and supervision and a merger of PSD2 and the electronic money directive (EMD2).

The establishment of an OF framework was first proposed in 2020 by the European Commission in the context of the Digital Finance Strategy as a key element of the 'European financial data space', which aims to enhance the access to and sharing of financial data across the EU in order to promote data-driven innovation in finance[13]. This objective was also put forward in the Capital Markets Union (CMU) communication of November 2021 as a driver for developing retail investment and diversifying the financing of SMEs[14]. The proposal to establish a European Single Access Point (ESAP) to corporate and financial institutions' public disclosures, adopted in November 2021, aiming to consolidate online access to financial and sustainability-related data in a single interface, is a first application of these objectives in the capital markets area.

A targeted consultation was subsequently led by the Commission in H12022 for the preparation of an EU open finance framework. A report on open finance was also published in October 2022 by an Expert Group set up by DG FISMA in 2021 for providing advice and expertise in relation to the preparation of legislative proposals and policy initiatives in the field of data sharing in the financial sector[15]. A number of other jurisdictions including the UK, US, Brazil and several APAC jurisdictions have also implemented or are considering implementing Open Banking and Open Finance initiatives either through regulatory-driven or market-led approaches[16].

The EU open finance framework is expected to build on the data sharing provisions of the EU Data Strategy framework in the process of being implemented[17] (comprising the Data Governance and Digital Markets Acts and the upcoming EU Data Act[18] – see further detail in Appendix 2) and the data portability and third-party access provisions of GDPR[19]. These rules will however need to be fine-tuned and completed for supporting open finance. Indeed the EU Data Strategy legislations do not introduce any new data access rights in the financial sector beyond those of PSD2 and while GDPR enables third party service providers to have direct access to personal data, including financial data, this only applies in cases where it is technically feasible, which does not guarantee such access.

4.2 Main lessons from the implementation of PSD2 open banking standards

Many stakeholders consider that the upcoming open finance framework should build on the lessons learned from PSD2, correcting the shortcomings observed in the initial implementation of open banking provision in the EU, and should not be a mere extension of PSD2 open banking requirements to a broader range of financial services.

A study conducted by the European Commission on the application and impact of PSD2[20] concludes that while PSD2 has laid the foundations of open banking and finance in the EU, many expected benefits and its full potential have not been realised due to issues relating to data access and sharing, consent and data protection and fragmentation of API standards in particular.

The main issues according to the Commission study on PSD2 relate to the lack of incentives for banks to provide appropriate access and to the insufficient standardisation of APIs.

The PSD2 indeed relies on the assumption that the costs of building interfaces for accessing payment data will be exclusively supported by ASPSPs (Account Servicing Payment Service Providers) such

13. The financial data covered by the European financial data space includes existing financial information provided through national registries (*e.g.* corporate disclosures) and information released under EU financial regulations. There is also an objective in the Digital Finance Strategy to improve supervisory reporting and the sharing of supervisory information with the use of new technologies (including RegTech and SupTech).
14. In December 2021, the Commission also adopted a supervisory data strategy for EU financial services, with the objective of modernising EU supervisory reporting and putting in place a system that delivers accurate, consistent, and timely data to supervisory authorities at EU and national levels, while minimising the aggregate reporting burden for all relevant parties.
15. Report on Open Finance of the Expert group on European financial data space, European Commission, October 2022.
16. For further detail see for example: Data portability in open banking, OECD, February 2023; Data mobility and the financial sector, DNB-AFM discussion paper, September 2022.
17. The European Data Strategy aims to establish by 2030 a single market for data in order to increase the availability and use of data across the EU.
18. These initiatives establish rules for data intermediaries and online gatekeeper platforms and requirements for the sharing of data held by public sector bodies and generated by connected devices.
19. The European General Data Protection Regulation (GDPR) ensures a consistent protection of personal data across EU Member States. GDPR also establishes a right to data portability *i.e.* a right for data subjects to receive personal data concerning them in a structured commonly used and machine-readable format and to port those data to other controllers. Data subjects also have the right to have their personal data transmitted from one controller to another, but only where technically feasible. These rules however do not establish any specific requirements on the format of a data request.
20. A study on the application and impact of Directive (EU) 2015/2366 on Payment Services (PSD2), FISMA, 2023.

as banks. This means that the costs related to the setting up and running of the infrastructure needed to share payment data with third-party providers (TPP) are not shared in a fair way and that banks do not have a real incentive to invest in well-functioning and effective APIs to provide TPPs with access to customer data. This resulted in most cases in the setting up of interfaces offering a limited access to the minimum data required by the PSD2 regulation[21]. The lack of reciprocity of PSD2 open banking rules in terms of data access has also been pointed out by some banks[22].

Moreover, PSD2 RTS do not detail specific API standards. This has led to the emergence of multiple API standards across the EU and differences in the application of these standards in the industry since their implementation was left to the discretion of each bank[23], leading to sub-optimal outcomes. This has resulted in APIs varying significantly in quality and functionality which increased costs and resources for the industry, creating obstacles to the seamless provision of open banking services across the EU. By way of comparison, in the UK, where a single standard has been enforced for the largest ASPSPs for providing access to TPP, the penetration of open banking appears to be higher than in the EU with an estimated 10-11% of digitally-enabled consumers having used open banking services in 2022 and a month-on-month growth of around 10% observed in 2022 for open-banking payments[24] and continuing to increase.

4.3 Main areas to consider for the establishment of an EU open finance framework

The different assessments undertaken by the European authorities regarding the impact and feasibility of OF and the lessons learned from the implementation of PSD2 have allowed the identification of a number of areas to be considered for establishing an effective OF framework[25]. These areas include data ownership and consumer protection issues; the fair access to data and the level playing field among OF market participants; liability issues; and data and API standardisation[26]. While there appears to be a certain consensus on these areas, the extent to which these issues should be subject to regulatory requirements and what they may involve still needs defining, particularly concerning API and data standardisation for which an appropriate balance needs to be found in order to achieve a sufficient degree of standardisation without being too prescriptive. How the open framework may be implemented (*e.g.* covering all financial sectors and data or a subset and possibly in a staged way) and which data may be most most relevant to share and may deliver most value to customers are further questions to address.

A first issue to address for implementing sound OF solutions is defining how individual and business customers may have sufficient transparency on and meaningful control over how their data is shared and reused for the purposes of OF services and how this interacts with GDPR principles and other data rules. A way to achieve this in regulatory terms is establishing the principle that personal data[27] should be owned and controlled by customers, in order to foster customer trust and protect their data, which involves inter alia that data should not be accessed without customers' explicit consent. In addition, consent should be granted for specific purposes only and end-users should have the possibility to withdraw consent. How these principles may be implemented still needs to be further determined however: first, which data may be covered by consent rules (*i.e.* personal data supplied by customers and also possibly data created on their behalf by the OF ecosystem) and how consent may be managed in practical terms (*e.g.* through consent interfaces provided by banks whereby customers can check with whom and how their data is being shared). Other possible measures that have been proposed to tackle data privacy concerns include the requirement to publish lists of customer data fields stored by financial institutions that may be potentially shared or determining data perimeters delineating the categories of personal data which may be used for the delivery of specific financial products and services. Measures may also be needed to mitigate the risks of discrimination, over-charging or exclusion in the use of data-based OF services, particularly when they are combined

21. See Eurofi Views Magazine, April 2023, The success of Open Finance is mainly dependent on the industry, not regulation, Geoffroy Goffinet, ACPR.
22. The current lack of reciprocity of PSD2 rules has indeed been criticized by banks. While PSD2 rules mandate access to bank account data in order to allow the development of new payment services, they do not provide the reverse *i.e.* access to data held by non-financial firms such as online platforms, creating an unbalanced level playing field and potentially limiting the overall flow of data.
23. The industry elaborated PSD2 API market standards but multiple standards were elaborated (*e.g.* Berling Group, STET standards) and their implementation was left at the discretion of each bank.
24. See OECD (2023), Shifting from open banking to open finance, Results from the 2022 OECD survey on data sharing frameworks, Eurofi Views Magazine, April 2023, The UK's approach to open banking and open finance, Sheldon Mills, FCA. According to this latter article in the UK over 7 million customers and over 600,000 SMEs are already using innovative open-banking enabled products and services to manage their money and make payments. The trend continues to accelerate with open-banking payments having grown at a rate of 500% year-on-year.
25. See for example BaFin, Paving the way towards open finance in the European Union, 12 December 2022; Report on Open Finance of the Expert group on European financial data space, European Commission, October 2022; EBA chairperson keynote speech at the Money Live Summit, 8 March 2023; Com. McGuinness keynote speech at event in European Parliament "From open banking to open finance" 21 March 2023.
26. The CMU communication of November 2021 pointed out that an OF framework should be based on the principles of customer consent, subject to data protection rules and clear security safeguards, and provide a level playing field for existing and new entrants.
27. *i.e.* personal data supplied by customers and also created on their behalf within the OF ecosystem.

with AI tools that may introduce biases or black-box issues.

A second issue to be considered in the OF framework is how to ensure a level playing field and a fair sharing of costs and obligations among the different players potentially contributing to and benefitting from OF. This first requires that market participants carrying out the same activity and giving rise to the same risks should be subject to equivalent rules, notably in relation to consumer protection and operational resilience. This means in particular that new entrants providing regulated financial services in the context of OF should be regulated under the relevant existing financial regulations. The creation of a license or registration system has also been proposed to allow access to OF APIs, particularly in cases where OF services combine a mix of financial services. Ensuring a proportionate and fair access to data and allocation of costs related to data sharing among the different players on the data value chain is also essential. This may be achieved through reciprocity in the access to data or with a fair compensation scheme for the provision of data, in cases where reciprocal access to data cannot be implemented or is not worthwhile. There is also a question as to which data may be accessed free of charge and which data may be monetized. Whether the setting up of interfaces such as APIs by data holders should be mandatory or voluntary is a further question to be addressed in this context.

Establishing clear liabilities with regards to the accessing, processing, sharing and storing of data is a further area to consider from a policy perspective. The possible liability claims stemming from the misuse of data or use of inadequate data (*e.g.* outdated or incomplete data sets) by entities operating in an OF context must be addressed in particular, in order to foster legal certainty, trust and accountability. This requires ensuring that liabilities are appropriately determined and addressed in an OF context either through common principles that may apply to contractual and non-contractual agreements or through existing rules, when applicable. A dispute resolution mechanism tailored to OF environments may also need developing.

Achieving a sufficient level of standardisation of data (definitions, core data fields and minimum sets of standardised data[28]), technical interfaces (such as APIs) and operating principles (including authentication, consent management, security protocols…) is also essential for supporting the development of effective OF ecosystems. Suggestions have been made that API standardisation should be addressed mainly through industry-driven initiatives, given the fact that regulatory standards may be too prescriptive, however the PSD2 experience shows that an involvement of the public authorities may be needed to ensure a sufficient level of standardisation either by the definition of minimum standards or to ensure that industry standards are implemented in a consistent way. As for data standards, these should build on existing regulations (*e.g.* the EU eiDAS standards) and international data standards such as LEI and ISO standards. The provision of a portable digital identity is another area of standardisation that could facilitate the development of OF by simplifying identification processes and the collection of documents necessary for certain financial activities such as opening an account or applying for a loan[29].

Another key aspect relates to security requirements (*e.g.* in terms of authentication of OF service users to avoid frauds), which are important for ensuring consumer trust in OF. The suggestion has been made that security requirements similar to those being used for PSD2 and currently being reviewed, should be used for the communication between TPPs and data providers in OF[30]. The Digital Operational Resilience Act (DORA), which has recently been adopted should also help to address possible ICT risks and cyber-risks from the implementation of OF solutions.

Finally, supervision also needs to be adapted to open finance activities that potentially fall within the remit of different competent authorities (*e.g.* combining different financial services currently supervised by different sectoral authorities) and that may give rise to new data protection and governance issues and ICT risks due to the interconnected OF infrastructure and the highly data-driven nature of OF products and services.

28. The areas of data standardisation required for OF suggested by the Expert Group on European financial data space in its report include authentication and identity management (*e.g.* based on the EU eIDAS Regulation (Electronic IDentification Authentication and trust Services), standards and technical requirements (*e.g.* field names, messaging format syntax, information exchange protocols…) and existing global data standards.

29. The EU digital ID proposed can for example facilitate the identification of customers by different financial providers operating in an OF environment and also support certain OF-enabled processes such as loan or credit applications, with users able to select the necessary documents for their application from those stored in their digital wallet.

30. See EBA chairperson keynote speech at the Money Live Summit, 8 March 2023.

Appendix 1: Main use cases of open finance

A number of use cases of open finance were outlined in the recent reports published for the preparation of an open finance framework in the EU and UK[31]. These use cases cover different areas of finance and steps of the financial value chain and may be combined with data analytics and artificial intelligence (AI) to improve decision-making and the efficiency of operations:

Investments and savings

- Personal financial management dashboards or nudge systems that enable customers to understand and optimise their overall financial position (cash flow, savings, investments, spending, future projects, pension needs) based on an aggregation of information from their different financial accounts: bank accounts, savings, investment and pension products held.
- Pension adequacy dashboards consolidating the information of the different pension schemes and products held and simulating expected pension payments.
- Wealth management or investment management advice tools supporting the financial decisions of retail investors, aggregating data on investors' current investments and making it easier to share comprehensive information with advisers.
- Automatic saving and investment solutions *i.e.* sweeping automatically excess funds into savings and investment accounts on a monthly basis and automatically covering possible overdraft.

Credit and mortgage

- Streamlining of credit and mortgage application processes (with OF based data collection).
- More accurate creditworthiness assessments of SMEs and individuals, based on a holistic view of financial assets, cash flows and payment and account history.
- Transfer of the credit applications of SMEs to other financial intermediaries or providers of finance in cases where credit applications are turned down.
- Credit imbedded in sales processes and credit-as-a-service.

Insurance

- Sharing of in-vehicle data to increase road safety and help insurers provide more customized policies.
- Handling of insurance claims management by third-parties.
- Insurance imbedded in sales processes.
- Tool assessing whether insurances are up-to-date based on the actual living situation inferred from the analysis of bank accounts.

Transferability and comparability

- Transferability of customer-profile data and information on current savings and investments[32] among financial intermediaries to facilitate in-boarding and support financial advice.
- Tools comparing services and products in terms of functionality and cost that may facilitate product choice and the switching of products and providers.

Supervision

- Suptech solutions offering access to prudential, product or consumer information on a real time basis to support oversight and supervisory capabilities.[33]

ESG and Carbon-footprint

- Digital tools to assess the ESG profile of financial products.
- Combining transaction and investment data to measure carbon footprint.

31. See: Report on Open Finance of the Expert group on European financial data space, European Commission, October 2022; Open Finance Feedback statement, FCA, March 2021; Open insurance: accessing and sharing insurance-related data Discussion paper EIOPA 2021.
32. Including information on customers' risk and sustainability preferences, financial knowledge and experience, transaction track record, ability to bear losses, wealth, income, investment horizon based on the customers' projects, AML-CFT information…
33. This may allow compliance with regulatory goals to be automatically monitored by reading the data that is exchanged by providers via standardised APIs thus reducing the need to actively collect, verify and deliver data for supervision, in particular for conduct of business supervision. Regarding distribution and product regulation, OF solutions could potentially allow supervisors to access directly and on a real-time basis information *e.g.* on the products effectively bought, insurance policies underwritten (costs, fees, features…) and consumer complaints filed.

Appendix 2: Data access and sharing rules of the EU Data Strategy

The pieces of regulation part of the EU Data Strategy[34] (the Data Governance and Digital Markets Acts and the upcoming EU Data Act) and the data portability and third-party access provisions of GDPR set out cross-sectoral rules for the re-use and sharing of personal and non-personal data that may form a basis for a more specific OF framework.

The EU Data Strategy legislations indeed do not introduce any new data access rights in the financial sector, focusing on the establishment of general rules for data intermediaries and online gatekeeper platforms and on requirements for the sharing of data held by public sector bodies and generated by connected devices. And while the GDPR enables third party service providers to have direct access to personal data, this is only when it is technically feasible, which does not guarantee such access.

- The Data Governance Act, adopted in April 2022, aims to facilitate the sharing of personal and non-personal data across the EU and between industry sectors. It sets out rules relating in particular to the re-use of data held by public sector bodies[35] and creates a regulatory framework for providers of data intermediation services such as data marketplaces, platforms and databases. This latter framework proposes a model establishing the neutrality and transparency of data intermediaries, which will be required to provide services via a separate legal entity and on commercial terms that are not dependent on whether data holders or users are using other services of the intermediary.
- The Digital Markets Act, adopted in July 2022 aims to ensure that large on-line platforms providing an important gateway between business users and consumers (so called gatekeepers) do not abuse their position and that digital markets remain fair and open. This includes provisions to ensure data portability, enabling businesses and end-users to access and transfer their data outside the gatekeeper platform, and also to allow access by business users to the data that they generate in their use of the gatekeeper's platform (*e.g.* transaction data)[36].
- The Data Act proposal published in February 2022 completes these rules with measures related to non-personal data sharing, allowing notably users of connected devices to gain access to data generated by them and to share such data with third-parties, and establishing model contractual terms to help SMEs draft and negotiate fair data-sharing contracts.
- The European General Data Protection Regulation (GDPR) ensures a consistent protection of personal data across EU Member States. GDPR also establishes a right to data portability *i.e.* a right for data subjects to receive personal data concerning them in a structured commonly used and machine-readable format and to port those data to other controllers. Data subjects also have the right to have their personal data transmitted from one controller to another, but only where technically feasible. These rules however do not establish any specific requirements on the format of a data request.
- Non-financial data that could be relevant in a broader scope of open finance including data from e-commerce platforms, utilities, telcos etc. may also be shared under the EU open data directive.
- In December 2021, the Commission also adopted a supervisory data strategy for EU financial services, with the objective of modernising EU supervisory reporting and putting in place a system that delivers accurate, consistent, and timely data to supervisory authorities at EU and national levels, while minimising the aggregate reporting burden for all relevant parties.

34. The European Data Strategy aims to establish by 2030 a single market for data in order to increase the availability and use of data across the EU.
35. These rules aim to ensure that data privacy and confidentiality are respected for protected data in particular, such as health data, data from social insurance institutions, pension registers, population registers...
36. However, in line with GDPR, business users have to request user consent to access and use personal data.

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Financing the green transition and avoiding greenwashing

4

Green investment in the European Union : situation, additional needs and funding

Note written by Jean-François Pons & Gwenaelle Varin , Alphalex-Consult

In 2020, the political authorities of the European Union approved the Green deal programme proposed by the European Commission. This programme has a goal to achieve net zero emissions by 2050. A year later was introduced the target of a reduction of 55% of greenhouse gas (GHG) emissions by 2030, accelerating the efforts needed to achieve this ambitious goal. The Green deal programme also includes a list of actions to protect and restore the environment (fight against pollution, protection of biodiversity, promotion of circular economy etc.). This paper focuses on the amount of "green" investments related to the Green deal programme, on the additional needs as estimated by the European Commission up to 2030 and looks at the different sources of "green" funding.

1. Green investment in the EU: situation and additional needs

1.1 Climate

1.1.1 Climate-related investments have been growing in recent years

In the **energy sector** – which includes from the installation of renewable energy to energy efficiency measures – the average investments per year in 2011-2020 were reaching € 192 billion[1] for the European Commission and € 215 billion[2] for the European Investment Bank (EIB). Those investments were equal to € 220 billion in 2020 and € 223 billion in 2021 for the EIB, and increased by 28% to reach € 285 billion in 2022.

This amount represents not less than 2% of EU GDP[3], a better effort than the United States' which only invested € 211 billion in 2021 (1,1% of their GDP). However, the EU remains behind China and its € 479 billion in 2021 (3,2% of their GDP).

TABLE 1.
Average annual Investment needs in the energy system and for transport, historical trend 2011-2020, and Fit-for-55 policy scenairo 2021-2030 (Eur 2022, billion) (annual)

Sector	2011-2020 (annual)	Fit-for-55 policy scenario 2021-30 (annual)	Difference (annual)
Supply side	**55**	**148**	**+93**
Power grid	15	55	+40
Power plants, incl. boilers and new fuels	40	93	+53
Demand side	**160**	**339**	**+178**
Industrial sector	12	34	+22
Residential	102	202	+100
Tertiary	46	103	+56
Total (Energy System)	**215**	**487**	**+272**
Transport sector[95]	549	754	+205
Total (energy and transport)	**764**	**1,241**	**+477**

Source : Staff Working document from the European Commission published in March 2023

1. European Investment Bank, "Investment Report 2021/2022: Recovery as a Springboard for Change" (Luxembourg: European Investment Bank, February 2022), p. 73. https://www.eib.org/attachments/publications/economic_investment_report_2021_2022_en.pdf.
2. European Commission, "COMMISSION STAFF WORKING DOCUMENT Investment Needs Assessment and Funding Availabilities to Strengthen EU's Net-Zero Technology Manufacturing Capacity" (Brussels: European Commission, March 23, 2023), p. 43. https://single-market-economy.ec.europa.eu/publications/staff-working-document-investment-needs-assessment-and-funding-availabilities-strengthen-eus-net_en.
3. European Investment Bank, "Investment Report 2022/2023: Resilience and Renewal in Europe" (Luxembourg: European Investment Bank, February 2023), p. 85 https://www.eib.org/attachments/lucalli/20220211_economic_investment_report_2022_2023_en.pdf.

As far as the **transport sector** is concerned, green investments in 2011-2020 have reached even higher levels, with € 549 billion per year for the European Commission[4]. When adding the investments of the energy and transport sector, what has been invested in climate reaches € 764 billion per year between 2011 and 2020[5].

1.1.2 The additional needs estimated by the European Commission

According to the following table from the European Commission, € 1,240 billion of average annual investments are needed between 2021 and 2030[6]. On top of that, the 2022 Repower EU Communication published in the months following the beginning of the war in Ukraine introduces new measures for the EU's energetical policy. An additional investment of € 270 billion is needed between 2022 and 2027, meaning that € 35 billion per year[7] is necessary. **Therefore the total additional effort needed equals € 510 billion per year between now and 2030, *i.e.* a little less than 3% of EU GDP.**

2. Environment

Apart from climate, there are other **environmental objectives**, such as the conservation of biodiversity, combating pollution, and advancing circular economy practices. There are less available figures to gauge the amount of investment dedicated to these objectives, as the EIB does not disclose any figure in this regard.

The European Commission estimates investments **at a trend between € 110 and € 130 billion per year**. These estimates are currently being reassessed.

And a Commission document[9] on the Green Deal programme established in 2020 (and which is still judged valid by the Commission) projects that a minimum of € 130 billion per year in additional investments is required to achieve the environmental targets besides the climate ones.

3. Green investments: additional needs

Therefore, **the total green investment needed – for climate and environment – is on the order of € 1.500 billion on average per year, or 10% of EU GDP and the additional need compared to the 2011-2020 period is € 640 billion on average per year.**

An interesting part of the EIB's Investment Report published in February 2023[10] is about the proportion of businesses (mostly SMEs) committed to taking climate action, which has rebounded after stagnating the previous year. Of the surveyed firms, 51% have already made investments in climate action, with 8% making their first investment in 2022. An equal percentage (51%) of firms are also planning future investments, a figure that has steadily increased since 2020 when it was 41%.

2. EU Green Finance in 2022

To our knowledge, there are no figures available on the total amount of green finance in the EU in 2022 (or 2021). But we have different sets of data which seem to show that the magnitude of the different sources of green finance is in line with the investments realised in 2022 and are even higher. It seems reasonable that significantly more investments can be financed in the years ahead, without having a clear idea about the limit.

2.1 Green and sustainable-linked bonds : € 270 billion in 2022

In 2022, Green bonds issued by EU entities (sovereigns, local authorities, public development banks, banks, corporates etc) amounted to € 233 billion (49% of global Green bonds issuance) and Sustainability-linked bonds issued by EU entities amounted to € 37 billion (50% of global SLB issuance).

This amount represents 30% of the EU total of investments in reduction of GHG (€ 764 billion) and for other environmental purposes (€ 120 billion) realised on average in the 2021-2030 period.

2.2 Green loans and Sustainability-linked loans to corporates: roughly € 200 billion in 2022

In 2022, Green loans to corporates and financials amounted to about € 100 billion and Sustainability-

4. European Commission, "COMMISSION STAFF WORKING DOCUMENT Investment Needs Assessment and Funding Availabilities to Strengthen EU's Net-Zero Technology Manufacturing Capacity" (Brussels: European Commission, March 23, 2023), p. 43. https://single-market-economy.ec.europa.eu/publications/staff-working-document-investment-needs-assessment-and-funding-availabilities-strengthen-eus-net_en.
5. Ibid, p. 43
6. Ibid, p. 43
7. Ibid, p. 3
8. Ibid, p. 43
9. European Commission, "COMMISSION STAFF WORKING DOCUMENT Identifying Europe's Recovery Needs Accompanying the Document COMMUNICATION FROM THE COMMISSION TO THE EUROPEAN PARLIAMENT, THE EUROPEAN COUNCIL, THE COUNCIL, THE EUROPEAN ECONOMIC AND SOCIAL COMMITTEE AND THE COMMITTEE OF THE REGIONS Europe's Moment: Repair and Prepare for the Next Generation" (Brussels: European Commission, May 27, 2020), p. 17. https://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:52020SC0098&from=EN.
10. European Investment Bank, "Investment Report 2021/2022: Recovery as a Springboard for Change" (Luxembourg: European Investment Bank, February 2022), p. 233. https://www.eib.org/attachments/publications/economic_investment_report_2021_2022_en.pdf.

linked loans to about € 400 billion (*Source: Bloomberg*). These two categories of loans disbursed in the EU amounted to about € 200 billion.

3. Green loans to households and SMEs: no data available to our knowledge

There is, to our knowledge, no general statistics for green loans to households and SMEs, the amount of which is certainly significant (for energy efficiency of their buildings or for the acquisition of electric cars for instance).

4. EIB funds: € 36 billion in 2022

The EIB estimates that € 1 billion lent by them triggers accompanying funds of € 3 billion. The EIB and the EIF also give guarantees which support banking loans for climate and environmental purposes.

5. EU and national public subsidies or loans: € 100-130 billion

At the time of the publication of the Green deal programme in the first weeks of 2020, the European Commission estimated the volume of EU and national subsidies linked to this programme at € 1.000 billion on 10 years, *i.e.* € 100 billion per year on average.

Since then, the EU Next generation programme, agreed in July 2020, should spend 30% of the additional package of € 730 billion, *i.e.* € 220 billion, in green projects in 5 years. There has been also a new package on energy, called RePower EU, which entails an additional programme of € 225 billion available in loans.

A conservative estimate of the public support would be between € 100 billion and € 130 billion per year between 2022 and 2027.

6. Other sources of funding green investments

There are at least 3 other sources of funding green investments which would need more research:

- self-financing by entreprises and households;
- funding by public development banks like KfW, CDC, CDP, etc.;
- financial investment by other financial institutions including insurance companies, asset-managers, private equity, etc.

Conclusion

- **It is today difficult to have a complete picture of the green financing of investment in the EU and a better reporting would be welcome:**
  a - There are missing elements like green loans to households and SMEs, national subsidies, self-financing, and many other fundings coming from the private sector (asset-managers, private equity, etc.).
  b - One cannot add the different sets of data like Green bonds and Green loans, because Green bonds can be used by the lenders of Green loans, the EIB, the Commission and national governments or local authorities to refinance their loans or subsidies.
- **But the important amounts of the funding instruments which can be measured seem to show that there is no shortage of green finance up to now and a greater effort seems possible.**
  Another element of comparison is the size of the assets of the EU banking sector: € 29.000 billion. These assets grow by 2% each year, *i.e.* € 580 billion.
- According to the last European Commission estimates, investment needs for climate and environment up to 2030 are in the order of € 1.500 billion/year, or 10% of EU GDP, which is a little less than the double of the level attained in 2021. **The increase of investment should reach € 640 billion per year on average in the years up to 2030.**
- Given all the sources of funding which have been listed in this article, **this additional investment need of € 640 billion per year does not seem to be out of reach for green finance**, provided other conditions are met: a regulation to induce structural changes of corporates, SMEs, public authorities and households (including a efficient pricing of carbon), and a public financial support for the most risky projects and for the SMEs and households who need it.

The implementation of the Green Deal legislative programme

Note written by Jean-François Pons & Gwenaelle Varin , Alphalex-Consult

The growth of green finance is not only a question of supply, but also of demand. To give one example, the ongoing growth of the sales of electric cars to the households triggers a growth of car loans, which are to be considered as green given their object. The demand of electric cars is largely influenced by the EU legislation which foresees the end of the sales of fossil fuel cars in 2035. This is why it is interesting for the financial sector to look at the state of execution of the Green Deal legislative programme, which will have implications for the demand for sustainable finance in the coming years.

In this article, we will focus on the part of the Green Deal designed to reduce the emission of greenhouse gas. This comprises some general regulations – like the Climate law setting the Green Deal and Fit for 55 objectives – and some sector-specific regulations on:

- renewable energies, and related infrastructure,
- energy efficiency in industrial production,
- energy efficiency in transport.

The good news is that a large part of these regulations, proposed by the European Commission, have been already adopted (*part 1*) or are near to their approval (*part 2*).

1. Green Deal legislations officially adopted by the legislators

1.1 Climate Law

The very first text which was adopted by the co-legislators is the **Climate Law**[1] . This regulation sets a legally binding EU-wide and economy-wide common target of net-zero greenhouse gas (GHG) emissions by 2050, and also comprises the -55% of GHG emissions by 2030 target, which gave birth to the Fit for 55 legislative package and all the related texts we evoke in this paper.

1.2 Emissions Trading Scheme: new benchmark values for free allocations and integration of CORSIA

One of the major projects in progress is the **reform of the Emissions Trading Scheme (ETS)**. Set up in 2005 as the first market tool of its kind, the EU ETS is now under its fourth trading phase (2021-2030). The legislative framework for phase 4 of the EU ETS was first revised in 2018, but given the new climate targets set, the Commission has proposed to strengthen the mechanism even more, with the objective to have a carbon pricing in line with the Fit for 55 objective. While the Commission Implementing Regulation on benchmarks values for free allocation of emission allowances 2021-2025[2] has been published in March 2021, a revision of aviation rules[3] in the EU ETS has been adopted to ensure that Member States notify EU-based airlines of their offsetting obligations for the year 2021 under CORSIA[4]. Other texts extending EU ETS to new sectors are close to be voted as well (*cf. infra*).

1.3 Electricity infrastructure: TEN-E regulation

Another important text that was adopted concerns **energy infrastructure in the continent**. The revision of the TEN-E regulation[5] provides a set of instructions for the prompt advancement and interoperability of the priority corridors and areas of energy infrastructure across Europe. The instructions specify the criteria for identifying projects of common interest (PCIs) and mutual interest (PMIs), while also expanding upon the previous guidelines. This updated version has an extended scope: it now includes smart electricity grids

1. Regulation (EU) 2021/1119 of the European Parliament and of the Council of 30 June 2021 establishing the framework for achieving climate neutrality and amending Regulations (EC) No 401/2009 and (EU) 2018/1999 ('European Climate Law'). Link : https://eur-lex.europa.eu/legal-content/EN/TXT/?uri=CELEX%3A32021R1119
2. Commission Implementing Regulation (EU) 2021/447 of 12 March 2021 determining revised benchmark values for free allocation of emission allowances for the period from 2021 to 2025 pursuant to Article 10a(2) of Directive 2003/87/EC of the European Parliament and of the Council (Text with EEA relevance). Link : https://eur-lex.europa.eu/legal-content/EN/ALL/?uri=CELEX%3A32021R0447
3. Decision (EU) 2023/136 of the European Parliament and of the Council of 18 January 2023 amending Directive 2003/87/EC as regards the notification of offsetting in respect of a global market-based measure for aircraft operators based in the Union (Text with EEA relevance). Link : https://eur-lex.europa.eu/legal-content/EN/TXT/?uri=CELEX%3A32023D0136
4. The Carbon Offsetting and Reduction Scheme for International Aviation (CORSIA) of the International Civil Aviation Organisation (ICAO) requires countries to ensure that airlines based in those countries offset CO2 emissions that exceed the relevant baseline (2019 CO2 emissions) by international credits.
5. Regulation (EU) 2022/869 of the European Parliament and of the Council of 30 May 2022 on guidelines for trans-European energy infrastructure, amending Regulations (EC) No 715/2009, (EU) 2019/942 and (EU) 2019/943 and Directives 2009/73/EC and (EU) 2019/944, and repealing Regulation (EU) No 347/2013. Link : https://eur-lex.europa.eu/legal-content/EN/TXT/?uri=CELEX%3A32022R0869

and electricity storage, hydrogen networks and power-to-gas, as well as projects with third countries; but it excludes natural Gas. It also simplifies procedures to grant permits, and proposes the creation of a one-stop-shop for offshore grid development.

1.4 Renewable energy: delegated Acts on RFNBOs

Lastly, three delegated acts have been published by the Commission. Two of them are of particular importance, as they complete the **implementation of the Renewable energy directive**[6]. The delegated Act on renewable liquid and gaseous transport fuels of non-biological origin[7] provides a methodology to ensure that the electricity used to produce renewable liquid and gaseous transport fuels of non-biological origin (the so called "RFNBOs") is indeed of renewable origin, while the delegated Act on GHG emissions savings of recycled carbon fuels[8] sets a minimum threshold and gives a methodology for assessing GHG emissions savings from RFNBOs.

1.5 Delegated Act on chemical hazard classes

The third delegated act published concerns new **chemical hazard classes**[9], and determines the classification, labelling and packaging of substances and mixtures, notably endocrine disruptors. It seeks to ensure a high level of protection of human health and the environment.

2. Green Deal legislations approved by the legislators

Political agreements have been reached for many other important texts, making them close to being officially enacted.

2.1 Emission Trading Scheme (ETS) for maritime sector and emissions reduction

There is an agreement on the reform of the **EU ETS**, which is strengthened and extended to new sectors in order to match the new ambitious target of the Climate Law. The co legislators agreed cutting emissions from EU ETS sectors – which will now also encompass the maritime industry – by 63% relative to 2005 levels by 2030. To accomplish this, the proposal[10] involves increasing the linear emissions reduction factor from 2.2% per year to 4.2%.

2.2 ETS Aviation

The **ETS Aviation** proposal to end free allowances and increase the auctioning system[11] has been approved. The EU ETS now includes intra-European flights to and from the UK and Switzerland, while extra-EU flights will be subject to CORSIA. The phasing out of free allowances will occur one year earlier than proposed by the Commission, and full auctioning will be reached by 2026. A mandatory reporting, verification and monitoring (MRV) framework for non-CO2 emissions from aviation is required to be implemented from 2025 and evaluated in 2027.

2.3 ETS II for building and road transport sector

In parallel, **a distinct emissions trading system, called ETS II, will be implemented for fuel distribution in the road transport and building sectors**. The political agreement sets the starting date for the ETS II to 2024 for commercial buildings and road transport, while residential buildings and private road transport would be included from 2029. The fuel distributors that

6. Directive (EU) 2018/2001 of the European Parliament and of the Council of 11 December 2018 on the promotion of the use of energy from renewable sources (recast) (Text with EEA relevance.) Link : https://eur-lex.europa.eu/legal-content/EN/TXT/?uri=celex%3A32018L2001. This Directive is currently under reviewal as well

7. Commission Delegated Regulation (EU) …/… of 10.2.2023 supplementing Directive (EU) 2018/2001 of the European Parliament and of the Council by establishing a Union methodology setting out detailed rules for the production of renewable liquid and gaseous transport fuels of non-biological origin.
Link : https://energy.ec.europa.eu/system/files/2023-02/C_2023_1087_1_EN_ACT_part1_v8.pdf

8. Commission Delegated Regulation (EU) …/… of 10.2.2023 supplementing Directive (EU) 2018/2001 of the European Parliament and of the Council by establishing a minimum threshold for greenhouse gas emissions savings of recycled carbon fuels and by specifying a methodology for assessing greenhouse gas emissions savings from renewable liquid and gaseous transport fuels of non-biological origin and from recycled carbon fuels.
Link : https://energy.ec.europa.eu/system/files/2023-02/C_2023_1086_1_EN_ACT_part1_v5.pdf

9. Commission Delegated Regulation (EU) …/… of 19.12.2022 amending Regulation (EC) No 1272/2008 as regards hazard classes and criteria for the classification, labelling and packaging of substances and mixtures.
Link : https://eur-lex.europa.eu/resource.html?uri=cellar:7f8116e9-7fc3-11ed-9887-01aa75ed71a1.0016.02/DOC_1&format=PDF

10. Proposal for a DIRECTIVE OF THE EUROPEAN PARLIAMENT AND OF THE COUNCIL amending Directive 2003/87/EC establishing a system for greenhouse gas emission allowance trading within the Union, Decision (EU) 2015/1814 concerning the establishment and operation of a market stability reserve for the Union greenhouse gas emission trading scheme and Regulation (EU) 2015/757. Link : https://ec.europa.eu/transparency/documents-register/detail?ref=COM(2021)551&lang=en

11. Proposal for a DIRECTIVE OF THE EUROPEAN PARLIAMENT AND OF THE COUNCIL amending Directive 2003/87/EC as regards aviation's contribution to the Union's economy-wide emission reduction target and appropriately implementing a global market-based measure.
Link : https://eur-lex.europa.eu/legal-content/EN/TXT/?uri=CELEX%3A52021PC0552

fall under regulation will be required to report the volume of fuels they place on the market, beginning in 2024. Starting in 2026, they must then surrender a corresponding quantity of allowances, determined on a proportional basis. The emissions cap for these sectors will be established in 2026 and gradually decrease, eventually achieving a 43% reduction in emissions by 2030 relative to 2005 levels. All allowances will be sold via auction, with none distributed for free.

2.4 Market Stability Reserve

The allowances system of ETS is dealt under the **Market Stability Reserve** which is also being reviewed. In order to expedite the absorption of the excess allowances and promote market stability, the proposal[12] – which the co legislators did not change – maintains the current elevated annual allowance intake rate.

2.5 Regulation on a Carbon Border Adjustment Mechanism

Finally, an agreement was reached on another highly debated text creating a **Carbon Border Adjustment Mechanism (CBAM)**[13], proposed to complement the ETS. Starting in 2026, EU importers will be required to pay a financial adjustment by surrendering CBAM certificates that align with the emissions integrated into their imports. The objective is to prevent the relocation of carbon-intensive industries outside of the EU (known as "carbon leakage"), which could compromise the EU's ambitious climate targets. Additionally, this policy aims to incentivize producers in third-party countries that export to the EU to adopt low-carbon technologies, and to ensure that the price of imports more accurately reflects their carbon footprint.

2.6 Regulation on fuels for maritime sector

Debate on Fuel **EU Maritime**[14] has almost come to an end. The Parliaments' report suggested keeping the objective of -2% of annual average carbon intensity in 2025 that was proposed by the Commission. However, it required a more stringent reduction in the greenhouse gas intensity of energy utilised on ships than the Commission. These reductions will take effect from 2035 onwards and will be 20% by that year, 38% from 2040, 64% by 2045, and 80% by 2050. The report also proposes a target of 2% for the use of non-biological renewable fuels starting from 2030. Additionally, the establishment of an Ocean Fund is recommended to enhance ships' energy efficiency and support investments that aim to decarbonize maritime transport. The Parliament and the Council reached a provisional agreement in March 2023 for Fuel EU maritime.

2.7 Regulation on emissions from cars and vans

Emissions from Cars and Vans[15] were finally agreed after last minute discussions with Germany which was threatening to withdraw from the agreed political agreement. In comparison to the CO2 emission targets applicable in 2021, the emissions of new passenger cars registered in the EU must be lowered by 55% in 2030, while new vans must exhibit a 50% reduction in emissions. By 2035, new passenger cars and vans must exhibit a 100% reduction in CO2 emissions, meaning all new vehicles must have zero emissions. The incentive for low and zero-emission vehicles will no longer apply from 2030. The compromise finally reached with Germany will allow the sale of internal combustion engines after 2035 if they run on e-fuels.

2.8 Regulation on land use and forestry: LULUCF

An agreement has also been reached on the revision of **regulation on land use, land use change and forestry (LULUCF)**[16]. It aims to reverse the current trend of declining removals in the land sector, to deliver 310 million tonnes of CO2 equivalent (MtCO2e) removals from the LULUCF sector by 2030, and make it neutral by 2035. Starting in 2026, the sector must achieve a net removal of emissions, and each member State will be responsible for a specific amount of removals to be accomplished by 2030. The revised regulations include more stringent reporting guidelines, increased transparency, and a review process by 2025 to ensure compliance. Between 2026 and 2029, if reporting indicates insufficient progress towards their national targets, Member States may face an extra penalty of 8% on their 2030 removal target.

12. Proposal for a DECISION OF THE EUROPEAN PARLIAMENT AND OF THE COUNCIL amending Decision (EU) 2015/1814 as regards the amount of allowances to be placed in the market stability reserve for the Union greenhouse gas emission trading scheme until 2030.
Link : https://eur-lex.europa.eu/legal-content/EN/TXT/?uri=CELEX%3A52021PC0571
13. Proposal for a REGULATION OF THE EUROPEAN PARLIAMENT AND OF THE COUNCIL establishing a carbon border adjustment mechanism.
Link : https://eur-lex.europa.eu/legal-content/EN/TXT/?uri=celex:52021PC0564
14. Proposal for a REGULATION OF THE EUROPEAN PARLIAMENT AND OF THE COUNCIL on the use of renewable and low-carbon fuels in maritime transport and amending Directive 2009/16/EC. Link : https://eur-lex.europa.eu/legal-content/EN/ALL/?uri=COM:2021:562:FIN
15. Proposal for a REGULATION OF THE EUROPEAN PARLIAMENT AND OF THE COUNCIL amending Regulation (EU) 2019/631 as regards strengthening the CO2 emission performance standards for new passenger cars and new light commercial vehicles in line with the Union's increased climate ambition.
Link : https://eur-lex.europa.eu/legal-content/EN/ALL/?uri=CELEX:52021PC0556
16. Proposal for a REGULATION OF THE EUROPEAN PARLIAMENT AND OF THE COUNCIL amending Regulations (EU) 2018/841 as regards the scope, simplifying the compliance rules, setting out the targets of the Member States for 2030 and committing to the collective achievement of climate neutrality by 2035 in the land use, forestry and agriculture sector, and (EU) 2018/1999 as regards improvement in monitoring, reporting, tracking of progress and review. Link : https://eur-lex.europa.eu/legal-content/EN/ALL/?uri=CELEX%3A52021PC0554

2.9 Regulation on deforestation-free products

Furthermore, an agreement was reached for the proposed regulation for **deforestation-free products**[17]. The proposal establishes a responsibility of reasonable care on operators who sell certain commodities or products within the EU market or export them outside the EU. The objective is to ensure that the goods have been manufactured in compliance with the legislation of the country of production and that the land used for production has not undergone deforestation or forest degradation after 31 December 2020.

2.10 Regulation on batteries and waste batteries

Finally, there has been a provisional agreement on the proposed **regulation on batteries and waste batteries**[18] which sets compulsory standards for all batteries that are introduced to the EU market. Starting from 2024, there will be a gradual implementation of sustainability requirements, and extended producer responsibility provisions will begin to be enforced in mid-2025. By the end of 2027, the minimum collection targets for waste portable batteries will be established at 63%, and this figure will increase to 73% by the end of 2030. Additionally, specific collection targets for waste light means of transport batteries will be introduced, with a target of 51% by the end of 2028 and 61% by the end of 2031. Lastly, there will be a material recovery target of 50% for lithium, which will be set by the end of 2027, and this target will increase to 80% by the end of 2031.

2.11 Revision of the Renewable Energy Directive

In addition to the proposed revision[19], the Commission has added a set of targeted amendments to the directive as part of the REPowerEU plan. Those have been incorporated into the agreement reached on March 30th by negotiators from the Council and Parliament. This provisional political agreement seeks to increase the share of renewable energy in the EU's overall energy consumption to 42.5% by 2030, with an additional 2.5% indicative top-up to achieve a total of 45%. Furthermore, negotiators agreed on sector-specific targets for transport, industry, buildings, and district heating and cooling to accelerate the integration of renewables in sectors where adoption has been slow. This agreement must still be endorsed by both institutions.

Conclusion

The Green Deal programme has been launched in the beginning of 2020. Significant texts of the European Commission's legislative package, which are linked to the reduction of emission of greenhouse gas, have now been adopted or are very close to being adopted. Amongst the important texts still under discussion – for which a political agreement has not yet been reached between the co-legislators – there are the revision of the alternative fuels infrastructure directive[20], a proposal on energy efficiency[21], and a proposal about the energy efficiency of buildings[22]. It is important to note that the progress of the negotiation of the two latter are affected by the RePower EU Plan[23] discussions.

Most of the adopted and almost approved texts are going to trigger investments in the sectors concerned: renewable energy, energy infrastructure, industry, road transport, maritime transport, aviation, land use, reforestation... Consequently, the development of investment projects in these sectors is anticipated to generate a significant increase in the demand for finance.

17. Proposal for a REGULATION OF THE EUROPEAN PARLIAMENT AND OF THE COUNCIL on the making available on the Union market as well as export from the Union of certain commodities and products associated with deforestation and forest degradation and repealing Regulation (EU) No 995/2010.
Link : https://eur-lex.europa.eu/legal-content/EN/ALL/?uri=CELEX:52021PC0706
18. Proposal for a REGULATION OF THE EUROPEAN PARLIAMENT AND OF THE COUNCIL concerning batteries and waste batteries, repealing Directive 2006/66/EC and amending Regulation (EU) No 2019/1020. Link :https://eur-lex.europa.eu/legal-content/EN/ALL/?uri=CELEX%3A52020PC0798
19. Proposal for a DIRECTIVE OF THE EUROPEAN PARLIAMENT AND OF THE COUNCIL amending Directive (EU) 2018/2001 of the European Parliament and of the Council, Regulation (EU) 2018/1999 of the European Parliament and of the Council and Directive 98/70/EC of the European Parliament and of the Council as regards the promotion of energy from renewable sources, and repealing Council Directive (EU) 2015/652
20. Proposal for a REGULATION OF THE EUROPEAN PARLIAMENT AND OF THE COUNCIL on the deployment of alternative fuels infrastructure, and repealing Directive 2014/94/EU of the European Parliament and of the Council. Link : https://eur-lex.europa.eu/legal-content/en/TXT/?uri=CELEX:52021PC0559
21. Proposal for a DIRECTIVE OF THE EUROPEAN PARLIAMENT AND OF THE COUNCIL on energy efficiency (recast).
Link :https://eur-lex.europa.eu/legal-content/EN/TXT/?uri=CELEX%3A52021PC0558
22. Proposal for a DIRECTIVE OF THE EUROPEAN PARLIAMENT AND OF THE COUNCIL on the energy performance of buildings (recast).
Link : https://eur-lex.europa.eu/legal-content/en/TXT/?uri=CELEX:52021PC0559
23. Proposal for a DIRECTIVE OF THE EUROPEAN PARLIAMENT AND OF THE COUNCIL amending Directive (EU) 2018/2001 on the promotion of the use of energy from renewable sources, Directive 2010/31/EU on the energy performance of buildings and Directive 2012/27/EU on energy efficiency.
Link : https://eur-lex.europa.eu/legal-content/EN/TXT/?uri=COM:2022:222:FIN

Sustainability transparency challenges : the case of "Article 9 funds"

Note written by Jean-François Pons, Alphalex-Consult

The implementation of the Sustainable Finance Disclosures Regulation (SFDR) faces important challenges since its implementation in March 2021.

A first fundamental reason is that the financial investors are requested to assess their portfolios and their financial products vis-à-vis the ESG (Environment – including Climate –, Social, Governance) or sustainable criteria but that a large part of the investees do not disclose their ESG data and trajectories. Large and listed corporates have some transparency obligations due to NFRD (Non-financial Reporting Directive) but there are new and more important obligations in CSRD (Corporate Sustainability Reporting Directive), which will apply only for the 2024 accounts. For other corporates, listed SMEs and SMEs (on a voluntary basis), it will be later.

The difficulties of the so-called "article 9 funds" illustrate another weakness of SFDR. The financial sector has launched funds in line with two articles of SFDR, article 8 and article 9. The so-called "article 8 funds" were supposed to be "light green" (moderately sustainable) and the so-called "article 9 funds" were supposed to be "dark green" (sustainable). As it is now well known, there has been a massive declassification of so-called "article 9 funds" in 2022. According to Morningstar, while assets in "article 8 funds" rose by 7.3% in the fourth quarter of last year, assets dropped by 40% in "article 9 funds", taking the total to € 175 billion ($ 190 billion). This declassification is due to the fact that SFDR is not a labelling regulation and that there is a lack of clarity on the definition of sustainability. Therefore many "article 9 funds" could be accused of greenwashing and their producers preferred to change them in "article 8 funds".

How can these difficulties be overcome? The first answer could be to be patient, to wait for the CSRD and the future European Sustainable Standards to be implemented; then financial investors will have a clearer assessment of the sustainability of their portfolios and their financial products.
But the declassification of the "article 9 funds" has created a troublesome uncertainty on the definition of sustainability which needs to be addressed.

1. SFDR in a nutshell

The aim of SFDR is to oblige financial investors to more transparency vis-à-vis sustainable (or ESG) criteria of their financial investments.

1.1 Its first major element is the definition of a sustainable investment in the article 2

According to which a sustainable investment can be:

- an investment in an economic activity that contributes to an environmental objective, as measured, for example, by key resource efficiency indicators on the use of energy, renewable energy, raw materials, water and land, on the production of waste, and greenhouse gas emissions, or on its impact on biodiversity and the circular economy;
- or an investment in an economic activity that contributes to a social objective in particular an investment that contributes to tackling inequality or that fosters social cohesion, social integration and labour relations;
- or an investment in human capital or economically or socially disadvantaged communities;
- provided that such investments do not significantly harm any of those objectives and that the investee companies follow good governance practices, in particular with respect to sound management structures.
  (this last principle called "no sufficient harm" is a cornerstone of EU sustainable reporting regulation, including in the sustainable Taxonomy for instance).

1.2 Another major article, the article 8, aims to organize the transparency of investments with environnemental or social characteritics

This article defines the information to be disclosed (*cf. Annex 1*).

1.3 The last major article, the article 9, does the same in three different cases:

- Where a financial product has sustainable investment as its objective and an index has been designated as a reference benchmark, the information to be disclosed must include information on the alignement of the index with that objective and an explanation as to why and how this index differs from a broad market index.

- Where a financial product has sustainable investment as its objective and no index has been designated as a reference benchmark, the information to be disclosed must include an explanation on how this objective is to be attained.
- Where a financial product has a reduction in carbon emissions as its objective, the information to be disclosed must include the objective of low carbon emission exposure in view of achieving the long-term global warming objectives of the Paris Agreement.

2. The declassification of “article 9 funds”

The financial sector invested in ESG assets has rapidly used article 8 and article 9 as new ESG labels. That was not their purpose as it has just been recalled.

“Article 8 funds” are then supposed to mean “light green” funds or more rightly “light ESG” funds (for they can be more focused on social issues than on green issues) and “article 9 funds” mean “dark green” funds or more rightly “dark ESG” funds.

Given the appetite of financial investors for ESG products, these funds have been very successful. There have been also a growing number of ETF “article 8 funds” and “article 9 funds”.

But, during the course of 2022, many doubts have been raised as to the true ESG nature of these funds, by market researchers like Morningstar or Novethic, by national supervisors (in the Netherlands, Sweden, etc.) and by journalists of important European newspapers (in November 2022). The “article 9 funds” have been criticized for not being transparent enough et not as green as they were supposed to be.

For example, Finansinpektion, the Swedish financial supervisor, has scrutinized the documentation of 30 “article 9 funds” during the summer of 2022 and concluded first that the information on the sustainability were not clear, difficult to understand and to compare, and secondly that the sustainable nature of the investments of some funds were questionable. A study of Clarity AI on 750 European “article 9 funds” – published in November 2022 – shows that 10% of these funds have more than 10% of their assets invested in the fossil energy sector and that 20% of these funds have at least 10% of their assets invested in corporates known for their violations of the principles of the Global Compact or of the Guiding Principles of the OECD.

Consequently, to avoid to be accused of greenwashing, the producers of “article 9 funds” have preferred to declassify most of these funds and transform them in “article 8 funds”. In the 4th quarter of 2022, more than 300 “article 9 funds”, representing total assets of $ 175 billion have been declassified into “article 9 funds” (*source: Morningstar*). The “article 9 funds” represent now 3% of the market and the “article 8 funds”, 35%.

3. The interesting elements of the study by Novethic on the “article 9 funds”

Novethic, with the support of ADEME (French agency for the Environnment), has studied 195 funds managed in France self-classified “article 9 funds” (143 invested in equities, 41 in bonds and 11 diversified).

Most of these funds give only a very general justification of the criteria according to article 9. 42 only published a document close to a template dedicated to SFDR which allows to better understand the goal of the investment (energetical transition, for instance) in guiding their investment in corporates.

The majority of indicators published by the funds are based on Annex 1 of the technical standards, which are the indicators called PAI (Principal adverse impacts). There are also indicators called “proprietary”, based on the ESG assessments of asset-managers.

During a conference in Paris in December to discuss the conclusions of this study with asset-managers, some interesting comments were made which confirmed that:

- asset-managers do not apply the same criteria;
- they often rely on ESG labels, which are themselves questionnable (for example, the most important label in France and in the EU, ISR, does not exclude investment in fossil fuels companies);
- given the doubts about the ESG quality of article 9 funds, most asset-managers have preferred to reclassify some of them into article 8 funds;
- the communication to the customer about the ESG performance of a fund is sometimes very poor (for example, after the reclassification of an article 9 fund into an article 8 fund, the message was “your fund has been reclassified, but do not worry, its content is the same and it is still an ESG fund”);
- some national market authorities have publicly said that they do not have the capacity to control the conformity of the funds with SFDR;
- the asset-managers would like a clarification of SFDR by the European Commission and/or the European supervisory authorities (ESAs).

4. The different reactions and proposals of supervisors and regulators

4.1 In 2022, the ESAs have published clarifications related to the technical standards which will be implemented in 2023, including through a last FAQ in November

In September 2022, they have also asked 8 questions to the Commission in order to get clarification on crucial points in accordance with the UE legislation, notably on the concept of sustainability of the article 2 and on the consideration of the PAIs. The answers to these questions are expected in the first quarter of 2023.

Some national supervisors (in Belgium, Denmark, France, Ireland, Netherlands, etc.) have also started to publish recommendations.

4.2 In February 2023 the French market authority (AMF) published a proposal to the European Commission for overcoming the difficulties. The main points of this proposal are:

- to introduce minimum standards that a financial product should meet in order to be classified either as "article 8 fund" or "article 9 fund";
- to clarify the definition of "sustainable investment" in Article 2 of SFDR, which should consist of a minimum alignment on the EU taxonomy, coupled with some clarifications on the possibility for Article 9 products to include investments not sustainable but made for liquidity and hedging purposes and also investments in "transition assets" (AMF recognizes that "transition assets" need to be defined by the legislators, but it sees this as a crucial long-term goal);
- to introduce a minimum standard of alignment with the EU taxonomy for Article 9 funds, which should be increased step by step, depending on how the EU's economy alignment with the taxonomy progresses over time;
- article 9 products should exclude investments in fossil fuel activities that are not aligned with the Taxonomy;
- AMF also suggests to the policymakers to consider some possible additional requirements;
- producers of Article 8 and Article 9 funds could be required to adopt engagement policies and disclose them;
- producers of Article 8 and Article 9 funds could be required to report on the principal adverse impacts (PAI).

Conclusion

The difficulties of the "article 9 funds" have been very clearly shown in 2022 and have raised many comments and suggestions of reform.

There are two general axis of improvement, on the asset-management side and on the regulatory side.

On the asset-management side, there is room for more transparency and for more comparability, especially by a common work which has already started. In fact, one of the main difficulties with present article 9 funds is that they mix very different ESG objectives and data: climate, diverse environmental data, social data and they have also incorporated the NSH principle. A first solution should be for the corporates to be explicit on all these objectives and data. But another way forward would be **to offer ESG funds more focused on one sustainable objective:** a fund specialized on climate, one on social issue, one on environment (including or excluding some very specific aspects as biodiversity for instance), even funds on one very specific aspect like biodiversity. The part of judgement of the investor (and or ESG ratings agency) should be made easier.

On the regulator side, the first axis of improvement is the clarification of the regulation asked by many actors and by the European Supervision authorities to the European Commission. The clarification of article 2 about what is sustainable is a crucial element of improvement. But the difficulty is that this clarification probably needs an amendment to SFDR which must be approved by the European Parliament and the Council.

The regulation, even if it is improved, will always keep a place for judgement. This is the same for financial and accounting reporting after decades of fine-tuning: they cannot presume by themselves the degree of financial solidity and profitability of corporates. And therefore **what is needed is as much transparency as possible. The proposals of the AMF go in this direction with the setting of minimum environmental standards.**

This approach also requires probably to amend SFDR.

The regulation on sustainable transparency developed in the European Union is still a young regulation. It is normal that there are difficulties of implementation which were not foreseen by the legislators and which have to be corrected. But it should not put in doubt the general orientation to more transparency, which will be helped by the implementation soon of CSDR.

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ANNEX 1 : MAIN EXCERPTS OF THE SFDR

Article 2.17:

'Sustainable investment' means an investment in an economic activity that contributes to an environmental objective, as measured, for example, by key resource efficiency indicators on the use of energy, renewable energy, raw materials, water and land, on the production of waste, and greenhouse gas emissions, or on its impact on biodiversity and the circular economy, or an investment in an economic activity that contributes to a social objective, in particular an investment that contributes to tackling inequality or that fosters social cohesion, social integration and labour relations, or an investment in human capital or economically or socially disadvantaged communities, provided that such investments do not significantly harm any of those objectives and that the investee companies follow good governance practices, in particular with respect to sound management structures.

Article 8

Transparency of the promotion of environmental or social characteristics in pre-contractual disclosures

1. *Where a financial product promotes, among other characteristics, environmental or social characteristics, or a combination of those characteristics, provided that the companies in which the investments are made follow good governance practices, the information to be disclosed pursuant to Article 6(1) and (3) shall include the following:*

- *a - information on how those characteristics are met;*
- *b - if an index has been designated as a reference benchmark, information on whether and how this index is consistent with those characteristics.*

2. *Financial market participants shall include in the information to be disclosed pursuant to Article 6(1) and (3) an indication of where the methodology used for the calculation of the index referred to in paragraph 1 of this Article is to be found.*

3. *The ESAs shall, through the Joint Committee, develop draft regulatory technical standards to specify the details of the presentation and content of the information to be disclosed pursuant to this Article.*

When developing the draft regulatory technical standards referred to in the first subparagraph, the ESAs shall take into account the various types of financial products, their characteristics and the differences between them, as well as the objective that disclosures are to be accurate, fair, clear, not misleading, simple and concise.

The ESAs shall submit the draft regulatory technical standards referred to in the first subparagraph to the Commission by 30 December 2020.

Power is delegated to the Commission to supplement this Regulation by adopting the regulatory technical standards referred to in the first subparagraph in accordance with Articles 10 to 14 of Regulations (EU) No 1093/2010, (EU) No 1094/2010 and (EU) No 1095/2010.

Article 9

Transparency of sustainable investments in pre-contractual disclosures

1. *Where a financial product has sustainable investment as its objective and an index has been designated as a reference benchmark, the information to be disclosed pursuant to Article 6(1) and (3) shall be accompanied by the following:*

- *a - information on how the designated index is aligned with that objective;*
- *b - an explanation as to why and how the designated index aligned with that objective differs from a broad market index.*

2. *Where a financial product has sustainable investment as its objective and no index has been designated as a reference benchmark, the information to be disclosed pursuant to Article 6(1) and (3) shall include an explanation on how that objective is to be attained.*

3. *Where a financial product has a reduction in carbon emissions as its objective, the information to be disclosed pursuant to Article 6(1) and (3) shall include the objective of low carbon emission exposure in view of achieving the long-term global warming objectives of the Paris Agreement.*

By way of derogation from paragraph 2 of this Article, where no EU Climate Transition Benchmark or EU Paris-aligned Benchmark in accordance with Regulation (EU) 2016/1011 of the European Parliament and of the Council (20) is available, the information referred to in Article 6 shall include a detailed explanation of how the continued effort of attaining the objective of reducing carbon emissions is ensured in view of achieving the long-term global warming objectives of the Paris Agreement.

4. *Financial market participants shall include in the information to be disclosed pursuant to Article 6(1) and (3) an indication of where the methodology* *used for the calculation of the indices referred to in paragraph 1 of this Article and the benchmarks referred to in the second subparagraph of paragraph 3 of this Article are to be found.*

5. *The ESAs shall, through the Joint Committee, develop draft regulatory technical standards to specify the details of the presentation and content of the information to be disclosed pursuant to this Article.*

When developing the draft regulatory technical standards referred to in the first subparagraph of this paragraph, the ESAs shall take into account the various types of financial products, their objectives as referred to in paragraphs 1, 2 and 3 and the differences between them as well as the objective that disclosures are to be accurate, fair, clear, not misleading, simple and concise.

The ESAs shall submit the draft regulatory technical standards referred to in the first subparagraph to the Commission by 30 December 2020.

Power is delegated to the Commission to supplement this Regulation by adopting the regulatory technical standards referred to in the first subparagraph in accordance with Articles 10 to 14 of Regulations (EU) No 1093/2010, (EU) No 1094/2010 and (EU) No 1095/2010.

ANNEX 2 BIBLIOGRAPHY

- ESMA: “Sustainability risks and disclosures in the area of asset-management”, May 2022.
- ESAs (EBA,EIOPA and ESMA): “ESAs provide clarifications on key areas od RTS under SFDR”, June 2022.
- ESAs (EBA,EIOPA and ESMA): “List of additionnal SFDR queries requiring the interpretation of EU law”.
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- Clarity AI: “SFDR: just how sustainable are article 9 funds?”, November 2022.
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- AMF (Autorité des Marchés Financiers): “Proposal for minimum environmental standards for financial products belonging to the Art.9 and 8 categories of SFDR”, February 2023.

ABOUT EUROFI

The European think tank dedicated to financial services

- **A platform for exchanges between the financial services industry and the public authorities**
- **Topics addressed include the latest developments in financial regulation and supervision and the macroeconomic and industry trends affecting the financial sector**
- **A process organised around 2 major international yearly events, supported by extensive research and consultation among the public and private sectors**

OUR OBJECTIVES

Eurofi was created in 2000 with the aim to contribute to the strengthening and integration of European financial markets.

Our objective is to improve the common understanding among the public and private sectors of the trends and risks affecting the financial sector and facilitate the identification of areas of improvement that may be addressed through regulatory or market-led actions.

OUR APPROACH

We work in a general interest perspective for the improvement of the overall financial market, using an analytical and fact-based approach that considers the impacts of regulations and trends for all concerned stakeholders. We also endeavour to approach issues in a holistic perspective including all relevant implications from a macro-economic, risk, efficiency and user standpoint.

We organise our work mainly around two-yearly international events gathering the main stakeholders concerned by financial regulation and macro-economic issues for informal debates. Research conducted by the Eurofi team and contributions from a wide range of private and public sector participants allow us to structure effective debates and offer extensive input. The result of discussions, once analysed and summarized, provides a comprehensive account of the latest thinking on financial regulation and helps to identify pending issues that merit further action or assessment.

This process combining analytical rigour, diverse inputs and informal interaction has proved over time to be an effective way of moving the regulatory debate forward in an objective and open manner.

OUR ORGANISATION AND MEMBERSHIP

Eurofi works on a membership basis and comprises a diverse range of more than 65 European and international firms, covering all sectors of the financial services industry and all steps of the value chain: banks, insurance companies, asset managers, stock exchanges, market infrastructures, service providers... The members support the activities of Eurofi both financially and in terms of content.

The association is chaired by David Wright who succeeded Jacques de Larosière, Honorary Chairman, in 2016. Its day-to-day activities are conducted by Didier Cahen (Secretary General), Jean-Marie Andres and Marc Truchet (Senior Fellows).

OUR EVENTS AND MEETINGS

Eurofi organizes annually two major international events (the High Level Seminar in April and the Financial Forum in September) for open and in-depth discussions about the latest developments in financial regulation and the possible implications of on-going macro-economic and industry trends. These events assemble a wide range of private sector representatives, EU and international public decision makers and representatives of the civil society.

More than 900 participants on average have attended these events over the last few years, with a balanced representation between the public and private sectors. All European countries are represented as well as several other G20 countries (US, Japan...) and international organisations. The logistics of these events are handled by Virginie Denis and her team. These events take place just before the informal meetings of the Ministers of Finance of the EU (Ecofin) in the country of the EU Council Presidency. Eurofi has also organized similar events in parallel with G20 Presidency meetings.

In addition, Eurofi organizes on an ad hoc basis some meetings and workshops on specific topics depending on the regulatory agenda.

OUR RESEARCH ACTIVITIES AND PUBLICATIONS

Eurofi conducts extensive research on the main topics on the European and global regulatory agenda, recent macro-economic and monetary developments affecting the financial sector and significant industry trends (technology, sustainable finance...). Three main documents are published every 6 months on the occasion of the annual events, as well as a number of research notes on key topics such as the Banking Union, the Capital Markets Union, the EMU, vulnerabilities in the financial sector, sustainable finance.... These documents are widely distributed in the market and to the public sector and are also publicly available on our website www.eurofi.net :

- Regulatory update: background notes and policy papers on the latest developments in financial regulation
- Views Magazine: over 190 contributions on current regulatory topics and trends from a wide and diversified group of European and international public and private sector representatives
- Summary of discussions: report providing a detailed and structured account of the different views expressed by public and private sector representatives during the sessions of the conference on on-going trends, regulatory initiatives underway and how to improve the functioning of the EU financial market.

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