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VIEWS
THE
EUROFI
MAGAZINE

APRIL 2023

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VIEWS MAGAZINE

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This bi-annual Views Magazine comprises contributions from a wide range of public and private sector representatives on the macro-economic challenges Europe is facing and their implications for finance, potential financial stability risks, on-going industry trends such as digitalisation and sustainable finance and key on going policy initiatives in the banking, insurance and capital market sectors.

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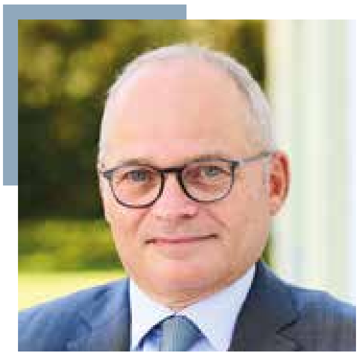

DIDIER CAHEN

MARC TRUCHET

JEAN-MARIE ANDRES

This new edition of the Eurofi Magazine is published at a time that continues to be very challenging for the European economy and financial sector.

Europe has entered a period of stagflation with inflation close to 7% in the Euro area in March 2023 and weak growth prospects below 1% for 2023. Labour productivity and productive investment are stagnating and indebtedness is reaching record levels in many European countries following the Covid crisis, limiting the growth potential of Europe. The macro context and the tightening of financing conditions also increase vulnerabilities in the banking and non-banking sectors, as shown by the recent failures of certain medium-sized US banks and the LDI crisis in the UK pensions sector in September 2022.

At the same time, the financing needs to relaunch growth and increase the strategic autonomy of Europe are huge - with the objectives of moving towards net-zero, boosting digitalization to enhance competitiveness and diversifying supply chains.

Actions have been undertaken to fight inflation with the initiation of a progressive normalization of monetary policy and interest rate increases, but rates remain negative in real terms, which continues to hinder investment with an insufficient remuneration of risk. In addition, indebtedness is holding back economic recovery and increasing debt spill-over risks, requiring a reform of the Stability and Growth Pact. The “Next Generation EU” Recovery plan is providing significant resources, but money alone will not ensure recovery if the conditions for investment do not improve more significantly.

On-going EU initiatives in the financial sector such as the Banking Union, the Capital Markets Union, the sustainable finance agenda and the Digital Finance Strategy should help to strengthen the EU financial sector, diversify sources of financing and support the green and digital transitions, but they need to move at a fast enough pace and deliver results that match the initial ambitions of these initiatives. Further developing capital markets is essential in particular in a context where public investment and bank financing will not be sufficient to provide the financing needed to relaunch growth in the EU and where risk capital is needed to support innovation. This should be a key objective in the coming months and also for the upcoming legislature.

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

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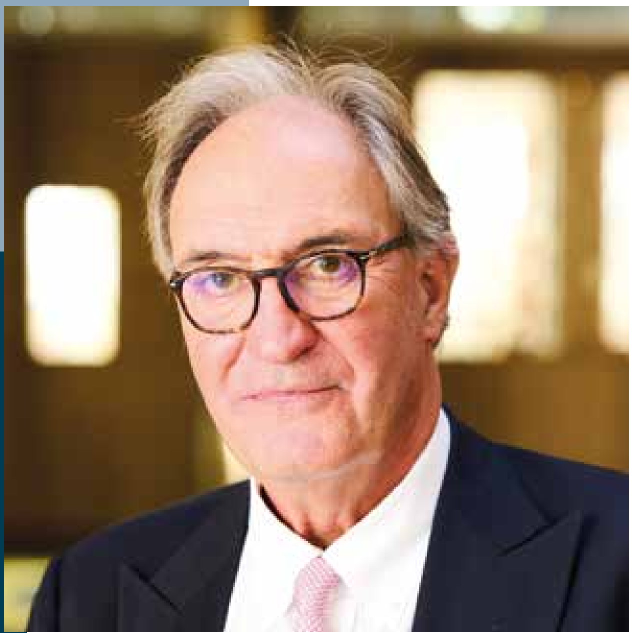

DAVID WRIGHT

President, EUROFI

A very warm welcome to all distinguished speakers and delegates to EUROFI, Stockholm, our 35th edition. We are delighted to be visiting Stockholm again, one of the great European cities. We thank the Swedish Presidency of the European Union firstly for all their expert assistance in helping EUROFI organise this event which is much appreciated and secondly, in advance, for their warm welcome and hospitality.

Never does a EUROFI meeting goes by without there being new European political, economic and financial challenges to confront - new trends, new nuances, new risks, new dangers both international and European in nature. This is evidently the case as we prepare for EUROFI, Stockholm. Financial markets are once again nervous, volatile, jittery. There is no end in sight to the war in Ukraine; there have been some significant recent banking failures in the United States and Switzerland; macroeconomic prospects are at best mixed with inflation still running high in many economies; and as interest rates have risen more financial market segments could come under pressure, commercial property lending and leverage being perhaps one example.

As this European political cycle enters its last phase before the European Parliament elections and institutional changes next year, it is my view that this European Commission has many impressive successes to its credit. Its fair and very effective handling of the COVID epidemic; its environmental leadership; the New Generation Economic Programme - €800 billion of structural reform expenditure backed up, inter alia, by common, ongoing EU bond issuance; the cohesive EU approach to the tragedy of the war in Ukraine and the demonstration of strong European solidarity with Ukraine illustrated by its robust sanctions regime against Russia; plus an emerging articulation of a stronger, more self-sufficient "future proof" EU concerning critical areas of its economy - "strategic autonomy" - replicating, to some degree, the strategic industrial policies of both the U.S and China.

However in the European financial policy areas progress in this political cycle has been more patchier and uneven. Perhaps this is due to the limited amount of high-level European political oxygen left after dealing with all the critical issues above. If that is the case, it can be partially understood. What is less understandable is still the lack of recognition that in order to achieve the EU's laudable, long-term political investment goals - whether social, digital, environmental, infrastructure, research and innovation etc - without EU capital markets functioning far more efficiently they will either be unachievable or result, at most, in third best outcomes. The European public sector, already highly indebted, pressured and deteriorating as the EU ages and as public sector demands grow incessantly, will be unable to pick up the tab. Profound, newly strengthened levels of public -private partnership are needed to succeed underpinned by a real single pan-European capital market.

True the European Council conclusions in March this year requested the Council and the European Parliament to accelerate work on Capital Markets Union and Banking Union - the first text of its type in nearly 5 years. However, they would have been far stronger if the European Parliament had been a co-signatory and if precise deadlines had been set to deliver each of the major files with a strong tripartite institutional monitoring mechanism. Be that as it may, and looking more positively, at long last the highest political levels of the EU are now beginning to realise what is at stake. Let us hope then that the European Council text can galvanise the negotiators to strike timely agreements in the short time left before the European Parliament breaks for its elections in Q2, 2024. Agreeing also the contours of the Eurozone Growth and Stability Pact as part of the same package. Pan-EU pension products should not be forgotten either. These challenges are immense, I do not underestimate them. But only politicians, the heads of State and Government and the European Parliament's leaders can accelerate their pace of delivery.

I have written many times in these EUROFI editorials that nothing will spur on the European Union more economically than good, balanced agreements in these vital financial policy areas. International investors will immediately take note. Delivery alone will boost European confidence. The EU's economic prospects will tick up and productivity will increase if we can implement a seamless, integrated and sufficient set of core macro- and micro- financial rules backed up by logical institutional architecture with strong and consistent supervision.

This is not a static challenge because new challenges are emerging, the most worrying of which is that the post-Great Financial Crisis Resolution resolution regime appears to be flawed in a number of areas. Maybe not fatally holed beneath the waterline, but changes are needed, and quickly to reassure markets and investors. This is so important because financial crises, as history has shown so often, can have hugely damaging effects on economic welfare, sometimes devastatingly so. They nearly always percolate through the banking sector.

Coco instruments now appear to be questionable and have significant stigma effects. Will they really help save or rescue a failing bank, or multiple banks in stressed, systemic market conditions? The Fed has bailed out uninsured deposit holders in a medium sized U.S bank that was evidently not properly supervised, creating moral hazard. Investors are asking whether this policy approach will be available to all U.S banks under duress, permanently or temporarily? The Swiss Authorities did not follow the established international hierarchy of creditors and legal cases lasting years are likely. EU banks, so far, have not been affected having been subject for a number of years to rigorous interest rate stress testing. The NSFR and LCR are applied to all banks in the EU, an important safety valve but not in the U.S.

Surely we need more international resolution policy predictability, some suggesting even stronger capital and liquidity requirements, even tougher supervision, tougher stress testing of all banks as far forward as possible. The rapid speed of deposit withdrawal now possible with electronic banking can be another rapid destabilising factor. Another big question it seems to me is the accounting treatment of held to maturity assets - should we continue with valuing them at historical cost or shift to mark-to -market accounting to give a truer picture of bank balance sheets?
These and other big issues like the future of ESG and crypto regulation and the EU's macroeconomic prospects will be discussed in depth at EUROFI.

So let me conclude by wishing everyone at EUROFI, Stockholm a very productive 2 1/2 days of intense financial debate, European and international, debates that we hope will contribute to help advance the process of European financial integration which is so vital for the future of the European Union.

Q&A

ELISABETH SVANTESSON

Minister for Finance,
Sweden

The Swedish Presidency's priorities for a more competitive and financially resilient EU

What are the priorities of the Swedish Presidency in the economic area?

The Swedish Presidency takes place during a time of historic challenges for Europe, both for our security and our economy. Households and businesses across the EU are struggling to make ends meet, pressured by soaring inflation and declining economic growth. However, as shown by the EU's response to the invasion of Ukraine, we are strong when we act together. Our unity is paramount, especially in these times of economic uncertainty and hardship. In the Ecofin Council, we monitor and regularly discuss the challenges associated with the economic situation and follow how the European economy develops.

In terms of priorities, I would firstly like to underline that a top priority for our Presidency is to make sure that the EU remains committed in its support to Ukraine. Among the finance ministers, we are closely monitoring Ukraine's funding needs and our Presidency stands ready to act if further financial support is needed. It is also important to look beyond the immediate needs of Ukraine, recognizing the urgency for close cooperation between the EU, its bilateral partners, and international financial institutions concerning Ukraine's reconstruction.

Second, I would like to highlight the Economic Governance Review. We need to have a solid fiscal framework that can contribute to sustainable public finances and economic growth in all Member States in years to come. The Presidency has focused on building consensus among Member States, and I am very happy that we have reached a first important step with the Council Conclusions at the Ecofin meeting in March.

Third, the Swedish Presidency has put the EU's long-term competitiveness and productivity at the forefront. We need a broad strategy to tackle future challenges, and the continued deepening of the Capital Markets Union is an important pillar of this work.

Fourth, having our Presidency at the end of this institutional cycle means working with many legislative files in parallel. To mention just a few things, we are prioritising work on the fight against money laundering and terrorism financing and the prevention of tax evasion, tax avoidance, aggressive tax planning and harmful tax competition.

Are policy makers in Europe on the right track to cope with persistent inflation and the reduction of growth?

Inflation increased at an alarming rate during 2022, fuelled by the war in Ukraine. Since its peak in September, inflation has fallen as a result of lower energy prices. Nevertheless, core inflation has continued to increase and has put immense pressure on households and businesses. High inflation has led many central banks to tighten monetary policy, which has a dampening effect on economic activity in EU Member States. GDP growth decreased in the last quarter of 2022, driven by falling investments and private consumption.

In its winter forecast, the European Commission predicted that inflation in the EU would gradually subside in 2023 and stabilize close to the inflation target at the end of 2024. GDP is expected to gain more traction as headwinds abate.

Many EU Member States reacted to the energy crisis with fiscal measures aimed at decreasing the social and economic impact on households and businesses. The potential impact of these measures on growth is hard to estimate, especially at EU level. It is likely that the measures have had both positive and negative impacts on inflation.

The initial support measures were to a large extent broad based, which might have been warranted given the suddenness and strength of the initial energy price shock. However, broad based fiscal stimulus may be less warranted going forward. For the year ahead, the support measures should preferably be phased out, starting with the least targeted ones. This could limit fiscal costs and reduce energy consumption as well as increase energy efficiency.

There is a need to strengthen fiscal sustainability through fiscal consolidation while undertaking reforms and investments that increase long term growth. In the field of energy, the EU needs to end its dependence on Russian fossil fuel by focusing on measures that increase energy efficiency, diversify energy supply, and accelerate the development of fossil free energy sources – in line with the RRF and REPowerEU.

How important is it to achieve a swift agreement on the reform of the EU economic governance framework in the coming months?

The reform of the EU economic governance framework is a priority for the Swedish Presidency, and the recent adoption of Council Conclusions on the economic governance framework is an important achievement. The efforts and the constructive spirit of the Member States and the Commission have resulted in an agreement covering general principles for the reform which will guide the Commission in its preparation of legislative proposals to make the reform a practical reality.

We have made important progress on the reform. However, it is clear that there are still outstanding issues concerning how the new framework will work in practice. These issues will have to be taken forward at the technical level. With such an important reform, it is central that we develop and agree on a framework that works for all Member States, while still recognising the need and commitment to proceed swiftly.

For our part, we will continue to take the reform forward in the Council for the remainder of our Presidency so that our Spanish colleagues can hopefully reach the finish line during their own forthcoming Presidency.

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

In our recently adopted Council Conclusions on a reform of the economic governance framework, we highlight the main elements where Member States' views have converged. Considering the Commission's orientations from November last year, we have had intense discussions in the Council and have aligned ourselves on the broad principles.

We affirm the importance of the existing reference values of 3 percent for the government deficit and 60 percent of GDP for public debt. These values should remain unchanged. When it comes to ensuring that these values are adhered to more effectively, we will move towards a system with a medium-term perspective where the Member States will make plans for fiscal consolidation, reforms, and investments for the coming years. The proposal for a new framework also includes upgraded enforcement, which will be key to ensuring its' effectiveness.

The Council Conclusions provide a solid basis for the future work that is needed on the Economic Governance Review. They pave the way for a concrete reform that ensures sustainable public finances and economic growth in all Member States for years to come.

Q&A

VALDIS DOMBROVSKIS

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

Investing in Europe's growth: from crisis reaction to building future prosperity

It is testament to the resilience of Europe's economy and society that both are holding up so strongly against shocks that nobody was expecting: first, the COVID-19 pandemic and now, Russia's relentless aggression against a sovereign neighbouring state, Ukraine.

This resilience has been built up by learning the lessons of previous crises: above all, the importance of providing a rapid, focused and coordinated EU response.

Economic output returned to pre-pandemic levels relatively quickly. We have now made a substantial shift away from Russia as an energy supplier, diversifying to gas and LNG providers in countries such as the United States, Norway, Israel and Egypt.

And take the SURE programme: this has been a real EU success story at a time of immense hardship. It provided essential support to workers and firms in the darkest months of the crisis, keeping many millions in a job to protect their incomes. It has also contributed to the unprecedentedly strong labour market that Europe is still experiencing today.

The many supply-side shocks, along with the shifting sands of geopolitics, have focused our minds towards devising innovative and flexible policies. They have worked well, and fit in with our longer-term policy ambitions too.

There are now more promising signs for Europe's economy. Energy prices have moved lower; inflation is starting to cool off after hitting record highs last autumn.

However, we are not out of the woods yet. There are also structural challenges we need to tackle: the EU's long-term energy dependence, the green and digital transitions and, more broadly, the need to strengthen our competitiveness.
All this in a context of high uncertainty as Russia continues its aggression against Ukraine.

Recent events have shown how excessive dependence – on Russian fossil fuels, for example - can be used against the EU's own interests. This is why we intend to strengthen the resilience of Member States and diversify supplies in strategically important areas.

This applies not only to reducing our energy dependence – we are already doing this via the REPowerEU inititiative - but also on inputs and advanced technologies that will be vital for advancing with the green and digital transitions.

It includes areas such as batteries, semiconductors, critical raw materials and hydrogen.

For the next few years, we have the NextGenerationEU programme to help Member States to become more sustainable, prepare them to face future challenges and tackle these challenges - thanks to the foresight in the design of its priorities.

Its flexible centrepiece instrument, the Recovery and Resilience Facility (RRF), is the vehicle for countries to carry out structural reforms and investments, to accelerate the green and digital transitions and to shore up the EU's ability to withstand future shocks. This should be done in close partnership with the private sector, including financial institutions.

For the medium term, the Commission estimates that the investments funded by NextGenerationEU could boost the EU's GDP by around 1.5% in 2024. Its reforms will have a long-lasting impact on our economies and societies even after the RRF ceases to exist.

Member States are firmly into the implementation phase of their investment and reform agendas as set out in each national Recovery and Resilience Plan. The money is flowing to Member States. The latest RRF payment to Spain brings total RRF disbursements to more than €150 billion.

This year will be critical, since we will be halfway through the RRF's lifetime. By the end of 2023, more than half of the milestones and targets will be due, so it will be essential for all Member States to get their reforms and investments into place as soon as possible.

At the same time, it is vital to maintain an anchor of macroeconomic and financial stability. This means ensuring sound public finances across all EU Member States.

The importance of investment for stimulating economic growth cannot be stressed enough. However, for Member States to invest, they require fiscal space - especially for the large investments needed for the green and digital transitions.

That said, we are now living in a high-debt environment. The unprecedented fiscal support provided during the pandemic has increased public debt and reduced the potential for fiscal manoeuvre.

Overall, debt and deficit levels are now significantly higher than a decade ago. Some countries have public debt ratios well above 100% of their GDP.

It is now time to start phasing out the support measures and improve their targeting, to avoid unfocused spending and adding to inflation.

Overall, fiscal policies need to become more prudent. They should prioritise rebuilding fiscal buffers and underpinning balanced growth. This will put us in a good position to tackle future challenges.

These are some of the priorities of the economic governance review: our blueprint for the EU's future fiscal rules. They should be credible, effective and enforceable, improving debt sustainability and boosting potential growth in a sustainable way.

It is how we can arrive at lower interest rates, create fiscal space for investment and allow countries to build buffers to cope with future economic shocks.

We are aiming for a simpler rules system, with greater country ownership and more latitude for debt reduction – but combined with stronger enforcement. Above all, we aim to ensure public debt sustainability. This will require fiscal adjustment as well as growth-enhancing reforms and investments.

Under the proposed new governance set-up, Member States will have the possibility to moderate their fiscal efforts in conjunction with carrying out reforms and investments in line with EU priorities that boost fiscal sustainability and potential growth.

This will help us to secure sustainable growth for the future. However, today's new geopolitical realities make it urgent to tackle long-standing challenges concerning our global competitiveness.

Here, the key element is the single market: our most valuable asset, now celebrating its 30-year anniversary. This must be preserved as a key source of productivity and innovation – with more reduction of barriers and more integration, especially for services.

In the last 30 years, for example, the level of integration for trade in both goods and services has doubled. But integration in services – which account for some 70% of the EU's GDP – is well below that for goods.

To maintain the EU's long-term competitiveness, the Commission has identified key areas to focus on: along with the single market, they include availability of private funding, public investments, energy, open trade, research and development, digitalisation, skills and circularity. These will come with key performance indicators that will help us to carry out annual monitoring.

We also need smooth access to private capital – and that means pushing ahead with the Capital Markets Union. Deepening and further integrating Europe's capital markets is the most cost-effective step that we can take to drive investment.

At such a challenging time for the bloc's economies, we need functioning capital markets more than ever to stimulate financing around Europe. More financing opportunities to help start-ups, to help larger companies to thrive, to create more opportunities for Europeans to invest safely.

Regulation must be simple, smart and targeted: for example, by looking at how we can reduce administrative burdens and reporting requirements.

In particular, there will be a new push for streamlining reporting requirements across the EU's green, digital and economic legislation, with first proposals by the autumn aiming for a 25% reduction in burden.

- **A globally attractive business environment, friendly to innovation.**
- **Targeted and productive investments based on sound public finances.**
- **Strong, resilient economic and financial architecture.**

These are the priorities and areas where we will focus to boost Europe's long-term growth.

Q&A

MAIREAD MCGUINNESS

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

Behind every challenge lies an opportunity: how the financial sector can support EU competitiveness in difficult times

During challenging times, the European Union is acting to support a competitive, resilient and sustainable financial system.

The EU's financial sector has recently weathered major shocks brought by the Covid-19 pandemic and Russia's war of aggression against Ukraine. The comprehensive reforms adopted after the 2008 global financial crisis played no small part in this resilience.

Still, there is no room for complacency. Higher inflation and rising interest rates present different challenges to financial stability than 'low-for-long' interest rates. The economic outlook remains uncertain, and significant market corrections are possible, as shown by the difficulties experienced by banks in the US and Switzerland in March.

On top of this, the EU economy faces challenges on competitiveness. Energy prices have risen, increasing costs to businesses. There is a shortage of skilled workers in key industries. And there is the challenge presented by the transition towards a net-zero economy.

To support the competitiveness of EU industry, in February the European Commission revealed a Green Deal Industrial Plan. This is based on four pillars: a simplified regulatory environment, speeding up access to finance, supporting skills, and open trade for resilient supply chains.

We've moved quickly to put this plan into action. On 16 March, the Commission proposed the Net-Zero Industry Act, to help the EU scale up the manufacturing of clean technologies. We also put forward the Critical Raw Materials Act to support raw material supply chains for those clean technologies. In a Communication published the same day, the Commission outlined its long-term plans to foster competitiveness, supporting better access to private capital and investment, research and innovation, circularity, and digitalisation.

The Green Deal Industrial Plan will require investment. On 9 March, the Commission adopted temporary changes to the state aid framework, allowing Member States to grant State aid in sectors that support the transition to net-zero. However, not all Member States have the same ability to grant State aid, and we need to pay attention to the level playing field in the Single Market. We also need to step up EU funding and utilise REPowerEU, the InvestEU Programme and the Innovation Fund. In addition, a future European Sovereignty Fund would have a major role to play to crowd in private investment in critical and emerging technologies for the green and digital transitions.

But when we talk about the need for investment, it's important to note that public money will not be enough. We need private financing too. That's where the Capital Markets Union comes in.

European capital markets are too fragmented along national lines, with companies in smaller markets losing out on access to a large investor base and finding it harder to get long-term capital. The Commission has a number of initiatives that are about tackling obstacles to market integration, notably in the areas of taxation and non-bank insolvency.

Europe has one of the highest individual savings rates in the world, but retail investor participation in capital markets remains comparably very low. The Commission will soon come out with a Retail Investment Strategy to help retail investors make the most of their money.

Other initiatives to support the Capital Markets Union include a one-stop shop for financial and sustainability-related company information, the European Single Access Point, and a new EU Listing Act to make listing easier, especially for smaller companies.

Finally, the co-legislators recently agreed changes to the regulation on European long-term investment funds (ELTIFs). These changes will make it easier and more attractive for fund managers to offer ELTIFs, and for investors to access them. This will directly contribute to providing more long-term private capital for unlisted companies, listed SMEs, and sustainable energy, transport and social infrastructure projects.

We also want to help investors make informed choices, especially around sustainability. The EU sustainable finance framework can help prepare EU companies and financial institutions to face the challenge of the transition to sustainability. And that preparedness can translate into a genuine competitive advantage.

In just four years, the EU has created the most advanced sustainable finance framework in the world, helping reorient capital flows towards the green transition.

We have the EU Taxonomy, which provides common definitions for sustainable economic activities. We are developing the Taxonomy further by adding activities that can contribute to four environmental objectives: the circular economy, biodiversity, pollution and water.

We also have the Regulation recently agreed by the co-legislators on the European Green Bond Standard. This will create a gold standard for companies and public authorities that want to use green bonds to raise funds for their transition.

And then there is the Corporate Sustainability Reporting Directive (CSRD), which is putting sustainability reporting on the same footing as financial reporting. Companies will have to get an assurance opinion on their sustainability reporting. This will improve the reliability of the information and reduce the risk of greenwashing. The information reported will be made available in a digital format – making it easily accessible and supporting our agenda in digital finance. When adopting the European Sustainability Reporting Standards under the CSRD, we are mindful of providing investors with useful sustainability-related information, while not creating excessive administrative burdens on companies.

Digital finance has a key role to play in shaping a more competitive, sustainable, resilient economy – and a more inclusive, modern, prosperous society. We need to make the most of these new opportunities, while managing the risks. We want to help consumers access digital services across the single market. And we want to help European financial companies scale up their digital operations across the single market as well.

We're supporting digital identification across the single market – the Commission has proposed a European Digital Identity, which would give EU citizens access to a digital wallet that works across the European Union. We've also proposed harmonising Customer Due Diligence rules.

The Commission is preparing a legislative proposal on Open Finance. Open Finance would allow a broader range of data to be shared to allow more tailored financial products and services, while putting users of financial services, whether they are consumers or businesses, in control of their data – how it is used and who can access it.

The European Union is setting clear rules for previously unregulated crypto-assets. The Markets in Crypto-Assets Regulation is expected to be published by the end of this spring. It will give legal certainty to market participants and promote innovation in the market. But it will also ensure that crypto-assets and crypto-asset service providers are subject to regulation and supervision to ensure consumer protection, market integrity and financial stability.

The Distributed Ledger Technology pilot regime entered into application in March. This pilot allows market participants to experiment with this technology in a safe environment, which is expected to bring more efficiency in trading and post-trading processes. It will also allow regulators and supervisors to learn from the experience – and we may make changes to EU legislation depending on what we learn.

We are also working closely with the European Central Bank on a possible digital euro. This would make central bank money available to people and businesses in digital form – supporting the European economy in the digital age. The digital euro would be a complement for physical cash. And it would co-exist with private means of payment.

Digital finance brings new risks, as financial institutions depend more and more on IT services and software. That makes them vulnerable to threats like cyber-attacks, especially in the current geopolitical context. The Digital Operational Resilience Act entered into force in January. This will help ensure that all financial firms have safeguards to mitigate against cyber-attacks and other risks to their digital resilience.

In the European Union, we want a financial sector that is both competitive and that supports the competitiveness of the wider European economy. That's the reasoning behind the EU financial services agenda, based on resilience, sustainability and digitalisation.

Q&A

JEAN-PAUL SERVAIS

Chair of the Board - International Organization of Securities Commissions (IOSCO) and Chairman - Financial Services and Markets Authority, Belgium (FSMA)

IOSCO takes a leading role in addressing some of the most pressing challenges facing the financial sector

What are the key priorities of IOSCO for 2023 and their implications for the EU financial policy agenda?

Needless to say, the financial sector has become increasingly interconnected over the past decades. This presents global challenges, such as those relating to financial stability, but also opportunities, provided we are able to formulate globally coordinated and consistent responses to these challenges as regulators.

The IOSCO membership of securities supervisors regulates more than 95% of the world's financial markets across 130 jurisdictions, including more than 90 members from Growth and Emerging Markets. This feature makes IOSCO unique amongst other financial standard setters in its ability to reach jurisdictions.

It is my view that despite the risks of fragmentation arising from geopolitical tensions, global trends within our remit, such as crypto-assets or climate change risks, can benefit from a globally coordinated response. Since my appointment as IOSCO Board Chair in October 2022, I have stressed the importance of delivering on previously identified priorities relating to sustainable finance, crypto-assets, and Non-Bank Financial Intermediation. Our recently published work programme for 2023-2024 reflects our determination to focus our resources and attention on these key priorities. Our Financial Stability Engagement Group will continue to help advance IOSCO's role in shaping international discussions on financial stability risks in the capital markets, as well as enhance IOSCO's working relationship with the FSB and other international standard-setting bodies.

Firstly, IOSCO is focusing on sustainable finance, with the aim of protecting investors by mitigating greenwashing and promoting well-functioning carbon markets that operate with integrity. Secondly, IOSCO will contribute to the swift rollout of global crypto-asset policy standards, critical in light of the crypto winter and most recently the collapse of FTX. In this regard, we will soon launch a consultation with the aim of releasing final policy recommendations before the end of the year. Thirdly, IOSCO is conscious of the structural vulnerabilities within NBFI, including liquidity and leverage risks. We will take further steps in 2023 to ensure that robust liquidity management frameworks are in place, both at the design phase and in the day-to-day operations of investment funds, to address vulnerabilities arising from non-bank financial intermediation.

What are IOSCO's key priorities and actions to mitigate greenwashing and protect investors in financial markets?

I spoke at COP27 in Sharm-al-Sheikh to underline that sustainability disclosures can make a significant difference in combating climate change and here, IOSCO and securities regulators can and will play an important role in supporting the transition to a low carbon economy. As securities regulators, our view is that climate-related risks are a source of financial risk that can affect not only specific firms or sectors but, more broadly, the stability of the financial system as a whole and can be a source of significant investor harm through greenwashing. This issue is therefore relevant to all the three IOSCO core objectives of (1) protecting investors, (2) ensuring fair, efficient and transparent markets, and (3) reducing systemic risk.

We aim to protect investors against the risks of greenwashing in financial markets by contributing to the development of sustainability disclosure standards that benefit issuers and investors alike. I welcome the efforts of the standard setters that are likely to result in both sustainability-related disclosure standards and related assurance standards to be ready for use by corporates for their end-2024 accounts.

This is in response to the significant investor demand for high quality and reliable sustainability disclosures. We need a global language for sustainability disclosures to replace the current alphabet soup of private disclosure frameworks, in order to promote greater consistency and comparability of disclosures.

We therefore welcome the International Sustainability Standards Board's commitment to publishing its global standards for climate disclosures and general requirements in Q2. Once they have been released, it will be IOSCO's responsibility to consider potential endorsement of the ISSB standards. A potential endorsement should be a game changer and give impetus for the adoption or use of the first global and inclusive framework for sustainability-related disclosures by corporates.

Three factors will be key to achieving global uptake. First, maximising interoperability between the global framework and jurisdictional frameworks will be an important factor. Second, IOSCO will be receptive to the mechanisms designed to allow for a sufficient degree of proportionality to ensure all jurisdictions can get on board. Third, we see merit in building in limited flexibility for some disclosure requirements, in order to alleviate legitimate concerns relating to data availability and the preparedness of companies to comply in a timely manner. This takes into account the reality that, while the direction of travel is the same, we may not all travel at the same speed.

We are in constant dialogue with the ISSB, and I welcome their determination to address global entities' diverse levels of ability and preparedness to implement the final standards.

How is IOSCO addressing the opportunities and risks from crypto-assets, stablecoin and DeFi activities? What are the next steps in the ongoing work of IOSCO in this area?

Another area of focus for IOSCO is the regulation of crypto-assets in order to deal with the severe investor protection and market integrity risks crystallising in this market.

IOSCO has been, and continues to be, deeply involved in the global response to risks, issues and vulnerabilities in the crypto-asset markets, having first identified this area as a corporate priority in 2017. Following an intense period of regulatory risk analysis, information sharing and capacity building, where we concentrated on understanding market functioning and assessing the risks to our regulatory objectives, we have now shifted gears and have moved into policy development to address the very clear and present risks to investor protection and market integrity.

Increasing numbers of securities regulators around the world agree that investor protection, market integrity and financial stability issues relating to crypto-assets are already within their regulatory remit. About a year ago, IOSCO established a Board-level taskforce to lead its regulatory policy agenda with respect to fintech, which consists of two work streams: Crypto and Digital Assets (CDA) and DeFI. In light of recent developments and the risks arising from intermediation and centralisation in the crypto asset market, we have accelerated work on CDA with a view to developing a detailed set of global principles for regulating crypto-assets and related service providers by year-end.

In December 2022, the FSB Plenary re-emphasised the urgency of advancing the FSB's financial stability-focussed policy work programme, and that of the standard-setting bodies like IOSCO, to establish a coordinated global framework of regulation and supervision for crypto-assets, including in non-FSB member jurisdictions. The complementarity of the expertise of central banks, securities and market regulators, and treasuries is more critical than ever. We are working together in a collaborative spirit.

We bear responsibility for translating the basic key tenets of our globally recognized standards for capital markets regulation to crypto-assets and their service providers. We examine substance over form when it comes to innovations, in order to focus on underlying economic attributes and behaviours and to deliver the right regulatory outcomes from a policy and implementation standpoint.

Our policy approach follows the paramount principle of same activity, same risk, same regulatory outcome informed by our expertise as securities markets regulators.

We will be issuing a public consultation in the coming months, which we expect to attract significant attention. I cannot emphasise enough the importance of delivering a coordinated and comprehensive framework for crypto-assets in a way that adequately protects investors.

Q&A

MONIQUE GOYENS

Director General -
The European Consumers' Organisation (BEUC)

Ensuring financial markets deliver for consumers: a work in progress

What are your views on the prospects of the digital euro? What are the conditions to ensure consumer acceptance of this project?

If properly designed the digital euro could boost digital financial inclusion, ensure privacy when paying online and create a non-commercial alternative for consumers in digital retail payments. However, we see strong pressure from the private sector to design the digital euro as a "business as usual" private digital payment method. This would not bring any added value for consumers. Instead, we are aiming for a digital euro which is a digital equivalent of cash.

This means that everyone should be able to use it, no matter their income, digital skills or disabilities. In practice this means that an inclusive digital euro relies on a dense network of ATMs and bank branches allowing consumers without digital skills or personal devices to use it and receive personal support by bank staff. As for cash, there will be a systemic cost but using the digital euro should be free of charge for all consumers.

A digital euro should also ensure privacy by design and by default. We ask for full anonymity in case of low-value transactions and limits to transaction data sharing in all cases. Money laundering preventions are of course a legitimate purpose but should not be used as an excuse to make payment data available to all sorts of commercial parties.

Are the opportunities and risks from cryptoassets for retail customers appropriately addressed in the MiCA regulation?

We need to be mindful of the fact that we are talking about very volatile products therefore from a retail investor perspective, it is extremely important to be aware of the risks they entail. MiCA is certainly a welcome step to ensure crypto markets are regulated and supervised. ESMA and the other European supervisors have been looking at crypto already for a while, raising the alarm about the risks for consumers putting their money in crypto schemes, which are often presented as offering promising returns, when the reality has told a different story. In addition, we see more and more pseudo-financial advisors on social media providing advice and guidance to consumers about crypto. We even see crypto advertising in football matches and billboards. This creates the wrong impression about what crypto really is and how risky is to invest in them without knowing or understanding the system. This is why we believe that we need to be even stricter about advertising and promotion of crypto across media and we hope the European Supervisory Authorities, together with the consumer authorities will take a strong stand to protect consumers against scams and misleading claims surrounding crypto.

What are the key drivers for developing retail investment in the EU and the obstacles to overcome?

The most fundamental and important issue is the quality of financial advice. Financial advice is essential, because consumers can't all be finance experts. They need assistance to find suitable products and they rely on advisors to do so. Finance is a complex world full of jargon and educating consumers to help them navigate it will not boost participation on its own, unfortunately. We need to fix the market first to create the conditions that allow for more consumer engagement.

We have concerns with the current advice system: "financial advisors" receive kickbacks from the industry for the products they sell, meaning they are sales agents rather than advisors. This leads to a conflict of interests: to earn money they must sell products, and its best for them to sell the product with the highest rate of inducements. The financial industry, who pay the "advisor", take this money from the consumers' investment as product cost. This reduces the net-returns of the investment product, which is bad because returns are the point of investing in the first place. Higher inducements sell more products, but they decrease the quality of the products sold. This is adverse selection; the worst products get the most traction. Accordingly, product quality is very poor in the EU, satisfaction on the consumer side is low and market participation is also low. This must change! We must ensure that all advisors are independent. We have done this already with other markets where consumers rely on experts: lawyers and doctors do not work for the industry but for the consumer.

The EU needs to fix the advice issue to be able to do meaningful work on other investment matters. For example: Disclosures could be designed to be much less burdensome and confusing, if there was less risk of advisors selling bad products.

The Commission seems to be willing to propose the solution here: A ban on inducements. We strongly support this direction, and we support it as an absolute priority in investment issues. If we manage to take this step, we can then spend the next ten years finetuning a market where consumers choose with the help of advisors, instead of one where the industry chooses which products to push.

What are the expected benefits and possible shortcomings of the Sustainable Finance Disclosure Regulation (SFDR) for retail investors?

The CSRD will lead to a fundamental shift in the way companies report about their sustainability, which until now has focused mainly on financial figures. This would certainly be an improvement on the current state of affairs, as reporting is for now a mostly voluntary and unstandardised free-for-all, full of fluffy language, lofty promises and rife with social- and greenwashing. This will benefit consumers who want to invest sustainably. If, that is, the European Sustainability Reporting Standards, which set the rules of the game, survive the current industry lobbying onslaught that want to dilute them. Another disclaimer is that the CSRD only applies to companies that operate in the EU, but funds often invest into other world regions, too. It remains to be seen how solid the sustainability reporting for third-country companies will be in the future.

As for the SFDR, it is currently severely flawed. It was meant to be a disclosure regulation, but has become a product standard and does not define sustainable investment products in a sufficiently clear and rigorous manner to be able to do this. Everybody agrees that a legislative review is needed, but we do not expect that to happen before the next European Parliament and Commission have settled in. The SFDR should function as a genuine product standard by setting criteria and minimum requirements for different types of sustainable investment products. It should also define 'sustainable investment' and the 'do-no-significant-harm' principle in a rigorous manner that is consistent over the relevant EU laws, such as the Taxonomy and MiFID.

We support current efforts by the European supervisory agencies to curb greenwashing in retail financial services, in particular ESMA's proposal to set minimum requirements for investment products with sustainability-related terms in their names. However, these can only be stopgap measures until a robust legal framework is in place.

Q&A

JACQUES DE LAROSIÈRE
Honorary President -
EUROFI

Central banks must get out of the control of the yield curve

How did the ultra-accommodating monetary policies of the last 10 years create the conditions for a financial crisis?

The policy stance has been continuously accommodative and interest rates have been kept too low for two long. Even if secular factors (ageing, globalization, ...) explain that interest rates have been declining, it remains that the Fed funds rate have been kept negative, in real terms for 20 years. After the worst was over after the Global Financial Crisis and the EU sovereign debt crisis, policy rates should have been gradually raised above zero. But monetary policies have been asymmetric especially in the euro area: as soon as the economy showed slight signs of weakening, monetary policy was immediately loosened while it was reluctantly tightened in case of overheating. The fear of deflation was overdone and was not based on objective facts (fall in prices never happened).

Lasting very low interest rates favored the growth of debt, which reached unprecedented levels and increased financial leverage which undermined financial stability. A normal monetary policy includes the monitoring of credit growth in its indicators, but the credit growth rates for 20 years have exploded without control by the central banks. Between 2000 and 2019, M3 grew between three and four times faster than GDP, in the US (2.9 times) and in the Eurozone (3.8 times). But it is always the explosion of credit that is the source of financial crises! The fact that central banks turned a blind eye to the explosion of credit is incomprehensible.

This created the conditions for financial and real estate asset prices inflation and discouraged productive investment. The entire financial system and the real economy have been weakened over the last 20 years by this addiction to permanently zero interest rates. A Mc Kinsey report shows that 75 per cent of the trebling of net wealth observed in the global balance sheet over the last 20 years came from higher market valuations of "speculative" assets and only 25 per cent resulted in real investments and wages!

Central banks were convinced that interest rates would remain at zero for a very long time, to the point that the markets were convinced of this. The risk of rising interest rates has even not been included in the US stress test in February 2022.

They have therefore prepared the financial crisis to come.

Faced with inflation, which they wrongly considered to be transitory, central banks are raising nominal rates since several months, which reduced the value of fixed-rate bond portfolios. Risk management, and in particular interest rate risk, is becoming essential. This is where we are today.

Last but not least, instead of stimulating money creation and public debt, it would have been better to undertake structural reforms capable of increasing productivity 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.

In the current macroeconomic context, what does normalizing monetary policy mean?

Central banks must get out of the control of the yield curve. QE has been used and abused to reduce artificially long-term yields while such yields should be the result of demand and supply on the financial markets. If central banks were to reduce their balance sheet only in a limited or symbolic way, the excess liquidity which is the source of financial instability would persist.

We need to stop telling fairy tales. We need to recognize that the policies that have been pursued over the past 20 years or so have caused serious damage to the soundness of the financial system.

We must not cling to positions that have proven dangerous in an attempt to pretend that we were right all along.

Denial is not a strategy. It is the recognition of the facts and the willingness to get out of the problem that justifies public action.

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.

But haven't monetary conditions tightened much in the Eurozone since July 2022?

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, for its part, bases its policy not on realised and observable inflation but on the expectations of economic agents. Market expectations seem reassuring. 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.

It can also be shown that positive real interest rates 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 remunerated. Actually, the huge monetary and accommodative fiscal stances of the last decades have not led to productive investment or growth.

How important is it to achieve a swift agreement on the reform of the EU economic governance framework in the coming months?

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.

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 and the others.

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. These two shocks have exacerbated these problems but are 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.

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ECONOMIC CHALLENGES AND IMPLICATIONS FOR FINANCE

- Implications of inflation and de-globalisation
- Stagflation threats in Europe
- Euro area economic governance challenges
- Investment needs for the green transition
- Trends in the Nordic-Baltic region

WHAT ECONOMIC GOVERNANCE IN THE EURO AREA

PIERRE GRAMEGNA
Managing Director -
European Stability Mechanism (ESM)

The reform of the EU fiscal rules: time is of the essence

Over the past 15 years, the euro area has been confronted with several crises. Unwavering determination, new tools, institutional reforms, and an increasing degree of solidarity have helped the euro area overcome these crises and become more resilient.

Following the severe pandemic-induced recession, the euro area experienced a strong economic rebound before waking up to the horrors of war at its doorstep. Beyond the unbearable human toll it has been engendering, the war on Ukraine has also significantly exacerbated inflationary pressures that had emerged during the COVID-19 crisis. Despite this new shock, the euro area narrowly escaped a new recession.

Even so, challenges remain. While headline inflation is receding, it remains elevated and core inflation has remained uncomfortably sticky. Both the pandemic and the energy crisis have required substantive fiscal stimulus, thereby augmenting public debt. In the short-term, this increase doesn't pose an imminent risk, as governments have been able to lock in their refinancing at very low rates during an extended period. However, as interest rates go up, vulnerabilities will increase over time.

While economic policies did reinforce each other during the pandemic, the current economic context necessitates a new alignment between monetary and fiscal policies. Government spending needs to remain in check to avoid undermining the effective transmission of monetary policy. In the same vein, prudent fiscal policies are imperative to safeguard debt sustainability over the medium-term.

Against this backdrop, the ongoing reform of the EU fiscal rules is crucial. With the general escape clause phasing out by the end of this year, time is of the essence. Reverting completely to the old set of rules would entail a clear risk: imposing an overly ambitious consolidation path on countries with higher debt level and thereby confronting them with unwarranted economic hardship. This would not only weaken these member states, but also the euro area as a whole.

The future fiscal framework will need to include several features so it can better serve its purpose:

- First, it will have to be transparent. Making rules less complex automatically leads to increased transparency. In this regard, setting targets in the form of simple and observable variables that are under the direct control of governments would help considerably.
- Second, the framework needs to gain in credibility. Once agreed, all parties will have to abide by the rules. If not, trust in the system will be undermined and fail to send reliable signals to the markets.
- Third, the reformed framework should be based on the clear tenet that any debt consolidation path should reconcile both stability and growth. Both should go hand in hand. This would foster ownership and generate superior outcomes.
- Finally, the emphasis should be on "sustainable" growth, as sustainable growth constitutes a strong foundation for stability.

The European Commission's communication on orientations for a reform of the EU economic governance provides a good basis for discussion. The proposal incorporates many of the features that policymakers, academics and analysts have been calling for in recent years. It represents a welcome step forward with its medium-term orientation and the move toward observable fiscal variables.

The consideration of members states' different starting points and the possibility to lengthen adjustment paths by up to three years to implement reforms and make investments are also welcome. Yet, such reforms and investments should be well-planned and growth-enhancing to justify longer adjustment paths.

This reform is critical from the standpoint of the ESM because it has several implications for its work.

First, debt sustainability, which is central to the Commission's proposal, is at the core of the ESM's work. Unsustainable public debts put at risk financial stability, the safeguard of which is the ESM's primary mandate. Furthermore, access to ESM financial assistance, particularly its precautionary credit lines, is tightly linked to criteria related to EU fiscal rules. Finally, the ability of the ESM to track countries' ability to repay their ESM loans – the so-called early warning system – is inextricably linked to post-programme surveillance, which is also addressed in the Commission's communication.

Agreeing on a reformed fiscal framework that strikes the right balance between sustainable growth and stability is key to make the euro area prosper and become even more resilient. The coming months present a unique window of opportunity to do so.

VINCENT VAN PETEGHEM
Minister of Finance, Belgium

Towards a tripartite framework: with debt reduction, investments, and reforms

The European budgetary rules have been temporarily put on hold due to the severe energy and purchasing power crises, allowing Member States to support households and companies. But starting in 2024, we will again fall under this EU framework.

Thirty years ago, the Maastricht Treaty created those debt and deficit rules. Because a monetary union without a full-fledged budgetary capacity, requires at least some stringent budgetary coordination.

But up to now, those European debt rules have not been a great success. The major starting point of those rules was its countercyclical nature: building up buffers in good economic times that can be used during economic downturn. However, recent decades do not show this in practice. In periods of economic prosperity, we did not build up sufficient buffers. And after the 2008 financial crisis Member States put in place austerity measures, that additionally caused a drop in public investment rates.

So the existing European budgetary rules did not work in the past, and would not do so in the future. Because these rules do not take into account the different foundations on which our economies are built. They do not recognize the heterogeneity of economic and fiscal performance between euro area countries. One-size clearly does not fit all, when it comes to debt reduction trajectories. Moreover, the budgetary rules are not adapted to the current macro-economic environment. The average public debt ratio of euro area countries has been close to 100% of GDP over the last years.

The European fiscal framework sets the pace (1/20th rule) at which Member States must reduce their debt levels to the 60% benchmark (the average when the rules were created in 1992). For many Member States, that pace is far too high, making compliance unachievable. In order for the rules to be applied, they should at least be realistic.

Therefore, more than ever, a thorough reform of those rules is needed.

Of course, the starting point of the European fiscal rules remains unchanged: we need sustainable debt ratios in the medium and long term. This should ensure the smooth functioning of our monetary union, and ensure governments find funds on financial markets at reasonable rates.

But the current rules did not manage to keep debt ratios under control. The current focus is too one-sided. In addition to a healthy budget, we also need a strong economy. Productivity and future economic growth - through investments and reforms - must also have their place. Because those also have a positive effect on future debt levels.

In order to incorporate reforms and investments into the European fiscal framework, I plead for a commitment-based approach which could be based on the RRF mechanism. Member States could set up a package of investments and reforms according to their country-specific needs. This could create more ex-ante flexibility, by giving governments the possibility to extend their debt reduction trajectory, in exchange for this package of investments and reforms. But ex-post, this RRF mechanism will also enhance compliance, due to strict control of this package.

We need a tripartite budgetary framework with a focus on debt reduction, investments and reforms.

The eligible investments allowing for a prolonged debt trajectory need to be of high-quality and should be growth-enhancing. This requires a clear labelling of investment, preferably by independent EU institutions such as for example the European Fiscal Board. Moreover, those 'labelled' investments would need approval by the Member States. This more country-specific approach will not only create more ownership for Members States, it will also encourage Member States to see debt reduction, investments, and reforms as one package for increasing the resilience of their economies.

Therefore, our future budgetary framework should shift away from the one-sided focus on debt reduction, towards a tripartite European budgetary framework with a focus on ánd debt reduction ánd investments ánd reforms.

GINTARĖ SKAISTĖ
Minister of Finance
of the Republic of Lithuania

The new fiscal framework should help overcome EU's challenges

In today's environment, marked with russia's unjustified war against Ukraine, ensuing inflationary pressures, lasting negative effects of the pandemic, risks stemming from climate change and other challenges, review of EU fiscal framework may seem as a rather technical issue. Yet it could not be further from truth. Revision of the European fiscal ruleset could and should become part of the solution to these numerous challenges – enabling governments' response in terms of enhancing resilience and growth potential of our economies, while safeguarding the overarching objective of fiscal sustainability.

With the challenging landscape, there is room for optimism. We see that in principle agreement on key pillars of the economic governance review proposal put forward by the Commission is emerging. The proposed new framework is rightly focused on a risk-based approach, with the central aim to boost domestic ownership. It also outlines a delicate balance between incentives to implement growth-enhancing reforms or investments, and commitment to credible debt reduction paths in high debt Member States. The fine line between tailored country-specific solutions and multilateral character of the fiscal framework still needs to be drawn, but the direction of travel is overall appropriate.

In this regard, a key issue is to ensure that the reviewed framework does not leave low debt Member States beyond the radar screen. A strong preventative element is needed in the system, in order to prevent unwarranted build-up of debt levels. Otherwise we face a risk that in several years' time the currently low risk countries may jump into the medium or high risk basket. This would not be the envisaged outcome of the economic governance review. Having said this, it is important to ensure that national Governments retain the right to decide on concrete policy instruments and their design, as long as the agreed fiscal targets are met.

Furthermore, a differentiated framework brings risks to transparency and equal treatment of Member States. To mitigate these risks, transparency is key, as it helps build trust. Especially, given that the new system would likely be based on debt sustainability analysis (DSA) as its key pillar. It is crucial to ensure that the underlying DSA assumptions are clear and agreed upon in advance, with the exercise itself replicable. In this regard, a stronger role for the European Fiscal Board should be explored. For instance, it could provide an independent verification of the DSA, which would form the basis of Member State's fiscal path.

No matter how well designed rules are on paper, if we do not implement them in practice, we will not reach the envisaged effect – be it increasing long-term fiscal sustainability or enhancing resilience and growth potential of our economies.

In this respect, effective enforcement is critical. We need to de-stigmatise financial sanctions and not be afraid to use them. Also, a higher degree of automaticity in applying the sanctions is necessary – especially if a Member State deviates from the approved (extended) fiscal adjustment path or fails to implement the agreed reforms.

Guarding against an existential threat cannot be lost in scrutiny of debt sustainability.

Finally, while providing de facto more room for growth-enhancing and green investments, we must not forget about the current geopolitical context, which dictates the need to invest heavily in boosting our defence capacities. Guarding against an existential threat cannot be lost in scrutiny of debt sustainability. This new reality must be reflected appropriately in the new framework.

To conclude, we have to aim for transparent and realistically applicable fiscal framework leading to fiscal sustainability, including through growth-enhancing reforms and investment. We are on good track and I see all preconditions to complete this review by the end of this institutional cycle.

HARALD WAIGLEIN

Director General Economic Policy,
Financial Markets and Customs -
Federal Ministry of Finance, Austria

A new economic governance framework: finally playing by the rules

Even before the pandemic crisis, the fiscal position of EU member states was quite heterogeneous. Countries entered the recent difficult years with different levels of government debt and deficit. There was thus very different fiscal room for manoeuvre to cope with some common, but also some quite diverging challenges.

For a long time, financing conditions were favourable due to a low interest rate environment. The window to buy time for reforms and adjustment to enhance resilience and create buffers is now closed again. The ECB cannot raise interest rates as vigorously as it would like in its fight against high inflation because it has to take account of countries with high debt levels. But what is even less feasible is to lower the rates, at it would risk de-anchoring inflation expectations.

Fiscal policy has sometimes relied too much on “low for long”, which reminds us that fiscal and monetary policies must always be well coordinated. And the inability to properly co-ordinate on measures to cushion the energy price hike has its roots also in the General Escape Clause.

It shows that a fiscal framework that ensures the sustainability of public finances is a key element of the economic architecture of the EU. Alternative narratives have not passed the reality-check. High deficits did not buy-in voters, nor markets.

With the presentation of the European Commission’s ideas for a new EU economic governance framework last November, we have entered into concrete and intensive negotiations on a new Pact, taking into account shortcomings of the current framework. As the ECOFIN Council Conclusions of mid-March say, we still have a lot of work to do and further clarifications and discussions are needed.

And that brings us to what I see as the key points for a possible reform of the Pact and for further clarification:

My first point concerns the agreement already reached by the Council to maintain the 3% deficit and 60% debt reference values. I am very satisfied with this agreement. These two targets are important reference points that are easy to communicate and clarify the direction in which public finances must move.

My second point concerns the proposed possibility of extending the consolidation period if reforms and investments meet certain criteria. It will be important to work out clear criteria to distinguish between productive and sustainable investments and those that are not. We have to take a holistic view, because it is not only the amount of public investment that counts, but also the “right investments” and the institutional environment. We should also focus more on the composition and quality of our budgets and transparency as regards implementation. For structural reforms, that are certainly urgently needed in many countries and areas, it is important to ensure that they are implemented at the beginning of the adjustment period. In a new framework, we should generally adopt the approach of performance first. Not first the reward for a promise that may never be kept.

Third, it has been and remains one of our central demands that we only agree to more flexibility, if enforcement is strengthened at the same time. After all, the weak enforcement of the Stability and Growth Pact in the past is one of the main weaknesses of the current fiscal framework. The design of a fiscal framework is essential for shaping expectations of politicians and market participants. No less important is the actual enforcement of the fiscal requirements. To ensure maximum compliance, the actual Pact is equipped with a sanction mechanism. But so far, no fiscal sanctions have been imposed. We need to define more “effective” sanction rules. I can well imagine that we will reduce the size of the fines to make them politically easier to enforce. And we certainly also need to improve enforcement mechanisms.

We have to play by sound and enforceable rules again. The sooner, the better.

My final message is about the special role of common fiscal rules for the euro area. I am generally in favour of stricter rules for euro area countries, with a focus on those with very high debt ratios. As regards the future of the Economic and Monetary Union and the repeated demand of the ECB and others, namely the establishment of a central fiscal capacity, I am very sceptical that this will solve our problems. If we use the enormous financial resources of the Recovery and Resilience Facility effectively and efficiently, and if all EU countries adhere consistently to the common EU fiscal rules, then we will not need a common borrowing capacity.

In conclusion, I hope that we will soon see concrete progress. It is high time that we start to move out of the vacuum of applied fiscal surveillance that has now existed for several years.

IMPLICATIONS OF INFLATION AND DE-GLOBALIZATION FOR FINANCE

IRENE TINAGLI

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

Coordination is the magical word at this time

After more than a decade with price changes almost permanently below the European Central Bank's target, in the last year we have been faced with a sudden and unexpected increase in inflation. While at the beginning this increase was mainly driven by a sharp rise in the price of energy raw materials, only partly justified by actual mismatches between supply and demand, as the months go by, inflation seems to be driven by endogenous factors, among which emerges in particular an average increase in mark-ups, albeit with a strong heterogeneity between countries, sectors and industries.

At first glance, inflation and negative real interest rates may appear to be a big opportunity for some sectors, especially the financial sector. However, as time goes by, inflation is not a good deal even for banking and finance. Indeed, the longer a period of inflation lasts, the more difficult it is for investors to predict future price trends. As a reaction, they shorten the time horizon of their choices. The result of this process may be a progressive drying up of medium and long-term financial markets and of investment. All of this may shorten the average duration of financial and non-financial investment, thus determine a negative impact on potential economic growth.

The fight against too-high inflation is therefore crucial. The ECB has taken up its role and engaged in raising the interest rates and in monetary tightening. What is important is that we should not be too demanding on what monetary policy can do in this context. If we give the idea that central banks can always have full control of inflation, we might risk endangering their credibility and therefore their own effectiveness. We should not ask them too much, but we have to ask them what is right.

As time goes by, inflation is not a good deal even for the financial sector.

Coordination is the magical word at this difficult time. However, coordination can be understood in different ways.

First, coordination among central banks at international level. As the most recent OECD economic outlook shows, when all central banks hike interest rates simultaneously, the negative impact on GDP is larger but the impact on inflation is smaller because the foreign exchange channel is muted. Coordination would therefore be essential, although we all know that it is historically extremely difficult to get.

Second, coordination between fiscal and monetary policy. By its nature, fiscal policy can be more targeted than monetary policy and therefore may help households and firms to face extra-large energy bills and can reduce possible second round effects on wages, making central banks' task easier. Monetary and fiscal policy can be synergic in the sense that if you use both, you can use less of each if taken alone. Of course, the coordination of monetary and fiscal policy is not easy too, in particular in the European Union where monetary policy is centralized while fiscal policies are left entirely to individual Member States. However, an uncoordinated solution may have a strong negative impact on real economy as well on financial stability.

Third, coordination within Member States or within the Union. The risk of price-wage spiral is not a monetary problem. It is a distributional conflict. As Olivier Blanchard recently explained, this conflict stops only when the various players are forced to accept the outcome. Forcing the players to accept the outcome, and thus stabilizing inflation, is typically left to the central bank. By slowing down the economy, it can force firms to accept lower prices given wages, and workers to accept lower wages given prices. In this perspective, leaving the fight against inflation entirely to central banks is probably not the most efficient way to stop prices increase. Other policy tools might be useful to resolve this distributional conflict without necessarily having to go through a major recession.

Last, but not least, coordination is important on a broader international level, in particular with regard to the Inflation Reduction Act (IRA) adopted in the United State and other measures that might have the effect of trade barriers or incentives to delocalize Europe's renewable energy industry.

While IRA's objective is to promote clean production and innovation in clean technology, and to accelerate climate efforts, some component of that act and the large amount of funding mobilized might pose challenges for transatlantic trade and investment. It is therefore important that the European Commission works for a mutual agreement with the US Administration based on the strong relationship/ties we share.

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

The case for a European financial strategic autonomy is more relevant than ever

In April 2022, under the French Presidency, the Council adopted ambitious conclusions on European financial strategic autonomy. Such conclusions were based on the consensus that the EU faces massive financing needs for the transition to a sustainable economy, estimated at € 350 bn additional financing every year until 2030, which requires a mobilization of the private sector.

One year later, the need for true strategic autonomy is more relevant than ever as the situation on financial markets has deteriorated and given protectionist tendencies in the world.

First, the economic context has profoundly changed. Geopolitical uncertainties triggered by Russia's war in Ukraine, the deterioration of the economic situation and the tightening of monetary policy have affected the European financial sector. It led to an increase of the interest income earned by financial institutions, but also to a renewed cautiousness in asset prices, particularly in the loan portfolios of lending institutions, and emerging vulnerabilities of the non-bank financial sector, due to potential market corrections. The recent stress that followed the collapse of the Silicon Valley Bank and the takeover of Crédit Suisse has added further market pressure on the European financial sector. Nevertheless, European banks are generally in a very strong position when it comes to capital and liquidity.

French banks are also well preserved from credit risk, and deposits are stable thanks to fixed rates, regulated savings and macroprudential framework. It also shows that when confidence is at stake, we are as strong as our weakest link. This is the best reason not to go for a two-tier system in banking regulation. But this is also true of supervision, and here as well we are better off the progress made with the implementation of the SSM: quality of supervision is key, and Europe is well endowed in this regard.

The IRA has underlined the urgency for the EU to unlock additional financing for its transition.

Second, the Inflation Reduction Act, signed into law last August in the United States, has underlined the acute need to develop and target additional financing solutions for the transition in the EU. As the US proposal aims to catalyze investments in domestic green technologies through significant federal funding. In February, the European Commission presented a Green Deal Industrial Plan to enhance the competitiveness of EU's net-zero industry, which included public support to unlock huge amounts of private financing, and included legislation covering technologies that significantly contribute to decarbonization. Overall, according to estimates, the EU will mobilize €400-500 bn over 2021-2027.

From these observations, I draw the urgent need of a coordinated response at European level.

In the short-term, the priority is to reach an agreement on banking and insurance regulations, which will increase further their resilience while ensuring their capacity to provide sufficient financing to the European economy: in the current juncture, both aspects are needed at the same time. This should be complemented by resolute actions to complete the Banking Union, which will further strengthen the resilience of the overall EU banking system and reduce perceived risks for savers and investors. As a first step, we look forward to the Commission's proposal on the crisis management framework.

In addition, the launch of a European Sovereignty Fund, to finance joint EU projects in clean technologies, would certainly help to unlock private capital to reach the goals of the Green Deal. In order for such plan to be a success, it is even more critical to ensure that EU and national governments put in place conditions to build a strong and competitive European home-market for financial services. Such home-market is best-placed to support EU strategic goals, by complementing public money and ensure that European private pools of capital can meet the European economy's strategic financing needs.

To ensure that capital is appropriately channeled towards strategic and sustainable activities, the legislative proposals on Capital Markets Union must be completed before the end of the current legislative cycle. It will help to diversify the sources of capital, increase retail participation and better channel long-term capital towards riskier projects.

The Capital Markets Union should catalyze the EU sustainable finance framework and support allocation of financial flows towards sustainable activities. In addition, trust from retail investors on green financial products should be increased, by addressing greenwashing concerns and their long-term detrimental effects. National measures could also help channel private capital towards long-term ESG funds.

Mobilizing these levers could unlock the financing needed for the ecological and digital transition without interruption. In short, we are already well equipped to weather the current turmoil and uncertainties, but we should definitely take a very proactive stance to strengthen the European financial sector as a key means of funding the future.

VITTORIO GRILLI

Chairman of the Corporate & Investment Bank, EMEA - J.P. Morgan

Inflation, de-globalisation and the provision of finance in the EU

Inflation and de-globalisation are two macro-trends impacting the financial sector. Policymakers should keep these in mind as we consider priorities for the next EU legislative cycle.

Inflation

The Eurozone is still experiencing higher than expected inflation into early 2023. This is likely due to lagging effects of the war-induced energy crisis from last year, which itself came on top of COVID-induced supply chain issues and post-lockdown reopening effects. For example, the Eurozone is likely only now seeing the effects of high gas and electricity prices on processed food, while unprocessed food price inflation has declined. Negotiated wages have also remained on an upward trend in recent months, which might lead to continued services price inflation. These lagging effects should be temporary, meaning over the medium term, I would expect Euro area inflation to gradually return to its 2% target.

The banking sector is already seeing some effects of recent inflation following several years of expansive monetary policy. Some of the large amount of government debt in the market has ended up on the asset side of banks, especially as such debt has been considered highly liquid by regulators, carrying very low capital requirements due to its supposedly risk-free nature. The recent moderation in macroeconomic policy, including a reversal of asset purchases and higher rates, should have normally helped an ailing banking sector with increased spreads.

However, the rapid rise of interest rates has also placed heightened focus on the potential for a deterioration in the fair value of held-to-maturity portfolios, including those which are composed of risk-free government debt. This should give pause for thought on how risk-free debt is treated. Rising rates also hurt certain banks more acutely where interest rate risk was not appropriately managed and which had a highly concentrated and flighty deposit base.

While the regulators and the industry have made considerable progress with regards to improving the resiliency of the banking system through more stringent capital, liquidity and other requirements, particularly for the world's largest banks, there is more work to do to ensure that the right set of requirements are applied to institutions of different sizes.

The EU should remain open to international financial markets, which fortifies its resilience.

De-globalisation

The recent banking troubles are a reminder of problems with high inflation. However, a trend towards de-globalisation could act as an obstacle to a return to pre-COVID and pre-war levels of low inflation. Empirical evidence is clear that globalisation, especially in the case of European trade with Asia, has had an important deflationary effect over the past decades. Reversing this trend will likely keep inflation higher than it otherwise would have been.

Arguments for strategic autonomy are based on increasing the EU's resilience in specific strategic sectors, where trade flows should no longer be the main determinant for openness. The experience of COVID has shown where Europe has vulnerabilities in some of its external dependences. However, applying the EU's strategic autonomy objectives in the financial sector should be handled with care. By their nature, banking and financial markets increase their resilience and quality through the strength and breadth of their network. The more national they are, the less resilient they are. The transatlantic nature of financial markets is a sign of strength.

Part of a concern about "reliance" on US banks relates to the incorrect perception that all non-EU banks retreat to their home markets in times of crisis. However, the opposite has happened. For example, JPMorgan increased lending by >20% during COVID in 2020. Similarly, non-EEA firm market share in syndicated lending was more-or-less stable between 2019 (36%) and 2020 (33%). Rather than retreating, the participation of global firms in the EU system brings added competition and market depth, to the benefit of EU clients. The EU should remain open to international financial markets, which fortifies its resilience.

Policymakers should keep this in mind when looking towards the next EU mandate. The objectives of the Capital Markets Union (CMU) – open and integrated EU financial markets – should be taken forward with even greater levels of ambition. Recent events have shown how more diversified sources of financing in the EU and relatively less dependence on bank funding increase resilience. Good progress has been made since the European Commission's 2015 CMU Green Paper, including on covered bonds, private pensions, long-term investment vehicles and listing rules.

Going forward, fundamental securitisation reform should be a key part of these efforts to reduce pressure on banks and open up lending to help support the economy.

Inflation and de-globalisation will impact financing in the EU. Policymakers should therefore ensure they draw the right lessons for the sake of financial stability and growth as they consider priorities for the next EU cycle.

KRISTINE BRADEN

Head of Europe and Chief Executive Officer of Citibank Europe plc - Citi

Access to global finance supports a strong autonomous Europe

The global economy is going through a challenging time - again. A broad-based economic slowdown, with inflation higher than in multiple decades, the cost-of-living crisis, tightening financial conditions and Russia's invasion of Ukraine, all weigh on the outlook. All of that was before the fate of SVB rattled markets. At the same time, there are good reasons to be optimistic about Europe's ability to weather the storm.

The EU has demonstrated it can respond quickly in crisis, with a targeted fiscal and monetary policy response. Unemployment is at its lowest since the inception of the Euro in 1999. At 3.3%, real GDP growth in 2022 was higher than in the US (1.8%) and better than the global average (3.1%), with southern Europe outperforming.

This does not mean that policymakers and business leaders should rest on their laurels. Ongoing external shocks require companies, the financial sector, and governments to respond and adapt. After years of growth in global trade in goods and services, the pendulum has started to swing the other way. Production bottlenecks and geopolitics have led businesses to reevaluate their supply chains and realign production processes. Governments are seeking to build capacity in strategic industries to decrease their dependence on third country suppliers and increase their ability to act autonomously. On both sides of the Atlantic, this has led to a reappraisal of subsidies and state aid.

In many ways, this is a predictable response. It is right for Europe to strengthen its position in the world. For financial services, this could be achieved by promoting the euro as a key currency in global trade. A Central Bank Digital Currency will help safeguard Europe's sovereignty in the digital space. And the integration of capital markets through the finalization of CMU would be an enormous boom for Europe's capacity in financial services to help companies raise capital.

Recent progress has been admirable. The introduction of a consolidated tape for equities will end an important source of fragmentation. The Listing Act will provide a boost to Europe's primary markets, better allowing its fast-growing companies to tap into new sources of capital. The recast of the Insolvency Directive has the potential to increase the attractiveness of European corporate debt to investors. New legislation to promote securitization, on which a consensus is emerging, would strengthen a vital funding tool in Europe and enable a channel for borrowers to access capital markets.

The EU has acted fast in crisis. Long-term resilience will require funding and capital flow access.

While European capacity building will bring many rewards, the war in Ukraine has also reminded us about the importance of allies. Close cooperation between partners has increased the strength of the Western world in the face of aggression. Similarly, close cooperation between partners on economic and financial affairs will make Europe and its allies stronger. This also applies to trade. Access to global sources of funding and financial flow allows companies to become more resilient, grow faster, and create more jobs in the process.

Reaping the benefits of global finance requires a supportive and harmonized regulatory regime. While Europe continues to foster its financial markets, it is also important to ensure its rulebook fosters the participation of global players. Two recent examples stand out.

Firstly, while the financial industry supports the strong ESG disclosure framework that the EU has introduced, applying disclosure rules to the global footprint of third country firms because of their investment in Europe, risks making Europe a less attractive place to invest. The recently passed CSRD applies EU disclosure rules to global issuers with non-equity securities listed in the EU. This is unlikely to help deepen EU capital markets. The CSDDD takes a similarly unhelpful extra-territorial approach. Instead, alignment with other regulatory disclosure regimes would achieve a similar outcome.

Secondly, the recently published EMIR Review proposal contains a requirement for EU participants subject to the clearing obligation to hold an active account at a CCP established in the EU. There they will need to clear at least a certain portion of the derivatives they hold, potentially having to meet a firm quantitative target. Such forced fragmentation of clearing would increase systemic and operational risk, negatively impact the competitiveness of EU-based firms, and in particular EU investors, and is not global best practice. It would also be inconsistent with the ambition of internationalizing the euro.

Europe's efforts to increase its strategic autonomy are an important way to protect its independence in an uncertain world. These efforts should not, however, come at the expense of less cooperation with partners, but instead foster a spirit of mutually beneficial openness. International cooperation, supported by a strong rulebook that underpins access of corporations and governments to global finance, will ensure Europe's economy will continue to flourish.

ODILE RENAUD-BASSO

President - European Bank for Reconstruction and Development (EBRD)

Now is the time to think strategically about trade finance

The Covid-19 pandemic, the war on Ukraine, rising geopolitical tensions and increasingly frequent extreme weather events have inflicted major pressure on supply chains for firms both in Emerging Europe, Central Asia and the Southern and Eastern Mediterranean, the region where the European Bank for Reconstruction and Development invests, and across the world. EBRD's latest Transition Report, fittingly called Business Unusual, focused on such supply chain disruptions and the ways firms have responded to these challenges.

More specifically, we conducted a survey of trading companies in countries where we work. It transpires that around three quarters of firms in emerging Europe that both import and export have recently experienced such disruptions. More than half suffered disruptions to shipments—due to China's zero-Covid policy or Russia's invasion of Ukraine. Remarkably, one in nine firms were recently disrupted by extreme weather such as floods or low levels of water in the rivers used to ship goods.

The EBRD has been active in this area of trade finance since the 1990s, connecting firms which are involved in trading and their banks with confirming banks in partner economies and supporting the development of innovative trade finance solutions. In 2022 the programme was scaled up in a major way, facilitating close to 2,000 trade transactions worth a record €3.6 billion with 91 partner banks. The supported transactions ranged from a modest €3,500 for medical equipment imports to Egypt to large deals to support imports of agricultural machinery to and wheat exports from wartime Ukraine.

Firms faced with supply chain disruptions have so far proved remarkably resilient. Three quarters responded by increasing inventory, finding new suppliers and digitalizing their supply chain management. Of the firms that found a new main supplier, in 80 per cent of cases this new supplier was based abroad. This is significant. Supply chains are fast evolving. But the changes do not have to mean closed borders or less trade.

This is the good news. But there is bad news too. The Asian Development Bank estimates that the financing deficit, estimated at 1.8 trillion dollars in 2020, continues to grow and now probably exceeds 2 trillion dollars. Easing this financing blockage is likely to require a two-pronged approach – mobilising more investors to the sector and streamlining some trade financing processes that have remained relatively unchanged for decades.

> Supply chains are fast evolving. But the changes do not have to mean closed borders or less trade.

Institutional investors currently provide only about five percent of the total trade finance funding required. Packaging rated products for institutional investors utilising tools such as specialist funds and securitizations will go some way to addressing the shortfall but technology is likely to provide the most effective response. Increasingly sophisticated trade financing platforms are now using AI to streamline their client's KYC requirements while the adoption of the Model Law for Electronic Transferable Records (MLETR) will likely lead to the emergence of electronic bills of exchange, potentially streamlining settlement times. In February 2023 the first digital bill of exchange was issued to facilitate a trade finance transaction in the sugar sector with no parallel paper bill of exchange being created.

The private sector is formidable at adapting. But policy support from regulators and IFIs are also needed in the key area of supply of goods and services to ensure that blockages do nor occur. It is also critical that disruptions to the supply chain do not contribute to further spikes in inflation, particularly in the energy sector. In the second half of 2022 as a result of Russia's unprovoked war on Ukraine supplies of pipeline gas from Russia were down more than 70 per cent year-on-year and gas prices in Europe reached unprecedented levels, ramping up inflationary pressures across the continent. While those prices have come down since, they remain several times higher than in the United States. In the short term, we may have seen a shift towards fossil fuels.

The hope must be that this is temporary, and that public opinion will support sustained investment in alternative clean energy sources. Trade finance efficiency gains are therefore inextricably linked to energy supply.

Many things have changed since the EBRD was founded in 1991. I believe that our Bank and its mandate to build open market economies are now more relevant than ever. Today's crisis is deep and the outlook cam sometimes appear bleak. Yet in the field of trade finance, as in many others, we also have the opportunity to think strategically and invest in a better future.

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STAGFLATION IN EUROPE: WAY FORWARD

AXEL A. WEBER
President - Center for Financial Studies (CFS)

Cheap money and rising debt undermined the growth potential of the euro zone

Most developed economies today are facing the same structural problems: many sectors, especially the public sector, are over-indebted, many markets, especially the labour market, are over-regulated and the workforce in many countries has been shrinking due to adverse demographics.

Instead of fighting structural problems with structural reforms, most countries over the last decade have attempted to counter structural problems with expansionary monetary and fiscal policy – cyclical policy instruments. Not surprisingly, the success is limited.

Even if monetary policy were effective in countering some of these problems, which it is not, it would have been the wrong tool. With interest rates at zero or slightly negative and central bank balance sheets massively expanded by quantitative easing, the ultra-loose monetary policy has largely operated through the exchange rate channel and the asset price channel, whilst the traditional interest rate channel and the credit channel of monetary policy transmission had become ineffective. Policymakers were trying to solve massive structural problems by pushing up debt to unprecedented levels and by using cheap money for devaluing their currencies and artificially inflating stock and real estate prices.

The longer the underlying structural problems are not tackled, the greater they become. Incidentally, I think that this ultra-expansionary monetary and fiscal policy itself has become a drag on economic growth, meaning that their negative side-effects in the long run by far outweigh their short-term positive effects. Nothing in the long run is as expensive as cheap money.

Cheap money has undermined European price stability, financial stability and the growth potential.

What are the risks of cheap money?

First, a long period of ultra-expansionary monetary policy leads to adverse redistribution. Monetary policy itself cannot create income or wealth. A central bank cannot solve a debt crisis by assuming debt itself. What monetary policy can do, however, is redistribute. Monetary policy can shift the costs of debt from debtors (e.g., households, firms, banks, governments, states) to creditors, i.e., savers and investors. By lowering interest rates to zero or even below and by buying up government bonds, monetary policy subsidizes governments and other borrowers at the expense of the private sector, savers and creditors. This can be seen as financial repression. In a broad sense, financial repression also includes liquidity and capital regulations for banks or regulations for pension funds, which give preferential treatment to low-yielding government securities, which in turn favours public debtors and at the expense of pensioners and savers.

Secondly, with their ultra-expansionary monetary policy, central banks have endangered their mandate of price stability and financial stability. With the recent massive reflation the risks to price stability have materialized. Central banks have also endangered financial stability by massively distorting asset prices. Distorted prices send the wrong signals to investors, who took bad investment decisions, for example in driving liquidity-fuelled boom-bust cycles in property markets or investing in the wrong financial products, firms, sectors, regions, or countries. Some of these investments will have to be written-off at some point in the future. In Europe, two specific risk that warrant detailed monitoring are related to real estate markets in the core and sovereign debt markets in the periphery of the euro zone.

Third, the ultra-loose monetary policy has undermined the growth potential of the euro zone. By subsidizing highly indebted countries or ailing economic sectors, central banks have not only lowered the cost of refinancing, but they also have contributed to reducing the pressure for the necessary consolidation and delaying restructuring. Labour and capital remained trapped in stagnant or, in the worst case, even value-destroying investments and were missing elsewhere. Reforms were being put off; structural crises became protracted.

By favouring government debt, monetary policy has damaged the long-term growth potential. I doubt that the high level of newly issued government debt in many countries in recent years has been used to make wise investments. The infrastructure of many developed economies including the euro zone is dramatically worse today than it was 10 years ago. Rather, government debt financed government consumption directly or was redistributed and consumed. Debt-financed consumption may stimulate the economy in the short term. In the long term, however, it is a burden for economic growth.

The production potential of the economy decreases with increasing debt levels, because the interest burden of servicing the higher public debt levels has now become a meaningful government expense again with higher interest rates. This will lead to a further increase of taxes and duties, with all their negative knock-on effects on economic incentives and future growth. In the long run, there will be a high price to pay for this recent period of cheap money.

ALFRED KAMMER

Director, European Department - International Monetary Fund (IMF)

Taming inflation while protecting growth: a tough act for European policymakers

Europe avoided an all-out recession this winter—but it is facing a triple challenge of too-high inflation, rapidly cooling growth, and financial market jitters. Ripple effects from the US banking sector woes and the failure of Credit Suisse have tested financial stability. Wage growth has accelerated but real incomes are still falling, depressing consumption, and growth in the second half of last year. Across the region, inflation remains too high and persistent. While food inflation keeps increasing, natural gas and electricity prices dropped to about half of their 2022 averages, reducing headline inflation. However, core inflation surprised repeatedly on the upside and continued increasing to double-digit levels in several advanced and emerging European economies.

The double blow of the pandemic and Russia's invasion of Ukraine raises the specter of lower potential output and high inflation. There is reason to believe that potential output has taken a hit. Long COVID is likely to have durably decreased the number of workdays. Along with shifting worker preferences toward shorter hours, this is contributing to record-high vacancy-to-unemployment ratios in advanced Europe. Simultaneously, permanently higher energy prices reduce productivity and further lower potential output. Another upside inflation risk is that nominal wages catch up with price increases, although in advanced European economies wage growth has been subdued in 2022 and firms' increased profit margins could provide some room to accommodate wage demands.

Monetary policy should remain tight until core inflation is unambiguously on a path back to central bank targets Although the cumulative increase in policy rates has been larger than in past tightening cycles, real rates remain low in many European economies. A tighter stance is still needed in the euro area. And monetary policy should remain tight for an extended period in emerging European economies where real policy rates are low, labor markets remain strong, and wage growth and risks of persistent inflation are high. Continuing quantitative tightening will support this tighter stance and reduce distortions from large central bank financial-market footprints.

Taming inflation while supporting growth requires policies to act in tandem.

Reducing inflation now is also desirable from a risk management perspective. While we cannot be certain how persistent inflation is going to be, overly optimistic assumptions about a quick return of inflation to targets could come at high social and economic costs. This is because underestimating inflation persistence would entrench high inflation and force central banks to tighten much more forcefully later, pushing the economy into a sharp recession.

The materialization of financial stability risks would warrant changing the course of monetary policy. In principle, financial risks should be contained through financial sector policy action, strong supervision and where appropriate liquidity provisions through the central banks' lender of last resort role. Unless strains in financial markets ratchet up and raise broad-based stability concerns, monetary policy should stay the course. This does not mean that central banks should not adjust their stance with new data and circumstances: bringing down inflation will be possible with lower policy rates if financial conditions tighten for other reasons, or vice versa.

Decisive fiscal consolidation is needed starting this year to support monetary policy and build buffers. More ambitious fiscal consolidation would help central banks meet their objectives at lower rates, with positive spillovers for public debt service costs and financial stability. Tighter fiscal policy would also enable governments to restore depleted fiscal space to cope with large future shocks and long-term spending pressures. Lower energy prices and the windfall tax revenue gains from inflation provide an opportunity to consolidate more.

Structural reforms should prioritize lifting crisis-damaged potential output and easing the growth-inflation trade-offs. This is particularly relevant given the restrictions placed on macroeconomic policies in the context of a currency union. Structural reforms should prioritize raising labor force participation of women and older workers—including through childcare and pension reforms. Workers' job transitions should be facilitated by scaling up and better designing active labor market policies. While only second best to an EU-wide fiscal capacity, Next Generation EU remains an important tool to lift productive capacity, ease medium-term price pressures, and green the economy.

This contribution has been co-written by Alfred Kammer and Sebastian Weber, IMF.

DECLAN COSTELLO
Deputy Director General,
DG for Economic and
Financial Affairs,
European Commission

The time is now: reforming the EU economic governance framework

Europe has entered 2023 on a stronger footing than previously projected. Despite the exceptional shock stemming from Russia's invasion of Ukraine, it looks as if a technical recession has been narrowly avoided in both the EU and the euro area, which is a sign of the remarkable resilience of the economies in the Member States. Labour markets continue to perform strongly, and the unemployment rates remain at historically low levels. Economic sentiment is also improving. In addition, European gas benchmark prices have fallen significantly, below the levels that prevailed before Russia's invasion. Recent inflation readings suggest that the peak in headline inflation is now behind us. Nevertheless, core inflationary pressures persist, with risks on the upside, and monetary policy is expected to continue tightening.

In this economic environment, fiscal policies need to be well calibrated and coordinated, also to facilitate the task of monetary policy. Triggering the general escape clause of the Stability and Growth Pact in 2020 was the right thing to do, as it allowed Member States to cushion the blows caused first by COVID-19 and then Russia's war against Ukraine. Due to the economic support measures at national and EU level, millions of people kept their jobs and business remained open.

However, these measures have not always been sufficiently targeted to the most vulnerable and all of them are well-designed in terms of preserving incentives to limit energy consumption. In some cases, the temporary emergency measure could turn into permanent ones. The fiscal support has also increased public debt, in some cases to very high levels, which now needs to be addressed. Hence, the focus of policymakers should now shift to phasing out emergency measures, starting with the least targeted ones, while refraining from broad-based fiscal support.

Credible fiscal rules are essential to ensure sound public finances across the EU.

As we expect the general escape clause to be deactivated by the end of 2023, fiscal policies should aim at ensuring medium-term debt sustainability as well as raising potential growth in a sustainable manner. Prudent fiscal policy will help ensure macroeconomic stability and facilitate the effective transmission of monetary policy in a high inflation environment. Moreover, sound financial management will be essential to tackle the common challenges that Europe is facing. Fostering the green and digital transitions and bolstering Europe's security capacity require significant and sustained public investments. Following a decade of ultra-low interest rates, financing conditions can be expected to be less favourable in the years ahead. In addition, the impact of ageing on public finances is becoming increasingly visible.

Credible fiscal rules with the right tools for enforcement are essential to ensure sound public finances across the EU. That is why the Commission has put forward concrete ideas on how to re-design the rules based on a number of key principles.

Firstly, we have to acknowledge that economic challenges and contexts differ across our Member States. A one-size-fits all approach does not work. Therefore, our new framework should differentiate between countries and allow for different adjustment pace, depending on public debt challenges.

Secondly, we want Member States to take ownership on their fiscal plans. This is the best way to ensure that ambitious plans are also implemented. Therefore, we want each Member State to design medium-term fiscal and economic strategies, but within a clear and transparent common framework.

Thirdly, based on our positive experience with the implementation of the Recovery and Resilience Facility so far, we know that both reforms and investments are essential. The right combination of ambitious reforms and investments, which are mutually enhancing, can boost growth and help reduce public debt.

Finally, rules only work if they can be enforced. But for rules to be enforceable, they must be realistic, credible, and owned by all. Therefore, our proposal seeks to achieve simpler rules and more realistic debt adjustment paths, coupled with a stricter and clearer enforcement regime.

Reaching an agreement across the EU on the new rules is essential. Recent financial market turbulences add to the important and urgency of making progress. The Commission is now engaging in a debate on its vision for the most comprehensive reform of the EU's fiscal rules since the economic and financial crisis. It will be crucial to reach a swift agreement on the future economic governance framework that fully takes into account the new post-pandemic reality.

MICHALA MARCUSSEN

Group Chief Economist - Société Générale

The stability trade-off is not in the ECB

With the recent turmoil in financial markets, the debate as to whether the European Central Bank (ECB) will have to choose between price stability and financial stability is once again live. This debate is not unique to the ECB, but financial fragmentation and the reality of having to deal with 20 national governments' policies raises specific challenges. The ECB toolkit is today well placed to address both risks, and the stability trade-off lies not within the ECB, but resides rather with governments to ensure effective fiscal policies and advance structural reforms.

The ECB monetary policy tightening that began last summer is the fastest on record, yet both headline and core inflation remain well in excess of the 2% target at, respectively, 8.5% YoY and 5.6% YoY in February. As monetary policy feeds through with considerable and uncertain lags, central banks draw on both medium-term and near-term analysis to set policy. The medium-term analysis builds on economic forecasts and risk hereto. Data releases help track any gaps to the near-term forecast, and near-term analysis is further informed by financial conditions and various inflation expectations. The fact that central banks meet frequently to set policy helps mitigate some of the uncertainty that surrounds this process.

The latest ECB Staff projections show a gradual decline for both headline inflation to 5.3% in 2023, 2.9% in 2024 and 2.1% in 2025, but with inflation "projected to remain too high for too long", the Governing Council decided to hike 50bp at the 16 March meeting. With on-going financial turmoil, a debate has opened as to whether the ECB will face a choice between price stability and financial stability. There is good reason, however, to believe President Lagarde's view that there is no such trade-off.

Fundamentally, the idea of a trade-off assumes that the credit crunches and asset price collapses that result from untamed financial instability would contribute to stagflation. History shows, however, that such shocks are powerful deflationary forces, as the resulting collapse in demand plays out much faster than that of supply.

The ECB, moreover, today has ample tools to tackle financial stability risks, be it through liquidity provision to banks or to combat unwarranted fragmentation in the euro area sovereign bond markets.

This is not to say that there is no risk of monetary policy error triggering adverse economic outcomes. Nor is it to say that stagflation risks do not exist.

Geopolitical shifts and accelerated transitions are likely to bring more volatile economic cycles.

The shocks of the Covid19 pandemic, the ugly War in Ukraine and heightened geopolitical tensions have driven a focus on more resilient supply chains, greater strategic autonomy and accelerated the green and digital transitions. Geopolitical shifts and accelerated transitions are likely to bring more volatile economic cycles and significant relative price shifts, raising the risk of stagflationary outcomes.

Limiting stagflation risks at the cyclical level, requires that monetary policy and fiscal policies work together. In mitigating the energy price shock, ECB President Lagarde warned that fiscal measures should meet a three Ts test – "temporary, targeted and tailored to preserving incentives to consume less energy". Looking over the individual member states, however, we can observe very divergent fiscal policy responses including several that fail this test and add to inflationary pressures.

Within the euro area, good fiscal policy co-ordination among the member states is a further prerequisite. Here, it's key that the ongoing review to produce a new set of fiscal rules delivers an efficient result. In times of crisis, moreover, additional measures may be required at the European level and the Next Generation EU facility agreed in response to the Covid19 pandemic marked an important milestone. Although presented as a one-off, many hope to see such a facility become permanent.

The final element relates to structural reforms, to boost growth and strengthen the resilience of the euro area economy. Such reforms are key at both the national and European level. Finalising the Banking Union and deepening Capital Markets Union are of particular importance given the significant financing needs of the transitions. The Commission estimate increased EU investment needs of €520bn per annum out to 2030 to deliver on the Green Deal and a further €125bn per annum for the digital transition. Much of this will have to be financed by the private sector.

The political reality is that this list of measures will require some challenging trade-offs. These reside outside the central bank, but euro area governments must be careful not to overburden the ECB. Herein lies the real stability risk.

DINO KOS
Special Advisor to the Chief Executive Officer, CLS

Inflation and monetary policy: way forward

Eurozone headline inflation peaked at 10.6% in October 2022 and has been steadily decelerating in the months that followed. The most recent reading, in March, came in at 6.9%. So, is the ECB's work done? With inflation decelerating so rapidly, should the ECB simply pause its tightening cycle and watch as the current trend continues and brings inflation back toward the 2% goal?

Unfortunately for the ECB, the situation is complex, and this is no time to declare victory over inflation. The primary driver of the decline in headline inflation is the fall in energy prices. If that had been the only factor pushing inflation higher, then the ECB would have far more flexibility. However, the initial spike in energy prices spilled over into other sectors and created secondary effects. Core inflation – excluding energy prices and food, alcohol and tobacco – in the eurozone continues to rise. In March, core inflation rose 5.7% and showed no sign of leveling off. Service prices – which provide a better indication of underlying inflationary pressures – have risen from less than 1% in mid-2021 to 5% by spring 2023.

The evidence is clear. Underlying inflationary pressures remain with key measures of inflation at record highs since the launch of the euro with little sign of a turn lower. Despite the ECB's tightening of policy, real short term interest rates remain negative. The ECB's policy stance is not yet exerting restraint.

So, what can monetary policy do from here? The ECB has two main instruments. First, it can continue to increase short term interest rates. The overnight lending rate is 3.75%, having risen from 0.25% in mid-2022. In the near term the ECB should continue to nudge this rate higher, but probably slow down the pace of tightening so as to assess the impact of earlier increases.

Second, the ECB can vary the pace at which it shrinks its own balance sheet – so-called "quantitative tightening" or QT. The ECB has contracted its balance sheet about 10% over the past 9 months (though it still exceeds pre-pandemic levels), mostly by not replacing securities and repurchase agreements when they matured. In the United States, the Federal Reserve is going through a similar process of raising interest rates and contracting its balance sheet.

As any tightening cycle progresses, the central bank has to be alert to signs that it should either accelerate tightening or decelerate and ultimately stop, as monetary policy works with a lag. This was the argument many analysts made in 2021 when inflation was picking up and central banks were anchored to zero interest rate policies. During 2021 central banks, including the ECB, should have begun a gradual increase of interest rates recognizing the lag inherent in policy outcomes. They failed to do that, and the result was the highest inflation in more than four decades.

Given the risks of too much or too little tightening, the prudent course is to move cautiously and adjust gradually.

In the same way, they should now be considering what signposts would make them slow down or stop. If tightening continues until reported inflation is back to 2%, the lagged effects of earlier tightening will assure both a further decline of inflation below target <u>and</u> a deep recession.

One signal to watch for is the health of the banking sector. Banking stress in both the United States and Switzerland has been noteworthy throughout early 2023. Perhaps these are coincidental idiosyncratic events that are unconnected to monetary policy and broader liquidity conditions. But perhaps not. In a period of uncertainty – and with other signs pointing to a slowdown or recession – should central banks be taking that risk?

The prudent course would be to slow down the pace of tightening and be prepared to adjust (faster or slower) as circumstances warrant. Similarly, the pace of quantitative tightening could also slow down for the same reason. Tighter policy could impact banks in several ways. First, all other things being equal, the economy will slow down, and the resulting pressure on certain sectors like commercial property could lead to rising bad loans. Second, banks will naturally hold back and be less willing to make new loans. Finally, the withdrawal of liquidity through quantitative tightening will tend to increase volatility and thus risk premiums, further pressurizing financial intermediaries to hold back new credit.

Ultimately, the ECB and other central banks were slow to tighten in 2021 in response to rising inflation, and then raised rates very rapidly in Q1 2023. Their recent haste creates a new set of risks that could restrain the economy in the future. Given the deep uncertainty and divergent risks of too much or too little tightening, the prudent course is to move cautiously and adjust gradually.

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FOSTERING INVESTMENT IN THE GREEN TRANSITION

MINDAUGAS LIUTVINSKAS
Vice Minister of Finance of the Republic of Lithuania

Geopolitical challenges further underline the need for green transition

There is no doubt that the mobilisation of necessary financial resources to enable green transition is one of the most urgent issues at the policymakers' table. While countering climate change is a critical strategic goal in itself, the urgency for pan-EU green transition efforts has increased dramatically after russia's invasion of Ukraine, which has exposed EU reliance on imports of fossil fuels from russia, followed by energy prices shock of an unprecedented scale.

Acceleration of the green transition will depend on multiple factors, including the development of net zero technologies, increasing renewable energy production capacities as well as enhancing energy efficiency. While different objectives require different measures there is one common denominator underpinning everything – the availability of the necessary financing.

EU level financial instruments, such as the MFF and NGEU, play and important role in this regard. RRF – the cornerstone of NGEU – has a clear focus on green transition measures, reflected in national RRF plans and further enhanced by the REPowerEU initiative. While RRF implementation is still to reach its peak, the instrument has vast potential to push the green transition effort forward and marks a fundamentally novel approach in striving for EU-level policy goals.

On top of EU-level funding, substantial national resources are devoted to the green transition measures like the scaling up renewable energy sources or modernization of the transport system. A key role here is also devoted to green taxation, which brings dual benefits by mobilizing additional budgetary resources and helping to change the consumption and investment patterns in favour of a more environment-friendly behaviour. Going forward, green taxes will play an increasingly important role, complementing the positive incentives provided by public funding to encourage energy efficiency and development of alternative energy resources.

We must step up our efforts in attracting private funds towards green transition goals.

Nevertheless, estimates suggest that the green transition is at risk of facing a persistent financing gap in the upcoming decade and it cannot be covered only by public funds, be it EU level or national. This means that we must step our efforts in attracting private resources and gearing them towards reaching green transition goals. This requires streamlining regulations and reducing barriers for investments in critical sectors like renewable energy. Also, we need a clear long-term framework for greening the EU economy, while also ensuring incentives – including regulatory ones – for companies to develop sustainable businesses. In this vein, well-functioning disclosure requirements are also essential, as they would allow attracting private capital into green projects and economic activities via the financial system.

In other words, financiers and investors need to be provided with tools and instruments that would enable greater clarity in assessing what asset classes, activities and projects are green. This includes assessment methodologies, certification solutions (when appropriate), standards for sustainable financial products and mechanisms for monitoring compliance. Taxonomy is and the green bond standard, once operational, will be right steps in this direction.

While EU-level decisions and green framework are of crucial importance, we also need to do our homework domestically. With this in mind, the Government of Lithuania has prepared ambitious plans covering the development of renewable energy capacities, boosting energy efficiency measures and investing in green transport solutions. We have estimated that there is a gap of at least EUR 4 bn until 2030 that needs to be covered by attracting private funds. To enable this, the Green Finance Action Plan has been developed, which sets out concrete steps to create an ecosystem enabling the mobilization of private investments, which would supplement public funding.

Key pillars of the Plan include establishing a centralized and publicly available sustainability database, creating a tailored labelling system, setting up of the Green Finance Institute, which will function as a public sector think-tank for green solutions, and constructing dedicated financial instruments via the national promotional agency. Building on our relevant experience in the FinTech field, we are in close dialogue with the private sector stakeholders and various public institutions, in order to create a vibrant and open ecosystem, which would work as a catalyst for channelling investments into the green economy.

When it comes to countering climate change and increasing resilience of the European economy, all of us – public and private actors – are in the same boat. We need to ensure that the right incentives and frameworks are in place for both sides to play their part.

LUDĚK NIEDERMAYER

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

Green transition in the EU: overcoming uncertainty and obstacles

Uncertainty is one of the main, if not the most important enemy of businesses. The EU set its climate objectives a while back, in the Climate Law, as well as drafted a detailed plan on how to reach them in the Fit for 55 Plan. This has delivered a clear environment in which the economy and firms will operate in the next decades.

As we navigate the complexities and unknowns, with technological progress continuing at a fast pace, leaving us wondering what new advancements will emerge and how they will impact our societies. At the same time, questions about the global economy remain, while unforeseeable events, such as Russia's recent aggression towards Ukraine can end even the best plans.

In the midst of all this uncertainty, the European Union has taken proactive steps to mitigate the risks and prepare for whatever lies ahead. One such measure is the creation of various funds designed to accelerate the implementation of necessary measures. These funds are targeted at assisting member states with lower GDP, providing support to those most affected by the changes, and bolstering strategic sectors of the economy.

In the ongoing debate about how to build a more sustainable economy, it is easy to overlook the fact that most of the funding for such initiatives will come from private sources. With this in mind, the predictability of policy and regulation becomes an essential factor in encouraging investment and spurring the growth of sustainable industries.

There are two approaches to encourage this shift: the first involves strict regulation to prevent certain actions, such as prohibiting the construction of highly inefficient buildings. The second approach prioritizes policies that promote behavior aligned with desired outcomes in the vast majority of cases, making it illogical to construct inefficient buildings. However, while the latter approach should take precedence, it is not always successful.

The ideal situation is that the business case for a new investment done in such a way that it is consistent with objectives would prevail over alternatives leading to less sustainable results. Given the stability and competitiveness of the EU banking sector, legislation promoting sustainable investments (like taxonomy), incentives for firms to act sustainably (like ESG), or efforts to promote the capital market, such projects based on strong business cases should be able to get financing.

EU's pursuit of sustainability requires predictable policies to encourage private sector investment.

The EU is facing several obstacles in achieving its sustainability goals. One of the major challenges is the limited development of a business-oriented approach to sustainability. Moreover, red tape, excessive bureaucracy, complex investments, and fragmented sustainability policies, with each country prioritizing its own approach, are significant risks that could impede the success of the transformation. These issues are hindering progress towards sustainability in the EU, and addressing them is critical to achieve the desired outcomes.

The lack of a "business case logic" in sustainability planning can result in the misallocation of public funds. When there is excessive support provided to investors without a sound business case, it can lead to a waste of public money. Conversely, the lack of investment occurs when public authorities fail to recognize that certain desired investments are either too risky or have a low likelihood of success.

Many problems can be addressed through market mechanisms, such as auctions for new capacities of renewable energy sources (RES). However, the effectiveness of public support measures and their interplay with other policies must also be considered. For instance, as the deployment of new RES occurs at an increasingly rapid rate, the cost of electricity production is likely to decrease in many periods. In such circumstances, an "investment subsidy" may be ineffective or require substantial funding. Instead, using a "contract for difference" or implementing a rapid increase in demand for electricity during peak hours through the production of hydrogen, energy storage, or other methods could potentially yield the desired outcome.

Initially and naturally, the emphasis was placed on defining the "correct objectives" in the first phase. Proposed milestones and policies for achieving those objectives have since been established and are now almost verified. Currently, the crucial concern is formulating strong business cases, which are essential for achieving the targets most efficiently and ensuring effective utilization of public funds.

The EU has clear climate objectives with a plan to achieve them, however, uncertainties and unforeseeable events pose some risks. The pursuit of sustainability is a complex and uncertain journey and the private sector's participation is crucial for success, making predictability of policies and regulations essential to encourage investment.

HARALD WAIGLEIN

Director General Economic Policy, Financial Markets and Customs - Federal Ministry of Finance, Austria

How green investments can bloom in times of drought

Almost everybody holding a governance function is on the same page these days on how investments should best look like: green, sustainable, targeted and conducive to greater independence. The global net social benefit of phasing out coal and transitioning to renewable energy by the end of the century has recently been estimated in an IMF working paper at 85 trillion dollars. Financing needs (investments and compensations) in that regard sum up to 29 trillion dollars. Additionally, in its world economic outlook update from January 2023, the IMF identifies “a concerted push for investment along the supply chain of green energy technologies” as a policy priority.

The current macro-economic environment is challenging: COVID revealed strategic dependencies and supply chain vulnerabilities, the Russian aggression towards Ukraine causes immense human suffering and economic distortions such as high inflation, growth expectations are muted, interest rates are climbing up, uncertainty is pronounced and budgets are stretched. The EU’s response to the COVID crisis – the Recovery and Resilience Facility and its recent REPowerEU supplement – will make a significant contribution to the green transition, but its success depends on the extent to which it also mobilises private investment.

The good news is that similar things had been achieved in the past – almost every crisis and pressing challenge has led to a certain learning and recalibrations of rules and growth models. Sometimes changes took longer to materialise, were more painful or needed exogenous nudging, but in the end the cart was pulled out of the mud in most cases. In the case of the green transition, costs and benefits and/or avoided damage are stretched in time, increasing the urgency of political communication and action. Profound structural reforms are hard to implement in economic good times and even harder in bad ones, but are a precondition for a sound investment environment. If this sequence is ignored, it is like bringing a leaking bucket to the garden – once you are at the flowers most in need for watering, there is nothing left.

Public sectors can function as role models and lever private action.

Most importantly, we have to stabilize expectations. We will not get a single homeowner to install a solar panel on his roof or a CEO to switch the car fleet of her company to sustainable ways of mobility if amortisation, value added, tomorrow´s regulatory regime or capital cost is unclear. In this regard, price signals have to be preserved to anchor net present values of investments in green alternatives. Too generous public subsidies, excessive interventions and unclear rules are to be avoided. If a government chooses to put a price tag on CO_2 emissions – which is one way to support price signals – a clear and fixed adjustment path should come along. Irrespective if you follow the economic lines of R. Coase (i.e. paying off polluters) or A. Pigou (i.e. taxing polluters) on internalisation of externalities, consistency and predictability is key.

Looking at private sector funding, we have to be creative and innovative. Regulatory sandboxes to test new ideas and filter best practices can help to find solutions. Supporting start-up employee shareholdings bears the potential to better link knowhow and capital. Idle or unproductive resources can be redirected to green purposes via tax disincentives on inactivity and brown investments. A clear-cut taxonomy ensures that everybody is on the same page on how green investments are defined. Special foundations to channel private capital to climate related endeavours could be established. Furthermore, the public sector can work as a role model via green bond emissions and green procurement, R&D expenditures and other investment decisions.

However, there may be setbacks. Nobody knows exactly what the world will look like in 2030 and beyond. This especially holds true when it comes to climate change, diseases or geopolitical tensions. Technologies that seem to be promising today may not necessarily do the trick tomorrow. On the other hand, there may be solutions and technological improvements around the corner nobody is aware of at the moment. It is therefore important to avoid lock-ins, remain flexible and stay vigilant to grasp new developments.

To sum up, circumstances are not 100% enabling right now but they probably never will. Economic policies, especially structural reform progress, are required to counter steer, softly guide and shape conducive frameworks. The Recovery and Resilience Facility’s reform angle should be fully exploited and further strengthened in the context of REPowerEU. As uncertainty is detrimental to investment decisions, it is key to stabilise expectations while allowing sufficient flexibility. Funding should be based on both, traditional and innovative pillars. Public sectors can function as role models and lever private action.

NIALL BOHAN

Director, Asset, Debt and Financial Risk Management, DG Budget - European Commission

Funding climate transition: EU firing on all cylinders

Funding climate transition is not a fair-weather policy. It is a core Union priority which will not be put on the back-burner when economic conditions become challenging. For reasons that will be obvious from following weather-driven headlines in recent years, it will be clear that this a luxury that we do not have.

Finance – both private and public – is critical in rewiring our economy and society on a sustainable basis. The European Union has been spearheading efforts to mobilise finance to fund climate transition for over a decade – through its own budget, policy development, regulatory proposals and more recently as one of the world's leading green bond issuers in its own right.

This commitment is reflected in the share of EU budget spent on supporting climate transition. The European Commission reports on EU budget climate spending, systematically since 2014 in its annual budget. With the launch of the 2021-27 long-term EU budget and NextGenerationEU (NGEU), the EU's ability to drive climate transition has moved into a higher gear. The overall share of climate spending in the EU budget has increased from 20% during 2014-20 to a 30% target for 2021-27.

The NGEU programme has taken EU support for climate transition to a qualitatively different level. Member States are required to spend 37% of their national Recovery and Resilience plans – the roadmaps to NGEU financing - on climate transition. Several Member States have significantly exceeded this target so that around 40% of the Recovery and Resilience funds already committed or around €190 billion are available as additional firepower to tackle the climate transition challenge.

The recently agreed REPowerEU, with its focus on energy diversification and funding renewables, is expected to enhance the climate-transition impact of these plans even further and ensure the full use of the budgetary availabilities under NGEU. Overall, between direct EU budget support and NGEU, the Commission is expecting to mobilise well over €600 billion on climate transition by 2027 – on top of national and private financing.

The EU has also been an innovator in other areas. The EU was the first jurisdiction to introduce an international Emissions Trading Scheme (in 2005). By ensuring that carbon-related externalities are reflected in fuel prices, this pioneering scheme is playing a key role in moving our economy to a more sustainable footing. The ETS market is maturing constantly and a portion of ETS revenues are set to become a new Own Resource to directly finance the EU budget.

The NGEU programme has taken EU support for climate transition to a qualitatively different level.

The EU has also led from the front in terms of regulatory action. Based on the road-map provided by the High Level Expert Group on Sustainable Finance (2017), the EU has focused on ensuring sound disclosure and transparency to enable investors to make climate-informed choices about where they place their capital. The introduction of Sustainable Finance Disclosures in 2019, the EU Taxonomy in 2020 and the agreement on the EU Green Bond Standard just this year are all important milestones on the road to a deep and liquid EU sustainable finance market.

The EU is not just talking the talk. With the launch of the NGEU green bond programme, it is also walking the walk. The NGEU Green Bond programme has the potential to be the largest single green issuance programme in the world. The Commission has verified that a pool of around €190 billion of Recovery and Resilience funds is eligible for green bond financing.

The inaugural NGEGU green bond issuance for €12 billion in October 2021 was the largest green bond issuance to date globally. By end-March 2023, the Commission has issued over €40 billion of NGEU Green Bonds.

A notable feature of the programme has been persistently strong level of investor interest – even in volatile or adverse market conditions. NGEU green bond issuances enjoy stronger demand than conventional bonds, leading to slightly tighter pricing and high oversubscription rates.

Strong investor confidence in the Commission is based on the NGEU Green Bond Framework aligned with a four-pillar model of the International Capital Markets Association (ICMA) and the Commission's AAA rating, which was just recently re-confirmed by Fitch. The Commission works hard to retain investors trust through its comprehensive and state-of-the-art reporting. The customised online Dashboard on green bonds which provides regularly updated information on eligible projects and the first use of proceeds report in 2022 have been strongly commended by investors. This will be followed at end 2023, by the first impact report to assess what projects funded by NGEU green bonds have achieved.

However challenging the immediate market outlook, the Commission will steadfastly pursue its sustainable finance agenda. These are not just empty words. The EU has taken pioneering steps on the disclosure and regulatory front. Climate transition and clean tech key investment is at the forefront of the policy agenda.

CORNELIA ANDERSSON

Groupe Leader,
Sustainable Finance and
Investment - London Stock
Exchange Group (LSEG)

The success of climate finance rests on policymakers mandating transition plans

The implementation of pledges to the Climate transition is getting harder for many European countries. The impact of war in Ukraine has thrown the spotlight on issues such as energy security and rising inflation. Yet, amidst this challenge, the question should not just be whether enough climate finance is flowing into industries; from energy, to transport or shipping to drive down emissions and scale new green sectors, but whether it is being invested most efficiently across the private sector.

For the second consecutive year, sustainable lending globally surpassed $650 billion, while green bond issuance in 2022 almost hit $400 billion, a significant rise against pre-pandemic levels. Yet, to enhance the sustainability outcomes of these investments and help grow the nascent green economy, we need far greater transparency in how companies are progressing against their publicly available climate targets.

The best way to equip investors and governments with the insight and data they need to deploy capital effectively is via policy intervention and specifically mandating the publication of climate transition plans not just in Europe, but on a global basis.

Sound and reliable information on which – and how - firms are making important progress on climate mitigation and adaptation is critical. High-quality transition plans would increase the climate effectiveness of funds by identifying the right companies and infrastructure projects that will help Europe achieve 2030 and 2050 emissions reduction targets.

Huge progress has already been made on corporate net zero targets across many developed markets. The majority of FTSE All Share companies have published some form of net zero target. Yet only 16% of them have formulated and published a transition plan – setting out how they intend to reach the target. The situation is similar in Europe: when half of European companies report having 1.5° climate transition plans, only 5% disclose a credible action plan. Across many markets, there is a lack of granular forward-looking insights into how companies are doing against their targets.

High-quality transition plans would increase the climate effectiveness of funds.

This 'accountability gap' is leaving investors in the dark on how to respond to climate risks and opportunities as they continue efforts to align portfolios to 2050 target. Regulators should intervene to close this gap as lack of data is not just impacting where capital is going, but is also a barrier to further investment. Concerns about the availability of ESG data and the use of estimated data is the number one barrier for investors considering sustainable investment opportunities according to FTSE Russell's 2022 survey of global asset owners.

The financial sector has a fundamental role to play in this transition, in tandem with public institutions. Turning to a net zero economy depends on the effective provision of financing to support environmentally sustainable projects and the growth of the green economy. A substantial and growing volume of capital is being deployed in this way.

There is, however, reason for optimism. Some governments are starting to mandate disclosure of transition plans. The proposed EU Directive on Corporate Sustainable Due Diligence includes a provision requiring in-scope companies to adopt a transition plan compatible with the 1.5 degrees objective of the Paris Agreement. The upcoming European Sustainability Reporting Standards (ESRS) developed by EFRAG will introduce specific metrics and milestones to assess the progresses made by a company's targets. This will provide for a granular and standardised reporting framework for those reporting companies.

Furthermore, industry-led guidance also now exists for corporates to publish voluntary plans. The Glasgow Financial Alliance for Net Zero (GFANZ) published supporting guidelines, focusing on practical steps, such as goal setting, aligning business and climate objectives and helping suppliers. Our CEO David Schwimmer is actively involved in the UK Government's new Transition Plan Taskforce, to develop a gold standard for what these crucial climate transition plans should look like. In short, those are opportunities for companies to get ahead of likely forthcoming regulation.

Data and insight on the progress companies in the private sector are making against their previously announced climate goals will not only ensure capital is deployed in the most efficient manner, but also remove barriers to investment that are preventing capital from reaching important projects.

It is my hope that by the next Eurofi conference in Spain next semester, we will have made meaningful progress to close the gap between targets and action plans on climate.

PIETRO CARLO PADOAN
Chairman - UniCredit S.p.A.

The power of investments to foster green transition

Green transition could represent an effective growth model for Europe which for many years has failed to reconcile growth and sustainability.

Climate change is a major threat to sustainability, but it can become a major opportunity to grow provided appropriate policies are implemented. The green transition requires a combination of micro and macro instruments and resources that involve both the private and the public sector policies at the national and the EU level. In this perspective, macro policies should include a green investment fund, on the wake of the SURE instrument, and a green golden rule for public budget management. Micro policies should include tax policies, regulatory policies, green R&D incentives, and green financial instruments which should make green investments more profitable for the private sector.

The purpose is to change the behavior of companies and households in their allocation choices. It's interesting to note that the RRFs experience shows that public sector involvement in investment projects have resulted in greater additionality and crowding-in effects. Measures such as loans and/or guarantees granted by the EIB and/or NPBIs, combined with the right policy support, have steered private financing into areas that otherwise would have been unattractive due to low returns for investors.

Statistical evidence shows that companies respond positively to investment in climate activities to the extent they have set climate targets, are energy intensive, have energy cost concerns, and have adopted digital technologies. Less prominently other factors include size, and adoption of advanced managerial practices. Obstacles to green investment are also to be considered and include uncertainty about environmental regulation, lack of skilled staff, cost of investment, uncertainty about regulation referred to new technologies, uncertainty about climate change, lack of green finance.

It is worth noting that for all specific factors, the obstructing factor is stronger in the EU with respect to the US. Not only innovation activities in EU are lagging behind US. Resources are limited and possibly misallocated. Misallocation reflects the lack of innovation friendly financial instruments such as venture capital.

Climate change can become a major opportunity to grow provided appropriate policies are implemented.

The public sector role will still have to increase, given the public-goods nature of some of the necessary investments or because of the existence of market failures in some activities that support policy objectives. Nevertheless, relying only on public money would simply make the achievement impossible. The additional investments in Europe needed for the achievement of the current 2030 targets are estimated to be equivalent to 2.3% of GDP.

Therefore, capital markets must provide appropriate private resources. More homogeneity could provide a boost to green investment, however there is great heterogeneity across EU countries both in propensity to green innovation and in the use of green policies. Some progress is being made in green financing but a slow pace.

Key elements of an effective and credible financing mechanism should have some basic characteristics. Firstly, fragmentation among national sources should be avoided to provide further common investment capacities and to stimulate local innovation and production of low carbon technologies. Secondly, structured solutions have to be shaped to foster the development of a common European goods (e.g. energy market). This is true especially in light of the recently announced "Green Deal Industrial Plan", in response to the multi-billion support programs launched by China and the US. Thirdly, it's necessary to ensure a level playing field through a careful balance between state aids relaxation and public expenditure flexibility. Finally, it' urgent to intensify efforts to create a fully developed Capital Markets Union.

The NGEU program and its operational arm, the Recovery and Resilience Facility which is translated into National Plans of Recovery and Resilience, is a good example which could pave the way for structural solutions aimed at revamping UE growth in quantitative and qualitative terms. It does so by supporting public investment and structural reforms through substantial financing.

But the increase in the potential output is a necessary, but not sufficient, condition for sustained growth as it may generate a negative output gap. A sufficient condition is the activation of demand side policies that can fill the long-term negative output gap. If there are no ways to fill the output gap, then the increase in potential output remains unexploited. This would perpetuate the secular stagnation pressure, possibly pushing back potential output and therefore the growth acceleration would not be sustained.

This relation clearly shows the need to activate NGEU also on the demand side through, over the long term, a new policy mix which includes a sustainable centralized fiscal capacity and a full-fledged growth policy along the lines of NGEU.

DEBORA REVOLTELLA
Chief Economist -
European Investment Bank (EIB)

Europe needs a coherent European effort for transformative investment

Delivering on the net zero transition requires substantial investment, for a rapid turnaround of the European economy. Estimates suggest that investment should increase by more than EUR 350 bn per year in this decade, to meet the EU net zero targets. Investment for adaptation and for a more resilient energy market add to those figures, as well as strategies to support green innovation and green technologies along the whole of the value chain.

Public investment has a crucial role to play. As the European economy has recovered from the pandemic and absorbs the hit of the energy shock, public investment remained resilient. It is however proven that public investment is extremely sensitive to possible future consolidations. Even in the benign scenario of continued relief from the recovery and resilient facility funds, we underline the importance of implementation capacity.

More than 50% of EU municipalities lack skills for climate investment, engineering, digital and legal issues. This is a substantial gap, which constrains the planning, preparation and implementation of public investment programs.

While public investment is important, most of the investment will nevertheless have to come from the private sector. The energy crisis and higher energy costs pushed firms' energy efficiency, overcoming the effect of uncertainty.

With climate action, instead, very clear incentive systems are needed to preserve the investment appetite, with no doubts on the policy priority for decarbonisation. Simplicity and predictability of intervention are key to reduce uncertainty.

There is no need to reinvent the wheal – de-risking mechanism exists but is also clear that finance needs to be accompanied by other market creating and enabling measures.

There is lots of talks on how to enhance EU competitiveness in green technologies, also in response to the IRA and China subsidies. To deliver on investment, designing European solutions is an important part of the answer. Already today, the level playing field within the EU single market is challenged, especially for business and labour regulations.

With the need to fully exploit the potential of the EU single market, to reap the competitive benefits of market scale.

We claim the starting point should be an effective EU single market for clean technology, offering the scale and predictability European producers and innovators need. This comes with strong and predictable internal demand, avoiding regulatory costs associated with fragmentation, reducing (and equalising within the EU) administrative delays in planning and permitting for green projects, developing unique standard systems to create a more integrated and competitive market.

All of those are necessary steps to create a sizable and predictable market, that should accompany de-risking instruments, designed at the EU level.

Last - a strategy to develop skills (particularly green and digital) as a necessary enabler and complement, in the private and the public sector and a strong imperative to think European. With the need to fully exploit the potential of the EU single market, to reap the competitive benefits of market scale.

PHILIPPE BLANCHOT

Director of Institutional, International and European Relations - Caisse des Dépôts Group

We need to act now before it's too late

The U.N. Intergovernmental Panel on Climate Change (IPCC) has just released the final part of its Sixth Assessment Report - the culmination of seven years of comprehensive analysis on anthropogenic climate change by the world's leading climate scientists. The report delivers a clear message on climate change: We need to act now before it's too late.

The report warns that global emissions are at record highs and current carbon reducing efforts are wildly insufficient: On the current trajectory, we are likely to surpass the Paris Agreement's target of limiting global warming to 1.5°C degrees above pre-industrial levels by the early 2030s.

We need to cut emissions in half by 2030 to be able to avoid irreversible damage. Despite the unprecedented degree of the challenge, the IPCC shows that we have many solutions available to reduce greenhouse gas (GHG) emissions and accelerate the phasing out of fossil fuels.

Europe is at the forefront to fight climate change through its European Green Deal, with the 2030 emissions reductions legislated for in the EU Climate Law. With its Fit for 55 package, the EU is acting decisively to cut net emissions by at least 55% by 2030 and pave the way to reach climate neutrality by 2050.

Solutions exist, policy makers are aware, and funding is available… But, although global climate adaptation and mitigation finance has shown an upward trend in recent years and success in reducing emissions has been demonstrated, current mobilisation of finance allocated to the green transition remains insufficient. Public and private finance flows for fossil fuels are still greater than those for climate adaptation and mitigation…

We need more incentives and financial players both able and willing to invest long-term. In Europe, National Promotional Banks and Institutions (NPBIs), such as Caisse des Dépôts, are established actors in financing of the green transition. With a combined balance sheet of € 1.7 trillion of the 31 NPBI members of the European Long-Term Investors Association (ELTI), NPBIs channel funds towards long-term green investments in form of loans or equity.

At Caisse des Dépôts, for example, we are committed to finance the transition towards a resilient carbon-neutral French economy through an ambitious sustainable investment policy relying on increasing funding in favour of ecological and energy transition, phasing out climate-damaging finance (exit from thermal coal, gradual withdrawal of unconventional hydrocarbons), decarbonising our portfolios through shareholder engagement and the companies we support.

We need more incentives and financial players both able and willing to invest long-term.

NPBIs combine both financial and project engineering expertise, have robust financing capacities and specific knowledge of both local actors and European institutions. As such, they do have the key assets for financing green transition projects in the territories and thereby contributing to massify investments from both the national sector, the EU, as well as the private sector. They need to go ahead and leverage on private finance, with the support of national and European policies. In this respect, InvestEU is an important milestone.

As part of the European Green Deal, InvestEU provides the European Union with crucial long-term funding scheme by absorbing risks and leveraging substantial private and public funds. The EU guarantee programme InvestEU, building on the success of the Juncker plan, shows how NPBIs unlock important investments in Europe through their direct access to the EU guarantee in their role as implementing partners.

Besides InvestEU, the European Commission introduced a "blending" scheme under the Connecting Europe Facility (CEF), allowing to combine European grants with financial support in form of traditional financial instruments from NPBIs. The scheme currently in force is the Alternative Fuels Infrastructure Facility (AFIF), contributing to decarbonising transport along the Trans-European Transport Network. Even though the conditions more restricted since 2021 (excluding rolling stock), this new instrument became indispensable in the financing of green hydrogen and electric charging stations. Given the difficult situation that energy markets are facing today, blending instruments are more important than ever to trigger works and mitigate financial obstacles linked to high up-front costs.

On a more general note, to meet the objectives of the European green deal, right regulatory incentives are required to allow green investments to thrive. The EU taxonomy is a vital step in directing investments towards sustainable projects and activities. By defining what is "green", the European Commission provides a common language that enables to classify future investments.

InvestEU, blending facilities, taxonomy and adequate financial regulation: We have many financial solutions at hand to fix the climate crisis in the EU. But we need to act now!

KEY TRENDS IN THE NORDIC-BALTIC FINANCIAL SECTOR

HENRIK BRACONIER

Chief Economist - Swedish Financial Supervisory Authority (Finansinspektionen)

Can we ensure the financing of the real economy?

The C in the Capital Markets Union represents the pool of capital available to finance the real economy, and its strength is vital for the union. A strong C requires directing household savings to investments rather than to bank deposits, and Sweden stands out in this respect. The ratio of Swedish households' financial assets to GDP is about 50 per cent higher than the EU average, and Swedish households deposit a much smaller portion of their assets.[1] Equity exposure is high; for example, equity funds make up 65 per cent of the assets managed by members of the Swedish Investment Fund Association.

The availability of risk capital has been a key driver for the Swedish equity market becoming one of the most active and efficient markets in the EU. In international comparison, the market capitalization of the Swedish stock exchange is high in relation to GDP. Listing activity has been high for years but naturally slowed following the rise in market volatility in 2022.

The equity market in Sweden began to develop in the 80s, but the corporate bond market developed much later, with growth accelerating in the past eight years. The rise of the bond market could have created a strong twin-engine system with robust capital markets for both equity and debt and a stable banking sector; key for financing the real economy. However, the corporate bond market in SEK, if anything, rather seems to have been a destabilizer during past and recent financial crises[2]. While the market has grown, it still lacks the depth and stability of larger and more developed capital markets such as those in USD or EUR.

Some of the reasons are obvious: the market has relatively low liquidity and a limited capacity to redistribute risk.This is partly due to a lack of diverse actors, which limits the generation of opposing interests. The market is dominated by open-ended investment funds with daily redemptions, while long-term investors play a more limited role.

The market has taken some tentative steps to increase diversity. The Swedish Securities Markets Association issued a new industry standard for transparent reporting of trade prices and volumes for corporate bonds in November 2020. Market participants also drafted a Swedish benchmark standard in 2022, which has since been followed by the issue of some benchmark corporate bonds. Continued efforts, most likely at the EU level, to limit the liquidity mismatch associated with open-ended funds will also be beneficial.

While Swedish households (and Nordic households in general) have largely invested their assets, they have also piled up high levels of debt. The reasons for this are all-too clear: strong economies, ultra-low interest rates and tax systems that favor debt and home ownership.[3] Commercial property firms have played the same carry trade game, more than doubling debt over the past 10 years. These strategies have been boosted by a general tendency to borrow at floating or short-term fixed rates and have played out handsomely since the GFC, and indeed even before.

However, as inflation and interest rates rise at the fastest pace observed for decades, leverage and interest-rate sensitivity are much less enticing. Nordic house prices are now falling, and commercial property firms are struggling with high refinancing costs. According to the EC, Sweden is the only EU country where GDP growth is forecast to be negative in 2023, although Denmark and Finland are also posed to lag.

Will the reeling real economy also spell trouble for financial stability? Probably not, although developments in the global banking sector have lately entailed increasing stress in the financial system. It has led to again sharply rising credits spreads in the bond market for perceived high-risk instruments.

More reassuringly, the other half of the conceivable twin-engine system, the Swedish banking sector, has proved so far to be more resilient. Profitability is strong, and credit losses are low. The capital position of large Swedish banks is strong, reflecting high capital requirements and specifically the fast and proactive reinstatement of the countercyclical buffer after the pandemic. The high requirements of banks on household lending – buffeted by borrower-based macroprudential measures – have reduced the vulnerability of households, and thereby lenders. This enabled banks to absorb some of the flowback when market-based financing for commercial property companies dried up.

Despite the challenging macroeconomic outlook and increase in financial stress, the silver lining of higher interest rates may over time be a less leveraged and less risk-prone economy. If the legislative improvements to the banking regulation are maintained and accompanied by more robust capital markets, the future may look more stable.

[1] https://ec.europa.eu/eurostat/
[2] https://www.fi.se/en/published/reports/fi-analysis/2020/fi-analysis-23-can-the-bond-market-dampen-the-credit-cycle/
[3] OECD, Brick by brick

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

Challenges and opportunities of the small economies in the fast-changing world

For many decades, the European Project has delivered and safeguarded its four freedoms and linked the prosperity of Europeans with their security. Liberalization of capital movements has geared up an evolutionary process and ensured economic and social convergence of the Member States as well as development and deepening of the Banking and Capital Market Union of the EU notwithstanding the different depth and development of capital market between its member states.

Current structure of the financial system in the Baltic States in many respects are confronted with similar challenges and questions that generally apply not only to these economies but to the small open economies in general.

Not too long-ago Latvia`s financial sector faced challenges that demanded immediate action to reduce national risks related to money laundering. It was a turning point to apply holistic reforms underlying our determination to ban criminals from exploiting vulnerabilities of the AML/CFT regime at the cost of reputation and stability of our financial system.

We were ahead of the curve in the terms of the accumulated threat to the integrity of our system, but more importantly in terms of decisive action that was taken to avoid predictable consequences to linger on the old path. Risk awareness and ability to calibrate response and actions to manage inherent and emerging risks effectively, was a lesson we chose to learn very quickly. We put innovations as an important component for financial intelligence, providing support for the long-term challenges in the AML arena, establishing the AML Innovation Hub – a permanent FIU platform for coordinated and technology-driven financial intelligence.

Latvia`s location and history require a strong focus on security, and this extends to the cyberspace as well. Especially given the country`s advanced digital infrastructure and rapidly digitalized society in the wake of pandemic. Through a heavy emphasis on legal, cooperative, and technical advancement in the field of cybersecurity, cyber professionals have developed hypersensitivity to disturbances, alongside a unique experience of dealing with threats coming from, among other bad actors, an aggressive neighbor.

The European Project has safeguarded its four freedoms and prosperity of Europeans with security.

When it comes to the other aspects of financial services, the borderline with Russia and Belarus still makes international investors cautious about investing in our region despite Latvia being part of the EU and NATO. This might trigger even more one of the structural issues of our economy – the low investment activity. For more than seven years, private sector investments in Latvia have been lagging our Baltic neighbors and EU on average. The volume of investments has been clearly insufficient hindering growth and so much needed investment for green and digital transition.

The answer to the question as to why investment activity has been so low in Latvia is complex. Companies have been rather cautious, particularly given the tough lessons learned during the global financial crisis and geopolitical reality. Meanwhile they have little alternatives to banks when it comes to attracting funding.

Borrowing directly from savers are rather undeveloped if compared to Western European countries, so companies mainly fund themselves through the bank lending. The stock market capitalisation in Latvia is extremely low, just around 3% of GDP, compared with the EU average - 54% of GDP, and 17% of GDP in Estonia.

In this situation a new approach towards a more balanced financial system is very needed. The government sees activation of capital market as a critical issue to support and provide necessary source of investment.

It is worth to acknowledge several capital market segment developments and initiatives in the recent years:

- For the SMEs - the number of bond issues of small and medium-sized companies is increasing thus providing better terms of financing.
- Sustainable and green bonds - State Treasury as well as number of largest state-owned enterprises have issued sustainable and green bonds and won the recognition of a wide range of investors.
- Municipal bonds - are a novelty, since there will be a legal framework allowing municipalities to issue bonds for infrastructure projects.

Besides latest developments, access to capital market for SME`s – a backbone for our economies, remains burdensome and expensive. We welcome regional approach for deepening our capital market and latest EU wide efforts for making listing rules simpler and affordable. These initiatives support our government's priority to develop and deepen capital market and use the benefits for our economy.

CARL MAGNUS MAGNUSSON

Policy Analyst, Capital Markets and Financial Institutions - Organisation for Economic Co-operation and Development (OECD)

The northern lights of Europe's capital markets

Discussions about European capital markets often centre around a familiar fact: they are smaller than they ought to be. That is certainly true – the EU's share in most global capital market activity is significantly smaller than its share in the global economy. But what is true for the whole is not necessarily true for the parts. While the EU at large is punching below its weight when it comes to market-based financing, there are member states that have been more successful in growing their domestic capital markets. Studying these can provide insights that are useful to furthering the EU's broader capital market agenda.

The Nordic capital markets, although still far from fully developed, stand out from much of the rest of the EU in terms of their size and activity. They are generally overrepresented in a number of measures of market-based financing activities, especially when it comes to equity financing. Denmark and Sweden together account for just below 6 percent of EU GDP, but almost 15 percent of its stock market capitalisation. Sweden alone made up one fifth of the total equity capital raised through IPOs and SPOs in the EU in 2021. It is the only EU country represented in the global top ten by number of non-financial IPOs in the past decade.

Why is this the case? Alas, the search for a straightforward answer is a Sisyphean task. Economies and financial markets are complex animals, and simple explanations are often more tempting than true. Still, even though there are no silver bullets for capital market development, a high-level comparative study of economic and regulatory landscapes can highlight focus areas for policymaking and help guide subsequent policy design. Ongoing OECD work on Swedish capital markets together with the Swedish Corporate Governance Institute points to a few notable characteristics.

When it comes to the capital supply side, meaning the investor base, two things in particular stand out. The first is that the equity exposure of pension funds is significantly larger in Sweden than in the EU at large, where these funds are typically more heavily invested in fixed-income instruments. Pension funds are important sources of capital for companies, and the way they allocate their money can shift the market more broadly towards that type of funding. Needless to say, as stewards of people's retirement savings pension funds cannot and should not expose themselves to excessively high-risk strategies. But there is room for equity investments, which should not be disregarded in the design and reform of pension systems.

The Nordic capital markets stand out from the EU more broadly in terms of their size and activity.

The second is the high level of retail investment activity and direct household exposure to capital markets. Swedish and Danish households allocate roughly a third more of their savings to equities and investment fund shares than the EU as a whole. Conversely, the share held as bank deposits is much lower. This is partly a reflection of active policies to encourage retail investment, such as the enormously popular Swedish investment savings accounts. At the end of 2022, more than one in ten Swedes held shares in companies listed on local exchanges.

This dynamism is also visible on the capital demand side. The balance sheets of Swedish non-financial companies reveal a funding structure that is substantially more equity-based than the rest of the EU. Of course, establishing the direction of causality, whether a successful corporate sector drives capital market dynamism or vice versa, is a notoriously difficult issue. Suffice to say that there is likely a two-way causality where the successes of the real economy and the capital markets reinforce each other in a virtuous cycle.

In addition to honourable mentions in magazine articles like this, well-functioning capital markets provide at least three crucial benefits. Firstly, their structure makes them well-suited to financing both large-scale projects such as infrastructure and uncertain ventures such as nascent technologies. The latter is particularly true of equity, given its risk-willing character and perpetual maturity. Secondly, market-based financing can help bolster the resilience of the broader economy.

Time and again we have seen companies increase their use of public capital markets in times of crisis to help them overcome downturns. Crucially, this countercyclicality can also be observed on debt markets, which can provide access to credit when traditional bank lending tends to contract. Finally, capital markets offer households a venue through which to take part in corporate wealth creation, an important aspect of democratising finance.

The ambition of the Capital Markets Union is rightly to disperse these benefits across the EU. Looking northward can provide some ideas.

BJØRN SIBBERN
President European Trading Services, Executive Vice President - Nasdaq

Financing European scale-up is a joint effort

Nasdaq is a leading exchange operator for listings and trading services across the Nordic and Baltic regions. While the opportunities and challenges vary according to the characteristics of each country, the role of capital markets remains vital in advancing economic growth. Through our experience operating in seven jurisdictions and our unique position in serving both investors and companies, Nasdaq recognises that open dialogues and close collaboration between all stakeholders at national and regional levels are critical to support prosperity and resilience of local economies.

Our success in the Baltic region demonstrates the value of this cooperative approach. In 2017, we took a significant step by merging the three central securities depositories (CSDs) in Estonia, Latvia and Lithuania. The integration provides businesses and investors with cost-efficient and seamless post-trade solutions when accessing capital markets across the region. It also established a strong foundation for exploring further integration and creating scale in the Baltic financial ecosystem.

Our Nordic markets are well-integrated, allowing market participants to access a range of investment and growth opportunities across national borders. Nasdaq Nordic leads global development in sustainability efforts, entrepreneurship and retail participation. We have successfully established as a major hub for sustainable finance with deep markets for green and sustainable bonds, as well as provided standardization and access to engineered carbon credits. Nasdaq First North, Europe's leading SME listing venue, enables smaller companies to access long-term finance, allowing them to grow and expand their businesses with the aim of graduating to the main market.

Support of local regulatory environment is key to SME growth. Rather than European policies, it is the local entrepreneurial culture, risk appetite of investors, pension and tax regimes, and equity culture of retail investors, that have major impact on the efficiency of the local financial ecosystem. We observe more growth in markets where retail investors are properly educated to participate alongside a supportive framework, either via pension plans, direct retail broker access or straightforward equity investment accounts.

The role of capital markets remains vital in advancing economic growth.

European policy initiatives can support local measures and accelerate growth at the regional level. We are encouraged to see European Commission's Listing Act initiative which for instance is intended to clarify and simplify the Prospectus regime. The changes should increase access to financing through secondary capital raisings and support progression of companies from the growth markets. Moreover, certain reporting requirements in the Market Abuse framework can be better calibrated. This should also unlock cross-border investments, with clearer rules providing less room for diverging interpretations in different countries.

In addition, we support a review of current listing requirements, including the free float, which is one of key factors contributing to liquidity. Liquidity is fundamental for a company's successful IPO entry as well as long-term life on the public markets. There are also other important factors, such as market capitalization, number of shares on the market, liquidity providers, and number of shareholders. We welcome a lower free float requirement, but what is more important is the flexibility in its implementation. Today there are several companies on markets across Europe where the free float may be 5% or lower, but still with strong liquidity. The Listing Act needs to recognise and continue to support such flexibility.

Our Nordic markets reach up to 50% retail participation, led by our growth market. An active retail investor participation is vital, especially for SMEs, both at the time of IPO and for maintaining liquidity on the secondary markets, where the share price is formed in a transparent and multilateral way with robust oversight. We believe that a more diverse investor base with retail and institutional lead to better execution quality in our markets.

The MiFID/MiFIR framework should be the backbone to protect secondary trading on regulated markets and MTFs. We are concerned that retail flow will be pulled away from these markets by Payment For Order Flow and larger investors being allowed to transact outside those markets at conditions which they deem preferential. Incentives should rather lead to more transactions on the multilateral and transparent venues, thereby strengthening Europe's capital markets ecosystem.

A more competitive and inclusive capital market in Europe benefits companies, investors and local economic development. The success of Capital Markets Union depends on close collaboration between local financial markets and policymakers. Together we can move forward with core initiatives and better regulatory framework to support efficient capital movements, accelerate growth opportunities and strengthen the competitiveness of EU capital markets.

ROGER STORM

Chief Executive Officer - Euroclear Sweden AB

Taking good care of financial eco systems – a Nordic Baltic perspective

As this is written, Europe and the US are reeling from another bank shock, an inflation/interest shock, and dealing with a COVID19-pandemic debt-overhang. Questions such as national security and resiliency has risen to the top of our agendas, whilst we are also charting ways to channel long-term investments into greening and digitalizing our economies. Change is crucial for Europe's long-term competitiveness and strategic autonomy. But let's not forget the importance of also caring for the foundational financial market infrastructure (FMIs). The Nordic-Baltics are looking to harmonize and upgrade its FMIs but are also concerned for the costs and returns.

Financial roads and bridges are the technical conduits and standards that allow money, financial instruments, and related data flow through the economy. We mainly notice them if they get congested. But a solid house needs a solid foundation and changing it later is hard and risky. Infrastructure investments come with very long pay-back periods, so a directional decision such as the Swedish Riksbank's to migrate SEK-settlements to T2/T2S by 2030 has far reaching implications.

Removing the known remaining market obstacles and furthering CMU are important steps on the way, but care must be taken of the eco systems as a whole and with a global view. The UK and the US are undertaking some very important changes, such as by compressing settlement cycles. With the ambition of making Europe the most attractive place for investing and raising funds, it needs the most efficient, secure and widely networked marketplace - and solid FMIs. We will need to match the betterments others have identified, along with basic elements such as a common digital ID, Cloud, bandwidth, energy assurance and bomb-safe data handling.

The Nord-Baltic region comprises Denmark, Estonia, Iceland, Lithuania, Latvia, Norway, Sweden and are closely linked through trade, geographic location, and shared history. It represents almost 15% of EU's GDP. It is a culturally diverse but also quite unique corner of the world, with an almost surprising appetite for digitalization and a steadfast careful fiscal policy (average government to debt in the region stood at the end of 2021 at 39.0% as compared to the 84.1% for the EU).
Not only is it a fiscally prudent region, a largely net savings contributing region, but also a digitally curious and proficient area. Digital IDs are largely in place, and instant digital payments is the norm. There is a significant direct retail engagement in investing since decades and reliable mobile networks.

Let's build a stronger vital Europe for the next generations, from the foundations and up.

The region's markets have developed well albeit quite differently. Euronext now owns and runs the regulated exchanges in Oslo, alongside with those of Amsterdam, Brussels, Dublin, Lisbon, Milan, and Paris, as well as the central clearing of Milan, and the Central Securities Depositories (CSDs) of Copenhagen, Milan, and Oslo. Nasdaq owns and operates the regulated exchanges in Copenhagen, Stockholm, Helsinki, and the combined Baltic Exchanges, along with the Nasdaq Clearing, and CSDs in the Baltics and for Iceland. Euroclear owns and operates in turn the CSDs in Sweden and Finland, as well as that of Amsterdam, Brussel, Dublin, Paris, London, and the international Euroclear Bank. The region therefore has an eclectic infrastructure, along with a range of currencies.

The Baltics having adopted the Euro along with Finland, whereas the Scandinavian countries have retained their respective Krona. Some regulatory specifics remain in many places which, apart from the known European wide differences in definitions of shareholders, tax processes and insolvency laws, can be both market distorting, barriers to entry and infrastructure protective elements. As the region evolves its FMIs, it must look to retain its trust, assure financing as well as assure control over who has which economic and fiduciary rights to which assets at each point in time.

After decades of addressing the Giovannini-reports' hurdles to a true pan-European financial market, massive efforts have gone into securing the financial system after the global financial crisis. The EU has crafted a range of new regulations, for exchanges, clearing, CSDs, banks, issuance, resiliency, market abuse, crypto, funds, insurance, and payments. With this Europe has become more harmonised and consolidated. Common standards and reduced complexity enhance resiliency and connectivity. But in times of stress, latency, segregation of networks and workloads, access controls, and intermittent processing, are also important.

In the next phase of evolving Europe's financial structure, care needs to be taken to also invest in its basic infrastructure. The Nordic-Baltic region is maybe a misnomer if one thinks of it as a homogenous unit, as it is rather a very vibrant and inspiring mixture.

As we change let's not leave it at a mere papering over of old processes but let's build a stronger vital Europe for the next generations, from the foundations and up.

ERIK SAVOLA
Head, Nordic Cluster & Country Officer - Citi

Nordic-Baltic region: mitigating risks to unleash multi-decade opportunities

The digitization of the Nordic-Baltic region makes the countries in it very agile and resilient, but equally exposes them to cyber threats. Since the beginning of Russia's invasion of Ukraine, critical incidents have increased and the number of cyber-attacks against banks has grown substantially. Significant disruption has so far been avoided thanks to the readiness of both public and private sectors, but continued vigilance is in order. Citi's globally based cyber fusion centers play a critical role in staying ahead of threats. We are working together with our clients, sharing intelligence across countries and industries to secure the business environment and the societies we operate in.

The advanced technological mindset of the Nordic-Baltic region sets it apart from the rest of the EU. Estonia has the highest number of unicorns per capita followed by Sweden. The traditional technology focus in telecoms has further expanded to FinTech, industrial tech, e-commerce, and bio-tech. The ability to scale up quickly is critical for the success of these businesses which in turn requires access to ample amounts of the right kind of capital along their growth journey.

To support further growth and innovation, Citi is investing heavily in our commercial banking offering for start-ups and mid-sized companies. Our Citi Ventures team sees major opportunities in the region. In addition to ensuring an environment that fosters innovation and supports a level playing field across all players, we believe it is essential for the EU to further deepen its capital markets capacity by continuing to build on its Capital Markets Union project. If we can get to emerging companies earlier, we can support their growth more by taking them to international capital markets.

In the changed geopolitical environment, we are also starting to see the first concrete signs of "near and friendly shoring". The definition of responsible business now encompasses a far more thorough analysis of compatibility of a corporate's values with those of its host government. Such analysis not only has a moral justification and enhances corporate reputation, but also reduces risk of severed supply chains and stranded assets. Citi is uniquely positioned to advise global businesses in this regard. Not only do we operate the most extensive global network of 95 presence countries, we also offer deep sector knowledge through our industry experts.

The Nordic-Baltic region is well-positioned for a digitized and sustainable future.

The Nordic-Baltic region not only leads in technology, but also in ESG. The clean energy transition is one of the most pressing topics on the agenda and one where the Nordic countries are ahead – be it in wind energy, biofuels, or hydrogen. Nordic companies are leading the way in decarbonizing hard to abate sectors through electric cars, green steel, and new battery technology. Sizeable deposits of rare earth minerals in Sweden will give the region a further competitive edge. The strategic importance of the recent finds will be magnified if the recent announcement of a potential US-EU trade agreement on Critical Minerals makes progress.

Given the huge cost of decarbonizing Europe's economy, private capital will have a key role to play and therefore it is critical that the EU remains open for international investment. Nordic and Baltic countries have long understood this and have made the case inside the EU for market openness and liberalization. After all, capital flows are global and erecting regulatory barriers or exporting national regulation is only likely to serve to deter investment in the EU.

Citi has made sustainability a company-wide priority and has pledged to be net zero on greenhouse gas emissions by 2050, including in our own operations by 2030. We also want to help our clients transition into greener business models and have committed $1 trillion to sustainable finance by 2030, including a specific environmental finance target of $500 billion.

Equally important is our sector specific ESG expertise, which allows us to provide actionable strategic and tactical advice on green transition. This deep insight is demonstrated in Citi's leadership in forming coalitions of banks to use financing as a tool to reduce carbon intensity of sectors such as Shipping and Steel.

As stated by President von der Leyen in her 2020 State of the Union address, the twin green and digital transition is a priority of the European Commission. Banking and capital markets will play a critical role in advancements in sustainability and technology ahead. The Nordic-Baltic region is well-positioned to be at the cutting edge of this transformation process. Citi has been on the ground in the Nordics for almost 50 years. We look forward to enabling growth over the next 50 years and beyond.

2

BANKING AND INSURANCE REGULATION PRIORITIES

- Basel III global consistency challenges
- Competitiveness issues in the EU banking sector
- Preserving diversity of the EU banking sector
- Enhancing bank crisis management rules

Q&A

JEAN LEMIERRE

Chairman -
BNP Paribas

Overcoming the obstacles to financing europe's green transition

Geopolitical tensions and the health and climate crises have led to a wide consensus in Europe on the need to strengthen our resilience and sovereignty and to accelerate the green and digital transitions. Addressing these challenges and meeting the very significant related financing needs will require continued reforms to Europe's economic growth and financing models. The EU estimates that the additional annual investments needed for the green and digital transitions over the next decade amount to €650 billion per year[1].

These figures surpass the trillion euro per year mark for the combined region of the EU, UK and EFTA countries, especially if defence investment is to reach 2% of GDP and industrial resilience is also factored in. Putting these numbers in perspective, it is worth noting that EU bank loans to all households and non-financial corporations amounted to some €500 billion[2] for the year 2021, which represents less than half of the additional annual financing required.

Although the public sector has obviously an essential role to play in the transition of the European economy –here I would highlight that the Next Generation EU programme and the Green Deal Industrial Plan are particularly welcome--, the fact is that the pace of European public investment and financing is far from being sufficient and that the bulk will have to come from private sources, which in Europe means banks. This will require a financing system that is as fluid and efficient as possible, allowing capital flows that fully leverage savers, investors, and companies.

Enhancing private capital flows will mean tapping into the full potential of Europe's private savings and further enabling securitisation, which remains greatly underdeveloped due to its lack of attractiveness for issuers and investors.

The fact is that the regulatory reforms of recent years did not recalibrate sufficiently the prudential treatment of European securitization exposures despite their high quality. Additional measures aimed at completing the Capital Markets Union as well as avoiding significant capital increases in the implementation of Basel III will level the playing field and the functioning of our financial markets, which will ultimately improve the business environment and attract the investments needed to successfully achieve Europe's political and economic priorities.

Further developing other sources of transition financing such as green bonds will also be essential. In this regard, the introduction of the EU Green Bond Standard is a very positive development which has the potential of securing Europe's role as a global leader in the sustainable bonds market. Driving the growth of sustainability-linked bonds and loans will also be a key part of the solution. The EU's role in setting market standards and disclosure requirements will be a key enabler of transition financing and we fully support the efforts underway.

The way in which the transition is undertaken is also crucial to achieving Europe's ambitious goals. In this, banks have a major role to play, incentivising, advising and financing their clients as they plan and implement their transition toward climate neutrality.

BNP Paribas is commited to provide as much support as possible to those who are already readying themselves for the ecological transition and acting in that purpose, while avoiding abrupt shocks that would compromise our energy security and the wider economy. As an illustration of this point, in 2015, when the Paris agreement was signed, low-carbon energy accounted for only a limited portion of BNP Paribas' financing for energy production. By 2030, it will represent nearly four-fifths.

Lastly, I would emphasize that the challenge is not only financial, but also one of having a common global ambition and a mutually consistent set of rules. For this, further strengthening international cooperation is crucial, even more so in these uncertain times.

The EU is today a recognized leader in these efforts and must continue to play this role to ensure that we are all progressing toward the same destination. We have only one planet. Having ambitious common goals and cooperating effectively in implementing the necessary measures are our only chance of achieving a sustainable future.

[1] EC report "Towards a green, digital and resilient economy" March 2022.
[2] EBF Facts & Figures 2022 - 2021 banking statistics

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

BASEL III IMPLEMENTATION

JOSÉ MANUEL CAMPA
Chairperson - European Banking Authority (EBA)

The EU implementation of Basel III and its impact

The finalisation of Basel III creates a clear and solid regulatory framework and ensures a global level-playing field. It is a key achievement at the international level. Its full and consistent implementation is key for its success, which will have clear macro-economic benefits and will further underpin the trust in the banking sector.

The EU sat at the negotiating table in Basel and defended the specificities of its banking market. Consequently, the final agreement incorporates many suggestions by EU authorities that make the Basel III framework fit for purpose to be adopted in the EU. The EC's proposal to implement Basel III in the EU, incorporates further specifications that better fit to the risk profiles of certain EU banks' business models. However, some possible deviations remain. Therefore, the EBA would advise the co-legislators to reconsider them as much as possible in their final negotiations, as, they might go further than what is justified in terms of the risk faced by EU banks. Making sure that the framework remains risk based would ensure the framework's robustness in these times of uncertainties.

The EBA has calculated, using data as of December 2021 and based on conservative assumptions, that capital requirements may increase by 11.5% if the EC's proposal would be implemented. The output floor (+6.4%) remains the key driver, explaining more than half of the total impact, followed by market risk (+1.8%) and operational risk (+1.7%). The credit risk reforms (+1.6%) and the revised CVA framework (+0.4%) contribute less to the total impact. The reform has a materially higher impact on globally systemic important institutions (G-SIIs) than on other types of banks.

On average G-SIIs see their capital requirements increase by 18%, while non systemically important group 1[1] banks and group 2 banks see their capital requirements increase from the baseline levels by 12.7% and 5.7% respectively. These estimates do not take into account possible adjustments on existing capital requirements beyond pillar 1 nor changes in banks current portfolio of activities that may occur going forward. This potential increase in capital requirements will not necessarily imply a corresponding increase in the amount of capital held by banks. The aggregate capital shortfall was found to be EUR 10.1 billion, out of which EUR 9.6 billion (i.e., more than 95%) is in Group 1 banks and of which EUR 7.8 billion (i.e., more than 75%) corresponds to G-SIIs.

All in all, only 7 out of 160 banks included in the impact study did show a capital shortfall following the implementation of the reforms under the EC's proposal. Finally, we have seen a clear reduction in EU banks' estimated aggregate capital shortfalls over the past 5 years as asset quality has improved and banks have enhanced their capital positions in anticipation of the future reform. This suggests that the increase in capital requirements is not significant for the majority of the EU banks and for the banking sector as a whole.

The outcome of the reform is therefore in line with what was intended. It remains risk based while ensuring that the use of internal models for capital purposes does not result in underestimation of potential unexpected losses. It is large systemic banks that are the most ardent users of IRB models who will experience the largest increase in capital requirements. Increased requirements to offset those risks should not come as a surprise. In fact, the rules were designed in such a way as to impose higher capital requirements to these types of banks. At the same time, an important element of the new rules is also the increased risk sensitivity of the standardised approach which will further reduce the gap between internal model banks and those using the standardised approach.

To mitigate the impact of implementation of Basel III in the EU, several transitional arrangements have been put forward, such as a 5-year phase-in period for the output floor and targeted provisions that help to spread the impact of the implementation over up to 8 years. This will provide banks more time to fully comply with the reforms, minimising the potential for any cliff effect.

Therefore, banks are ready today to implement the reforms loyally and in time, which will ensure that banks remain robust to confront the risks they face and that , when crises hit (as for instance during COVID) are capable to provide adequate lending to the economy to support growth. This is a key objective and requires the reforms to be implemented quickly.

[1] Group 1 banks are banks that have Tier 1 capital in excess of EUR 3 billion and are internationally active. All other banks are labelled as Group 2 banks.

JONÁS FERNÁNDEZ

MEP, Committee on Economic and Monetary Affairs - European Parliament

Towards a final agreement on CRR/CRD

In the coming weeks, the Council of the EU and the European Parliament will finalise the agreement on the CRR/CRD banking package, with technical support from the European Commission. More than 15 months of intense work, analysis and negotiations have passed since the initial proposal was published and we are now reaching the final discussions to strengthen the regulatory and supervisory framework of the European banking sector.

The events that happened in March should serve as a reminder of the risks within the banking activity. These risks must be managed and channelled, finding a difficult balance between the aims of industry, regulators and legislative powers.

Given this, as rapporteur, I must first call on the Council, the Commission and my colleagues in Parliament to reflect further on the implementation of the Basel recommendations and their co-existence with the so-called "European specificities". Of course, within our banking sector and financial system as a whole, there are some European particularities that must be considered, although not all of them lead to a potential relaxation of prudential rules. It's rare to hear industry voices mention any of the specificities that imply greater risks, despite the fact they obviously exist.

On the other hand, local interests are often presented as such and at certain moments the principle of proportionality is used as a way to escape the regulatory straitjacket. Moreover, some seem to demand that possible capital increases resulting from the implementation of an output floor – designed to minimise the risks of using internal models – must be netted of other capital buffers that exist within the regulation to achieve other objectives. All in all, having been reminded of the banking crisis by the events of little more than a month ago, co-legislators should exercise extreme caution.

Secondly, there is a key difference in the positions of the Council and Parliament regarding the level at which the output floor is applied. While the Council applies this measure at all individual and consolidated levels, leaving some room for manoeuvre within each Member State, Parliament recognises the reality of the single market. Despite the outstanding matters that must be addressed to complete the banking union, Parliament opts to implement the output floor at a consolidated level only.

The application of the output floor at consolidated level only comes, nonetheless, with two safeguards. On the one hand, if any competent authority considers that the capital calculated at the subsidiary is too low, it can request a redistribution with the competent authority of the parent organisation. On the other hand, if we don't make progress in the coming years towards completing the banking union, then the Commission would have the power to propose the output floor be applied at all levels.

Parliament considers this to be the most suitable option to relaunch the banking union and introduce additional incentives in this direction. Finding an agreement on this point will not be easy, but I hope that the Council will manage to listen to Parliament's arguments and find alternative ways forward in the interest of the Member States. Furthermore, there are major differences regarding transitional provisions for the introduction of the output floor, which Parliament wants to limit in time.

An agreement before the summer will allow banks and regulators to implement both legal texts in time.

Finally, the two texts differ on other significant issues. Parliament supports the Commission's attempt to improve the selection processes for board members and key positions in banking institutions, as well as increasing adequate supervisory control on third country branches. The Council, however, does not. I therefore trust Member States will further reflect on this issue. We also hope to see similar levels of receptiveness when it comes to implementing the latest Basel recommendations on prudential management to crypto-asset exposures in the EU.

In short, Parliament has begun negotiations with the Council in good faith and with the aim of reaching an agreement before the summer, which will allow banks and regulators to implement both legal texts in time. And that is where we remain.

ALBAN AUCOIN
Head of Public Affairs - Crédit Agricole

Unravelling the economic impact of Basel and its implications for the EU

The latest BCBS Basel III Monitoring Report issued in February 2023 highlights that the 2017 recommendation on the finalisation of Basel III would result in a 19% increase in minimum Tier 1 capital risk-based requirements for Group 1 European banks. In contrast, the impact on the Americas was nearly neutral with a mere increase of 0.3%, and the rest of the world would even witness a 4.8% decrease.

The banking package discussed now is not going to dramatically change this impact. According to the EBA Basel III Monitoring Report published in September 2022, the impact of the Basel norms on European banks would be a 15% increase in Tier 1 capital requirements, with Group 1 banks seeing an even higher increase of 16%. For G-SIBs, the impact is even more significant with a 24.7% increase in capital requirements. Even with the adjustments included in the banking package, the fully loaded impact would be a 10.7% increase for all banks, a 12% increase for Group 1 banks and a 20% increase for GSIBs. These figures are underestimated, since some adjustments, for instance on SA-CRR, have already been rejected at the current stage of the legislative process.

It is evident from these figures that the EU is not going to comply with the Basel accord overarching principle of 'no significant increase in capital requirements'. Meanwhile, banks in other jurisdictions will get a competitive advantage. The study 'The EU Banking Regulatory Framework and its Impact on Banks and the Economy' published by Oliver Wyman in January 2023, shows that on average and taking into account differences in business models and market structures, EU banks face higher capital requirements than their US peers (10.6% of CET1 in the EU versus 9.9% in the US). The Basel III framework is bound to widen this gap further. In addition, only 13 US banks apply the Basel standards, leaving many others with much weaker requirements, as illustrated by the collapse of the Silicon Valley bank.

Since the US was the impetus for the Basel framework, many of its features have been designed to address the specific conditions of the US economy. However, the situation is very different for the EU where distinct features call for a different approach. For instance, the EU has a much smaller capital market and an economy based on a majority of unrated corporates. Additionally, the output floor significantly reduces the risk sensitivity on mortgage loans in internal models. This penalises European banks, which have lower risk thanks to the double recourse to debtors and real estate assets, while US banks have recourse only to assets. The solvency ratios may be identical but conceal very different realities.

International convergence of prudential regulations is desirable to avoid the distortion of competition, but also for that, it is necessary to take into account the specificities of each market. The banking package incorporates some adjustments to cope with these specificities. Unfortunately, the most significant adjustments are temporary and European adaptations only give 5pp relief on the increase in capital requirements. This is a limited adaptation to the EU risk profile and, even with this relief the impact remains very significant for European banks.

While the temporary measures proposed by the Commission have helped to avoid a one-size fits all approach and to adapt the international standard to the EU economy, the impact of the banking package on the financing of the European economy will still be massive. Apart from unfair competition, banks have the means to adapt to this situation by reducing their financing and/or increasing their margins and fees to cope with the extra cost of capital. The problem will mostly be for European borrowers. According to Oliver Wyman's study considering the higher capital requirements in the EU vs the US 'A review of current capital requirements and supervisory processes could, in a hypothetical scenario, provide capacity for €4-4.5 trillion additional bank lending'.

The impact of the banking package on the financing of the European economy will still be massive.

The Copenhagen Economics study 'EU implementation of the final implementation of the final Basel II standard' estimated that the finalisation of Basel III could reduce banks' financing capacity by approximately €3 trillion. This increasingly unlevelled playing field when it comes to prudential standards is very detrimental to the EU, when at least € 500bn is required every year to finance new investments in sustainability and digitalisation.

Copenhagen Economics has calculated that the cost of borrowing in Europe will significantly increase by €25-30bn overall. Corporate customers are expected to be the most impacted, with a 0.25pp estimated increase in borrowing costs in average in the EU.

MARTIN NEISEN

Risk & Regulation Lead Germany, Head of SSM Office, Global Basel IV Leader - PricewaterhouseCoopers GmbH Wirtschaftsprüfungsgesellschaft

A closer look at the individual impacts of CRR III on European banks

While the goal of the finalisation of Basel III is to improve the resilience of banks, the specific changes focus mainly on calculating Risk Weighted Assets (RWAs) and increasing the risk sensitivity of capital requirements. Impact studies of BCBS and EBA showed that the weighted average in total Tier 1 minimum required capital increased by 13.7 per cent. Considering the adjustments made in the EU Banking package, the EU Commission estimates the impact of Basel IV/CRR 3 to be significantly lower, especially during the transition phase: the average increase in total minimum required capital will be between 0.7 per cent and 2.7 per cent in 2025, considering all transitional provisions. In 2030, when the major part of the transitional provisions will be phased out, the increase will be between 6.4 per cent and 8.4 per cent.

The results of detailed impact analyses by PwC, based on a high granularity and even single exposure level, showed that the impact varies significantly depending on banks' business model and to the extent internal models are used. Generally, the higher the risk appetite of banks, the higher the increase of RWA. And the impact of the new output floor (OF) increases with the use of internal models. For example, banks with a low-risk credit portfolio that use mostly the IRB approach will face a significant increase due to the OF.

A closer look shows how the effects of the new CRR III regulations are material in individual cases. Regarding the new standardised approach for credit risk (SA-CR), for example, the changes in the exposure class "institutions" may reduce RWAs for individual-rated institutions. However, a significant increase in risk weights is expected for unrated banks with high creditworthiness in countries with excellent external ratings. Applying the sub-exposure class specialised lending definition can be challenging and surprising and may lead to higher RW impact for corporate exposures. Regarding the exposure class "real estate financing," we observed that the credit splitting approach could lead to higher risk weights in the first years after the origination of the loans, as the loan-to-exposure ratios (LTE) are relatively high.

Moreover, the more a loan is paid back over the loan lifetime, the whole loan approach would be more beneficial for banks. We identified banks with a conservative business model based on very low LTEs that face an increase in RWA compared to the current rules, while banks tend to grant high LTE loans. Another interesting observation is that LTEs in more rural areas were lower than in urban areas. Therefore, banks with a portfolio concentration in metropolitan areas often have relief in terms of RWA than banks in more rural areas.

The biggest lever for real estate exposure is the real estate value. Without detailed guidelines by EBA, the variation of RWs will stay huge. A surprisingly high impact was observed for subordinated debt and equity exposures. Currently, these exposures are not easy to identify according to the new definition. Once identified, the impact became clear and higher than expected.

The impact on RWA in the Internal Ratings Based Approach (IRB) depends on the bank's business model and if the foundation or advanced IRB approach is used. For example, well-collateralised positions will likely experience an RWA boost from the new LGD floor rules for banks using the advanced IRB approach. In contrast, the over-collateralisation of loans under the foundation IRB approach will lead to significant relief compared to today.

The impact of the OF is very individual and depends on various factors, such as business model and the degree of coverage with internal models. Banks whose business model is relatively low-risk and at the same time have a high degree of coverage with internal models are potentially more affected than banks with higher-risk business models.

CRR III impact varies significantly depending on business models and the use of internal models.

The differences between RWAs according to standardised approaches and RWAs according to internal models tend to be smaller for higher-risk business models. Complex interdependencies between the newly introduced OF, new SA-CR, new rules for IRB and a new standard for internal models for market risk will make optimal capital management more difficult in future. One of the biggest challenges will be an adequate reallocation of the OF to the exposure level.

New regulatory requirements have always had an impact on banks' business models. However, with the CRR III regulations, a new level has been reached. The influence on the institutions' business models is very individual and can have both positive and negative effects – and will pose strategic, operational, and regulatory challenges for the banks concerned.

PHILIP EVANS

Director, Banking Policy -
Bank of England

Implementing Basel 3.1 in the UK

On 30 November last year, the UK's Prudential Regulation Authority (PRA) published our proposals for the final part of the post-crisis reforms designed to improve the resilience of the international banking system. We call these standards 'Basel 3.1' and they will be by far the largest package of international banking standards that the PRA has implemented since the UK left the EU.

The high-level aims of the Basel Committee on Banking Supervision's (BCBS) Basel 3.1 package are twofold:

The first is to improve the robustness of RWAs by increasing risk-sensitivity and reducing excessive variability. To achieve this, Basel 3.1 makes the standardised approaches better reflect the risk of institutions' exposures and makes internal models unavailable in areas where modelling is too difficult to perform robustly.

The second is to contain the capital benefits of using internal models because of concerns about model risk and uncertainty. To achieve this, Basel 3.1 introduces an 'output floor' – a 'backstop' that stops modelled RWAs from falling too far below those of the standardised approaches.

So, what has the PRA proposed?

In keeping with the UK's status as a global financial centre, we have proposed an approach that maintains high standards that are aligned with the international standards that we helped to shape. We do not see a fundamental trade-off between maintaining high standards to underpin confidence and maintaining the UK's global competitiveness and relative standing. Quite the reverse. As long as we are careful to avoid excessive conservatism, these goals should be re-enforcing over the medium term – recent events in the banking sector remind us just how important maintaining confidence is.

There are many tricky issues in constructing a balanced package. For instance, we haven't chosen to adopt one standardised approach for small firms without models, and a different one for larger firms with models for the purposes of output floor. We believe that having a different approach for larger firms would perform poorly against our secondary competition objective of seeking a level playing field between small and large firms.

Alignment with international standards also raises a delicate issue because some parts of the UK's existing rulebook are below existing Basel standards. Two of the most significant examples are the Small and Medium Enterprise (SME) and infrastructure support factors. They lower the risk weights for lending to their respective sectors and are intended to support lending, though the evidence is quite mixed on whether they have been effective in that regard.

Helpfully, the Basel 3.1 rules introduce new lower risk weights that at least partially cover the ground of the support factors. We propose to align with the risk weights that the BCBS members agreed to, and the vast majority have aligned with.

Although alignment with international standards is at the core of our proposals, we can, and do, propose to make some limited evidence-based adjustments to tailor the package to the UK market where we believe the prudential outcome would not be materially different.

One example is our proposed approach to unrated corporates in the standardised approach. In Basel, for countries that allow the use of external credit ratings, like the UK, risk weights would vary by external rating where one exists, and a flat 100% risk weight would apply where the corporate is unrated. However, the 100% risk weight for unrated corporates is particularly risk insensitive. We have therefore proposed a hybrid approach for this that introduces more risk-sensitivity with a lower risk weight for investment grade corporates and a higher risk weight for non-investment grade.

So, what happens from here?

The window for feedback on our consultation closed on 31 March, and we are in the process of reviewing responses with a view to finalising the package. We are acutely aware that the package is large and covers many significant and complex issues. We worked hard to gather evidence to support our proposals before the consultation, and during the consultation period that effort has continued with our institutions actively working with us to gather all the evidence available to support us in settling on the final package.

ANNA DUNN

EMEA Chief Financial Officer - J.P. Morgan

Importance of Basel III implementation for financial stability and resiliency

As I write this article, the aftermath of the Credit Suisse merger with UBS is just beginning and the initial repercussions from the collapse of Silicon Valley Bank are gaining in strength and clarity. Capital adequacy is not the topic of the hour. Nonetheless it is more important than ever to complete the implementation of the Basel III post-crisis reforms, as the international banking system being well capitalised relative to its risk is the foundation for any further reflections in areas such as liquidity and interest rate risk. Yet again the markets have shown that investor sentiment on banking is global, and consistency in standards is a strength.

It is helpful to remind ourselves of why we began this journey: bank capital is meant to appropriately address the risks held by banks, and Basel III is a meaningful step forward in providing consistent capital calculations that are risk sensitive. Exemptions for favoured sectors, whilst appearing a neat lever in the short term, ultimately through the economic cycle will mean that banks are not adequately capitalized for the risk they assume.

“Specialised lending” or “Project Finance” risk weights for infrastructure have been lowered in Basel III, so keeping current EU CRR supporting factors as a dual regime seems unnecessary. Another example is CVA exemptions for corporates being offered at a point in the credit cycle when credit risk is increasing for many corporates due to rising interest rates and inflation. In short, capital being reflective of risk should be an inviolate principle. The area of most contention with respect to convergence - unrated corporates- arguably creates controversy because the standardized approach is too rudimentary to robustly approximate credit risk.

To the extent that an improvement to capital calculations is agreed, the case for phasing-in improvements gradually over time rests upon potential disruption from rapid changes. Years ago when the Basel III negotiations began, the European banking sector had a significant gap to the level of the proposed standard. Since that point there has been a notable increase in capital levels. Based on the EBA’s analysis, in December 2018 European banks’ Pillar 1 Tier 1 aggregate capital shortfall to implement Basel III was EUR 24.1 bn. By December 2021 the aggregate Pillar 1 shortfall for European banks was EUR 0.8 bn. Over that period Tier 1 capital ratios on a Basel III fully-phased basis went from 12.7% to 14.1%.

The resiliency of the European banking sector in improving their capital levels during a period of considerable economic disturbance has been admirable, and suggests that seven years may be excess to requirements for the remaining uplift. One way or another, it would be good to be transparent regarding the purpose of phase-in periods, and then to be data driven regarding how the length of the period has been calibrated.

Third country branches are another area in which the European approach should be assisted by more comprehensive data. Third country branches are an integral part of the international financial system, and are a structure on which European banks rely for their international operations.

Given the intrinsically international nature of the topic, it is particularly important to consider global benchmarking. To the extent that third country branches in Europe acquire financial requirements such as capital or liquidity that are more normally aligned to subsidiaries, an unhelpful precedent will be set that may result in inter alia worse banking outcomes for European corporates and challenges for European banks abroad. It is however clear that cross border financial flows can introduce financial stability risk into Europe, particularly if they are not compliant with existing restrictions.

Increased collaboration between home and host supervisors along with transparency at the pan-European level regarding the activities being undertaken by third country branches would better inform European supervisors and regulators regarding whether a stability risk is being introduced. This data driven approach would also permit a targeted response that addresses any actual risk, rather than an indiscriminate measure which could undermine European competitiveness.

The markets show investor sentiment on banking is global. Consistency in standards is a strength.

In summary, Basel III was a collective international effort in which Europe played a leading role in defining the methodology. Current events remind us that there are always new problems but it is incumbent on us ensure that we do not repeat the old ones.

We should implement Basel III as faithfully as possible as soon as possible, with the knowledge that international banks being well capitalised relative to their risks is a prerequisite for global financial stability.

COMPETITIVENESS OF THE EU BANKING SECTOR

GIUSEPPE SIANI

Director General for Financial Supervision and Regulation - Banca d'Italia

Global competition between EU and US banks: root causes and opportunities

In the aftermath of the great financial crisis, the Euro area banking sector went through significant changes. Capital level and liquidity profiles improved considerably, thanks to updated regulatory frameworks (i.e. implementation of Basel III reforms) and a new supervisory framework (Banking Union and Single Supervisory Mechanism-SSM). Indeed, the SSM banking sector proved to be resilient against the effects of COVID-19 pandemic, since institutions entered that dramatic phase stronger than in the past.

However, SSM banks suffer from structurally lower profitability in comparison with the US banks. SSM banks' Return-on-Equity in third quarter 2022 stood at 7.6%, compared to 13.1% in the US[1]. This weaker performance has been reflected in their valuations, with price-to-book ratios and market capitalisation of SSM banks well behind US peers.

There are several reasons explaining this gap in competitiveness:

1. Euro area growth has been slower[2] than US one. This was also reflected in monetary policy, with the ECB that kept rates down longer than the US Federal Reserve, putting pressures on banks' interest margins;

2. Prevailing bank business model in Europe implies, in principle, the retention of loans on the balance sheet until full repayment, given also a less developed capital markets. In contrast, US banks can leverage on large and developed capital markets for their lending business, employing the originate-to-distribute model, where loans are securitised and transferred to the financial market;

3. European banking sector is less concentrated than the US one. SSM banks have generally shown less appetite for cross-border M&A operations; this means that banks in Europe face higher competitive pressure than US peers, with an additional impact on pricing. Indeed, despite efforts towards establishing banking union, the SSM banking sector remains segmented along national lines and barriers to cross-border consolidation with capital or liquidity ring-fencing still exist. Therefore, SSM banks cannot fully exploit economies of scale and risk diversification;

4. SSM banks show larger management buffers above capital requirements than US peers. In particular, European banks are typically concerned with market stigma, rating downgrades and distribution restrictions; therefore, they usually decide to hold significant management buffers, which are expensive.

5. Regulatory pressures and supervisory intrusiveness are perceived to be very high for SSM banks. Indeed, despite the application of the proportionality principle, actual differences between large and small banks are not perceived very material from the regulatory nor from the supervisory standpoints. For example, CRR and CRD frameworks are applied to all banks and regular stress test exercises are conducted on all significant institutions (by EBA and ECB) and on the majority of less significant institutions (by National Supervisory Authorities); on the contrary, in the US, mid-sized banks are treated preferentially under liquidity and capital requirements and do not participate to annual CCAR (Comprehensive Capital Analysis and Review). However, it seems to rather represent one strong point for the SSM banking sector: Silicon Valley Bank (SVB) demise has showed that financial crises can start with institutions of all sizes and we need to remain vigilant on the whole financial sector, in order to preserve financial stability.

As the SVB case demonstrated, the presence of a comprehensive deposit insurance is crucial and, unfortunately, the Banking Union still lacks its third Pillar. However, in a crisis event, the activation of the European deposit insurance scheme could help restore confidence and head off financial contagion.

In addition, at European level, we still lack well-developed capital markets.

Finally, financing digital and green transition will play a decisive role in the global competition. SSM banks are reviewing their digital strategies, but seem to be still one step behind US peers and competition from non-banks is particularly aggressive. Differently, the transition to a greener economy represents a big opportunity for EU banks, as this will require enormous amount of long-term investments, to be channelled to those projects bringing the most value added to both environment and investors. European regulators and supervisors are devoting a lot of effort from the very beginning and the SSM banks may be better prepared than international peers. This is a strategic opportunity to catch in order to preserve competitiveness.

[1] ECB and Bankregdata.com data.
[2] In the period 2007-2021, US GDP rose by 1.6% per year on average, compared to 0.6% in the Euro area (Eurostat).

JOSÉ MANUEL CAMPA
Chairperson - European Banking Authority (EBA)

Making the Banking Union a reality

The launch of the Banking Union in 2014 was a powerful response to the Great Financial Crisis. The establishment of the EU single rulebook, the set-up of the single supervision mechanism and resolution framework have enhanced resilience and confidence in the European financial system. However, the European integration of banking services remains unfinished. Real progress is slow despite some political ambition: Banking groups continue to be fragmented along national borders; funding differentials for banks across the European Union and the bank-sovereign nexus persist.

The creation of the Banking Union delivered in shoring up resilience of banks. Supervision has been enhanced and made more uniform across banks. Banks are better capitalised, managed, and governed. However, the banking union still falls short in terms of fostering a genuine European single market. Cross-border banking activity in the European Union has not recovered since its significant drop during the Great Financial Crisis. In fact, the share of EU/EEA banks exposures (loans and advances and debt securities) towards counterparties in other EU/EEA countries has stubbornly remained stable since 2014, at around 24% in 2021.

Equally, banking sector consolidation never reached pre-crisis levels in terms of M&A transaction number and volumes. In 2020, there were 19 major M&A transactions involving EU Banks (up from 13 in 2019) with a total value of EUR 10.8 bn (EUR 5.6 bn in 2019)[1] in contrast with a total value of USD 95 bn for M&A activity in the US in 2020.

The fundamental rationale for the Banking Union never changed. On the contrary, the adverse macroeconomic headwinds are an acute reminder of the need for a pragmatic and swift path towards completing the Banking Union. Tightened monetary conditions challenge business model viability, especially for banks which were built for the low-rate environment. As rates started to gradually increase last year, banks first saw their profitability rise with net interest income and interest margin gains. But repeated rate hikes have impacted valuation of financial assets and expectations of potential deterioration of credit quality.

As a result of changing rates, bank deposits have become more sensitive to interest rate differences and susceptible to be moved at short notice. This may impact duration sensitive business models in particular. This sensitivity is heightened by digitalisation and instant communication technology which can easily accelerate this quest for deposit yield.

Adverse macroeconomic headwinds are a reminder to swiftly complete the Banking Union.

The Banking Union was to enhance trust in European banks. On the regulatory side, we have built the Single Rulebook and strengthened supervision. Those achievements are put to a test regularly by the EBA through its stress test exercises. Our 2023 exercise covers an increased number of banks[2] and uses a particularly severe scenario with assumptions for both interest rates and inflation. The adverse scenario puts banks to the test of high and persistent inflation and interest rates and a severe GDP contraction, ultimately focused on solvency concerns.

A consistent and effective framework for managing banks in distress is a precondition for further integration and for avoiding national ring-fencing when problems arise. It is important to push progress on a more comprehensive and efficient set of resolution tools for smaller and medium-sized banks. Beyond that, a strong resolution framework requires us to clarify and harmonise the public interest assessment and banks' insolvency rules as well as to introduce more flexibility and effectiveness for the deployment of resolution funds. The Commission's upcoming proposal should address these issues.

Progress on risk reduction is widely acknowledged. However, advances on risk sharing remain rather elusive. As long as the European Deposit Insurance Scheme (EDIS) is stuck at the finishing line, the only pragmatic and swift way forward is to resort to the minimum common denominator. This entails the harmonisation of the use of DGS resources in resolution to ensure clear and consistent access conditions as depositors' trust is contingent on having those funds accessible without lowering the level of protection.

Recent volatility in the market and subsequent developments highlight the need to advance swiftly in completing the banking union. With the Basel III negotiation in final stages, co-legislators have the opportunity to advance on pragmatic use and effective implementation of cross-border liquidity and capital waivers. In addition, the banking landscape has changed since the inception of the banking union due to the entrance of new digital players and service providers. This offers the unique opportunity to finalise the banking union alongside the development of a level for new players and technologies.

[1] EBA Risk Assessment of the European Banking System, December 2021.
[2] 70 banks in 2023 compared to 50 banks in 2021.

AXEL A. WEBER

President - Center for Financial Studies (CFS)

European Banking Union needs a Big Bang

The world today is desperate for price stability and once again deeply concerned about financial stability. The EU is shaken by the war in Ukraine and still trying to come to terms with the consequences of BREXIT, the fallout from the pandemic crises and the challenges from a looming global climate crisis. Bold steps are needed to deliver growth and stability globally.

The EU as a single market is not fully integrated, especially for services, including finance. To a financial services provider wanting to serve clients across the region, the EU appears more like a conglomerate of 27 different markets, each with its own regulator plus a 28th European-level regulator on top. While we have seen the establishment of the Single European Payments Area and a nucleus for a banking union, significant friction and fragmentation remain. European banking needs a Big Bang overhaul now.

Creating new rules for cross-border lenders is vital. As a result of financial fragmentation, hundreds of millions of EU consumers, businesses, and the bloc's overall economy are not reaping the full benefits of the single market. More financial integration would not only benefit consumers and the economy, it would also pave the way for long-overdue consolidation in European banking and help to deliver more uniform transmission of monetary policy. This would break the vicious circle linking banks and sovereigns that lay at the heart of the euro area sovereign debt crisis in 2010. And it would add stability today if this consolidation is achieved in a proactive orderly process as opposed to improvised reactive crisis management.

To speed up the very slow pace of organic integration and consolidation, we need a regulatory Big Bang. To reshape the European financial sector it is time to now introduce a fully-fledged EU banking framework for cross-border banking groups. I've made these suggestions before, but they are worth repeating.

Such a framework would rest on five key pillars. Cross-border banks would be subject to EU rather than national law, including for their contracts. This would allow EU banks to exploit significant economies of scale and operate much more efficiently using a single platform. Today, that is hampered by differences in national anti-money laundering requirements, and mortgage rules. EU-wide lenders would only be supervised by the EU Single Supervisory Mechanism, rather than national watchdogs. This would free cross-border banks from differing prudential rules, allowing a free flow of capital and liquidity within banking groups. Harmonised regulation will also make it easier to harness new technologies, such as digital identity measures, which are key to the fight against financial crime.

Only an EU single market for financial services will prevent looming financial stability risks.

Cross-border banks would be able to provide a full suite of banking services across all 27 countries using a single International Bank Account Number code. Today, some consumers and businesses cannot transfer money across national lines because of discrimination against foreign Iban codes. This has paralysed competition and innovation in cross-border payments. And innovative services, such as mobile wallets, are primarily offered at national levels. The EU's "free movement of people" principle should be accompanied by the "free movement of funds", with no barriers and with no additional charges to consumers.

Cross-border banking groups would be subject only to a single EU bankruptcy framework, leading to more consistency in dealing with bank failures. Today, only the largest banks are subject to EU rules if they fail; others are dealt with under national rules. These are often inconsistent with each other, including on key issues such as state aid rules. Creating a single administrative tool for bank liquidation, as proposed by the EU's Single Resolution Board, could be a first step.

Last, but not least, these changes would alleviate most remaining concerns about risk sharing, paving the way towards a common EU deposit guarantee scheme. This would strengthen the credibility of deposit insurance and, again, reduce the bank-sovereign vicious circle. A single common deposit insurance programme would be an additional safeguard and will make sure that customers from different member states benefit from the same level of protection. Regulators and European policymakers have a simple choice here: wait for the next accident to happen and react then or act now. Never before in recent years has the potential benefit of a proactive legislation and regulation been higher for the EU than now.

Only a regulatory Big Bang would provide the nucleus of a proper single European market in financial services, a decisive advantage for consumers, banks and the economy as a whole. There is no better time than now.

Creating a truely single market for financial services would enable the EU to not only prevent a deepening of financial stability concerns, it would lay the foundations for managing the multiple intertwined crises we face today in a stronger and more united way than before.

SEBASTIEN RASPILLER

Head of Service for the Financial Sector - Ministry of the Economy, Finance and Industrial and Digital Sovereignty, France

How the EU can reap the benefits of a single market for banking activities

For consumers that are not familiar with the institutional landscape composed of the SSM, the SRB and the SRF, the idea of a European banking « union » is not a very tangible one. Most banking services, from payments to mortgages or to retail investment, are still being provided to them by national players. According to the ECB, about only 1% of European credit is distributed on a cross-border basis.

Of course, banking is not the only fragmented industry in Europe : telecom, transportation or utilities also operate with a significant domestic bias. But such industries have their own specificities, they rely on heavy physical infrastructures and they have often been deemed critical in some way or the other. It is hard to argue that in the 21st century this should still be the case of banking too. On the contrary, there is a strong economic case to have more paneuropean banks: geographical diversification in assets and liabilities would increase the stability of banks; such banks could contribute more to the private matching of excess savings and financing needs across Europe, which would benefit the growth potential of Europe.

But even more striking is that, in the case of banking, legal steps like the 1993 single banking licence and passporting had opened up cross border opportunities long before the inception of the banking union agenda, and had actually led to more formation of crossborder activities before this agenda was launched rather than since then.

So why does the European banking sector still resemble a mosaic of national markets and what can we do about it?

The usual policy answer would be to stress the need for completing the banking union, starting with the review of our crisis management framework, which is under way and should help reduce overcapacities, and at a later stage for agreeing on a form of European depositor insurance that would equalize the protection of covered deposits across the European Union.

But it is likely that none of these two files can actually be a silver bullet. In fact, prior progress of the banking union agenda was actually associated with a retrenchment of cross-border banking activities rather than the other way around.

The real solution might lie elsewhere, and be closer to business considerations than institutional ones.

On the revenue side, the lack of standardization of retail products makes it harder for banks to sell the same product to other countries' customers in the EU, and undermines their capacity to refinance these assets via non domestic investors, through securitization or asset sale.

The real solution might be closer to business considerations than institutional ones.

On the cost side, there is insufficient synergy potential between EU countries of operation: for example, rules on taxation, insolvency and consumer protection are all very much governed by national laws and not harmonized, which in turn does not allow to scale the cost of compliance at EU level.

These two elements suggest that it only makes sense in terms of business to develop a cross border retail activity when it can immediately reach a critical mass in each concerned MS. This means cross border organic growth is not an option, and leaves it to relatively large - and more complex - M&A deals.

Such deals have arguably been difficult to see coming in the past few years because of depressed sector profitability and valuations, as well as constant increase in capital intensity because of regulatory reforms. The recent paradigm shift with rising rates that support - at least over the medium term - profitability and valuations could however change that outlook.

This is less true for corporate and investment banking (CIB) activities, where platforms are European and global in nature. But even for these activities, since they require mere size of the balance sheet (but for advisory) and are structurally more volatile in revenues, it is difficult to conceive that large CIBs could thrive outside of a larger group active in retail too.

All in all, one cannot see a complete set of credible policies that would erase with certainty all hurdles to paneuropean banking business. Some of these hurdles can also even be cultural, like when local and regional banks keep thriving within some countries. It can only be a long process, steered by business initiatives taking advantage of market opportunities and only facilitated by more crossborder-friendly regulations regarding asset and liabilities management on the back of the stronger solidarity created by the integrated crisis management regime that is now in force.

We should get back to basics, when it comes to the banking union agenda.

FERNANDO VICARIO

Chief Executive Officer & Country Head, Ireland - Bank of America Europe DAC

A competitive banking sector in the EU – an objective to pursue

Developing a more competitive economy has been one of the long-standing political priorities of the EU. The banking sector is at the core of such an objective, given its role in the financing of the economy, the transmission of monetary policy and, more recently, sustaining the EU climate targets. Nevertheless, EU banks have suffered from a chronic competitiveness gap with other international markets. This competitiveness gap can be attributed to both cyclical and structural factors.

Cyclical factors, such as weak economic growth and a double-dip recession at the beginning of the last decade, have proved to be a constant headwind for the profitability of EU banks. Monetary policy has also played its part, sustaining a long run low interest rate environment, which only now is changing. While this has supported banks' funding costs and indirectly helped to address non-performing exposures, low rates in the euro area have led to a significant contraction in the net interest margins of banks, which is critical to profitability.

Structural factors have also impacted EU banks' competitiveness. Overcapacity and fragmented domestic banking markets continue to hold back EU banks from realising economies of scale, resulting in higher average cost-to-income ratios and insufficient size to compete effectively with international peers. While we have already seen considerable progress in banking consolidation within single Member States, particularly in those markets that were historically less concentrated, such as Italy or Spain, there are still several barriers to cross border consolidation.

With cyclical factors turning the tide (or arguably remaining outside of direct control of legislators), the EU should focus on addressing these structural factors, doubling down on existing initiatives to address the causes of fragmentation and overcapacity in its banking sector.

Credibility, consistency and competition are objectives EU regulators should pursue to enable a genuine single market and allow banks to deploy their capital, and ultimately lending capacity more effectively. In order to achieve these, we share a few ideas.

First, cross-border mergers within the Eurozone banking sector have been almost absent so far, notwithstanding the benefits of having the Single Supervisory Mechanism. The completion of the Banking Union, and a solution on a deposit insurance scheme in particular, are the obvious missing pieces. Recent global market turmoil around financial institutions should be the necessary incentive to restart the dialogue.

Credibility, consistency and competition are objectives EU regulators should pursue.

Second, pending a (difficult) political agreement on the deposit insurance front, regulators and supervisors could still work on addressing the current barriers in the form of capital and liquidity ring-fencing within cross-border banking groups. The current CRR3/CRD6 package offers a great opportunity to tackle the problem, for instance with regard to the level of application of the output floor in the 2017 Basel agreement and the potential extension of capital/liquidity waivers within the Banking Union. Concerns from host countries could be addressed by expanding group-wide resolution requirements and increasing supervisory cooperation. Designing a regulatory environment that could favour the establishment of branches instead of more complex subsidiaries would also play an important role.

Third, further harmonisation of local tax, insolvency and anti-money laundering frameworks would also help increase commercial synergies, whose relatively small size is one of the main hindering factors to cross-border deals in the banking sector. Some of these issues will admittedly require several years to get resolved. However, authorities should further build on initiatives such as the Capital Markets Union or the EU strategy for retail investors.

Finally, the standardisation of capital requirements and macro-prudential tools at EU level would also reduce complexity and uncertainty due to differences in local prudential requirements. This includes national discretions around capital buffers such as systemic risk charges for other systemically important institutions or countercyclical capital buffers, which also impact the calculation of the capital haircuts for minority interests in case of mergers.

Achieving a coherent banking market across the EU would significantly enhance the efficiency of the financial banking system. In turn, this would contribute to address the relative shallower depth of the EU capital market and allow the EU to fully seize the opportunity presented by its early leadership in financing the transition to net zero. One of the more recent examples is the adoption of the corporate sustainability reporting framework, as increased ESG reporting will provide visibility of banks' broader ESG engagement but also seek to ensure transparency, accountability, and comparability of the corporate sector in its entirety.

BÁRBARA NAVARRO
Head of Research, Public Policy & Institutional Relations - Santander

When rethinking regulation

We are not in 2008. Many checked their calendar after the collapse of Silicon Valley Bank (SVB) to make sure we hadn't gone back in time. We haven't, and it is worth noting why.

Since the Global Financial Crisis, banks have taken major steps to enhance their resilience. They have three times more capital and liquidity ratios are well above the mandatory minimum. The collapse of certain banks responds to a very specific issue linked to bad risk management. No amount of capital or liquidity can save us from every bad business decision.

Like banks, the EU has been very active and ambitious on different fronts. Despite things moving faster in the EU, there is no time or place for complacency and we should all help achieving more.

As it reviews its regulatory framework, the EU should consider striking the right balance between financial stability on the one hand and growth and competitiveness on the other. The work has started as the European Commission will introduce competitiveness checks. Furthermore, the Commission has released a communication with key areas for competitiveness; financial services comes on top.

The EU can be very ambitious, even more if it strategically allows businesses to use their strengths. A few examples:

First, in banking, a review of current capital requirements and supervisory processes, including how rules are implemented, could provide capacity for additional banking lending (€4-4.5 trillion; Oliver Wyman's: "The EU banking regulatory framework and implications"). Additional lending could also support the financing of the green and digital transitions, and more generally investments in strengthening the competitiveness of the EU economy.

Furthermore, despite the setup of a single resolution authority and fund, and the improved authorities' ability to respond to future banking crises, there are still obstacles to cross-border bank mergers within the Eurozone. This prevents banks from realizing scale or synergies across markets. Post-SVB, it is even more urgent to finalize the Banking Union with an EU-wide deposit insurance scheme. A single market in retail financial services is needed to provide scale and enhance competitiveness.

Businesses can help the EU bringing growth, innovation and competitiveness.

This will also help jump-start the Capital Markets Union. Insolvency rules and other fragmentation on disclosure, consumer protection and compliance, hamper cross-border investment and dampen funding from outside. This happens at a time when more financing is needed to overcome geopolitical, environmental and digitalization challenges.

Second, it is essential that the sustainable finance regulatory framework is defined in a way that enables the transition of all economic sectors and actors. Europe has taken a decisive role in the sustainability agenda, leading with ambition and encouraging other jurisdictions to act as well. Given the depth and speed in which the regulatory framework has been developed, we encourage policy makers to reflect on the progress achieved to date. As a priority, they should aim to achieve as much alignment and harmonisation as possible across jurisdictions, to avoid fragmentation and support the competitiveness of businesses.

Last but not least is innovation and technology. Financial services are already digital, but to make sure businesses can innovate and reap all the potential benefits of technology and digitalization, regulation and supervision should be simple and future-proof, based on principles and guidelines that allow rules to match the pace of innovation.

In the case of data, there are unexploited opportunities. The data economy should be customer-centric and cross-sectoral. The combination of data from different sectors holds the greatest potential for delivering new services and experiences for people and businesses. In the case of financial services, non-financial data is important for the development of new better financial products and services, fulfilling the needs of people and business.

For all these reasons, we need to strike the right balance between risk and growth. Other countries like the UK are taking steps, discussing with its private sector how to achieve the best possible outcomes. The US has passed the Inflation Reduction Act, which offers financial incentives to support the green transition. A significant law, which will have an effect on EU competitiveness. These are reasons for the EU to pursue broader aims, focusing on boosting its structural competitiveness.

The EU should be a single market for goods and services that enables people, businesses and communities enjoy the benefits of scale, of free movement and democracy.

In the end, I did check my calendar. We are in 2023. However, we should start looking into the future, into what the EU can do during the next political cycle: to review how rules effectively work and how they are implemented; to define a sustainability framework that enables the green transition; and to allow businesses to innovate. The EU must never lose sight of the goal, growth, and all the potential it holds.

CHRISTIANA RILEY

Member of the Management Board, Deutsche Bank AG and Chief Executive Officer, Deutsche Bank USA Corp.

Europe needs more funding through capital markets to improve competitiveness

Europe needs more funding through capital markets to improve competitiveness

Europe faces longstanding challenges, intensified by the war in Ukraine, inflation and financial market volatility. Geopolitical tensions are elevating, and Europe is still too dependent on other nations for commodities and energy. At the same time, Europe has considerable strengths: strong education, deep expertise and innovative skills in key industries, particularly related to fighting climate change.

For Europe to achieve its growth potential, it requires a framework that enables its institutions to compete effectively. This calls for major targeted investments, including:

1. **Accelerate the European green energy transition:** Reaching net-zero will require € 28 trillion investment in the next 30 years.
2. **Diversify global supply chains to reduce reliance on specific countries:** European corporates will have to source critical inputs from a smaller pool of suppliers, while building up strategic reserves.
3. **Increase defense spending to address geopolitical realities:** Annual spending will need to increase by around $ 100 billion versus 2021.
4. **Catch-up on digitalisation and new technologies:** Europe leads in only 2 out of 10 key transversal technologies (Artificial Intelligence – AI, quantum computing, cloud). Without improvement, European companies would miss out on a value-added opportunity of € 2-4 trillion a year by 2040.

The financial sector plays a crucial role, because 70% of funding in Europe is provided by banks. In the U.S., this is reversed. Bank lending capacity is determined by capital requirements, which constrain banks' capacity to fund the necessary investments. Recent bank failures have also demonstrated the need to reduce the economy's reliance on bank funding, as this creates risk concentration. European governments are also constrained by high debt.

In parallel, the EU capital market is still smaller than in the U.S. with 14% versus 42% of global market share. Europe is fragmented along 27 national markets. Due to Brexit, the EU lost around a third of its capital market, and gained a competitor with deep liquidity.

Key measures for an integrated, open and liquid capital market to address Europe's challenges.

Short-term steps

The current landscape creates new momentum for an integrated, open and liquid European capital market that can secure prosperity for companies and citizens. EU policymakers have one year left to deliver progress ahead of May 2024 European Parliament elections. Focus on three measures can provide tangible support:

1. Securitisation is indispensable to diversify funding sources and finance the green transition. The European market for securitised assets represents 8% of eurozone GDP, compared with 47% in the U.S. One reason is that the Basel and EU regulatory treatment of securitisations lacks risk sensitivity, with the capital treatment making it unattractive for banks and insurers. The U.S. has not implemented the relevant Basel framework. Action: Progress needs to be made in 2023, via the ongoing Banking Package, for targeted reduction to capital charges, so that change is seen in early 2025.
2. Proposed measures for strategic autonomy, such as the review of the EU clearing framework could penalize European banks and drive business to non-EU markets. Careful consideration should be given in the legislative process to determine how to protect EU liquidity providers/market makers competing internationally. Action: While supporting more clearing on the Continent, European banks should be allowed to service non-European clients where the client wants to clear. This would allow them to remain competitive with US and UK peers.
3. The retail investment strategy should empower participation in capital markets: Potential introduction of an inducements ban in the sale of investment products will drive retail investors to more risky asset classes or away from capital markets, creating an advice gap as already apparent in the UK which introduced such a ban in 2014. Action: Make disclosures clearer. Knowledgeable investors should be able to choose from a broad range of products. A full ban of inducements should be avoided.

Long term changes

Policymakers should consider broader challenges such as demographics and a low growth potential, and how they can be prioritised by specific reforms, including on capital markets. Progress and reform will come with tradeoffs, but this will benefit the EU overall. The regulatory framework must not undermine access to global liquidity. There are a number of areas to address:

1. **Lack of flexibility of EU regulatory framework creates disadvantages:** Extraterritorial application impacts EU bank competitiveness. Adjustment to international standards and more flexible equivalence assessments are needed.
2. **More consolidation of market infrastructures:** EU equity capital markets are only 25% the size of the US, however, the EU has 3 times as many exchange groups, 18 central counterparties (CCPs) and 22 central securities depositories (CSDs), as opposed to 1 each in the U.S. Further consolidation creates deeper liquidity pools, making it more attractive for investors to invest in Europe.

These policies would permit Europe to build on its strengths while adapting its weaknesses, leading to higher living standards, a better climate and long-term growth.

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ENHANCING THE EU BANK CRISIS MANAGEMENT FRAMEWORK

DOMINIQUE LABOUREIX
Chair - Single Resolution Board (SRB)

Building a common European crisis management framework fit for all banks

The European crisis management framework is a strong, flexible framework that is well-designed to manage bank failure. However, work remains to be done to enhance the framework. I will focus on two key issues: ensuring we have the options needed to manage the failures of small and medium-sized banks, and ensuring we have a harmonised framework across the Banking Union for banks of all sizes.

While there is broad support for widening the use of resolution tools to cover medium-sized banks, how to finance those tools remains more controversial.

The European framework is built on the assumption that banks within the scope of resolution are able to build up loss-absorbing capacity, typically through market issuance of instruments eligible to meet the MREL requirement, which can be used in resolution. To address concerns of moral hazard, strict conditions are applied for access to additional financing (both for deposit guarantee scheme ("DGS") funds and the Single Resolution Fund). Where such conditions cannot be met, this raises the risk there will be inadequate loss-absorbing capacity to support a resolution at the level of the firm, but that it will also not be possible to access additional funds. This could pose risks to the SRB's objectives of preserving financial stability and protecting depositors. This may incentivise finding ways to circumvent the framework.

...more banks under the scope of resolution [...] must go alongside effective funding arrangements.

On its side, the SRB stands ready to incorporate more banks under the scope of resolution, but this must go alongside effective funding arrangements. Banks' shareholders and creditors will always be the first to bear losses, but the question may be asked whether it is desirable to bail in deposits in some cases (e.g. where it undermines financial stability or depletes the franchise value). In the absence of a European Deposit Insurance Scheme, DGS funds can still play a key role under a robust and harmonised "least cost test" and with a clear market exit strategy. However, the current use of DGS funds in resolution is extremely restricted due to their priority afforded to covered deposits, even relative to other deposits, in the creditor hierarchy. Moving to a general depositor preference would allow DGSs to play a greater role in the financial safety net. DGSs could step in in lieu of deposits, once shareholders and creditors have been bailed-in and before accessing SRF funds, where needed. This would put in place a clear and predictable framework that would enable DGSs to support the Resolution Authority in protecting all depositors, though, of course, only where needed in the public interest.

Importantly, DGS funds must only be used in resolution when it is less costly than the counterfactual pay-out to depositors. Given the need for immediate pay-out of the whole deposit book in such a scenario, past cases show how costly pay-out can be for a DGS, even for smaller banks. The key difference would be that changing DGSs' position in the creditor hierarchy would increase its potential losses in a counterfactual insolvency, and, as a result, its possible role in supporting a resolution scheme. As noted, this should only be possible to support market exit, ensuring that industry funds are only used to support the efficient removal of market actors and minimise value destruction.

The second issue concerns the wide-ranging set of approaches across Member States for the management of small bank failures. This leads to an uneven playing field, prevents predictability across the Banking Union and hinders its integration. The current framework allows for significant national discretion, particularly as regards the treatment of creditors and the possibilities to use DGS funds: this can lead to a wide divergence in the outcomes across Member States.

In this context, the Banking Union urgently needs a more harmonised creditor hierarchy and a single set of criteria that would apply for the use of DGS funds, however those funds are used (preventive measures prior to failure, alternative measures in the context of insolvency, or to support resolution). A crucial element relates to the least cost test for which a robust framework is critical, aligning its calculation across both Member States and the different possible interventions. Taken together with the above measures to expand access to DGS funds in resolution, this would remove options that circumvent the framework or lead to the use of public funds, without increasing risks to financial stability or depositors.

Coming to a conclusion, European DGSs are a key part of the financial safety net, and this role could be further enhanced by revising the crisis management and deposit insurance framework. Expanding the scope of resolution without proper funding presents a clear risk that resolution authorities will not be able to deliver their mandate.

Co-legislators and the industry should beware of leaving gaps in the framework that undermine predictability, financial stability and, ultimately, Banking Union integration.

STEFANO CAPPIELLO

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

Constrained flexibility, the missing element to manage banking crises

The forthcoming European Commission proposal for the review of the crisis management and deposit insurance framework (CMDI) represents a unique opportunity to address the rigidities and the weaknesses in the current framework.

Evidence from the last decade shows that, for national and European authorities, managing the crisis of ailing banks has been a strenuous exercise of adaptivity and interpretation. In fact, ensuring the ordinary resolution or liquidation of banks, while – at the same time – preventing spill overs threatening financial stability (e.g., by shielding certain un-covered deposits from disruptive impacts), requires a comprehensive toolkit, adaptable to various business models and different scenarios.

Such lesson is pivotal in view of the upcoming reform. Resolution is not a goal per se, but a means to the end of preserving financial stability and tackling moral hazard. To that end, an adequate degree of "constrained flexibility" is needed in the framework. In this regard, three elements are still missing but essential.

First, the EU banking sector is characterized by the coexistence of a variety of banks, which differ in terms of size, business model, and funding structure. Biodiversity, a strength of the EU banking system, must be preserved. In that respect, a resolvability approach focused solely on the MREL requirement would, on the one hand, represent a competitive distortion (i.e., it would rule out the business model of local banks that lack sustainable access to wholesale markets) and, on the other hand, be unjustified, since there are other means to ensure the goals of resolution.

In fact, the CMDI review should not provide a one-size-fits-all recipe but rather allow for a wider recourse to industry-funded safety nets to manage the crises of different banks, including the use of DGSs to support transfer strategies (as successfully done by the FDIC for almost a century in the US as well as in some Member States), both in resolution and in liquidation. To effectively pursue this goal, and foster value-preserving transfer strategies, two adjustments are imperative: the elimination of the so-called DGS super-priority, and the inclusion of indirect costs in the least-cost test (LCT).

Constrained flexibility for authorities is needed to secure financial stability in banking crises.

As highlighted by several studies (most recently, the ECB's October occasional paper), ranking DGSs' claims pari passu with uncovered deposits (through a single-tier system, or the so-called depositors general preference) underpins financial stability and comes at a lower cost compared to a mere depositors pay-out in liquidation. Furthermore, including indirect costs in the LCT would allow a proper identification of the real costs borne by the DGS and the whole financial system, and unleash the effective deployment of efficient and value-preserving bank crisis management tools.

Second, inherent rigidities of the resolution framework (including the application of the so-called 8% TLOF rule) substantially limit the possibility of using the Single Resolution Fund (SRF) to manage bank failures. The latter will soon reach its €80 billion target, while its function seems doomed to remain only on paper, due to the above-mentioned rigidities. For an efficient use of such resources combined with the ultimate goal of preserving financial stability, it should be clarified that national DGSs are allowed to fill the funding gap needed to reach the 8% TLOF threshold.

By ensuring effective access to the SRF, the risk of bailing-in deposits in resolution (which would raise financial stability concerns) could be averted. Such tool would prove particularly useful when the resolution strategy envisages the use of the sale of business tool, making – in turn – the transfer strategy even more credible.

Finally, the EU framework should adopt a holistic approach in the field of banking crisis management: BRRD and State aid rules should be more consistent and be both cognisant of the need to allow for State support in order to preserve financial stability, while curbing moral hazard. A financial stability exemption (proposed by the IMF) should always be available as an important safety valve, allowing the resolution to operate also in extreme situations. A wide and flexible toolkit available to authorities when dealing with banking crises under strong time pressure, encompassing also a well-framed State aid regime tailored to the specificities of the financial sector, is needed to ensure and foster financial stability.

Fixing the CMDI framework in Europe will be a stepping stone to get to a truly integrated banking and financial Single Market: as game theory tells us and past experiences showed, what happens in the gone concern stage does impact the incentives of market players and national institutions to trust each other in going concern.

An effective CMDI will therefore be key to bring together the Banking Union and the Capital Markets Union, a goal which is fundamental to have deep and liquid EU capital markets to finance the green and digital transitions.

SIMONAS KRĖPŠTA
Board Member - Bank of Lithuania

The role of bank resolution in the turbulent macroeconomic context

The current environment of high inflation, rising interest rates and elevated uncertainty puts financial institutions under stress. A bump in the road – the failure of a medium-sized or even a small bank – can result in financial markets questioning if it is a systemic moment, implying contagion risks. The recent banking turmoil in the United States and Switzerland vividly demonstrates that in a highly unpredictable macroeconomic and financial environment, a resolution toolkit that prevents contagion should have a broad basis in its applicability.

In Europe, in contrast to the US, higher capital and liquidity requirements, and stress tests established following the Global Financial Crisis account much better for the resilience against systemic risks. For example, unlike in the United States, all banks in Europe are subject to Liquidity Coverage Ratio (LCR) and the Net Stable Funding Ratio (NSFR) requirements. Hence, a broader implementation of Basel III regulation has put the continental banking system in a more favourable position compared to its US counterparts. Despite this, the digitalisation of economies – rapid spread of financial news and rumours on social media, the ease with which deposits are transferable across the banking system, the rise of instant payments which can be performed 24/7, including weekends – puts individual banks at greater risk of liquidity dry-ups and evaporation of trust.

The risks to individual banks also arise through the asset side of the balance sheet. An environment of higher interest rates tests the viability of firms' business models and risk management practices. Besides higher interest rates, weaker growth and higher energy bills dampen corporate profitability in affected economic sectors, implying a higher risk for the banks' assets performance.

The banks have crucial importance in the financial ecosystems of every European Union economy. Hence, it is even more important to further expand and sharpen the resolution tools such that they remain able to ensure banking sector's continuous contribution to the real sector in case of shocks and financial difficulties.

The overarching principle for the second pillar of the Banking Union is to strengthen financial stability by ensuring that a sufficient range of EU banks is resolvable. Even though the EU crisis management framework for banks has undergone several improvements since the Global Financial Crisis, there are additional steps that are yet to be taken.

Stronger EU bank resolution framework would make the Union more resilient.

While larger banks issue MREL instruments to absorb losses in resolution and avoid tapping into the public funds in case of a failure, medium-sized and smaller banks may have a harder time accessing capital markets, especially in smaller economies. Therefore, the crisis framework could be improved further by enabling a more effective use of the Deposit Guarantee Scheme (DGS) funds in resolution or alternative financing measures. This could enable the controlled market exit of banks while minimising market panic and preserving the value of the bank under resolution.

There is a need to unify principles of the least cost test, which is important for more cost-efficient interventions by the DGSs. While this test is to be applied in case of the DGS interventions other than the payout of covered deposits, there may be some differences in how it is implemented in practice because the designated authorities have some room for discretion.

The fragmentation of EU insolvency regimes adds another layer of complication. Hence, harmonisation, at least in terms of the creditor hierarchy, is needed to level the playing field by providing industry and investors with an equal degree of certainty in liquidation. Such harmonisation would mitigate the risk of breaching the "no creditor worse off" (NCWO) safeguard in the current resolution framework.

There are many detailed steps involved in implementing the above principles, but these steps need to be taken to make improvements with respect to the Banking Union's Pillar II. They are also important from a broader perspective. The current macroeconomic juncture has brought a costly invoice to the public finances table – there is a need to step up investments in defence and foster green as well as digital transformations. At the same time, debt sustainability needs to be safeguarded and public finances protected from incurring additional costs.

The banking sector – a strategically important industry – requires a broad and powerful set of tools ready to be used in times of distress. Crucially, we need to be strategic in learning from recent events in the United States, as well as in Switzerland, and strengthen our bank resolution framework going forward.

KAROLIN SCHRIEVER

Executive Member of the Board - Deutscher Sparkassen- und Giroverband (DSGV)

A CMDI Review that has the specificities in the national banking sectors in mind

The European Commission's task of drafting a well-balanced proposal reviewing the Crisis Management and Deposit Insurance Framework (CMDI) is everything but trivial. While most aspects may appear to be of technical nature, they can quickly lead to repercussions with other objectives and elements of the Banking Union, which explains why Member States and voices from the EU's diversified banking sector have expressed legitimate concerns.

After last June's Eurogroup statement, the CMDI Review appeared to have the necessary political backing and guidance. Importantly, the statement stressed that the proposal needs to have the "specificities in the national banking sectors in mind". This unambiguous acknowledgement of the importance of the EU's diversified banking sector to financial stability by the EU's Finance Ministers offered a clear baseline. But still, the debates accompanying the review suggest that the Commission could be aiming for a fundamental overhaul which would be incompatible with structural neutrality.

In fact, the CMDI Review appears to be intended as just another step on the path towards a full mutualisation of deposit funds in the EU. In June, the Finance Ministers decided to discontinue discussions on EDIS with the intention to allow for tangible progress on CMDI within the remaining institutional cycle. A fundamental overhaul of the existing framework would be neither in line with the Eurogroup result nor would it seem politically achievable.

One debated aspect is the suggestion of including small and medium-sized institutions in the resolution regime. This paradigm shift towards "resolution for the many" would end the current assumption that resolution is only suitable if it is in the public interest, e.g. due to financial stability concerns. Institutions added into the scope would face unnecessary burdens from an administrative side, due to resolution planning and reporting obligations, and financially, due to higher MREL requirements. This is exactly what legislators wanted to avoid in 2014 when setting up a proportionate framework assigning regular insolvency procedures where financial stability is not at risk. Instead of further blurring the lines, the duality between insolvency should be strengthened.

Recent events in other jurisdictions have shown that it is necessary to subject large banks to thorough resolution planning on a European scale. Efforts should not be wasted on small banks, especially if there are additional protection measures in place.

What is needed, is a CMDI Review building on a framework that has proven its capabilities.

It seems likely that the proposal tries to free additional financing sources by extending the use of Deposit Guarantee Schemes (DGS). To allow for this, changes to the creditor hierarchy are discussed allowing for an easier access to DGS funds by introducing a pari-passu ranking for all deposits. As a result, the available means of DGSs and their credibility would be negatively affected. Furthermore, there are considerations of modifying and harmonising the "Least Cost Test", which is the assessment of whether insolvency and pay-outs to depositors would be a less costly alternative when compared to support measures and business continuity. If these changes were applied to preventive measures, Institutional Protection Schemes (IPS) would be significantly restricted in the use of their funds. How does this comply with the Eurogroup Statement (June 2022), according to which the proper functioning of IPSs has to be ensured?

It is to be feared that the proposals will not guarantee effective protection for customers and financial markets. In the event of a crisis, overly detailed and bureaucratic regulations will leave insolvency or wind-down as only possible outcomes. If legal depositor protection is reduced to a paybox, it has procyclical effects.

It is not obvious why these far-reaching measures are being considered. What is needed instead, is a Review focussing on improving of a framework that has proven its capabilities – even more so when considering that the DGSD already provides for so-called alternative measures. They can be used to allow a failing mid-sized institution that is not going into resolution to maintain business relations with its customers avoiding a disruption of the economic cycle. The European Court of Justice has confirmed their sound legal basis.

Instead of discontinuing or at least significantly limiting these measures, the Commission should enhance their usability and encourage Member States to make better use of them.

Whatever the proposal will look like in the end, it will need to strike the right balance for the wide array of the EU's banking models. The stability of the Banking Union during crisis hinges on this diversity of business models, sizes, and ownership structures. This setup allows to cushion shocks by diversifying risks and thus enables parts of the financial system to compensate for the failure of affected banks. In order to maintain these benefits, there needs to be a holistic approach on the way forward for the Banking Union.

TAKING ADVANTAGE OF BANK DIVERSITY IN EUROPE

GIUSEPPE SIANI

Director General for Financial Supervision and Regulation - Banca d'Italia

Navigating traditional and emerging risks in EU banking supervision

One of the primary objectives of European banking supervision is to push the EU banks to review their business models in order to ensure a steady growth of their profitability and its sustainability. SSM follows a risk-based strategy, in principle neutral towards the variety of business models, which represents a factor of bio-diversification, contributing to the system's overall resilience. Sometimes, high profitability is accompanied by imprudent or not well monitored risk-taking, both for financial risks and for operational risks. Hence, it is crucial to consider whether profits can be sustained and regularly maintained over an economic cycle.

The dynamic and ever-changing business environment poses several challenges to the sustainability of different business models. Traditional business models may appear to be preferable nowadays, due to the recent shifts in monetary policy and interest rates hikes and the related positive effects on interest margins, but the same factors can pose high risks when it comes for example to the asset evaluation. However, traditional banks are nevertheless the ones under higher regulatory and supervisory pressure. More innovative or "niche" business models, instead, may be more volatile in income generation, but might have some benefits due to a less "fit" regulation and supervision assumptions and approaches.

Recent crisis cases, which are still being analysed, first pose a very important question on the effective neutrality of supervisors towards different business models. The answer cannot ignore that the supervision becomes increasingly challenging, handling conventional risks, often altered and less discernible in the balance sheets, and emerging risks and opportunities, with a lack of well-developed toolkits and expertise.

The support of the regulation frequently comes with a slower pace, but in the meanwhile supervisors should act promptly, even though the rules are not completely defined. The SSM is working constantly in order to develop supervisory tools able to better capture risks of non-traditional activities or the link between banks' and non-banks' sectors, but the attention and the actions on traditional risks, such as credit risk, remains largely predominant. Against this background, I will elaborate on some of the features that supervision, and the SSM in particular, should work on.

Strengthen the supervisory framework

We can agree on the fact that a "one-size fits all" approach is inadequate for supervising many different entities. Combining the homogeneity of banking rules with the diversity of business models require a careful balancing between consistency and flexibility. We need to keep on customizing, differentiating, and adjusting the supervisory toolkit in order to face as many specific situations as possible. This may potentially weaken overall consistency, but the principle of a real level playing field requires us to handle comparable situations in a consistent manner. Accordingly, it is crucial to keep on improving benchmarking activities to mitigate the risk of inconsistency and to reinforce the focus on long-term viability.

To establish distinct 'standards' for different business models, certain measures would need to be taken. Firstly, develop a more nuanced and refined assessment methodology to duly acknowledge the idiosyncrasies of the different business models. This would require a deeper understanding of each bank's activities and the different risks they face.

In addition, data transparency, quality and comparability are crucial for meaningful analyses and decision-making, not just for large banks, but also for smaller institutions. Increased data transparency can also help to identify best practices and benchmark performance across the EU significant institutions and in the global comparison.

Get prepared to the ever-changing environment

Fostering a culture of innovation is also essential in encouraging banks to explore new business models and opportunities that are more resilient to exogenous shocks, also with benefits for their cost-effectiveness. At the same time, consistent investments are required to update knowledge and skills of supervisory teams, in order to be prepared to assess related risks that follow changes in banks' business models, and safeguarding the stability of the financial system.

Increase the cooperation

Lastly, supervisors and regulators should work closely with each other but also with industry representatives, academic experts and consumer advocacy groups, in order to facilitate dialogue and cooperation between all the different stakeholders involved and in order to share knowledge and best practices, especially for new or peculiar business models. Tackle with risks is a global challenge and recent crises cases pointed clearly out the need of a joint effort, so to have a comprehensive picture and act accordingly.

MARGARITA DELGADO
Deputy Governor - Banco de España

Adapting SSM supervision to the diversity of banking business models

In the wake of the collapse of some local US banks, the debate on the risks inherent in their business strategies has heated up. Aggressive growth with strong ties to the technology industry, concentration in large deposits, and investment of ample excess liquidity in long-term bonds in times of low interest rates were the basic features of such strategies. This confirms that a clear business model, coupled with robust governance, is key to ensuring the viability of firms.

In the Single Supervisory Mechanism (SSM) banking landscape, with over 2,200 consolidated credit institutions, more than 10 different business models are used for peer comparison based on banks':

(i) main source of income;
(ii) customer and funding base;
(iii) size and geographical focus. These embody quite different competitive banking strategies, taking in everything from custodian banks to diversified lenders, consumer credit lenders to development lenders and G-SIBs to small market lenders, to name but a few contrasting examples. Each bank business model is typically associated with certain common vulnerabilities and is affected in different ways by market threats.

At the SSM we have to deal with this considerable diversity of banking models in the context of a common European banking regulation that seeks to preserve a level playing field. Under the coordination of the European Banking Authority (EBA), the Single Rulebook comprises a set of harmonised prudential rules, which all banks in the European Union must respect so as to ensure a resilient, transparent and efficient European banking sector. However, the characteristics of individual banks, especially the specific features of their different business models, need to be factored in when enforcing these common rules. Banking supervision can play an important role in this respect, with supervisory activities tailored to specific groups of banks.

The supervisory risk management framework at the SSM is made up of four sequential phases:

1. Identifying and monitoring of risks to the SSM banking sector;
2. Formulation of strategic priorities;
3. Operationalisation of strategy;
4. Monitoring priorities and supervisory activities.

The SSM deals with a great diversity of banking models while applying risk based expert judgement.

In the first two phases we generally adopt a universal approach for the entire set of banks, paying limited attention to business model-related aspects. It is at the operationalisation stage where banking business models come into play, with detailed action plans for particular banks or clusters. This typically results in the design of thematic reviews or horizontal analyses for off-site activities and the planning of OSI campaigns for on-site supervision and the selection of participating banks. Business models are among the elements considered when assembling these samples. Finally, the SREP benchmarking exercises include a peer comparison within each business model group.

Taking into consideration all the available tools, the SSM could take a further step forward in the continuous improvement of its banking supervisory practices if needed. The risk and vulnerabilities assessment could be tailored to the specific business models from the very beginning, while also allowing for more targeted strategic priorities as a prior step to defining the detailed action plans. This would help to better focus the supervisory efforts on the risks that are relevant for each institution.

A supervisory risk management framework more centred around banking business models offers certain clear benefits for SSM banking supervision, given that it would:

- Contribute to a more focused process, by contemplating from the outset the risks associated with the specific vulnerabilities of the different banking models, allowing potential common problems for groups of banks with similar attributes to be identified.
- Help to better estimate the impact of events affecting some specific activities according to business models, facilitating proportionality and a more risk-based approach to supervision, by further tailoring the intensity and focus of supervisory activities to banks' characteristics.
- Enhance the level playing field treatment of SSM banks, by better accounting for their similarities and differences and facilitating peer comparison throughout the entire supervisory process.

Recent events have shown the importance of proper risk management, backed by the appropriate analysis and supervision of business models.

Here at the SSM, we must analyze the tools required to fine-tune the methodology and the supervisory and risk tolerance framework in order to better adapt them to the different business models. This process calls for seamless implementation, taking cautious steps so as not to overcomplicate matters and always considering the expert judgment that the Joint Supervisory Teams bring to risk-based supervision.

HELMUT ETTL

Executive Director - Austrian Financial Market Authority

Sound supervision of diverse markets, business models and products

Europe still does not have a single financial market. As part of the financial market, the banking market is also highly fragmented within Europe and the SSM. How does supervision take this situation into account?

When examining the cause of these differences, one of the main reasons lies in the specific design of respective financial markets. Namely, whether bank-based or capital market-based financing is more prevalent in a financial market. Indicators for a capital market's development include, for instance, the structure of the real estate market and the extent to which pension financing is provided via the capital market. In this respect, one could bemoan a country's less developed capital market, for example in Austria, but the fact remains in this context that banks are required to take over the financing function. Incidentally, there is no definite answer about whether bank-based or capital market-based financial markets perform better overall.

Another factor determines differences in a respective financial market: business models. On the supervisory side, the SSM takes different business models into account, for example in stress testing or in the institution-specific SREP, which reflects credit institutions' individual business models. With regard to the regulatory framework component, defining what exactly constitutes a business model is far from trivial. For this reason, a risk of over-complication also exists if banking regulations are directly broken down in too much detail by business models. This is reflected in the fact that supervisors ensure the best possible and most sound supervision within the framework of the existing regulations.

The next level concerning diversity are the distributed financial products. Respective geographic and market-specific circumstances have to be taken into account in this regard. One suitable example in this regard is the granting of mortgage loans to retail customers in different regions and markets. Mortgage loans function very inhomogeneously in different real estate markets, not least due to relevant national (borrower-based) measures to safeguard financial market stability. Consequently, banks with a focus on mortgage lending should not automatically be considered similar to one another, even if their business models are almost identical. At the beginning of the banking union, it had indeed been mused that banks should ideally have a pan-European portfolio, regardless of their location. The positive consequence in this context would be greater independence from a geographical component in the event of problems or crises.

Business model supervision is accurate when considering the relevant risk profile and diversity.

An overarching dimension has come to the fore against the backdrop of current events in the banking sector. The question arises whether size dimensions really (should) create a cliff effect in supervision. The diversity of business models is taken into account with regard to systemically important banks, as there are differences in monitoring, the frequency of supervisory contacts and governance. Thus, even in the "standardized" Pillar 1, the leeway is utilized. We supervise banks in a way that permits them to manage the risks inherent in their business model, taking into account their risk situation and profitability. Of course, macroeconomic scenarios are also taken into account in supervision - a bank's business model must be able to withstand a recession or similar negative scenarios. In recent years, especially regarding diversity, one must also consider the extent to which regionally active banks, which fulfil the important financing function for SMEs, for example, are adapting to the risks of digitalization, with the greatest risk being not to participate in the digitalization.

Overall, it should be noted that banks and their business models in Europe are already supervised on the basis of proportionality and an individual assessment. However, exercising of supervisory leeway is explicitly not to be understood in the sense of a deregulated approach. The current imbalance in the U.S. has arisen as a result of deregulation in the late 2010s, where thresholds for the full application of banking regulations where raised considerably. In my view, falling below the obligation to apply the strictest supervisory standards has allowed the situation to develop as it did.

Current events should be a timely wake-up call that brings a renewed purpose back into the regulation debate. In the light of recent developments, the discussion on deregulation in the banking market should find a more realistic direction again. We have seen that the failure of smaller, non-significant banks can also have systemic effects, so that they should be analysed (even) more closely in this respect. Admittedly, this would mean a half-step away from simply "too big to fail" to "what happens if it fails". In my view, however, it is a positive sign overall if occasional market exits happen, because this is evidence of the disciplined application of reasonable and accurate regulations.

MARIJA KOLAK
President - National Association of German Cooperative Banks (BVR)

Diversity is a valuable resource

The banking structure in Europe is based on historically shaped and evolved traditions. It is characterized by diversity. This includes the coexistence of big banks, savings banks, cooperative banks and specialized institutions. This is associated with different legal forms, but above all with very different business models.

Institutional diversity in the banking sector is associated with major advantages. Different business models of banks and savings banks are matched by different customer needs. Major international banks are geared to supporting companies worldwide. They have branches all over the world wherever their corporate customers are active. Regional banks, on the other hand, are mainly domestically active. They are not only located in places where major banks are also established, but also in sparsely populated or structurally weak regions, for example. This is because there is demand for financial services from private customers, small and medium-sized enterprises and traders in all regions. If they do not find suitable offers, this reduces the future potential of these regions.

Diversity can increase the resilience of the banking industry. Since the impact of financial crises also depends on the business model, a diversity of business models can ensure that restrictions on supply can be reduced or even largely offset in difficult times. This is particularly the case if the institutions themselves are sufficiently crisis-proof. Adequate prudential regulation on the one hand and a high level of competition on the banking market on the other contribute to this.

The German banking industry is a good example of the benefits of diversity. It is characterized by a three-pillar structure. This consists of the financial networks of the savings banks and cooperative banks and the other banks, which include not only internationally known major banks, but also numerous other regional banks.

The Volksbanken Raiffeisenbanken Cooperative Financial Network is one of the three main pillars of the German banking industry. The majority of the 737 credit cooperatives are Volksbanken and Raiffeisenbanken, which provide local banking services throughout Germany. The Volksbanken and Raiffeisenbanken are legally independent banks and know their regional markets. At the same time, they are part of the financial network and can thus achieve economies of scale and offer a wide range of financial services. In addition to the cooperative banks, the Cooperative Financial Network includes, for example, DZ BANK as a central bank, Union Investment as an investment company, R+V Versicherung as insurance company and DZ HYP as a mortgage bank. The DZ BANK is also present worldwide and supports the international business of companies that require a supra-regional banking partner.

Like biodiversity in nature, institutional diversity is an important resource in the economy.

Like biodiversity in nature, institutional diversity is as an important resource in the economy. However, diversity in banking regulation is currently hardly taken into account in the prevailing "one-size-fits-all" approach to banking regulation with its focus on large banking groups. Divergent business models thus have to contend with disadvantages and diversity is likely to tend to decline.

An important area for action is proportionality in banking regulation, so that smaller and medium-sized credit institutions do not have to contend with regulation that is oversized in relation to their risks. This also applies to reporting, where institutions below a critical size can be significantly relieved through simplification options, graduations and exemptions.

Of central importance for the German financial networks is an appropriate consideration of the institutional protection systems that guarantee the protection of the institutions and thus also of customer deposits. Institutional protection schemes exist not only in Germany but also in a number of Member States, including Austria, Italy, Poland and Spain. The Genossenschaftliche FinanzGruppe's protection scheme has been in existence for more than 80 years, making it the oldest private protection scheme in the world. Since its inception, depositors have never had to be compensated, nor has there ever been an insolvency of an affiliated bank.

Communitization of deposit insurance in the euro area, as envisaged by the European Commission, would amount to the elimination of these tried and tested systems. Equally to be rejected are the Commission's plans to significantly change the European framework for crisis management of banks. The planned extension to small and medium-sized banks would create problems where there are none today, to the point of unsettling customers who rightly rely on the current system.

The work of institution-based protection schemes should not be made more difficult by additional requirements. The existing banking union already provides a solid foundation for bank stability.

BENOÎT DE LA CHAPELLE BIZOT

Head of Public Affairs - Groupe BPCE

Acknowledging banking diversity in Europe through tailored supervision

The European banking sector is fundamentally different today than in 2014, when the principles of the Banking Union were approved in Brussels. At the time, EU economies were still recovering from the financial crisis. It was essential to create a Single Supervisory Mechanism, which could efficiently and swiftly assess the financial stability of Europe's biggest banks.

Almost ten years later, it is undeniable that the SSM has largely fulfilled its main role: keeping the banking system safe and sound through a variety of harmonized prudential tools that are used daily by Joint Supervisory Teams (JSTs). In this regard, the Supervisory Review and Evaluation Process (SREP) should be regarded as a breakthrough.

However, European banks' business models and corporate structures are diverse. Cooperative banks, which were once disregarded for their risk aversion and their locally grounded culture, effectively act as a source of resilience for the entire financial sector during difficult times, thanks to the non-dilutive nature of their capital, long term business models and low risks approach. This diversity is a key driver behind Europe's financial stability and economic resilience, and this has been repeatedly recognized by European supervisors.

It is true that cooperative banks, on average, may have lower profitability than some of their commercial counterparts. But there are several reasons for this: a very high management buffer (profitability is a ratio which compares results on equity), a low-risk business model which leads to low profitability (high proportion of mortgages in the balance sheet), and a nationwide granular presence allowing a decentralised decision making close to clients (BPCE has 6500 branches in France).

It is therefore key to adapt supervisory procedures and processes so that supervisors' approaches fit better with the different business models. Benchmarks should not be the gold standard of supervision if they do not recognise in practice the specificity of banking models in Europe, especially those who proved to be sustainable over time. JSTs should thus not be guided only by standardised benchmarking for banks' profitability, cost and risk management, and governance.

Time has come to combine the homogeneity of banking rules with the diversity of business models.

In terms of profitability for instance, our Group has a pay-out ratio around 10%. Its capacity to put earnings into reserves is therefore comparable to listed groups even though their net incomes are higher. Furthermore, our reserves are not distributable, and our high level of capital, which is a choice of the group, naturally explains the relatively lower profitability.

On the same vein, analyses on the cost income ratio should encapsulate some characteristics of the business model, as the ratio remains high for some banks: the weight of real estate credit in the balance sheet should be considered as it mechanically explains a high cost income ratio because the margin is low (and the risk too), while the number of branches also has an impact (see above) …

Hence, a better indicator could be the residual income after distribution and a proper assessment of the risk/return ratio. Other indicators could also be put in place in terms of cost efficiency and governance. In short: it is the right time to combine the homogeneity of banking rules with the diversity of business models. Moreover, the SSM should make sure that the transparency of different benchmarks and the suitably of the samples are the cornerstone of supervision analysis: each bank should be able to position itself vis-à-vis the benchmark and either comply or explain.

Our capacity to serve customers and small companies in all regions should also be a key indicator for supervisors, who should consider that maintaining banking activities in all regions of France is key for our business.

Beyond supervision, regulation itself could lead to numerous unintended consequences on the different business models if we don't look at the big picture. I have one example in mind: the cumulative effect of the leverage ratio and the NSFR. The first ratio, if applied individually and not globally, tends to favour risky activities, while the second one favours long-term activities. Those indicators would incentivize banks to favour a non-diversified risky long-term business model.

For BPCE, it is essential to preserve the DNA of our Group and support our 36 million customers, whether they are individuals, professionals, associations, corporates, or local authorities, over the long term and at every stage of their lives. We stand ready with European cooperative banks to work hand in hand with the SSM on this matter: it is time to acknowledge banking diversity in Europe through tailored supervision.

3

DIGITALISATION AND PAYMENTS

- Digitalisation trends and new technology impacts
- Cryptoasset regulation and technology
- Digital operational resilience
- Digital Euro
- Payment framework enhancements

Q&A

SCOTT MULLINS

Managing Director & General Manager,
Worldwide Financial Services - AWS

Cloud's role in building a modern and secure European financial services sector

By working with AWS, financial services organizations are optimizing all aspects of their operations – from customer service delivery models to risk management – in order to build a foundation for long-term innovation and growth. As we enter the second decade of AWS adoption in financial services, the use of cloud is broad and varied. In fact, we even see this breadth and variation of cloud adoption within a single customer. As organizations gain experience running applications on AWS, they use that experience to drive additional experimentation and innovation. Standard Chartered Bank is a good example. The bank launched its Nexus banking-as-a service solution and Mox, its new virtual bank in Hong Kong, on AWS.

The bank's award-winning global payments system, SC Pay, and core banking system, eBBS, are cloud-native services, which have resulted in faster and more secure transfer of funds with reduced cost per transaction. Standard Chartered's Financial Markets business, which includes risk management, financing, and investment services, also uses AWS to run algorithms that assess market risk to scale up those workloads during peak demands.

In Europe, but also globally, use of cloud in financial services is gaining momentum, but there are great opportunities for further adoption. And that's not only true of financial services, but of all industries. According to a study commissioned by AWS and published last year by independent consultancy Public First, if you look across all sectors of the economy, only 26% of European companies have taken up key technologies such as the cloud, 25% AI, and 14% big data[1]. This is a long way from the target for 75% of companies to adopt cloud, big data and AI as set out in the European Commission's Digital Decade program[2] so the potential opportunity from technology in the wider EU economy is still very significant. The same study points out that accelerating progress will require a sustained, collective focus – across the public and private sectors – on digital adoption, skills development, infrastructures, entrepreneurship, and digital transformation of businesses and government.

One area in particular that would benefit from this type of sustained, collective focus is operational resilience, which has always been a critical topic in financial services. Indeed, AWS, the financial services industry, and the regulatory community all share a common interest in enhancing operational resilience. The ability to provide continuous service despite potential disruptions, is a key prerequisite for financial stability. Operational resilience is a shared responsibility – AWS is responsible for ensuring that the services used by our customers—the building blocks for their applications—are continuously available, as well as ensuring that we are prepared to handle a wide range of events that could affect our infrastructure.

Our customers can design, deploy, and test their applications on the cloud to achieve the availability and resiliency they need, including for mission-critical applications that require almost no downtime.

Our builds guard against outages and incidents, and accounts for them in the design of AWS services, so that when disruptions do occur, their impact on customers and the continuity of services is as minimal as possible. To avoid single points of failure, AWS minimizes interconnectedness within our global infrastructure. Our global infrastructure is geographically dispersed over five continents and is composed of 31 geographic Regions, which are composed of 99 Availability Zones (AZs). The AZs, which are physically separated and independent from one another, are also built with highly redundant networking to withstand local disruptions. Regions are isolated from one another, meaning that a disruption in one Region does not result in disruption in other Regions. Compared to global financial institutions' on-premises environments today, the locational diversity of AWS's infrastructure greatly reduces geographic concentration risk.

AWS also provides guidance for how customers can design, deploy, and architect financial services industry workloads to improve the resiliency, security, and operational performance, and regularly provides additional educational content on best practices. We refer to these practices as "well architected principles". These principles, to a certain extent, have been adopted widely by several providers, and although they vary in some form from CSP to CSP depending on the way their infrastructure is built, broadly speaking they guide financial firms to make certain architectural choices depending on their risk appetite for the applications they are looking to run on the cloud.

At AWS, we also make it easier for our customers to translate these principles into actions, via our Well-Architected Tool and Well-Architected Reviews, so we don't just supply the principles, we supply the hands-on guidance needed to translate those principles into actions.

Looking ahead to DORA and the emerging regulatory framework, ensuring that financial firms have full access to technologies like cloud and machine learning is crucial for the future competitiveness of the European financial sector. In particular, any type of localization requirements would not only reduce choice for EU financial organizations, but would also pose risks for the cybersecurity of Europe's most important workloads. This goes directly against the objectives of DORA in terms of enhancing the security and resilience of the financial sector.

For DORA and any future regulatory initiatives, it remains fundamentally important for policy makers and regulators to carefully consider the need to achieve an approach that recognizes the operational resilience, security and innovation benefits of cloud, and enables firms to make the most of that opportunity.

DORA provides the right foundations for a framework that can address ICT risks; however, a lot of the detail is yet to be decided in the regulatory technical standards so it is important that these reflect the specificities of not just cloud but all types of providers. For example, specifically in relation to cloud, it is important to consider the 'digital native' aspects of the technology and the principles that deliver enhanced 'digital native operational resilience'. In this sense, the well architected framework which I referred to before could be leveraged to achieve this.

I would also contend there is a need to re-think regulatory and supervisory practices in light of the digitalization of the sector, for example by considering the shared responsibility model, where the cloud provider looks after the security and resiliency of the cloud, while the financial entity looks after their security and resilience in the cloud. Further, given the fast pace of technological innovation, both regulation and supervision need to be forward looking and flexible enough to adapt to future developments in technology. I believe DORA provides the opportunity to achieve this in order to deliver on its objectives of enhancing digital operational resilience across the EU financial sector.

In relation to the oversight of critical providers, as it is acknowledged in the introductory section of DORA, the framework could potentially lead to synergies that would support the adoption of technology, for example by avoiding duplicative efforts by supervisors and/or firms. However, as I said earlier, we are yet to see how this is implemented in the regulatory technical standards and in practice. More broadly, I'd also add that it is critical that regulators actively facilitate the dialogue among financial firms, service providers and regulators to develop a coherent cross-border framework that continues to support the adoption of technology by financial services firms.

We are seeing differences starting to emerge and are concerned about the potential impact on the ability of financial firms to access services globally at a time when cyberthreats have become a key risk to the financial sector and firms require the latest security toolbox in order to be able to defend themselves against these threats.

[1] https://awsdigitaldecade.publicfirst.co.uk/
[2] https://commission.europa.eu/strategy-and-policy/priorities-2019-2024/europe-fit-digital-age/europes-digital-decade-digital-targets-2030_en

Q&A

KRISTIN JOHNSON

Commissioner - U.S. Commodity Futures Trading Commission (U.S. CFTC)

Lessons learned from the recent failures in the crypto market

Has the failure of certain cryptoasset service providers and stablecoins and the downturn of the market since 2021 revealed major fragilities of the crypto ecosystem? To what extent are these events attributable to crypto-specific issues?

Events over the last year reveal notable fragilities within asset classes, among critical financial market intermediaries, and, more generally across the financial market ecosystem. On the heels of a global health crisis, monetary and fiscal policies have endeavored to effectively address challenging conditions driving macroeconomic indicators, including international supply chain disruptions, persistent and extreme volatility, and inflationary pressures. Geopolitical events, most significantly Russia's invasion of Ukraine, have contributed to additional pricing volatility in many of our key markets and, simultaneously, record trading volume on global platforms. Notably, markets have demonstrated significant resilience in response to this confluence of pressures.

Almost a year ago, a daisy-chain of counterparty risk management failures triggered liquidity crises and cascading losses among a handful of critical cryptoasset service providers. The series of crises (a contagion) in cryptomarkets reveal debilitating governance and risk management failures within individual firms and the interconnectedness among several of the largest institutions in the crypto ecosystem.

In May of 2022, the TerraUSD stablecoin fell below its fixed value, triggering a selloff. TerraUSD and its sister coin Luna lost $40 billion in value. One month later, citing extreme market conditions, Celsius Network, a crypto lender with $11.8 billion under management, ceased permitting withdrawals. Following the Celsius announcement, on a near weekly basis crypto asset providers faced insurmountable liquidity crises and failed. Crypto lender Babel Finance halted withdrawals citing "unusual liquidity pressures." Ten days later, crypto hedge fund Three Arrows Capital defaulted on loan payments to crypto lender Voyager—and Voyager collapsed. Later in the year, FTX and BlockFi experienced similar pressure and in January of 2023 the lending unit of Genesis suffered a market rout. In the face of these liquidity crises, the firms formed a queue as each filed for bankruptcy protection in turn.

In many ways, the macroeconomic challenges in traditional financial markets have demonstrated the effectiveness of post-financial crisis reforms designed to enhance governance (specifically risk management policies among systemically important intermediaries), minimize single points of failure, and strengthen resilience by requiring appropriate allocation of financial reserves and other default-centered reforms. And perhaps as importantly, the post-crisis traditional finance setting includes regulatory responses that are global in nature and comprehensive in effect. These features are regulatory constructs and glaringly absent within cryptomarkets, possibly fostering endemic fragilities and governance and risk management failures. Governance, risk management, recovery, and resilience reforms comprise critical elements that must inform crypto asset regulation.

Do we have a clearer view on the economic value of cryptoasset activities and the opportunities and risks for different types of investors?

To confirm that crypto asset activities have economic value, we must first identify the problem that these introducing these assets will solve. We must ensure disparate exposure to risk of loss does not amplify existing inequities.

Careful study of crypto markets crises reveals important observations regarding two classes of market participants and their trading behavior following the episodes of crypto market shocks. First, according to a recent paper by the Bank of International Settlements, as losses resulting from the crypto crises mounted, major exchanges that execute trading and settlement for retail investors witnessed a marked increase in account activity and upticks in trading volume. Evidence of trading activity also suggests significant sell-offs by large and sophisticated investors. An analogy proves illustrative.

One might describe the sophisticated investors— those who own 1,000 or more crypto units—as "whales" and the retail investors as "the krill." The study carefully details and further demonstrates that the increased retail market exposure is even more pronounced in emerging economies such as Brazil, India, Pakistan, Thailand, and Turkey. Under such conditions, it is important to note and address the likelihood that, in stormy seas, the whales eat the krill.

Second, participation of institutional investors also merits careful evaluation. In the context of FTX's collapse, two Canadian pension funds acknowledged significant investments in the crypto ecosystem. In 2019, the Ontario Teachers' Pension Plan ("OTPP") launched the Teachers' Venture Growth platform. In October 2021, OTPP invested $75 million in FTX International and its US entity, FTX. US (together "FTX"). In January 2022, OTPP increased its investment in FTX.US by $20 million. On November 11, 2022, FTX filed for bankruptcy. OTTP announced its intention to write-off the fund's $95 million investment in FTX. Similarly, Caisse de dépôt et placement du Québec, Canada's second largest pension fund manager has written off its $150 million investment in crypto lending platform Celsius Network.

As we survey the costs of crypto crises or the contagion over the last year, it is imperative to note and address the losses experienced by these two classes of market participants. Beyond the challenges posed in evaluating the complexities surrounding crypto investment decisions, the Commission has filed a number of notable enforcement actions presenting well-supported and disturbing claims of fraud, misappropriation, and other concerning misconduct. Recent events reveal devastating losses experienced by unsuspecting retail customers lured by marketing schemes into transactions that rendered their investments worthless. Coupled with these scams, bankruptcies in the crypto ecosystem have converted ordinary customers (depositors) into general unsecured creditors. We are executing our mandate to enforce against misconduct. For the mounting and sobering questions regarding the more challenging catalysts that prompted losses over the last year, we must identify effective risk management, market, and regulatory interventions.

Can the use of the technology underlying crypto activities have a significant added value for the financial system? Are vibrant cryptoasset market necessary for the sustained development of these technologies?

There are use cases for blockchain or distributed digital ledger technology that may prove valuable including the possibility that these technologies may enhance climate resiliency. Reliable carbon accounting—meaning real transparency—requires verification in low-trust environments. During a recent meeting of the Market Risk Advisory Committee, which I sponsor, we also recently discussed other potential uses in financial markets including clearing and settlement, digital identities, and global payment systems. The nature and extent of any relationship between these use cases and currently circulating cryptocurrencies is not yet clear.

How are the opportunities and risks from cryptoassets being addressed in the US in policy and supervisory terms? Is there a need for global coordination on this topic?

The United States Congress is currently considering several bipartisan bills that aim to introduce a regulatory framework for cryptocurrency and stablecoins. While we await Congressional action, we may advance and inform the regulatory dialogue within the Commission, with our fellow federal and state regulatory agencies, and with international regulators in jurisdictions around the world. During a keynote speech at the Federal Reserve Bank of Chicago Financial Markets Group Fall Conference hosted only one week after FTX announced plans to enter bankruptcy proceedings, I encouraged the Commission to consider initiating a notice and comment rulemaking process to evaluate the need for regulation mandating segregation of customer funds, treatment of customer funds, and the introduction of financial resource requirements for certain derivatives clearing organizations that offer direct clearing to retail customers. Recently, I advanced suggestions regarding corporate governance, risk management, and compliance reforms including introducing effective auditing, internal controls, risk management oversight, and appropriate governance of conflict of interests.

International standard-setting bodies including, the FSB, the Basel Committee on Banking Supervision, and IOSCO, have each introduced thoughtful work that should be foundational in the development of any crypto regulatory framework. We note the active development of standards by the tri-partite dialogue in the European Union and policymakers in the United Kingdom—among others. We look forward to working with counterparts to identify an effective direction of travel for creating and implementing regulatory standards.

Q&A

TOMOKO AMAYA

Vice Minister for International Affairs,
Financial Services Agency, Japan (J-FSA)

The crypto-asset world is sobering up

Are we in the midst of another crypto winter or is the current market downturn the sign of more structural fragilities?

It is not a crypto winter right now. Rather, the crypto-asset world, including service providers, investors and other stakeholders, is waking up from its drunkenness.

Recent market turmoil, including the collapse of Terra, Celsius, and FTX, has revealed the truth about reality and vulnerabilities of self-proclaimed "stablecoins," liquidity and maturity mismatches, excessive leverage, misuse of client assets, and conflicts of interest. It also exposed the illusion that most of what once appeared to be growth was supported by unsustainable business models.

These structural vulnerabilities are similar to those inherent in traditional financial activities, and some crypto-asset activities are not unlike "Ponzi schemes." While various regulatory and supervisory measures address these structural vulnerabilities in the traditional financial sector, few jurisdictions have taken such measures for the crypto-asset sector.

This has led to a number of disruptions in the crypto-asset sector, but so far spillover to the financial system and the real economy has been limited. However, I believe that if the crypto-asset sector continues to grow and strengthen its interconnectedness with the traditional financial system and the real economy, it could threaten global financial stability.

How are the opportunities and risks from cryptoassets addressed from a policy perspective in Japan?

Financial regulators need to consider three major policy perspectives concerning the risks posed by rapidly evolving crypto-asset markets: financial stability, user protection, and AML/CFT. These are not necessarily mutually exclusive. User protection, such as providing users with sufficient information as well as protecting their assets, and AML/CFT, such as knowing your customers, can contribute to financial stability by enhancing user confidence. Regulations should be comprehensive and commensurate with the risks, while also harnessing the potential benefits of underlying technologies. In Japan, the FSA has centralised jurisdiction over all three policy perspectives and has been developing a comprehensive regulatory framework for them since the FSA introduced a regulatory framework for crypto-assets in 2016.

For example, virtual asset service providers (VASPs) are required to use highly reliable methods, such as cold wallets, to manage and protect customer`s crypto-assets separately from their own, and to undergo external audits of the status of their segregation management. VASPs are also required to have their financial statements audited, report them annually to the FSA, and disclose them publicly. Therefore, even after the bankruptcy of FTX Trading Ltd., its Japanese subsidiary, FTX Japan, successfully protected client assets, and clients have had access to their funds since February of this year. In addition, the regulation and supervision of VASPs includes establishing a conflict of interest management system, notifying in advance crypto-assets to be dealt with, and preventing unfair acts. As a result, trading platform networks with complex and opaque intertwining of various functions, as seen in some jurisdictions, have not developed in Japan.

While the existing regulation of "gateway" operators has been effective, this does not mean that all activities that have caused problems recently, including crypto-asset lending, are regulated and supervised in Japan. Future development in the crypto-asset ecosystem is yet to be determined in some areas, such as decentralised finance, which many jurisdictions recognise as a challenge.

The FSA aims to harness the benefits of the technology underlying crypto-assets amid the rapidly changing nature and form of crypto-asset transactions, while ensuring that the social economy is not exposed to the risk of disruptions.

To do this, the FSA will continue to take a forward-looking and comprehensive approach, including considering new regulation where necessary, taking into account international regulatory and supervisory discussions.

Is there a need for a global coordination of cryptoasset regulation and supervision? What can be expected from the work underway at the FSB and IOSCO levels in this regard?

Given the cross-border nature of crypto-assets, it goes without saying that there is a need to strongly promote consistent and effective regulation and supervision across jurisdictions to avoid market fragmentation and prevent regulatory arbitrage.

In light of the recent market turmoil, the press release of the Financial Stability Board's plenary meeting in December 2022 mentioned the urgency of advancing the policy work to establish a global regulatory and supervisory framework. The potential threats to financial stability posed by crypto-asset activities and markets highlight the urgent need for effective regulation and supervision.

The FSB's high-level recommendations, which are currently being finalized, are an important step towards building international regulation, supervision, and oversight of the risks posed by crypto-asset activities and markets. These recommendations will cover all crypto-asset activities and entire stablecoin arrangements and will provide a comprehensive regulatory framework to address structural vulnerabilities in crypto-asset markets. As well, IOSCO's work is critical to the practical application of the FSB's high-level recommendations by securities regulators.

One of the G7`s top priorities for the financial sector is to address the vulnerabilities of crypto-asset activities and markets. As Japan assumes the G7 Presidency this year, our utmost priority is the finalization and consistent and effective implementation of the FSB's high-level recommendations.

In light of the recent market turmoil, such as the failure of FTX, I believe it is important to identify key issues that need to be immediately addressed on a global basis. These issues include ensuring redemption rights, segregation of client assets, and proper governance of crypto-asset service providers.

It is important to then consider early on the consistent and effective implementation of these key issues. In promoting consistent and effective implementation of the FSB's high-level recommendations, I also believe that, in addition to cooperation between the FSB and standard-setting bodies, including IOSCO, and between authorities and private stakeholders, engagement with jurisdictions that are not FSB members is essential.

How is digitalisation impacting financial value chains and the structure of the financial industry and what are the regulatory implications of these evolutions?

In the area of cloud computing, on one hand, the use of outsourcing is expanding globally, while on the other hand, a small number of tech players are dominating the market. Thus, while the entities involved in financial services are diversifying and decentralising, their relationships are becoming more complex and opaque, and financial stability concerns such as new forms of concentration risk are emerging.

For regulators and supervisors, to promote innovation while mitigating risks in these circumstances, the guiding principle is "same activity, same risk, same regulation."

Regulatory perimeters are critical to putting this principle into practice. A typical example is the treatment of outsourced providers and third parties. Regulating these parties has many challenges due to the long and complex supply chain for the operations of financial institutions and the global reach of third parties.

Furthermore, there are cases where financial institutions and non-financial institutions together form an ecosystem in which each entity provides financial services through interactions with another. In such cases, it may be challenging to determine the regulatory perimeter because the financial function cannot be captured simply in outsourcing or third-party relationships.

Addressing these challenges may require cooperation and collaboration with a variety of stakeholders, including in the private sector. In this regard, I would like to share, for your reference, initiatives regarding the "travel rule" (TR) by the FATF's Virtual Asset Contact Group (VACG), which the FSA has co-chaired.

To address the risk of money laundering and terrorist financing, the TR requires VASPs to conduct screening, submission, and record-keeping of both originator and beneficiary information for virtual asset transfers. When the TR for virtual assets was introduced in the FATF Standards in 2019, most private sector stakeholders argued that implementation of the TR was not technically feasible with virtual assets.

The FATF, through its newly established VACG, conducted a series of public-private dialogues, identified issues to be solved, and published more granular guidance on the TR as well as monitoring reports to support private sector implementation. As a result of these initiatives, the private sector has developed technological solutions for the TR, although many of them have some deficiencies that are still to be addressed. I think this experience illustrates how collaboration with diverse stakeholders can solve challenging issues.

Q&A

JÉRÔME GRIVET

Deputy Chief Executive Officer - Crédit Agricole S.A.

Why a retail digital Euro?

Why create a central bank digital euro?

For the ECB, a digital euro as a monetary anchor would preserve public access to central bank money in the digitalised world where banknotes and coins are replaced by digital payments. A digital euro would strengthen the strategic autonomy of the euro area by increasing its independence from non-European payment solutions. The ECB also argues that central banks throughout the world are exploring retail central bank digital currencies (CBDCs). Finally, it is a response to private initiatives in cryptocurrencies and stablecoins.

Banknotes and coins, however, are still the most popular payment instrument for transactions (in number) in the euro area, and competition from private stablecoins is limited and efficiently controlled. The attempts by foreign countries to launch a CBDC have not been very successful: the e-yuan, for example, launched in the spring of 2022, is still struggling to be accepted by the Chinese population.

Europe should follow the development of these digital transformations before making a final decision on launching a retail central bank digital currency.

What are the main expectations of citizens concerning the digital euro?

The major criterion for launching a digital euro should be a clear benefit for citizens. There is no clear new-use case identified for the digital euro, however, and citizens, as in China, would have difficulty understanding the added value of CBDCs compared to current digital payments.

In the past, the innovative technological solution of the electronic wallet (Moneo) in France at the end of the 1990s led to significant investments by the banking sector. Nevertheless, it was stopped because it attracted only a limited interest from users.

Although the technology is available, it is difficult to predict how customers will react to this new form of central bank money and to what extent the general public will adopt it. A failure would have a negative impact on the euro, which is now very popular, and on the ECB itself.

According to surveys, personal data protection is a priority for citizens, and anonymity should be guaranteed so as to maintain user confidence.

What would be the impact of the digital euro on the current framework for payments in the Eurozone?

Payment systems in the euro area work correctly at a reasonable cost and cover the needs of the population.

The only area in which the service can be improved is instant payment because only a small proportion of payments is instant at the moment. There is, however, a new regulation in the pipeline to foster instant payments, and huge private investments are being made, which should not be put at risk by public-private competition.

If the digital euro were created, what would be the main points of concern?

Firstly, there may be a contradiction between citizens' aspirations for anonymity and protection against money laundering or other fraud.

Indeed, to prevent illegal activities such as money laundering or terrorist financing, the authorities should be able to trace transactions in individual and justified cases.

The ECB is considering specific privacy features such as anonymity below certain thresholds or a low holding limit.

Finding the right balance will be difficult, however, as many countries are accustomed to cash payments, which are anonymous, even for large amounts.

The second point of concern is that of 'knowing your customer' because that is the role of commercial banks and not of central banks.

Banks have numerous regulatory requirements including anti-money laundering and combating the financing of terrorism (AML/CFT). In this context, for security and operational reasons, data relating to digital euro transactions for the benefit of customers should be transparent for banks.

Information sharing in the fight against financial crime is essential between commercial banks, financial intelligence units, law enforcement agencies and authorities. Restricting commercial banks' access to transaction data would facilitate domestic or cross-border criminal activities.

It seems essential that the deployment of the digital euro relies on commercial banks being capable of ensuring proper customer identification (KYC) while respecting the protection of privacy (GDPR).

This role must be remunerated, however. It is currently paid via the fees for the services provided by banks. Nevertheless, what will happen for the digital euro, and how can a duplication of costs for commercial and central banks' digital euro payment schemes be avoided?

Commercial banks should not be driven out of the payment business in favour of a public scheme, and sufficient revenues must cover the cost of new infrastructure for the financial sector.

The third main concern is the impact of the digital euro on financial stability.

Central bank digital money could threaten the traditional banks' business model by competing with their collection activity and disrupting their financing capacity.

In order to minimise the negative impact on banks' lending capacity and their crowding out of payments, a limit on the holding of digital euros should be set that is consistent with the banks' role in financing the economy, with the use of this digital euro as a payment method rather than a store of value, and, lastly, with the average amount of retail payments. Indeed, a massive outflow of bank deposits into the digital euro would negatively affect banks' lending capacity and pose a serious threat to financial stability.

Of course, the digital euro should not be remunerated. Otherwise, it could massively drive liquidity outflows from commercial banks and launch competition between the public and private sectors.

Beyond these elementary precautions, it may be necessary for the ECB to provide banks with specific access to liquidity, in case of significant outflows of deposits towards digital euros.

How will roles and responsibilities be shared?

The ECB should focus mainly on issuing the digital euro and ensuring settlements.

Regulated intermediaries such as commercial banks should distribute this new digital currency. Indeed, they are the most likely to carry out the appropriate checks to ensure a client's identity (KYC) and the application of anti-money laundering and anti-terrorist financing rules (AML/CTF).

The ECB and policymakers should avoid crowding out the private sector or distorting competition in the market between the public and private sectors.

How will the European Central Bank's digital currency project co-exist with other European payment projects?

The European Commission is examining several transformation projects in parallel, including the European Digital Identity Wallet, which aims to standardise and secure the digital identification of customers, and the generalisation of instant transfers for private customers, merchants, and businesses.

These projects will have technical adherence to the digital euro project.

We believe that this integration needs to be planned and analysed to ensure better complementarity and a smooth customer experience.

What should the next steps be?

The design of a digital euro will need to be carefully considered. Indeed, this is not only a technical decision regarding payment transactions, but a fundamental political decision regarding the future interaction of the central and commercial banks in the economy.

Before the introduction of the digital euro, detailed impact studies conducted jointly by the public sector (ECB, European Commission, etc.) and the private sector (financial services, EPCs, etc.) will be needed to assess the effects that the introduction of the digital euro will have on the financing of private households and businesses, and thus on our economic area as a whole.

For all these economic, strategic and ethical reasons, we are committed to contributing to the debate and remain vigilant with regard to protecting our customers and investors.

The introduction of a digital euro will be framed by a regulation to be proposed by the European Commission in 2023. Banks should be consulted during the process in order to be able to contribute to the appropriate shaping of this project.

DIGITALISATION TRENDS IN FINANCIAL SERVICES

ROBERT OPHÈLE

Digitalization in the financial services, new challenges and new opportunities

Digitalization in the financial services is profoundly reshaping the way markets work and challenges the whole set of financial regulation and supervision.

While regulators and supervisors labor to rightly frame the issues linked to cryptos, as illustrated by the FTX collapse, digitalization has also demonstrated how destabilizing it could be for traditional financial activities. Both the GameStop episode in January 2021 and the SVB crisis in March this year have illustrated how social media combined with fast digital transaction possibilities could trigger devastating runs, either in (GameStop) or out (SVB).

According to the SEC Staff report on the GameStop episode, in January 13-29 2021, the average GameStop shares traded per day increased by more than 1,400% over the 2020 average; on March 9 this year, customers withdrew in this single day $42 billion from SVB, nearly a quarter of the bank's total deposits, precipitating its closure.

Old patterns -- be it scam, market manipulation and short squeeze, or bank run -- but new increased scale triggered by the combination of social media and instantaneous transactions allowed by their digitalization. In the three mentioned cases neither the regulation nor the supervision have enabled to prevent the failure.

Nevertheless, it is fair to say that only the SVB case has really put global financial stability at risk, triggering an unprecedented reaction of Authorities, contradictory to their principles: bailing out depositors above the guarantee ceiling and opening a central bank facility collateralized by papers not priced at their market value (similarly to what SVB has done backing sight deposits with secure but long-dated bonds accounted for at amortized cost).

It should obviously invite us to review regulations and the way we supervised markets and financial intermediaries, taking more into account the speed and magnitude of possible trends.

Monitoring social media by financial supervisors and incentivizing the operators by holding them responsible for misuses are an obvious priority. In the EU it should be clarified that it is allowed by RGPD and that the Digital Services Act provides an efficient basis for enforcing such a monitoring.

While digitalization goes beyond domestic boundaries, one should consider banning reverse solicitation for retail customers. Reverse solicitation is a too lax concept and paves the way for many scams.

Since the speediness allowed by digitalization triggers increased liquidity risks, liquidity stress testing should be tightened and correcting tools should be adapted according to the specificities of the sector (LMTs, circuit breakers, moratorium …).

Finally, regulatory arbitrages allowed by non-consistent regulatory frameworks (small and large banks, on and off venues, centrally cleared and pure OTC …) should be prevented.

These cases illustrate how Public Authorities are mainly reacting to innovations in general and more specifically to the digitalization in the financial services sectors, torn between often contradictory objectives: increasing the efficiency of the services while reducing their cost, protecting retail customers, safeguarding financial stability, enhancing the competitiveness of domestic service providers … we have just experienced how digitalization could dramatically accelerate a bank run and how influencers and social media could trigger a shift of capital flows towards very risky financial products for retail investors.

But in some cases, the digitalization process could also be at the initiative of Public Authorities in order to increase the efficiency of financial services. The digitalization of reporting is a good example in that respect.

By requesting the preparation of annual financial reports by companies listed on an EU regulated market in a Single Electronic Reporting Format (ESEF), the Transparency Directive has provided a quantum leap forward facilitating accessibility, analysis and comparability of annual financial reports. While the digitalization of financial reporting has been introduced on already existing reports, with the upcoming standards for sustainability reporting, digitalization is by now introduced from the beginning and to a large extent is an integral part of the standards. The CSRD requires entities to prepare their management report in the ESEF format. In its role as technical advisor, EFRAG needs to prepare at the same time the ESRSs and an XBRL taxonomy.

When you consider the high number of data points which could be requested from a large multi-sectorial corporation in its sustainability reporting, without appropriate tagging it will remain largely useless. It should reduce the cost of access to sustainability data and provide a better reliability in ESG ratings. It will become a basic tool for asset managers … and for supervisors reviewing the consistency of financial products with their marketing presentation.

PAULINA DEJMEK-HACK

Director for General Affairs - DG for Financial Stability, Financial Services and Capital Markets Union, European Commission

The new frontiers of digital finance

The European Commission adopted a digital finance package in September 2020. The main objective is to achieve a competitive EU financial sector with access to innovative financial products, while ensuring consumer protection and financial stability. Financial regulation and supervision must ensure that all risks are properly covered along the 'same activity, same risks, same rules' principle.

Our four strategic priorities are to overcome fragmentation, boost digital innovation, promote data-driven finance and tackle challenges linked to the digital transformation, such as cyber-risks.

The EU's Digital Strategy includes two Regulations on crypto-assets and digital resilience, as well as a Distributed Ledger Technology (DLT) pilot regime, which is already operational. As part of this DLT pilot, market participants will be able to experiment with issuing, trading and settling shares or bonds using blockchain technology. The Markets in Crypto-Assets Regulation (MiCA) was agreed by the EU legislators last June. MiCA is comprehensive legal framework for the supervision of stablecoins (asset referenced tokens and e-money tokens in the EU terminology), of other types of crypto-assets as well as of crypto-asset service providers. Publication is expected before the summer and the entry into application is foreseen 12 months (stablecoin rules) and 18 months (other parts) after publication.

The EU Digital operational resilience Regulation (DORA) establishes an oversight framework for critical ICT third-party providers and will strengthen financial firms' ability to withstand problems with the technology upon which they increasingly rely. DORA will start applying as of 17 January 2025, after the European Supervisory Authorities have delivered 13 draft technical standards, as mandated by the Regulation.

Looking into new areas, we are working on a European financial sector data space. Moreover, the Commission intends to propose a framework for open finance. The second Payment Services Directive will also be reviewed. These new frameworks will empower retail and business clients and get them control over the access to their data, as a key part of the European Financial Data Space. With the Digital Finance Platform, we want to improve the ability for innovative business models to scale up across the EU.

Finally, the Commission cooperates with the European Central Bank on the possible introduction of a digital euro to provide citizens and businesses with a safe, secure, innovative, and competitive means of making their daily payments. Whilst the decision to introduce a digital euro or not belongs to the European Central Bank, the Commission will propose the legislation necessary to accompany a digital euro later this year.

Technology is contributing to the break-up of previously integrated value chains. While most financial services have traditionally been offered by one provider, digital technologies allow firms to specialise in a particular leg in the value chain. This increases competition and may improve efficiency but could also makes value chains more complex and more difficult to regulate. The Commission is therefore paying particular attention to the principle "same risk, same rules, same regulation". At the same time, this may pose challenges in terms of practical implementation, as some technologies may require particular attention when crafting legislation. For example, existing rules do not always cater for DLT-based finance. The DLT Pilot regime is a good example of how we adjust the current system to allow DLT to function for trading, clearing and settlement. Overall, we strive to ensure that our regulatory interventions are sufficiently broad and technology-neutral to stand the test of time and be as future-proof as possible.

There is a risk that financial services migrate to digital environments with fragmented ecosystems, comprising interconnected digital service providers falling partially outside financial regulation and supervision. Digital finance may therefore make it more challenging for the existing regulatory and supervisory frameworks to safeguard financial stability, consumer protection and market integrity. The digital transition will profoundly transform our financial sector. Crypto assets are increasingly institutionalised, central bank digital currencies are being explored, decentralised finance is growing fast. The challenge will be to ensure appropriate regulation, ensuring high levels of consumer and investor protection.Digital finance is inherently cross-border and cross-sectoral. We aim to enable scaling up across the single market and overcome remaining fragmentation, promoting data sharing, ensuring cyber resilience, creating a European Digital Identity or regulating artificial intelligence.

Firstly, the role of technology providers will increase. To reflect this, we have introduced oversight over third party providers, with the new Digital Operational Resilience Act (DORA).

Secondly, as the boundaries between finance and other businesses are increasingly blurred, we are closely monitoring how large technology firms provide financial services themselves. Based on advice received by the European Supervisory Authorities, we are reflecting on additional measures to cater for specific risks linked to the provision of financial services by multi activity corporate groups.

Thirdly, we need to monitor new and emerging areas of innovation – notably decentralised finance (DeFi). Although the DeFi market remains small in relative terms, the area has seen considerable uptake over the past year.

The Commission is continuously monitoring the developments within crypto-asset markets (in particular DeFi). So far, it appears that most DeFi systems are decentralised in name only and still involve some kind of central entity – or intermediary. In case this entity performs one of the activities covered by MiCA, or by any other piece of our extensive EU financial services legislation, the rules will apply to them.

FERNANDO RESTOY
Chair - Financial Stability Institute (FSI)

Technological disruption: the policy response

Regulation

Technological disruption implies three main structural changes in the market for financial services. First is the modification of the production process for traditional financial services, which now rely more on digital delivery channels and services provided by third parties. Second is the availability of new products (like digital or tokenised assets) that leverage more decentralised issuance, trading and settlement processes. And third is the emergence of new players, like tech companies, that benefit from data and technological advantages to compete with traditional financial institutions.

Those developments generate many opportunities but also risks which might impede their ability to support social welfare. At times, there is a relatively complacent view on the required scale of the regulatory response.

Frequently repeated slogans such as “same activity, same risk, same regulation” represent a relatively optimistic view according to which the existing regulatory approaches would still be roughly valid in the new technological environment if their scope of application is extended to the new products, the new production processes and the new players.

In many cases, this adjustment of the regulatory perimeter is an essential first step, but it may not be sufficient. For instance, in the crypto world, the adjustment of the regulatory perimeter to include related service providers can hardly effectively address the risks posed by decentralised platforms, where transactions and back-end procedures are conducted through automatic protocols (smart contracts) whose beneficial owners cannot be easily identified.

As to new production processes of regulated institutions, the current rules on operational resilience and, in particular, outsourcing controls clearly fall short of limiting the risks posed by the increasing reliance on the services, like cloud computing, offered by a few (big tech) providers. The large concentration of this market calls for direct regulatory intervention on cloud service providers themselves and not only on the banks demanding those services.[1]

Finally, any new entrant providing regulated services (like payments or wealth management) is normally subject to the corresponding activity-based regulation.

The problem is that when those new providers (like big techs) are also active in other financial and non-financial markets, there could be interdependencies and conflicts across activities which might not be well addressed by activity-by-activity regulation. When this is the case, you may need new bespoke entity-based rules for those multi-activity players.[2]

In sum, technological disruption calls for a significant regulatory revamp, which entails much more than simply adapting old rules to the new technological environment.

Supervision

Actually, even introducing new well defined rules that attempt to directly address all relevant financial stability implications of the technological disruption would hardly be enough either. The policy response should also include an adaptation of oversight procedures.

This is particularly important in the case of banking regulation. The main channels through which technological developments affect banks’ safety and soundness are probably the challenges they pose to preserving banks’ operational resilience and the sustainability of their business models as they face tougher competition from new tech players. While those risks could eventually affect banks’ solvency, they cannot be more effectively addressed by standard capital requirements. There is simply no sensible level of capital that could compensate for a significant disruption in banks’ ability to deliver critical services to their clients. The same could be said of the sustainability of banks’ business models. In fact, a bank’s difficulties to deliver sufficient return to its equity holders can hardly be addressed by requiring that bank to hold more equity.

Technological disruption calls for a significant regulatory and supervisory revamp.

Therefore, the increased importance of technological risks points to the need for a supervisory framework in which the role of direct risk-preventing management actions will be enhanced. While quantitative capital and liquidity requirements need to remain at the core of the prudential regime, the technological disruption support the move towards a possibly more intrusive and forward-looking, but also less capital-centric, bank prudential framework.

[1] J Prenio and F Restoy, “Safeguarding operational resilience: the macroprudential perspective”, FSI Briefs, no 17, August 2022.
[2] J Ehrentraud, J L Evans, A Monteil and F Restoy, ”Big tech regulation: in search of a new framework”, FSI Occasional Papers, no 22, October 2022.

ONDREJ KOVAŘÍK
MEP, Committee on Economic and Monetary Affairs - European Parliament

Time to recognise that digitalisation in financial services is a market reality

There is a wealth of opportunities through the digitalisation of the financial sector, from faster payment flows to wider choices for consumers. On the other hand, we must also bear in mind that digitalisation is spurred not necessarily by legislation, but by circumstance, and there are risks that may be associated with it that we are either coming to discover, fearing, or yet to even consider.

From the perspective of a policy maker, what is most important is that we strike the right balance in facilitating innovation, from our micro and small businesses right through to large multinational companies, while at the same time taking proportionate action to address and potentially anticipate any clear risks to those same businesses, consumers and the financial industry as a whole.

Recent market events have demonstrated some of the risks of the digitalisation of the financial services sector. During the 2007-2008 financial crisis, when we saw runs on deposits, they tended to play out over a number of days. However, 15-16 years later, we are seeing that if a run happens, as was the case recently with the Silicon Valley Bank, depositors can withdraw their money within hours. Word spreads quickly in our 24-7 digital world. This is a circumstance we must get accustomed to and adapt our frameworks to suit.

However, I am of the belief that the potential benefits of digitalisation far outweigh the risks. Processes become quicker, consumers have more options, particularly considering cross-border disruptive innovators in the sector such as e-banks or trading platforms in the form of Apps.

The new technology we see appearing can also bring advantages in both trust and ownership of financial data if addressed correctly by businesses and also legislation. For example, DLT has the potential to drastically speed up settlement speeds, smart contracts can bring extra financial security to both businesses and consumers.

I am also of the view that regulatory and supervisory technology has great potential to meet the regulatory challenges brought about by the adoption of new technologies in the financial sector. Often, we see that it takes our regulators and supervisors more time to adapt new ways of approaching their tasks, but I believe that in such a fast-paced development of the sector, this should be thoroughly and rapidly studied.

In terms of legislation, we have already adopted the first main proposals from the Commission as regards their digital finance package. The DLT pilot regime offers a lot of potential in a suitable environment for industry and supervisors to explore whether and how this technology can be used to improve the financial services offerings in Europe. We can also learn from the experience of jurisdictions such as Singapore in this respect.

The MiCA and DORA frameworks offer a regulated space for activities that already exist and which we are able to have an initial assessment as regards risks. The MiCA framework, together with the amendments to the Transfer of Funds Regulation, provide for trading in crypto assets, a pioneer for large markets. They will hopefully pave the way for other markets across the world to follow. The DORA framework will give some further certainty for citizens and industry participants as regards cyber security and resilience, and I believe that again we have a good balance between innovation and addressing potential risks.

One aspect that is very important to me is avoiding a silo-style approach to cross-cutting legislation. In that respect, it is of the utmost importance that the outcome on the EU's new AML framework align with what has already been agreed under MiCA and the TFR. This is particularly relevant given the fact that MiCA will come into full application before the AML provisions, and any deviation of the AML rules can create uncertainty. I fear that fewer companies, and particularly smaller crypto-asset service providers, will seek authorisation under MiCA then, leaving consumers less protected.

The potential benefits of digitalisation far outweigh the risks.

We are only at the initial stages of our foray into regulating the digitalisation of the financial sector, and the traditional finance sector is already wrestling with decisions on how far to match the new challengers in the area of Fintech. The Commission will come forward with a number of new proposals for the sector.

All of these proposals will need to consider the impact of the digitalisation of the economy, and we need to look at past experiences, how other jurisdictions are approaching this trend and also the specificities of our own single market in order to maximise opportunities while minimising risk for citizens, businesses and the financial service industry across Europe.

SARA MELLA

Head of Personal Banking, Group Leadership Team - Nordea Bank Abp

Digitalisation of European banking with customers at the heart of development

If you are a Nordea customer, information about your account, a direct link to your savings adviser, tracking of all your payments, and maybe an application for a mortgage, is all there at your fingertips via your phone or laptop. Advances in digital technology have changed the way people interact with banks and the development of customer needs and expectations.

For Nordea this means our customer services experts can spend more time guiding our customers through their first home purchase, providing advice in a life crisis, or spending time making a suitable savings plan, and spend less time on data entry and administration. The developments in our digital offerings mean that customers can more easily get an overview of their finances which contributes to financial literacy.

The EU has over the past decade introduced several regulatory measures to foster innovation within the financial services space, to increase competition and contribute to better and more secure services for the end user. PSD2 is one such example which has facilitated increased competition and better customer experience through the access provided to Third Party Providers (TPPs). In fact, Nordea has seen increased traffic both on our own platforms and traffic through TPPs following the implementation of PSD2.

At the heart of new and upcoming regulation such as Open Finance is data sharing and the idea of the data economy. Data sharing, although beneficial, raises several important questions regulators must tackle: How do you prevent fraud, and avoid increased risk of ID theft and other cyber risks? How do you ensure the existence of business models to incentivise high quality data and continued services to European customers and businesses? When, and in what areas, is standardisation a necessity, and when does it have the potential to kill innovation?

Nordea does not have all the answers, however, a few priorities and concerns are worth mentioning:

- As more banking services are performed online, the risk of cyberattacks and data breaches increases. Data sharing, if not done right, has the potential to further increase the risk of ID theft, data breaches, privacy, cyber and information security risks. As banks are subject to financial regulation and bank secrecy laws, sharing data outside the banking sector to non-regulated entities could further increase the risk of breaches and generate liability issues. These challenges must be addressed in the development of any data sharing framework. Again, the customer must be the core of the regulatory development. Every customer must be able to trust that their data is safe.
- New regulation should strive to avoid asymmetries of data access, which currently exist between the financial sector and other sectors. To truly get the potential from a data economy, data sharing must be cross-sectoral. The Data Act, described as a building block in the Commission's strategy, is an important initiative in this work.
- A lack of harmonisation across member states hampers innovation and halts true competition across borders and between incumbents and new players. Particularly, in the digital space where location is not an issue, a harmonised rulebook across Europe would contribute to creating a stronger European data economy for the benefit of customers and people in Europe.
- Competition and innovation also depend on a level playing field. The principle of same activity-same risk-same rules must continue to be the core of policy-making and should also extend beyond policy formation and into the operations and priorities of supervisory activities.
- Finally, to understand, address and solve the challenges of an increased digital banking sector, the industry needs relevant skill sets and competencies. Banks, regulators and supervisors must therefore do their utmost to train and retrain, recruit and retain people and talent.

In some cases, we are trying to regulate for a future we are only seeing the contours of.

Can we future-proof regulation or even banking services? Probably not. In some cases, we are trying to regulate for a future we are only seeing the contours of. In the future, the main challenge for EU regulators and banks alike, will be to find the right balance between the customer needs and expectations on the one hand and risks related to increased data sharing and speed of services on the other.

PHILIPPE LAURENSY

Managing Director - Head of Strategy, Innovation, Product Developments and M&A - Euroclear S.A.

Accelerating the digitalisation journey in European securities markets

Our world is increasingly digital, and it is transforming how we work. When I asked ChatGPT, the well-known artificial intelligence programme, how digitalisation is transforming the European securities industry it confirmed that:

"Digitalisation is leading to increased automation of securities trading, settlement and clearing processes. This has resulted in faster and more efficient transaction processing, reducing the time required for trade settlement and reducing the risk of errors."

Indeed, digitalisation is already a success story in reshaping European securities markets, and the pace of change is only accelerating. In recent years, we have experienced a raft of changes which, ultimately, have been providing greater efficiency, accessibility, and transparency to market participants.

Take, for example, the emergence of new trading platforms, such as multilateral trading facilities, over the past two decades. These were enabled by digitalisation and gave new channels for market participants to trade securities. This, in turn, has created more competition, giving rise to new fintech entrants to challenge traditional market structure and business models, and fostering a higher pace of innovation by all players.

Likewise, the advent of digitalisation has improved access to information for market participants, with real-time and trusted data leading to more transparency and improved efficiency.

There is more to come. At Euroclear, we also believe that leveraging digitalisation and data can enable positive shifts in ESG finance.

Ultimately, trustworthy ESG data will be key for both issuers and investors to meet incoming regulatory reporting standards, such as the Sustainable Finance Disclosure Regulation, and to meet new governance requirements, such as those embodied in the Shareholder Rights Directive II.

While so many advancements have already happened, tomorrow's securities landscape will continue to be shaped by new technology, such as distributed ledger technology and artificial intelligence. If used wisely, such innovations have the potential to accelerate the modernisation of the securities market, providing greater automation, accuracy, and speed to enable new business models and customer solutions. In parallel, customer demand for digital and data-enabled services will only grow as we are all accustomed to being digital first in our daily lives.

That's why it is important for the European securities markets to actively explore new areas of possible value creation. For example, digitalisation and the tokenisation of assets can enable Central Bank Digital Currencies where we have already seen – and, at Euroclear, actively participated in –some interesting experiments. Such a sandbox approach of experimenting together is sensible with such an important and complex ecosystem.

It will be important to stay coordinated across European financial markets and avoid unnecessary risks in a desire to "win the race" for digitalisation. Indeed, the European Commission's Action Plan on Financial Technology (FinTech) acknowledges the growing importance of digitalisation in financial services and calls for a harmonised approach to support innovation and investment in the sector.

As always, the regulatory context will be a critical enabler of European securities markets' digitalisation journey, and we are building on strong foundations.

Such innovations have the potential to accelerate the modernisation of the securities market.

The implementation of the Markets in Financial Instruments Directive II (MiFID II) in January 2018 and the Shareholder Rights Directive II (SDR II) in September 2020 have driven market participants to digitize their processes and workflows to comply with new reporting and transparency requirements. The emergence of new regulatory regimes such as the Digital Operational Resilience Act (DORA) will further accelerate the digitisation of the securities market. Considering these drivers of evolving customer demands, technology advancements and regulatory developments, a new phase of digitalisation for securities markets may be ahead of us.

The potential impacts on the securities market value chain and market structure could be far-reaching. While there are risks and challenges, digitalisation can continue to unlock substantial benefits – from cost savings, to improved efficiency, to greater transparency, and more.

As Eric Schmidt, the former CEO of Google, once said: "The future is digital. We can either sit back and wait for it to happen, or we can embrace it and lead the way." For me, there is only one option.

NICLAS NEGLEN
Chief Financial Officer - Klarna

Promote consumer choice in EU: opportunity to embrace outcomes-based regulation

In recent years, the digitalisation of the financial services industry has provided European consumers access to sustainable credit, new payment options and healthy financial tools. For the sector this much-needed innovation is helping to reduce costs, speed up access to capital, improve transparency and promote financial inclusion.

At Klarna, we are on a mission to help people save time, money and worry less by restoring the original purpose of payments and banking - putting the consumers best interest first and accelerating commerce through increased consumer choice, transparency, and cost-effectiveness. We are taking on the $16 trillion-dollar global payments industry that costs society an outrageous $440bn annually.

We commend the important work started by the European Commission in adopting the digital finance package and engaging in major revisions of consumer credit rules, payment services and open finance, and other key digital policies to facilitate access to financial services. However, upcoming regulatory frameworks must not hold back on Europe's promise of championing digital transformation of the financial sector.

European consumers deserve better

Consumers' financial preferences and needs are changing, with the cost of living crisis raging and prices at a 40 year high. People are looking closely at their finances, thinking about how they can save money and find better options than personal loans charging up to 48% in interest. Access to lower cost alternatives to high-cost credit is more important than ever. Unsurprisingly, consumers of all ages and demographics are now opting for interest-free BNPL, which is already a fairer and better value choice, putting money back into their pockets.

At the same time, consumers are frustrated to see their personal and financial data locked-in by incumbents and big tech companies, reducing their ability to choose the products and services that best serve their needs and decide who to share their data with. They want to access financial services that reflect the way they live their lives - seamlessly across borders and platforms. Financial firms should compete for customers by delivering value, not by locking away data. Open banking, which is part of Klarna's DNA and connecting over 15,000 banks globally, offers significant benefits for all consumers - and we believe it is the future of banking.

An opportunity to get it right

Europe wants to strengthen its competitiveness and promote an ambitious digital finance agenda. We believe there is a timely opportunity to warrant that the digital policies currently in the making are future-proof and avoid regulatory loopholes that would disadvantage consumers and businesses.

Effective EU policy must promote mobility and choice; regulate outcomes, not inputs; and be proportionate to the risks. This will simplify compliance with regulatory requirements, unlock the potential for more growth-driven innovation, as well as make the EU regulatory framework more coherent. This is not about reducing regulation - it is about making EU regulation more effective and fair. We welcome regulation that sets a standard for providers to meet but does not prescribe how those standards should be met, forcing the industry to think about how they can best drive good consumer outcomes.

EU needs smarter rules; customer-centric Open Finance model enables consumers to control their data

To expand as a digital finance hub, the EU needs to opt for smarter regulation, especially when it comes to the data consumers might want to share and the possibilities that entail. A customer-centric Open Finance model would enable consumers to control their data and decide who they allow access to. With the PSD2 reboot and the Open Finance framework, the European Union has a huge opportunity to redesign a regulatory environment that enables local fintechs to compete, innovate, and deliver maximum value for European consumers. We advocate for data mobility, free of charge and easily done, becoming readily available for all consumers. We believe this should be the core of the revision, enabling much needed new and innovative services to deliver the best outcomes for consumers and society, and bringing healthy competition to traditional banks in Europe.

As Klarna continues to put customers at the heart of everything it does on its mission to accelerate commerce and disrupt the massive trillion dollar retail banking industry, we call on Europe to provide the grounds to support the digital transformation and innovation of financial services through outcomes-based regulation.

PETRA HIELKEMA

Chairperson - European Insurance and Occupational Pensions Authority (EIOPA)

Digitalisation in insurance: keeping track on current pace of change

Data is the raw material for insurers who have always used data analytics to inform underwriting decisions, price policies, settle claims and detect fraud. However, the availability of data has exponentially increased, and traditional data sets are combined with new data sets derived from social media, the Internet of Things, weather reporting, and wearables. The capacity to store and process data has also multiplied. It helps to transform raw material into insights and these insights into new digital business models.

Growing digitalisation has accelerated the fragmentation of the insurance value chain. Insurers pursue new forms of cooperation and increasingly turn to innovative third-party service providers for quick and efficient access to new technologies and business models. While the so-called BigTech entrance into the EU insurance sector remains limited so far, it has the potential for a quick scale-up.

Digital platforms have also emerged. They offer convenience by bundling financial, insurance and non-financial products and services from different providers. The growing adoption of Artificial Intelligence (AI) and the use of data exchanges governed by standardized Application Programming Interfaces (APIs) facilitate the development of enhanced front and back-office processes and online access. APIs also enable open finance and insurance business models that may facilitate industry-wide innovation and increase the agility of businesses in responding to changes in customer needs and expectations.

There are new opportunities for consumers and businesses. Outsourcing allows insurers to focus on core services, leading to flexibility and efficiency gains. Digital platforms enhance convenience through 24/7 access to a wider range of products and services. This is likely to be attractive to firms who, thanks to the internal market and freedom to provide services regime, could tap into a broader customer base, including cross-border. BigTechs can leverage network effects to reach a wide range of consumers, including some that may be otherwise underserved.

New risks and supervisory challenges also emerge. The growing reliance on tech companies can create new types of operational risk. Digital distribution channels, coupled with sometimes aggressive marketing techniques, e.g. focused on so-called 'dark patterns' or leveraging on social media, may also exacerbate risks to consumer protection.

The entry of BigTechs into insurance may further create concentration risks and raise level playing field issues for incumbent financial groups, requiring a stronger supervisory focus on both prudential and conduct, product oversight and governance and value for money issues.

While the first question policymakers face is almost always: 'is regulation necessary?' for supervisors the better question is: 'how can we keep abreast of changing markets and their risks?' There is a need to focus on digital developments and ensure supervisors are equipped with the right skills – an understanding of new technologies, emerging business models, front and back-office processes. Supervisors cannot always wait for regulation as business models do not wait for regulatory change. In addition, digital innovation spreads quickly across sectors and borders.

To keep supervisory skills up-to-date, last year the European Commission together with the European Supervisory Authorities and the Florence School of Banking and Finance launched a new EU Supervisory Digital Finance Academy. It offers a training programme to supervisors, enabling them to deepen their understanding of the complex digital transformation impacting finance.

Supervisors need to focus on digitalisation and ensure that they are equipped with the right skills

EIOPA is also constantly engaging with stakeholders, old and new, to get views on market trends, and recently launched a structured Digitalisation Market Monitoring survey on developments including the growth of digital distribution, adoption of AI or blockchain, the identification of cyber risks, as well as on possible areas where regulation and practice do not neatly fit together. A natural next step is to turn market intelligence into support for supervisors. Hence EIOPA continues its work on digital business model analysis, open insurance, and AI. As a supervisor, EIOPA also needs to make sure that regulation remains relevant. This means adopting a 'same regulation, same rules, same risks' approach while remaining technology neutral.

Supervisors that have a good and up-to-date oversight on market developments, with good cooperation between themselves and those driving change can support sound progress for the benefit of the European economy, its citizens and businesses. The current pace of change makes it one of the key challenges.

CRYPTOASSET AND STABLECOIN REGULATION

MARTIN MOLONEY

Secretary General - International Organization of Securities Commissions (IOSCO)

Crypto: the systemic risk puzzle

The concept of systemically important institutions tends to be a size related concept and that is a reasonable proxy. But it is only a proxy.

There is a thousand-year-old English nursery rhyme, with equivalents in other cultures, which begins: 'For want of a nail…" and explains how the Kingdom was lost, for want of that nail. The point is that a failure to deal with what is ostensibly a minor issue can cause multiple compounding problems that lead to major loss in the end.

We all tend to differentiate clearly between trigger events and amplificatory processes in the causation of systemic crises and that is a good way to think about crises. It focuses our attention on the amplificatory process which can be managed, rather than the trigger events which are arguably inherent in financial markets. Markets regularly feature sudden price adjustments as markets process novel information. We do have policies to smooth sudden changes in market direction. But trying to prevent such markets events entirely would be a fool's errand and policy makers wisely focus on limiting amplification.

This is all very logical, but it doesn't exhaust the question of financial stability. Market crises are not only driven by the amplificatory effect of direct and indirect connectedness of different market participants, but also by the little understood phenomenon of 'contagion'. Contagion is a nice label for the phenomenon of market participants managing the unknown. Any market trigger event creates a risk that the consequential losses will trigger other losses and protective actions because asset prices have fallen, or counterparties have defaulted. This is interconnectedness. But it also creates a very different phenomenon: uncertainty.

Famously, most of Lehman's clients and counterparties got most of their money back once the whole insolvency process had completed, but one could not know at the time that would happen. Like hedgehogs curling into a ball in the face of threat, market participants sometimes face such uncertainty in markets that they retreat even though they actually face few risks.

The argument to leave crypto outside the regulatory net to facilitate innovation is exhausted.

If we think about the systemic risk of crypto in that context, it is evident that there is a risk. Crypto has three key features as a market subsector which make it particularly risky from a systemic risk perspective.

Firstly, the corporate structures, business models and exposures of the main crypto market participants are not transparent. It is not practical to know where their real exposures are. In the face of any trigger event in the crypto sector they all seem so intertwined that any of them could fall. This is exacerbated by evident market concentration with the three largest so-called trading platforms.

Secondly emerging DEFI protocols operate with a degree of automaticity and speed that human judgement-based protocols simply cannot compete. Risk managers have no choice but to allow automated protocols to respond in a risk minimising fashion of they have been designed to do without any assessment of what is really going on.

Thirdly, institutional investors do have a footprint in this space. Put all these three together and it is evident that any significant crypto trigger event can trigger a shudder throughout the crypto sector which only needs one possible bridge to 'tradfi' to raise the spectre of contagion into broader financial markets.

This is despite the small size of crypto. Fully applied, the G-SIFI methodology put in place in the aftermath of the GFC is meant to take not only size, but also complexity, substitutability, cross-border activities and interconnectedness into account as criteria in measuring systemic riskiness. The weighting of those other elements is important. When it comes to crypto inter-connectedness is evidently of particular importance as is cross-border footprint, but so is their lack of transparency which constitutes the same threat as complexity.

Now consider another fact about financial stability policy work and regulation: it has systematically and quite appropriately piggy-backed on regulation designed to prevent bank runs, ensure markets that operate with integrity and protect investors. That is about to happen again and it is welcome.

We have now reached the point where the argument to leave crypto outside the regulatory net to facilitate innovation has exhausted itself. Regulation to protect investors and to ensure the integrity of crypto markets is coming fast. Without a doubt, with that comes the need to improve transparency and manage inter-connectedness in crypto markets. Without that, crypto markets would remain a locus of the oblique uncertainty, which would mean that they would continue as outsized threats of contagion.

If crypto market participants are required to adopt more justifiable business models and a light is shone on the crypto sector's secret web of interconnections and dependencies in order to protect investors and support market integrity, the risk of contagion also falls.

JOSÉ MANUEL CAMPA
Chairperson - European Banking Authority (EBA)

Crypto-assets: strengthening the framework for mitigating risk transmission

Recent market developments, in particular the impact of the recent US bank failures, have served as a timely reminder of the need for the effective monitoring and mitigation of risk transmission channels within the crypto-asset sector and, indeed, across all parts of our financial system.

In the EU, the crypto-asset sector will soon be bound by the Markets in Crypto-assets Regulation (MiCA), which is expected to enter into force in early-summer 2023.

MiCA will establish a comprehensive framework for the regulation of crypto-asset issuance and service provision and will confer on the European Banking Authority (EBA) extensive new policy and supervision mandates for issuers of asset-referenced tokens (ARTs) and electronic money tokens (EMTs).

In taking forward these mandates the EBA will be paying close attention to the potential for risk transmission within the crypto-asset sector and, importantly, between the crypto and traditional finance sectors.

For example:

- in establishing the reserve requirements for ART and EMT issuers, the EBA will be paying special attention to diversification of the deposit component of the reserve;
- in defining governance requirements, the EBA will be highlighting the importance of identifying and mitigating conflicts of interest between different parts of an issuer, or an issuer's group, activities; and
- in establishing our future supervisory approach for issuers of significant ARTs and EMTs, the EBA will be taking account of interconnectedness, including in the context of the supervisory colleges to be established under MiCA which, among other themes, can be expected to monitor the business model of the issuer, and interconnectedness between the different components of crypto-asset ecosystems, such as custodians and trading platforms. These college structures will provide a useful forum for to facilitate discussion between supervisors on issues relating to potential risk transmission channels and the coordination of actions to mitigate these risks.

However, experience shows that risk transmission is typically not a one-way phenomenon and our policy response needs to be necessarily multilateral. Therefore, as well as regulating and supervising the crypto-asset sector, it is necessary for us to strengthen the framework for the regulation of other parts of the financial system, including the banking sector.

Risk transmission is not a one-way phenomenon and our policy response needs to be multilateral.

In December 2022 the Basel Committee on Banking Supervision (BCBS) published its standard for the prudential treatment of banks' exposures to crypto-assets. This framework sets clear expectations regarding the reporting of banks' exposures to crypto-assets, thereby enabling more effective monitoring of potential interconnectedness risks, and establishes a globally consistent approach for quantifying the capital to be held against exposures. I expect this framework to be implemented faithfully in the EU and welcome the follow-up actions of the BCBS to promote convergence in the application of the framework to specific crypto-assets.

However, due to the global nature of crypto activities and the risks of regulatory arbitrage, more work is needed at the international level to promote global consistency in the regulation and supervision of crypto-assets in order to mitigate the risks of contagion across borders, whether via financial, reputational or confidence effects.

In this respect, the Financial Stability Board's (FSB) work this year on the revised high-level recommendations for the regulation and supervision of so-called global stablecoin arrangements, and for other parts of crypto-asset ecosystems, will provide an important catalyst for jurisdictions to continue to strengthen their regulatory frameworks.

In the meantime, the EBA will continue to advocate a proactive 'compliance by design' approach within the industry. The contours of MiCA are, by now, familiar and I would encourage market participants to already adjust their operations in line with the requirements to benefit from the sound risk management practices it instils.

We will also continue to actively engage with our European Commission, European Supervisory Authority, and competent authority colleagues within and beyond the EU to foster supervisory convergence in order that the opportunities offered by the underlying technologies can be leveraged whilst mitigating effectively the risks.

BENOÎT DE JUVIGNY
Secretary General - Autorité des Marchés Financiers (AMF)

The current crypto market downturn: healthy shakeout or crypto endgame?

The downturn of the crypto market since the first semester of 2022 has been a cause for concern for many crypto-assets investors and, more broadly, for the crypto ecosystem. This was accompanied by the failure of several crypto-asset service providers, including major players with a global footprint The question on many people's minds is whether this is a mere fluctuation of the market and a healthy shakeout, the bursting of a bubble, or the first stage of a possible crypto endgame.

First, it is key to note that the crypto market has always been volatile, with extreme fluctuations in price being a common occurrence. This is due to a variety of factors, including speculation, news events, current or future regulatory changes. The present downturn may simply be a healthy market correction, allowing it to stabilize in the long term as regulation builds up, as use cases in the field of finance develop or social utility for crypto holders evolves.

However, the failure of certain crypto-asset service providers and stablecoins has raised major concerns about the fragilities of existing crypto ecosystems. This has revealed weaknesses in infrastructures supporting the crypto market and has highlighted the need for greater regulation and oversight.

It is difficult to determine the exact causes of these events, as they are likely the result of a combination of factors. While some issues may be specific to the crypto market, such as crypto-assets service provider's governance problems, fraud, or issues related to the design of blockchain protocols, others may depend on broader factors such as macroeconomic conditions or economic uncertainty.

The failure of certain stablecoins, designed to maintain a stable value, has also raised concerns about the viability of such assets. This has led to calls for greater regulation and oversight of stablecoins, to ensure that they are able to fulfil their intended purpose.

The EU Markets in Crypto-Assets (MiCA) regulation, which is planned to start applying in 2024, aims to provide a harmonized framework for the regulation of crypto-assets. Ensuring better investor protection and addressing risks associated with crypto-asset markets, MiCA will also provide legal certainty to players seeking to develop their activities in the EU.

The EU is on the right path by making the choice to regulate in a comprehensive but sensible manner.

It remains unclear whether the MiCA regulation would have completely prevented the issues that have arisen in the crypto market in recent months. In the same way that traditional financial regulations could not prevent all kind of financial downturns, the regulation of crypto-assets could not be able to prevent all the possible frauds and irregularities of the crypto market.

However, it is likely that MiCA would have provided greater oversight and transparency, making it easier to identify and address issues at an earlier stage. Regarding the collapse of FTX which remains a key moment in the recent history of crypto-asset markets, a number of MICA's provisions would have at least mitigated some risks and potentially prevented this failure and the magnitude of its consequences, if the company had been established in the EU and licensed under MiCA. These provisions notably include the segregation of clients' crypto-assets and funds, measures around the management of conflicts of interest, better disclosure requirements towards clients and to some extent rules preventing the use of insider information.

This cutting-edge regulation was also designed to take into account the rapid pace of innovation in the crypto market, including emerging trends such as Decentralized Finance ("DeFi") or Non-Fungible Tokens ("NFTs") which will be the subject of ad-hoc reports by the Commission, accompanied if necessary by tailor-made legislative proposals. It remains to be seen whether EU regulation will be able to keep up with the pace of technological change and whether it will be effective in addressing future challenges, but the EU is on the right path by making the choice to regulate in a comprehensive but sensible manner.

Finally, for this regulation to be truly effective in a crypto environment that is cross-border in nature, cooperation with other international authorities will also be an important factor for success and a decisive element for adequate investor protection.

Europe has chosen tailor-made regulation for crypto-assets, designed to enable innovation while protecting against risk. The crypto asset market has seen several upheavals, but these events can help clean up a bubbling ecosystem that is constantly evolving. The MiCA regulation is a major step in the right direction, but it remains to be seen whether it will be effective in addressing the challenges faced by the crypto market in the years ahead.

MARCO SANTORI
Chief Legal Officer - Kraken Digital Asset Exchange

Executing the next phase of the EU's leadership in crypto assets

The EU has taken an important step in developing a bespoke regulatory framework for crypto assets. The design and agreement of the Markets in Crypto Assets regulation (MiCAR), is the foundation of a functional and efficient market for cryptoassets. Likewise, the regulation's forward-looking technical implementation will be critical to member states maximizing the economic opportunity of digital assets.

MiCAR, which once seemed a lofty legislative ideal, has come into its own as a comprehensive blueprint for other jurisdictions to consider as they develop their own frameworks. While jurisdictions across the globe are playing catch-up following the fallout of FTX, the EU had foresight to recognise both the digital asset sector's economic opportunity and the investor protections required to mature the sector. Dedication to understanding traditional finance's challenges, as well as the viable alternative of decentralized finance, empowered the EU to develop clear expectations, definitions and scope to regulate digital assets.

While the industry scrutinises individual aspects of MiCAR, it's important to recognise the laudable achievement of having secured a political agreement on such a fast-moving sector. This agreement now bears the potential to translate into practical regulation that allows cryptoassets to innovate. Crypto asset-focused businesses, aspiring innovators and entrepreneurs, venture capitalists and retail investors all stand to gain from the legal clarity it offers. The framework opens the door to a pragmatic and proportionate regime which can evolve over time as the digital asset industry develops within a sensible regulatory perimeter.

To capitalize on the economic opportunities of crypto assets, the EU should continue its efforts. Improved accessibility of financial services, efficiencies in payment settlements, job creation, and boosted growth are only a few of the rewards waiting at the finish line if the EU can get the final technical implementation right. The European Supervisory Authorities, including the European Securities and Markets Authority (ESMA) and the European Banking Authority (EBA), alongside the competent national authorities, will have key roles to play in promoting orderly financial markets and in how this new framework is implemented.

MiCAR opens the door to a pragmatic and proportionate regime which can evolve over time as the digital asset industry develops within a sensible regulatory perimeter. As we approach this final stretch, there are three key components of MICAR's implementation that both policymakers and regulators must keep in the forefront of their minds.

MiCAR opens the door to a pragmatic regime which can evolve along with the digital asset industry.

- **Deliver workable transitional arrangements** - the transition from national crypto regulatory regimes (so-called "VASP regimes") to a pan-European regime should be orderly and structured if it is to be successful. Crypto businesses should be able to avoid operational disruption while adapting to the new pan-EU framework. This adjustment period will require a predictable and universally agreed upon grandfathering process. This is currently at the discretion of each EU member state. We recommend instead a coordinated approach in the pan-EU spirit of MiCAR.
- **Ensure a level playing field across the Member States** - obtaining a CASP license should be a clear sign that the business is mature, has invested in appropriate functions and controls, and is willing to cooperate with the regulators in a constructive manner, regardless of in which Member State the licensing takes place.
- **Collaborate with global stakeholders to ensure harmonized international markets** - Crypto asset markets are inherently fungible and global. Thus they will require a globally-coordinated oversight. For this reason, the implementation of MiCAR, while setting a high bar for others to follow, should also be compatible with international financial standards from across the world. An efficient customer experience requires efficient interplay between the laws of jurisdictions across the globe.

The world's eyes are trained on the progression of MiCAR. Europe has the opportunity to set a critical global standard for customer protection and business efficiency. We stand ready to support policymakers and regulators through this important next phase.

RICHARD TENG

Regional Head of Europe
and MENA - Binance

Transitioning towards MiCA

In a few weeks, the EU's long awaited crypto regulatory framework is set to enter into force. The clock will start ticking for European issuers of stablecoins and crypto asset service providers (CASPs), who will have 12 months and 18 months, respectively, to prepare for implementing the Markets in Crypto Assets (MiCA) requirements.

MiCA is an example of the EU's determination to leverage its regulatory heft to advance the agenda of strategic autonomy. It seeks to reconcile the impulse to tame markets and to harmonize rules across the block, with the objective of taking a leap towards global leadership in Web 3.0.

EU policymakers have accepted that crypto assets can be different from financial instruments and offered a bespoke regulatory framework for them. But whether MiCA will meet its objectives hinges on how the regulation is translated into detailed rules, so-called level 2, and how it is implemented.

The work on regulatory standards and guidelines will unfold as the industry strives to rebuild and regain trust from the negative events of the past year and against the backdrop of a volatile monetary and financial environment. Throughout this work, EU regulators should not lose sight of the ethos of MiCA - to provide clarity around the rules for the sector to thrive - and the industry must engage more constructively than before to help them find pragmatic solutions to implementation.

This must be achieved notwithstanding the tight timelines. In some instances, there is a risk that MiCA will apply before the technical standards are finalized. This will be a challenge for CASPs. Clear communication on the key requirements, supervisory expectations and enforcement actions will be paramount for the industry to overcome it.

MiCA aims to protect consumers and investors, and increase financial stability within the market, while at the same time not hampering innovation within the crypto and Web3 space. Binance is committed to play its part. As the largest crypto trading venue, by volume, we have a responsibility to lead by example. We are registered in seven Member States under the AML Directive, including France, Italy, Poland and Spain, and are accelerating our transition towards MiCA.

We are building on the existing strong processes and infrastructure to offer further confidence to European users that their crypto assets are segregated, that heightened protections are enforced, and that trading happens in a fair environment. This is our way to contribute to the development of the Web 3.0 economy in Europe.

Binance is committed to play its part in making stablecoins in Euro available to users.

Euro stablecoins

The range of issues to be covered in the Level 2 work is wide, from the criteria to identify crypto assets that are financial instruments, to the rules on conflicts of interest for CASPs and the requirements for stablecoins. The latter will be especially important because they straddle the worlds of traditional finance and crypto.

Stablecoins have been an early concern of policymakers. MiCA, which was negotiated under the shadow of Libra, Facebook's failed digital currency project, strictly regulates the issuance of stablecoins and introduces negative incentives to move the market away from USD and towards Euro stablecoins.

We are looking at a huge shift. The top 5 USD coins have $130bn (€120bn) in reserves, according to Coinmarketcap. The top 5 EURO coins have less than €150m. Any transition and rebalancing, no matter how desirable, should be done gradually to avoid market dislocations that will ultimately hurt consumers.

While we are opposed to measures that reduce consumer choice and fragment liquidity in a global market such as crypto, Binance is committed to play its part in making stablecoins in Euro available to users.

We believe blockchain is, in many ways, a superior technology and appropriately designed stablecoins, fully backed, are, therefore, a superior form of money. Not only do they play a critical role in supporting crypto markets and DeFi, they can support faster, more efficient and inclusive payments.

Research by the Digital Euro Association, supported by Binance, shows how Euro stablecoins hold the promise of propelling Europe to leadership in machine-to-machine payments. Furthermore, Euro stablecoins can become the settlement asset in tokenised financial markets, as envisaged in the DLT Pilot Project.

Regulation should not stand in the way but play an enabling role. In the context of MiCA, this will require sensible rules on stablecoin reserves and capital, as well as a pragmatic definition of the scope of the prohibition of interest payments by CASPs. But this issue goes beyond the crypto regulation and will permeate discussions on a range of policy files, from payments to the digital euro.

Ultimately, the question that needs answering is where do stablecoins fit in the financial system, alongside bank deposits, backed by fractional reserves, and central bank money. Europe must create a level playing field, to foster competition and, with it, innovation.

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THE POTENTIAL OF CRYPTO TECHNOLOGY IN FINANCE

SEBASTIEN RASPILLER
Head of Service for the Financial Sector - Ministry of the Economy, Finance and Industrial and Digital Sovereignty, France

Exploring the potential of blockchain for finance

Crypto-assets and decentralized finance (DeFi) markets have emerged as disruptors of traditional finance. The Distributed Ledger Technology (DLT) supporting those markets allows for innovative features such as tokenization of securities or smart contracts. Tokenization could make traditional assets such as real estate or private equity more accessible to a wider range of investors. Smart contracts could automate financial agreements, reduce the need for intermediaries and improve the speed of financial transactions. DeFi offers new and particularly challenging and innovative services in potential disruption of traditional players.

The potential for this technology to transform traditional finance is massive, but some regulatory thinking needs first to be carried out. On the one hand, the absence of a clear regulatory framework has prevented a large number of players from fully jumping into the innovation fray. On the other hand, while blockchain technology is promising, crypto-assets and stablecoins still present significant risks, in particular for investor and consumer protection, for market integrity, money laundering and terrorism financing, or even financial stability and monetary sovereignty.

Therefore, benefits of blockchain technology for traditional finance will be difficult to achieve unless crypto-assets markets are well regulated and supervised. Consequently, France most recent efforts focused on establishing a robust and harmonized framework within the EU while ensuring that innovation can be fully deployed.

France has indeed been a forerunner in the crypto-asset sector, implementing a registration and licensing regime for digital asset service providers from 2019 with the PACTE bill. The entry into force of the Markets in Crypto-Assets regulation (MiCA), expected before summer, will cover both new players and traditional players wishing to be issuers or service providers in crypto-assets. Thanks to a political agreement reached in June 2021, under the French presidency of the Council, MiCA will provide a comprehensive framework with a common set of rules for issuers of crypto-assets including stablecoins, service providers, and market participants, with consumer protection obligation, governance requirements, reserve and prudential rules applicable.

Europe should be at the forefront of financial innovation.

In addition to the MiCA regulation, the EU has also adopted a pilot regime for market infrastructures based on DLT, which has entered into application in March 2023. It must allow the emergence of European projects experimenting the use of blockchain technology in financial instruments, which is crucial to staying on top of financial innovations on a global scale.

Moreover, France continues to position itself as a hub for blockchain and crypto innovation aligning financial authorities with this objective. One of the components of this strategy is to bring blockchain innovation to traditional finance by fostering closer ties between traditional players, fintech, and new crypto-asset players to create all the necessary synergies.

The challenges to achieve these objectives remain multiple.

In the short term, the implementation of the MiCA framework requires further work both to ensure regulatory compliance and to develop all level 2 standards. More broadly, the alignment of all the texts that affect DLT players will be a key task to embrace this technology.

A real pact of trust between all the players still needs to be created to promote the use of blockchain technology. Public authorities continue to build up expertise to support this objective. The installation of a new BIS Innovation Hub centre in Paris and Frankfurt in March is a clear signal in that direction. This centre will notably allow the exploration of the uses of DLT for CBDCs.

In the longer term, the rise of the crypto-asset markets and stronger ties with the traditional financial system warrant close attention leading to the transmission of new risks. More globally, in order to ensure that there is a real level playing field and that a viable tokenized financial system develops internationally, it is important that each jurisdiction adopts a set of rules following coming FSB high-level recommendations.

The DeFi sector whose development is still largely underway, requires further exploration to understand opportunities and risks. Although premature in MiCA, any regulatory approach will not be able to simply duplicate the rules of traditional finance to regulate DeFi, but to focus on the new risks linked to this sector in order to be appropriate.

In conclusion, although these challenges will be demanding, they are key steps to drive a new wave of digital innovation in the financial sector. Europe should be at the forefront of financial innovation. The integration of new projects, regulatory approaches and appropriate supervision will allow their full development, framing the inherent risks and ensuring our strategic autonomy on these subjects.

RICHARD KNOX

Director, Financial Services International - HM Treasury

Innovation and risk in digital assets

The adoption of digital asset technologies may represent an historic turning point for financial services. While innovation will be driven by the private sector, the response of policymakers to these technologies will be essential in determining how they will be adopted, how risks are mitigated, and whether the benefits will be fully realised.

The potential for these innovations to reshape financial markets is considerable. Developments in markets for pure crypto assets are of course widely publicly reported, but the potential scope of digital assets is much more extensive. In capital markets, post-trade processing could be radically improved, moving transactions in cash markets closer to real time – therefore potentially avoiding the need to risk-manage these transactions through central clearing, reducing margin and collateral requirements. It could enable real-time transaction matching and automated reporting to regulators or trade repositories.

New types of assets could be created, and existing assets transformed, for example by introducing programmable features. Use of digital assets could help revolutionise financial market processes, by delivering atomic – instant and simultaneous – settlement, or enabling the operation of markets 24/7.

These technologies have yet to be adopted at scale in regulated markets. The ability to do this will depend on whether the benefits of the technology can be shown to outweigh the costs of adoption, and how risks – including any emergent wider financial stability risks – are managed. The adoption of digital assets will necessitate the creation of new digital financial market infrastructures (FMIs) capable of issuing, trading, maintaining, and settling them.

It is important that regulation across financial services can adapt quickly to new technology. In the UK, we are building a smarter financial services framework, which will repeal legislation that in many cases will be replaced by rules made by our expert regulators – including the Bank and FCA, who regulate FMIs – in order to stay agile and adaptive. We are also taking forward a number of different initiatives, such as consultations on the regulatory framework for cryptoassets and for a retail central bank digital currency in order to ensure that we stay ahead.

Regulation should facilitate innovation but must hold firms to the same standards - especially FMIs.

As some of the most systemically important elements of the financial system, FMIs have, rightly, extremely high standards of regulation. It is essential that digital FMIs prove themselves able to safeguard operational resilience, cybersecurity, financial stability and consumer protections on the same terms as any other FMI. However, regulation is not just about protecting against risk. Regulation also facilitates innovation by creating the trust needed for potential users of FMIs to feel comfortable adopting new kinds of financial products, and in creating the environment for firms to make more informed decisions when investing in new technology.

Given the speed at which technology is evolving, there are already many cases where regulators need to work with innovators to bring their new models within the regulatory framework. In 2016, the FCA launched its "Regulatory sandbox" to deal with these cases – which has been highly successful. Yet in order to fully explore the transformative potential of digital assets in markets, we will need to look at more fundamental changes to regulation. Doing this in anticipation of the development of technologies is challenging given the breadth of digital innovations. It is not clear at the outset, and may not be clear for some time, how legislation and regulation will need to adapt to facilitate and safeguard these changes.

The UK's Financial Market Infrastructure Sandbox, the first iteration of which will be implemented this year, should be a big part of the solution. Unlike the existing FCA sandbox, users of an FMI Sandbox will have access to modified legislation that allows them to innovate while continuing to comply with regulatory standards, enabling them to test and scale digital technologies in FMIs where they otherwise could not. If the new practices tested in the Sandbox are successful, HMT will make permanent changes to UK legislation, and participating platforms will be able to continue providing their services outside the Sandbox. The ability to adapt regulation in response to practical experience should be a powerful tool in facilitating innovation whilst vigilantly protecting against risk.

The principle of 'same risk, same regulatory outcome' will not change, even in the face of substantial innovation in the digital space. If different regulatory requirements are needed to achieve the same outcomes, then it is important that government and regulators have the ability to facilitate this end. The UK government is looking forward to working with the sector to help realise – safely – the potential of these technologies in the coming months and years.

JOCHEN DURR
Chief Risk Officer & Member of the Executive Board, SIX Group Services AG

Broader adoption of digital assets needs facilitation by institutional players

Compared to the size, activities, and regulatory framework of the financial services industry, Crypto, DLT and tokenization are still in their infancy. Nevertheless, in the last ten years, these technologies have enabled new marketplaces, new business models, new services and already quite a few boom-and-bust cycles. High hopes and deep concerns, underpinned by strong growth and spectacular failings like FTX and Silvergate, or more recently Signature Bank, alternated and led to questions whether these technologies will really transform financial services or not.

However, these are largely questions about the sustainability of the providers concerned rather than the potential of the underlying technologies. The latter are here to stay and will change the way financial services and especially securities services are done. The remaining question is how these technologies will transform the world we operate in and how long it takes.

Institutional adoption of digital assets is a key success factor

A key success factor is the broad acceptance of digital assets by institutional players since a majority of (retail) clients is unlikely to access digital assets directly for the foreseeable future but will still need intermediaries such as banks or asset managers. Facilitation by regulated and fully licensed players would not only lead to increased adoption and growth by easing retail access to these new technologies, but also significantly help to gain the trust of investors and authorities alike.

However, this requires that not only individual actors deserve trust, but that the standards and safeguards apply along the entire value chain. This is precisely where traditional Financial Market Infrastructures (FMIs) come into play.

Sound risk, compliance, and security standards along the value chain needed to promote trust

At SIX, we follow two approaches to support institutional adoption by creating a secure and stable environment that provides the same level of confidence and security as today's financial market infrastructure:

The first approach is to create new fully regulated and licensed end-to-end FMIs for digital assets which build on the experience and expertise of traditional FMIs. An FMI of this type can cover the whole value chain from listing, trading, settlement, and even custody for the full range of digital assets and benefits from proven and well-established security, risk management, and compliance processes and procedures. The resulting high level of resilience, stability, and security ensures the necessary robustness of the services needed to win the trust of institutional clients.
This approach is also relevant for new asset classes such as private equity, carbon credit, or music rights, etc. The new technologies offer the opportunity to improve their liquidity and tradability, and enhance efficiency e.g., through smart contracts. A DLT-based FMI set up as described above can play an important role as "trusted intermediary" since it combines the new technology with the institutional trust built over time. This is what both the issuers and the (often non-traditional) client base for these new asset classes are looking for.

> **Broader adoption and institutionalization demand smart and competitive regulation.**

The second approach is to extend existing services into the DLT or more specifically the crypto space. This allows for fostering the interaction and the embedding of crypto currency related business into the existing financial industry. The provision of clearing services for crypto derivatives is well known. Another example is the data area. The establishment of pure index data for the valuation of crypto products has been improved and expanded to include reference and market data, making it easier to understand and process digital assets by comparing them to traditional products traded on traditional venues. This comparability and connection to the existing financial industry is a prerequisite for the desired institutionalization and professionalization of this developing industry.

Broader adoption and institutionalization demand smart and competitive regulation

The new possibilities, but also broader (institutional) adoption, will call for a regulatory framework that allows for growth and innovation, while ensuring high quality of processes, investor protection, and stability of the entire financial system. While this will certainly be a demanding task that will also require a certain flexibility to adjust to evolving situations, we see a few criteria against which the appropriateness of a future regulatory framework should be assessed:

- Technology-neutral and principles-based
- Appropriate and proportionate
- Open and competitive
- Interoperable and coordinated

It is in the hand of regulators to acknowledge this and consider it in their current and upcoming policies in order to enable financial market infrastructures to continue performing and playing a crucial role in promoting financial stability, facilitating economic growth, and supporting the smooth functioning of the global financial system.

DANIEL KAPFFER

Chief Financial Officer & Chief Operating Officer - DekaBank Deutsche Girozentrale

Digital securities - A tsunami for capital markets?

When assessing the digital development in the financial sector, we should first look at the role and importance of the sector. The purpose of the financial services industry is to provide services that meet the economic needs of society and must not deal with itself. Banks, insurance companies and investment managers essentially have five roles within the economy:

They create money and enable payments, store value, finance companies as well as households, provide investment opportunities and help to manage financial risks. With the emergence of crypto technology and digital asset ecosystems in financial services, fundamental changes are on the horizon and offer new use cases.

Crypto is a very wide range of asset classes and often the discussion gets mixed up between very different types of assets. There are four types of crypto assets: Coins, CBDC, Digital securities, Tokenized assets (securities as well as real assets).

All of these have one thing in common - in order to benefit from all the advantages, the crypto asset needs to exist on the blockchain technology. Just having a digital documentation of the existing central infrastructure is "digitalization 1.0". The lack of a fair value of coins, as we have seen it in recent history shows that coins do not fulfill any of the purposes of the financial sector. The only exception might be payment in economies that lack a stable and transparent monetary system.

Looking at the advantages of CBDC only from a retail perspective is short sighted. It primarily needs to exist for settling the cash lag of a transaction on the blockchain. By the way European Central Banks should also think about CBDC as a mean to establish an EU DLT infrastructure.

DLT will make the market much more efficient especially for investors as well as issuers

Ultimately, the most important transformative aspect of crypto asset is in digital securities and tokens. Due to considerable cost advantages and efficiency gains, digital securities will become a new standard and their success needs to be driven by issuers.

Digital securities have the potential to strengthen Europe's position in global capital markets.

Issuance costs of a classical bond are estimated at around 75 bps to 100 bps of par. Issuing a bond on a public blockchain and selling it directly to investors however leads to massive cost reductions, as no paper-based documentation is needed and there will be no clearing fees and no margins for distribution through banks. According to ECB there are more than 20 trn EUR of EUR-denominated long-term securities issued, not including equity. Roughly 6 % of the outstanding volume is the gross issue per year – the lever is significant.

Transferring a digital security is just another transaction on the chain and settlement takes place by entry in the registry. Thus, the complexity of the market infrastructure can be reduced significantly. It is not important anymore if the transaction is cross border or not – the mechanisms are just the same. Hence the cost of trading in the secondary market will be much lower.

Finally, handling life cycle events can be much easier through the use of smart contracts. Competition should bring parts of these cost advantages to the end investor. In order to capture the advantages, we will see plenty of tokenization of existing securities.

Is it just efficiency gains or is there a transformational aspect to it?

We have seen many cases where improving market efficiency led to structural changes. The best-known example is exchange traded derivatives which have been made available to more market participants, resulting in a six-fold increase in trading volume. The same is true for digital securities. As issuance costs decrease, capital market-based funding may become available to smaller companies that today need access either to bank loans or venture capital.

In Debt Capital Markets the role of banks will change significantly to a provider of services around digital securities. Investors could also invest directly with the issuer; therefore, the role of intermediaries like broker, clearer or transfer agents will also change significantly.

These new technological opportunities support directly the top EU goals: the single capital markets union, Europe's competiveness on the global landscape and enabling financing the green transformation.

Initially, the shift to digital securities will be slow – but if you don't see it today that does not mean it is not going to happen. Under the surface, it's already underway and gaining momentum – like a tsunami.

There is no doubt that these enormous technological changes need to be covered by appropriate regulations at EU level – to cover the risks but also to enable the markets to prosper.

EU as well as national regulators have picked up the topic among others through the DLT pilot regime. We should not be too hesitant on these as the US seems to be focused on Coins and Asia somewhat behind.

PHILIPPE BORDENAVE

Senior Executive Advisor to the General Management and Chair of the Board - BNP Paribas

Can we securely benefit from blockchain technology?

Blockchain technology is entering different sides of many businesses, with the promise of efficiency gain. As this technology has still not really proven its potential in any industrial use case, we have seen in parallel the rise of use cases based on public blockchain and open protocols.

But this technology is clearly very far from being secured and trustly from a global society perspective (anti money laundering, terrorism financing, frauds, etc.). Moreover, whatever regulation is in place on digital assets service providers, supervisors need also to tackle the underlying infrastructure to make it as secure and trustly as current payment/delivery platforms.

On Digital Assets Service Providers

As many frauds, crimes or money laundering issues have happened on use cases with blockchain technology (especially using the so called crypto-currencies), regulators have globally started to look after those digital assets service providers offering services on blockchain-based assets and are currently building dedicated regulations. Some countries have already set up the basis for them but one can say that they are still very far from what shall be expected from those players, especially the ones acting with retail flows and crypto-currencies. Those regulations are still missing the operational control organizations, especially if it is compared to what is in place for credit institutions. As a consequence, if a bank were to partner or even to serve those new crypto/blockchain players, it should look at it with a similar set of rules and constraints that a bank is itself facing. Those new players are still very far from the level of control banks have put in place globally.

In a few words, regulation should allow to select only proper and secured player for the good of our society, but it will not happen before at least a few years.

On blockchain as the underlying infrastructure

Once only secured and trustful players will be allowed to manage and transfer blockchain-based assets, the underlying question on the blockchain itself will remain. As a matter of fact, we can distinguish at least three ways to use the blockchain: (i) a private blockchain, (ii) a public blockchain or (iii) a permissioned blockchain.

> **There is as of today no way to securely benefit from blockchain technology on a large scale.**

Private blockchains are operated by identified players, meaning the technical operations (servers, computation forces) are clearly chosen, mostly with a limited number of nodes and knowingly shared with others. Such operational mode is used by large institutions to test the expected benefits of the blockchain and its associated smart contracts for instance. In such a setup, controls are clearly defined and identified, and it is not fundamentally different from most current operational setups. But many private blockchains separated from each other would make a fragmented and costly framework.

On the contrary, public blockchains rely on multiple players, acting as nodes validators. To make the transactions secured, many players are required. The incentives given by the system itself is supposed to guarantee the good behaviors of all players, each player acting in its own interest. This is what blockchain is mostly known for. Bitcoin in particular works this way. What is missing here is that it also relies on the supposed good faith of all those players. What is obviously missing here is defining the rules that those players should respect and controlling them effectively.

Permissioned blockchain are somehow in the middle of the road: even if they use public blockchains, only identified players are allowed to manage particular assets using such a blockchain. Sellers and buyers are fully known and identified, but still, the infrastructures used to transfer the assets are completely out of scope of any control.

In short, there is as of today no way to securely benefit from blockchain technology on a large scale. It is of utmost importance for the global financial authorities to address this issue.

AI AND ML APPLICATIONS IN FINANCE

PETRA HIELKEMA
Chairperson - European Insurance and Occupational Pensions Authority (EIOPA)

A sectorial approach to address the opportunities and challenges of AI

Any process or decision that is data-driven can be automated or streamlined using artificial intelligence (AI). For a sector such as insurance, where data is the raw material and data analytics is the main working tool, it is not surprising that AI will play a central role in the digital transformation of the sector.

Opportunities: using AI across the insurance value chain

AI systems are being used in insurance to automatically triage claims and determine their complexity, urgency and potential fraud risk. This can speed up the claims management process for simple property damage or medical claims, for example, by extracting relevant information from documents (such as medical bills), verifying coverage and calculating settlement amounts.

In the area of pricing and underwriting, some insurers are also starting to use AI to process satellite imagery and other new sources of information to better underwrite natural catastrophe risks and more efficiently address the risks posed by climate change. From a sales and distribution perspective, insurers are using AI to inform marketing campaigns and provide more tailored advertising and discounts. AI is also being used to assist agents in determining the "next best action" during the sales process.

While the above use cases are all noteworthy and are already being used in the sector, the step brought about by the large language models that recently hit the headlines around the world shows that we are arguably only seeing the beginning of what AI can do for the sector and for society as a whole.

Adoption of AI also brings risks that need to be addressed

While AI has the potential to bring many benefits, it also poses significant risks. Many of these risks are not new, but the inherent characteristics of AI can exacerbate them. One of the main risks relates to bias and discrimination; AI systems can inherit or learn biases from the data they are trained on, which can lead to discriminatory outcomes that disadvantage certain groups.

The opaque operation of some AI algorithms (sometimes referred to as the black box effect) also poses significant challenges, particularly in customer-facing applications where consumers may need to be provided with sufficient information to make informed decisions or have access to appropriate redress and accountability mechanisms.

From another perspective, the automation and sophistication of certain tasks will also imply changes for the insurance workforce, which will need to adapt and receive adequate training to be able to use AI to support their work and mitigate challenges.

Policy response in highly regulated sectors such as insurance

The widespread adoption of AI raises a number of questions for regulators and supervisors. First and foremost, do we need to adapt regulatory frameworks to the technological advances brought about by AI? If so, how should this be done?

The AI Act aims to establish new rules for the development, deployment and use of AI systems in the European Union. These ex-ante measures will be complemented by the AI Liability Directive, which will ensure that consumers have access to adequate redress mechanisms in case of harm. EIOPA welcomes these legislative proposals and supports their objectives and principles to promote the ethical and trustworthy use of AI in the European Union. However, legislation such as the AI Act has the complex task of integrating provisions into existing sectoral regulatory frameworks. In the case of insurance, the sector is already highly regulated and the application of the AI Act is likely to cause some friction.

Indeed, when insurance companies and intermediaries use AI today, they are not doing so in an unregulated space. A number of legally binding instruments at international, European and national level already apply to the use of AI in the insurance sector. The insurance sector has certain specificities that deserve special attention in any cross-sectoral legislative proposal, such as the role of actuaries in the supervision of underwriting risks, which does not exist in other sectors. In addition, insurance supervisors, who are being trained on new technologies and business models through initiatives such as the Digital Finance Academy, already have extensive experience in supervising mathematical models in insurance and should continue to do so. EIOPA has also recently launched a new market monitoring survey on digitalisation, which will, among other things, gather further evidence on the level of adoption of AI and the governance measures that insurance companies are developing around it.

EIOPA recognises the challenges posed by complex AI systems and the need to promote the responsible use of AI. EIOPA stands ready to develop further guidance to the sector. However, rather than creating new, often overlapping rules, we strongly believe that this should be done building on existing sectoral requirements for governance, risk management, conduct of business and product oversight and management.

TSVETELINA PENKOVA

MEP - Committee on Industry, Research and Energy - European Parliament

Opportunities and challenges for effective and secure financial solutions

The finance industry is going through significant transformation pressure – the players in the sector should adapt quickly if they want to stay competitive in the fast-paced market environment. AI and other disruptive technologies have the potential to boost the financial sector and transform the way services are being delivered. It is quite logical that many of the data-driven innovations are originating exactly from the financial sector.

From fraud detection, easier access and more tailor-made financial products to personalised client service, artificial intelligence (AI) and machine learning (ML) are rapidly changing the way the financial services sector operates. Several main requirements must be respected when talking about AI and ML integration into financial services.

Primarily, data security and privacy are the most crucial elements. In order to provide insights and financial predictions, AI and ML largely rely on enormous amounts of sensitive data. Thus, safeguarding that data from unsolicited access, theft, or misuse is essential. Hence, to protect clients' information, financial institutions must use strong data encryption, access control measures, and routine security audits in order to provide topmost data security services.

Customers' must have faith that financial institutions are using their personal information in an ethical and secure manner. Accordingly, in order to ensure customers' trust, as a safeguard against theft and misuse of information, the financial institutions must implement additional security measure and ensure that sensitive and financial data protection is the highest priority.

Secondly, transparency and accountability is key. Customers' right to information with regards to the use of their financial data must always be respected. Financial institutions should make sure that the AI and ML algorithms and models are transparent and accountable. Customers' digital literacy has to be also taken into account, when introducing AI based decisions in order to ensure customers' faith and understanding.

Thirdly, financial organisations must carefully implement the algorithms in a non-biased way. Regularly monitor algorithms for any discriminatory patterns, corrective actions and precautionary measures are a necessity in order to ensure fairness in the technology driven financial ecosystem.

The finance industry is going through significant transformation pressure.

Last but not least, the use of AI and ML must strike to supplement, rather than replace, human expertise. While AI and ML can automate repetitive tasks and make data-driven recommendations, they cannot replace the judgment, experience and expertise of human advisors. Financial institutions have to aim at striking the right balance between automation and human oversight in order to provide the best possible customer experience and protection.

Due to the volume of data available and the accessible processing power, AI and ML approaches are being used a lot in the various fields of the financial industry - asset management, algorithmic trading, credit assessment, blockchain-based finance.

The deployment of AI in finance is expected to increasingly drive competitive advantages for financial services providers, by improving their efficiency through cost reduction and productivity enhancement. Yet, AI applications in finance may create or intensify financial and non-financial risks, and give rise to potential customers worries and distrust.

Hence, from a regulatory perspective, the AI Act and the Data strategy are just one of the steps towards providing a comprehensive framework for supporting the uptake of AI and ML in finance. These legislative frameworks contribute to ensuring that AI and ML systems used in the financial sector are transparent, explainable, and subject to human oversight.

EU legislation strives to ensure that the development and deployment of AI is in secure, ethical, customers' and business friendly manner. At the same time, it seeks to promote innovation and growth in the sector by providing a clear regulatory framework for the development and use of disruptive technologies.

Likewise, the new proposal for the Data Act will unlock even more data that will encourage a bigger competition on the data market and will open more opportunities not only for the already established financial institutions, but also for smaller players and newcomers on the market.

In conclusion, AI and ML have the potential to revolutionise the financial services industry. However, these technologies must always be used ethically and effectively. Data privacy and security, transparency, fairness and a balance between automation and human expertise are all crucial in order AI and ML in finance to succeed and to enjoy customer's trust.

NIKHIL RATHI

Chief Executive Officer - Financial Conduct Authority (FCA)

How AI and ML are shaping UK financial services

The use of Artificial Intelligence and Machine Learning within the UK financial services sector has grown rapidly in recent years. A recent FCA survey conducted jointly with the Bank of England suggests that the trend is expected to more than triple in the next three years.

Of the regulated firms who responded to the survey, 72% of firms reported that they are actively using or developing machine learning applications. Firms also noted that machine learning applications are now more advanced and increasingly embedded in day-to-day operations, with nearly eight out of ten use cases in the later stages of development.

From our research and supervision, the FCA knows that the digitalisation of financial services can bring many potential benefits to consumers. For example, firms using Artificial Intelligence and Machine Learning can offer more tailored products and services to consumers, improve operational efficiency, increase revenue, and drive innovation – to name just some examples.

The FCA is also increasingly using the technology itself. For example, we are currently developing a machine learning application that allows us to analyse over 100,000 new web domains daily to identify potential scam sites. We are also leveraging Natural Language Processing (NLP) to support our supervision work. And we are investing in Artificial Intelligence tools in our digital intelligence environment.

However, we must not underestimate the challenges these technologies can create. Previous work by the supervisory authorities has shown that the drivers of Artificial Intelligence risk in financial services can occur at different levels within Artificial Intelligence systems, starting with the risks associated with the use of data to train, test, and run Artificial Intelligence models; which can feed into risks arising from the design and use of Artificial Intelligence models themselves. These can, in turn, lead to challenges for the governance structures necessary to manage those risks.

As a result of these, the FCA will continue to monitor the state of Artificial Intelligence and Machine Learning deployment and ensure we understand the different use cases, maturity of applications, benefits, and risks.

We recently published a Discussion Paper with the Bank of England that sets out these issues in more detail. Responses to the Discussion Paper also allow us to gain a better understanding of how the technology is impacting markets and what this may mean for regulation going forwards.

ML applications are now more advanced and increasingly embedded in day-to-day operations.

We are also using the FCA Digital Sandbox to enable new technology propositions to be tested. This allows participants to access a suite of tools to collaborate and develop proof of concepts, as well as access high-quality synthetic data. The FCA Digital Sandbox is likely to become more important in testing and evaluating Artificial Intelligence propositions.

We are also using the FCA Digital Sandbox for our work programme on synthetic data. This is an increasingly important area of research for the FCA. Our Synthetic Data Feedback Statement highlighted industry perspectives and the significant challenges of accessing and sharing data – particularly for smaller firms, however there is a real potential for synthetic data to help combat fraud and money laundering. We will be launching a Synthetic Data Expert Group to explore these issues in more detail with stakeholders across industry and academia.

We are also exploring the impact of other emerging technologies such as quantum computing and quantum communications. Through joint work with the UK Digital Regulation Cooperation Forum (DRCF), we are collaborating on identifying and understanding how quantum technologies could impact digital markets and consumers.

Technology is driving rapid and far-reaching change in financial markets, raising issues from a supervisory, regulatory, ethical and competition point of view. But the frameworks and tools are starting to emerge to think through and address, where needed, the key regulatory issues.

Through collaborative exploration we believe we can develop shared understandings of what matters and how best to achieve the right outcomes for markets and consumers.

GEORGINA BULKELEY

Director for EMEA Financial Services Solutions - Google Cloud

AI can help to build the future of financial services

There are many applications for artificial intelligence (AI) and machine learning (ML) in financial services. Use of these tools within the industry, both in Europe and across the globe, is likely to increase in the near term. According to the International Data Corporation (IDC), global spending on AI systems was $85.3 billion in 2021 and is forecasted to increase to more than $204 billion in 2025, with a compound annual growth rate (CAGR) of 24.5% over the period.

AI/ML is fundamental to the work Google Cloud does in financial services: ranging from contact centre automation, to document parsing, to services that help customers uncover market trends, perform predictions, and identify transaction anomalies to detect fraud and mitigate risk. This March, Google Cloud announced the next generation of AI for enterprises, developers, and Workspace. Generative AI is an emerging and rapidly evolving technology with complex challenges.

That's why we have invited select developers, including financial services customers, to test these new products and experiences. Our AI Principles and product reviews guide this work and serve as an ongoing commitment to our customers worldwide who rely on our products to build and grow their businesses safely with AI.

As we have said for many years, AI is too important not to regulate. And, it's too important not to regulate well. Policymakers have an important role to play in maximising AI's benefits, and managing its risks. We welcome regulators' efforts around the world to develop proportional, risk-based policies that promote reliable, robust and trustworthy AI applications, while still enabling innovation and the promise of AI for societal benefit. In Europe, the EU AI Act will become the most important regulation to further guide adoption of this technology across different sectors including in finance.

It is critically important that regulation remains focused on the outcomes and specific high risk use cases. Purpose-agnostic technologies like general purpose AI should not be classed as high-risk en-masse, but evaluated instead based on the risk of the applications in which they are embedded. In finance, for instance, these applications may be used to digitise invoices or help a customer quickly access commonly asked questions. Additions to the list of high risk AI applications should not be overly broad in scope, and reflect only genuinely high risk usage to ensure focus on riskiest applications while leaving room for innovation in low-risk applications and general-purpose AI technologies.

AI is too important not to regulate. And, it's too important not to regulate well.

A risk-based framework should focus not on the existence or non-existence of AI in a given tool or application, but rather on how such tools and applications are used by financial services firms—their function—and what they are expected to do – their output. This would allow for risk scoring and management techniques that are well-understood and already in wide use across the financial services industry. A technology-neutral and definition-agnostic regulatory approach also would promote risk management techniques that are themselves flexible, adaptable, and better equipped to adapt over time to technological developments.

In thinking about appropriate regulatory approaches to AI, priority should be placed on standards and frameworks that:

(i) promote parity between between AI and non-AI systems;
(ii) balance the benefits of widespread adoption of AI against reasonably expected risks; and, perhaps most importantly,
(iii) leverage existing rules, standards, and guidance to the fullest extent possible. Google Cloud believes that the Supervisory Authorities should not seek to regulate the use of AI in financial services at the sector-level, but seek to clarify the responsibilities that various parties play in the AI lifecycle. Only where existing regulatory tools are demonstrably insufficient (which, we think, will be the rare case) should additional or AI-specific rules and standards be considered.

We believe that a sound regulatory framework should encourage firms to deploy well-established tools for managing the risk of discriminatory effects of AI-enhanced tools similarly to how they are managed in other contexts. This includes:

(i) processes for ensuring routine and robust data validation and testing throughout the technology lifecycle;
(ii) appropriate governance, and escalation protocols to maximise human oversight;
(iii) standards for AI that emphasise transparency, explainability, and reproducibility;
(iv) requirements for standards-based and technologically-appropriate independent audits.

DIANA PAREDES
Chief Executive Officer & Co-founder - Suade Labs

AI and ML: revolutionizing financial regulatory and supervisory activities

Recent events involving SVB and Credit Suisse have made the conversation around AI and ML more relevant than ever, demonstrating that their use can be crucial to efficiently process large amounts of data and perform risk assessment for supervisors. One wonders if through them, information that is difficult or impossible for humans to detect manually could have surfaced in time to avert the crisis the banking system is currently experiencing.

In April 2020, the Financial Stability Board (FSB) published a report where it stated that "the use of AI and ML in financial services is at an inflection point, moving from a period of experimentation towards widespread adoption." Indeed, the use of AI and ML in financial regulatory and supervisory activities is still in its early stages, but it is rapidly gaining momentum – notably since the COVID-19 pandemic - as data becomes increasingly available, algorithms improve, and more regulators and financial institutions recognize the benefits of these technologies. Regulatory sandboxes and innovation hubs are being established to provide a safe space for regulators, financial institutions, and technology firms to collaborate and experiment with new technologies, helping to accelerate the development and adoption of AI and ML, further driving the trend towards their increasing use in regulatory and supervisory activities.

How AI and ML are bringing value to regulatory and supervisory activities

Regulators and financial institutions are leveraging AI and ML to improve reporting, compliance, risk monitoring, AML and CFT checks, stress tests, capital assessments, and more. These technologies bring significant benefits to regulatory and supervisory activities, improving their risk assessments and compliance monitoring accuracy and, ultimately, the safety and stability of the financial system. They are notably very useful in identifying outliers. Thus, their more intensive use could have helped, in recent events, to detect risky lending practices and disproportionate exposure of assets to rising long-term interest rates, allowing regulators to intervene earlier and perhaps prevent a bank collapse. Similarly, the use of AI and ML could have been more effective in identifying and mitigating inadequate risk management practices, which, as we saw in March, lead to reduced client confidence and exposure to highly leveraged positions.

Recent events with SVB and Credit Suisse have made the AI/ ML conversation more relevant than ever.

Lastly, the progressive automation that AI and ML enables also lowers costs by reducing the need for manual labour and frees up regulators to focus on more complex tasks that require human judgment and decision-making. However, it is important to balance the benefits of automation with the need for human oversight and expertise. Some regulatory and supervisory activities require human judgment and cannot be fully programmed.

How to optimize AI and ML use for regulatory and supervisory activities

To optimize the use of AI and ML for regulatory and supervisory activities, a number of conditions must be met. One key factor is data standardization, ensuring that data is properly categorized, labelled, and formatted to enable effective analysis using AI and ML algorithms. Hundreds of thousands of data points must be reported in an increasingly complex regulatory reporting system. Without a coherent structure of data in corporate repositories, a lot of time and resources are lost cleaning and interpreting that data instead of using it.

Moreover, to effectively analyse data using AI algorithms, it is important to have appropriate access to data flows. This may require collaboration between regulators, financial institutions, and other stakeholders to ensure that data is shared in a secure and standardized manner. High-quality data is also essential for effective AI analysis. This includes ensuring that data is accurate, complete, and up-to-date, and that there are appropriate controls in place to ensure data integrity.

Additionally, as AI continues to evolve and become more sophisticated, it will be critical to continue monitoring its impact and developing appropriate safeguards to ensure that it is used in a responsible and ethical manner. Effective governance and oversight structures, including developing clear guidelines and protocols for data use, are necessary to ensure that AI models are transparent and explainable.

Finally, policymakers should also consider the potential impact of AI and ML on the workforce and develop strategies to address the replacement of jobs with machines or the lack of staff skills to work alongside these technologies. Indeed, AI and ML become more prevalent in the financial industry, some jobs may become redundant.

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DIGITAL OPERATIONAL AND CYBER-RESILIENCE

MARGARITA DELGADO

Deputy Governor - Banco de España

Challenges for a coordinated and proportional approach to resilience

While the financial sector has always been keen to adopt new technological solutions to improve the services it offers and increase efficiency, the current speed of digital transformation at financial institutions is unprecedented. Changing customer expectations, greater competition within the sector (together with new actors offering financial services) and the pace of technological development have significantly accelerated this transformation.

Increased digitalization also entails greater ICT (information and communication technology) and cyber risks. Not only are malicious attacks against financial institutions and their customers on the rise, the huge complexity of such institutions' ICT systems also makes operational mistakes more likely. Additionally, institutions' increasing reliance on specialized third parties, very often involving a multi-level supply chain, makes operational risk management an even more challenging affair.

With the goal of supporting digital transformation in the financial sector, while ensuring an adequate level of operational resilience, the EU has published DORA[1] and the NIS2[2] Directive, two different but complementary regulatory approaches to the problem. While DORA is a common text applicable to the entire EU financial sector, NIS2 is a transversal directive focused on the cybersecurity of the most critical sectors in each jurisdiction, including the financial sector. Not surprisingly, both texts set out supervisory frameworks for some critical technology service providers, showing a clear determination on the part of the EU to address the issue of dependency on these third parties. The coexistence of the two supervisory frameworks will require close coordination between the DORA and NIS2 authorities.

The requirements applicable to financial institutions need to be proportional to their specificities.

But this is not the only issue that will need to be clarified in the Level 2 regulatory standards. The requirements applicable to financial institutions as regards ICT risk management, ICT-related incident classification and reporting, resilience testing and third-party risk management must be proportional to the size and overall risk profile of such institutions and the nature, scale and complexity of their services, activities and operations. Easy to say, but extremely hard to define in a legal text, striking the right balance between prescriptiveness and legal certainty, on the one hand, and a principles-based, technology-neutral and future-proofing approach on the other.

The precise structure of relations between the DORA and NIS2 ecosystems will also need further clarification, on aspects such as how information on significant incidents and threats is to be shared or the role of the NIS2 authorities in the DORA mechanism for oversight of critical ICT third parties.

Due to its innovative nature, this mechanism is, by far, the section of DORA that has attracted the most attention. While defining the detailed governance arrangements required to set up the oversight system in the Level 2 texts will no doubt be challenging, actual implementation will be doubly so. This is in part due to a complex decision-making process in which the ESAs[3], the competent authorities and observers such as the European Central Bank, the European Single Resolution Board, the European Agency for Cybersecurity (ENISA) and the NIS2 authorities are all involved. Moreover, practical aspects such as the identification of the most critical ICT third parties or how to ensure that examination teams are sufficiently staffed with skilled personnel are still under discussion.

It is fair to highlight the additional challenges that both regulations pose for the authorities in terms of resources and cooperation. Building the necessary capacity and learning to work together at this scale will require a major effort on all our parts.

Financial institutions also have gaps to fill, with significant differences across entities as regards their levels of readiness and awareness. Although the precise requirements will only be clear once the Level 2 work has been completed, there is already enough detail in the legal texts to start working in the right direction. NIS2 will be applicable as from October 2024, and DORA as from January 2025.

Financial institutions, authorities and providers must continue working hard to meet these tight deadlines and contribute to the common goal of enhancing the EU financial sector's operational resilience.

[1] Digital Operational Resilience Act
[2] Directive on measures for a high common level of cybersecurity across the Union
[3] European Supervisory Agencies, namely EBA, ESMA and EIOPA

GERRY CROSS

Director Financial Regulation – Policy and Risk - Central Bank of Ireland

DORA - A truly cross-sector ICT Regulation

DORA is a cross-sector Regulation, affecting all regulated financial firms. It has the key objective to mitigate technology and cyber risk by enhancing the ability of financial firms to build and ensure on an ongoing basis their operational integrity and resilience. The European Supervisory Authorities (ESAs) are tasked with jointly delivering the regulatory standards implementing the framework. The Joint Committee of the three ESAs has established a Sub-Committee to deliver these standards.

DORA will change the way regulated firms and supervisory authorities look at ICT risk. A key to overcome challenges will be early stakeholder engagement. The ESAs jointly started such engagement earlier this year with a technical event on the Digital Operational Resilience Act attended by more than 2000 interested parties. Events like this, including the upcoming public consultations for the Level 2 regulatory standards, will be important in delivering a high quality final framework.

The financial sector has always relied heavily on ICT and the COVID-19 pandemic has further intensified reliance on remote working and on network connectivity as well as ICT infrastructures to support it in a secure manner. The consequences of a cyber-attack or disruption of an important cross-border financial service can have far-reaching effects on other companies, sub-sectors, or even the rest of the economy.

DORA's relevance in mitigating these risks across all member states and across all sectors is clear but not without challenges given its ambition in setting expectations across the whole spectrum of ICT risks.

ICT risk management principles are not different to operational risk management, but complexity derives from the requirement that firms have a good understanding of all their ICT assets and their respective vulnerabilities. DORA will require regulated financial firms to identify, classify and adequately document all ICT supported business functions and to identify, classify and adequately document all the information assets and ICT assets supporting these functions. This will be a challenge for some firms, especially those with complex ICT systems or extensive reliance on outsourced ICT services.

DORA's operational resilience testing requirement will bring significant benefits but also implementation challenges.

DORA is a cross-sector regulation, affecting all regulated financial firms.

DORA Level 2 regulatory standards will provide templates for the creation of a register of information for all contractual arrangements regarding ICT services provided by third-party providers and for the reporting of ICT incidents. Harmonizing ICT incident reporting will be challenging because of the number of different ICT incident report recipients and on the other hand the need for a timely notification of incidents. In addition, two other EU directives, NIS2 and the Critical Entities Resilience Directive (CER), are being introduced to strengthen the resilience of European infrastructure, with DORA intended to operate as lex specialis for both for the financial sector.

The new oversight framework and the designation of critical third-party providers (CTPP) is new territory for both regulators and technology firms and will bring new challenges. Level 2 regulatory standards are currently being developed to establish oversight frameworks and designation criteria.

SAMU
KURRI
Head of Department - Finnish Financial Supervisory Authority (FIN-FSA)

An entirely new role for financial supervisors

With the high degree of digitalisation of the financial sector, it is utmost important to prepare for various cyber threats. The cyber resilience of the financial sector is generally at a good level thanks to long tradition in risk management. Already today, several regulations oblige financial entities to ensure an adequate level of information management, information security and business continuity. Supervisors, like the FIN-FSA, monitor the fulfilment of these requirements during new entities' authorisation and registration phase, through inspection activities and other supervisory duties. Supervisors also monitor significant disruptions in the services provided by the financial entities as well as in payment and information systems.

DORA brings an important step towards an even stronger harmonization of the supervision of ICT and cyber threats in the EU. NIS2, on the other hand, ensures that the important pipeline, including electric and information networks, that is required for providing digital financial services, is resilient for cyber threats.

Already for some time, supervisors have been witnessing the growing number of outsourcing notifications from financial entities. DORA introduces an entirely new role for financial supervisors. For now, financial sector supervisors have been the watchdog for financial sector entities. DORA brings critical ICT third-party service providers of the financial sector under their supervision.

The Lead Overseer that is appointed among the ESAs conducts oversight of the critical ICT third party service providers. Joint examination teams that consist of staff from ESAs and national competent authorities assist the Lead Overseer in particular in investigations and inspections.

This entirely new role requires extensive preparation, but it is a necessity considering the fast pace of outsourcing activities. We need clear processes for both ongoing and periodic supervision of the critical third-party ICT providers to succeed. This new role also puts supervisors´ credibility to test. Supervision must be structured so that there are no loopholes. Joint examination teams that assist the Lead Overseer need to function effectively from early on.

An important step towards an even stronger harmonization of the supervision of ICT and cyber threats.

The has often been very little or no room for negotiation with the large and critical ICT third-party providers. DORA introduces requirements for the key contractual provisions and defines the elements that should at least be included in the contractual arrangements on the use of ICT. The key contractual provisions shall contain clauses on exit strategies, in particular the establishment of a mandatory adequate transition period. In practice, the switching of ICT third-party provider may be impossible.

The degree of concentration in ICT outsourcing among financial entities is an element that needs further scrutinization also after the application of DORA. The FIN-FSA has witnessed the names of certain ICT services providers popping out in the outsourcing notification documents more frequently than others. This raises concentration risks that should be further observed from systemic point of view.

Finally, I would like to highlight the importance of having enough skilled personnel in the financial entities to ensure that they are fit for DORA from day one. The FIN-FSA has recently conducted a thematic review of state of the use of new digital technologies among financial entities[1]. The thematic review also identified risks faced by financial entities in connection with the use of new technologies. The most common type of risk identified was the inadequate digitalisation expertise of personnel[2]. This was the most common risk regardless of the technology or sector of financial entity.

Evolving cyber threats and the introduction of DORA require that the financial entities have personnel with sufficient experience on ICT risk governance and management. Special expertise is also required in sourcing functions of financial entities. It is up to the financial entities´ decisions and strategic choices to ensure that these capabilities are at high level. ICT outsourcing is often heavily driven by agility, scalability and also cost savings.

Digitalisation and evolving cyber threats naturally put high demands on the management of financial entities. As DORA clearly states, the management body of the financial entity is responsible for the implementation of all arrangements related to the ICT risk management framework. This is a role that shall not be taken lightly.

[1] https://www.finanssivalvonta.fi/en/publications-and-press-releases/supervision-releases/2022/thematic-review-of-the-use-of-new-technologies-and-related-risks/

[2] This risk covers circumstances where the organisation lacks adequate expertise, or expertise is limited to a small group, as well as those where there are no experts available in the market to facilitate digitalisation.

FRANÇOIS-LOUIS MICHAUD

Executive Director - European Banking Authority (EBA)

Pave the way for DORA application

In April 2019, the EBA, EIOPA and ESMA (the 'ESAs'), sent a technical advice[1] to the European Commission, calling for a coherent approach to ICT risk in finance and recommending to strengthen the digital operational resilience of the financial services industry. In September 2020 the European Commission proposed the DORA legislation, to establish a comprehensive framework on digital operational resilience for a wide scope of regulated EU financial entities. DORA will thus provide a comprehensive rulebook and enhance the digital operational resilience of the financial sector, consolidating the various aspects of digital operational resilience, and complementing the existing prudential treatment of operational risk.

DORA mandates the ESAs to deliver a whole range of technical standards and other regulatory products by 2025, to further specify the key pillars of the legal text. This will supplement the legal framework on digital operational resilience, in particular the details of the ICT risk management framework, the ICT-incident reporting framework, the rules and scope for advanced digital operational resilience testing, the aspects of the oversight framework as well as the design of relevant templates.

DORA allows for a proportionate application of requirements to certain financial entities, particularly microenterprises, as well as financial entities subject to a simplified ICT risk management framework. Moreover, the ESAs will calibrate their rules in a proportionate manner, taking into account the financial entities' sizes and overall risk profiles, and the nature, scale and complexity of their services, activities, and operations.

DORA could further integrate ICT risk management supervision across the supervision of the financial sector via strengthening the mandates of the competent authorities and at the same time enhancing supervisory convergence across the EU. In addition, DORA will allow supervisors to obtain a complete overview on ICT-related incidents and to acquire a better understanding of ICT third-party dependencies. These will require the overall integration of DORA provisions into the current supervisory processes. It could further enhance the need for the supervisory community to keep pace with the technological developments as well as to acquire the necessary skills and talent.

DORA is a major step for addressing dependencies to CTPPs through an EU-wide oversight framework.

DORA sets the first concrete initiative to address the complex issue of the dependencies to critical ICT third-party providers (CTPPs) through an EU-wide oversight framework for CTPPs. The EBA, EIOPA and ESMA will act as Lead Overseers for the ICT risks these critical players may pose to EU regulated financial entities. They will not supervise them across the full range of their activities.

The oversight framework will build on the well-established cross-sectoral coordination mechanism of the ESAs' Joint Committee level. The Lead Overseers will conduct their oversight activities with the support of experts from the national and European relevant competent authorities. Their recommendations to the CTPPs would need to be taken into account by these competent authorities through their prudential supervision of financial entities relying on the CTPPs. Given the close cooperation and coordination envisaged for the oversight, the ESAs are already preparing for their role with a 'one team' spirit.

DORA's sectoral provisions will interplay with other relevant legislations, especially those of the Directive on measures for a high common level of cybersecurity across the Union (NIS2). DORA's oversight will complement the supervision of essential and important entities under NIS2D. This will apply to CTPPs which will be considered as essential or important entities under NIS2D.

The successful implementation of this EU-wide oversight framework will require a carefully crafted ESAs-led oversight model, along with the appropriate resources and expertise, to address coordination and consistency challenges, as individual CTPPs may serve businesses across the wider economy. The finalisation of DORA is timely and long-awaited as it contributes towards the stability and the integrity of the EU financial system.

The EBA, together with the other ESAs, are looking forward to fostering a resilient industry and will work closely together for the successful implementation of DORA.

[1] *https://www.eba.europa.eu/esas-publish-joint-advice-on-information-and-communication-technology-risk-management-and-cybersecurity*

JASON HARRELL

Head of External Engagements - The Depository Trust & Clearing Corporation (DTCC)

Resilient operations require a whole-of-business approach

Operational resilience has emerged as a key area of focus for supervisory authorities and financial institutions. As the financial services sector continues to experience cyber incidents impacting multiple firms, policymakers and institutions are asking: *How does my organization rapidly and safely recover from a cyber incident?*

At the same time, the financial services industry continues to undergo significant technology modernization providing new products and enhancing or expanding existing offerings. When considering this landscape, emerging technologies have provided new finance streams, expanded financial services to unserved and underserved communities, increased credit and lending opportunities for small and medium businesses, and enabled new market entrants. These advancements have also lengthened the supply chain used to deliver financial services and have contributed to the growing interconnectedness of the financial markets which could also introduce new risks.

To address growing cyber threats and their potential impacts on a significantly interconnected financial services sector, financial authorities have partnered with standards bodies, financial trade associations, and institutions to develop a framework that enhances the industry's preparedness for material operational events. As an example of the industry's resilience partnership efforts, the Digital Operational Resilience Act (DORA) represents a major step towards defining minimum controls and capabilities in the areas of cyber and ICT third-party risk management across the European Union and will help financial institutions strengthen their control in a core pillar of operational resilience. While DORA represents a significant and positive step forward, financial firms must realize that resilience is not solely an extension of business continuity or the result of strong IT and cybersecurity controls.

Business continuity and technology implementations support the delivery of resilient operations, with business areas playing a pivotal role in the delivery and sustainability of resilience across a number of functions. There are three (3) key pillars in firm's resilience frameworks where the level of business engagement is particularly important.

> **Financial firms must realize that resilience is not solely an extension of business continuity**

Critical Operations Mapping

First, financial institutions must document and agree a consistent view of the people, processes, technology, and third parties needed to deliver critical operations. Institutions rely on different business areas to deliver products and services, with each area having its own view on how products and services are delivered based on their responsibilities. Therefore, gaining an accurate view of dependencies, across functions, will require each group to validate its role in the delivery of services. These business maps will assist organizations with understanding the true impacts of a material operational event and the potential cascading effects to other critical operations.

Tabletop Exercises

Second, no financial institution wants to experience an operationally impacting incident. However, experiencing these events without the benefit of previously exercising an organizational response only serves to increase the severity of the impact. Tabletop exercises should facilitate the business' thought process around decision-making, decreasing the operational friction that may arise when an incident occurs. Further, these exercises help the business understand where recovery is within tolerance and where additional capabilities may be required.

Capability Building

Third, the development of new capabilities is at the heart of any resilience strategy and separates resilience from risk management. Building capabilities requires business areas' support to drive integration and to validate and test solution effectiveness. By building capability, firms can close the loop and bring the business within its tolerance for disruption for certain extreme but plausible events while providing reasonable assurance for rapid and safe recovery strategies.

Resilience is more extensive than business continuity, cybersecurity, or IT solutions and more important than ever as the cyber incident and technology landscape continues to evolve. The successful delivery of resilient operations requires a whole-of-business approach to understand threat impacts to business operations, determine current capabilities to address those impacts, and gain the business insights necessary to build new capabilities and enhance existing processes.

Institutions relying solely on IT or business continuity to deliver on operational resilience may ultimately find themselves ill-equipped to execute on their resilience expectations.

It is incumbent on financial institutions to develop the governance models necessary, across their entire organization, to deliver on resilience for the benefit of the individual firm and the entire financial services sector.

NEXT EUROFI EVENTS

THE EUROFI FINANCIAL FORUM 2023

13, 14 & 15 September 2023

SANTIAGO DE COMPOSTELA - SPAIN

THE EUROFI HIGH LEVEL SEMINAR 2024

21, 22 & 23 February 2024

GENT - BELGIUM

OPEN FINANCE: AMBITION AND POLICY APPROACH

GEOFFROY GOFFINET

Director of Authorization - Autorité de Contrôle Prudentiel et de Résolution (ACPR)

The success Open Finance is mainly dependent on the industry, not regulation

If PSD2 cannot as such considered as the final achievement of Open Finance, since it only covers part of the financial data by focusing on the payment data, its recent implementation in EU countries teaches a lot about what the future opportunities and challenges associated with open finance.

Given the format of the article, I will limit my comments to three issues: the need to further harmonize industry standards, the need for the industry to define a viable business model and the role of any future regulatory framework.

First, for open finance to be a success, the industry should work on further harmonizing standards allowing an efficient and secure exchange of financial data. In that respect, PSD2, while remaining technology neutral, supported the development of APIs.

The industry engaged into elaborating PSD2 APIs market standards, such as the Berlin Group or STET API standards, but their implementation was left at the discretion of each bank.

Without a harmonized level of services offered among banks at European level or even within a domestic market, the implementation of these standards has created several challenges for account information service (AIS) and payment initiation service (PIS) providers and required many clarifications by authorities, in particular the European Banking Authority via guidelines, opinions and 100+ PSD2 questions and answers.

Given the investments already made by market participants for the PSD2, the industry should aim at building on the PSD2 APIs standards to develop the access to other financial data in the context of open finance. Nevertheless, the industry main challenge is now to streamline the implementation options left at each market participants discretion to converge towards a minimum standardized level of services to support the development of open finance.

The success of open finance is dependent on the industry capacity to convert the PSD2 try.

Second, the industry should work on defining the conditions for a viable open finance business model. PSD2 relied on the assumption that the costs of building interfaces for accessing payment data will be exclusively supported by the account servicing payment service providers (ASPSP). Such decision was required in the absence of dialogue between ASPSP, AIS and PIS providers. It eventually resulted in the setting up of interfaces offering a limited access to the minimum data required by the regulation.

For making open finance a success, the industry should again rely on the PSD2 experience, with the development of "premium" PSD2 APIs allowing ASPSP and other entities holding financial data to recover part of the interfaces infrastructure cost. This is an essential condition for them to provide a scalable access to value-added data by third parties.

Third, from a regulatory perspective, the experience of PSD2 demonstrates that the regulation has been a clear success by bringing the AIS and PIS providers under supervision, making sure that they comply with minimum security and internal control standards. This was necessary to provide the level of confidence toward these new players storing banking credentials. In France, half of the licensed payment and electronic money institutions since the implementation of PSD2 in 2018 have now incorporated an open banking component in their business models.

However, PSD2 regulation also teaches us that regulation is not the best solution to define solutions in the absence of industry standards. Indeed, technology evolves far more rapidly than the regulation is able to change. When PSD2 was adopted, account information services (AIS) were principally services that "provide the payment service user with aggregated online information on one or more payment accounts held with one or more other payment service providers and accessed via online interfaces of the account servicing payment service provider. The payment service user is thus able to have an overall view of its financial situation immediately at any given moment." Nowadays, account information services allow collecting online payment data on behalf third providers offering corporate accounting services, credit risk assessments or even loyalty programs based on payment data.

Regulation is therefore more efficient when it comes into play to impose a standard designed by the industry, as it was the case for the Sepa credit transfer or direct debit standards.

To conclude, to refer to a rugby analogy, the success of open finance is primarily dependent on the industry capacity to convert the PSD2 try. As a priority, the industry should work on further harmonizing industry APIs standards, in order to avoid the regulator to be prescriptive in that field.

TSVETELINA PENKOVA

MEP - Committee on Industry, Research and Energy - European Parliament

Open finance can boost competitiveness and customer engagement

The next logical step in the development of open banking is open finance. It broadens its scope and boosts benefits for users, third parties, and financial institutions. Open finance is an increased access to banking and financial data beyond the bounds of only payment data, which is already in existence for many years.

Open finance refers to the idea of gathering all of a user's financial data in one place, such as bank transactions, purchases made with digital wallets, payments made with insurance and retirement accounts, investments, money transfers, cryptocurrency transactions.

For both consumers and businesses, open finance has the potential to provide wider opportunities. However, it also introduces new challenges.

Providing more data to product and services providers, start-ups, scale-ups, and SME's will undoubtedly result in the introduction of novel services and goods to the EUs' internal market.

Higher expansion of data will result in more innovative product diversity that meets clients' needs and demands.

Open finance will introduce bigger transparency to investors and customers. The latter will have the opportunity to improve their credit scores based on all financial data, not just bank financial information. It is equally beneficial for investors as it offers more opportunities for implementation of lower risk strategies.

All this will guarantee a more stable and secure financial market, with much lower probability of unpredictable market shocks and collapses of specific financial instruments or asset classes. This is a necessary step to ensure the building and the functioning of a stable Capital market union within the EU. The current pressure on the global financial markets once more re-iterates on the need to establish a strong and secure financial markets in the EU, driven by the technological enhancement, customers' protection and an adequate regulatory framework.

The next logical step in the development of open banking is open finance.

Banks and insurance companies are complex and highly competitive businesses, subject to considerable transformational pressures to survive on the market. At the same time, we should make sure enough information is provided to consumers, especially when it comes to two main aspects. First, the digital literacy for the proper use of the new technologies, should be a priority of both the service providers and the regulators. Second, data protection and fair usage of personal data is key to ensure a just and competitive market functioning.

Open finance certainly has the potential to boost the financial sector and transform the way services are being delivered. Hence, the implementation of proper regulatory frameworks will facilitate and encourage trust in open finance, while ensuring minimisation of the risks associated with it.

Unlocking more data that will encourage a bigger competition between the market participants and will open more opportunities not only for the already established financial institutions, but also for smaller players and FinTech newcomers to the market.

However, opening more and more data to circulate on the market carries certain risks, especially with respect to cybersecurity and the protection of personal and confidential data. For this reason, the EU is constantly working to improve upcoming legislations in these fields.

Issues such as data security, a clear and precise legal framework, customer mistrust and cyber-related risks require special attention. These challenges must be addressed before any open finance implementation can proceed.

The latest adoption of the Data Act is a prime example of introducing a fair balance when it comes to data by taking into account the interests of all stakeholders involved, protecting business interests while safeguarding customers' rights.

Likewise, PSD2 is a great example illustrating how to ensure security standards for the protection of customers' financial information while processing customer's data in electronic payments. Extending PSD2 to open finance has certain positive merits that cannot be denied.

However, a standardised approach for sharing data and a high level of trust among actors is essential. In order to achieve that, particular emphasis on the collaboration between the public and private sectors is necessary.

The EU needs to promote further the financial industry's digital transformation while managing the potential risks. By doing so it will stimulate more companies to engage in the market, which will lead to new and innovative financial services to emerge.

Open finance has the potential to foster a new financial transformation. Nonetheless, proper regulatory and technical measures have to be implemented in order to ensure a high level of customer and business protection and trust.

SHELDON MILLS

Executive Director for Consumers and Competition - Financial Conduct Authority (FCA)

The UK's approach to open banking and open finance

Open banking is an excellent example of an area where the financial services industry can, through competition and innovation, bring tangible benefits and transform the experience of consumers and businesses.

In the UK, over 7 million consumers and over 600,000 small and medium-sized enterprises (SMEs) are already using innovative open banking-enabled products and services to better manage their money and make payments. The trend continues to accelerate with open banking-enabled payments having grown at a rate of 500% year-on-year.

As a financial services regulator, the FCA has been supporting innovation and competition that are in the interest of better consumer and market outcomes.

We have authorised or registered over 270 firms that can carry out account information services and/or payment initiation services. This has allowed over 8 million successful payment initiations to be made in January alone and, since May last year, over a billion successful API calls a month.

Some of the benefits of open banking are already being realised, from empowering users to make better-informed decisions, to improving access to financial services and choice of services and products. We have seen charities using open banking-enabled produces to advise consumers with debt issues; SMEs managing their budget and estimating their taxes more efficiently; and consumers being offered loans they can repay based on more accurate information about their finances.

In the UK, we have taken the approach of mandating all account servicing payment services firms (ASPSPs) provide access to third party providers and enforcing a single standard for the largest ASPSPs. This allowed the ecosystem to overcome some significant coordination challenges. But we recognise that there is more that can be done to deliver the full benefits of open banking and the technology that underpins it.

Today, over 7 million UK consumers and SMEs are using open banking-enabled products and services.

This is why we have been working with other public authorities in the UK, to define a common vision for open banking and the framework for industry-led developments in the ecosystem. Together with HM Treasury, the Competition and Markets Authority, and the Payment Systems Regulator (PSR), we formed a new joint regulatory oversight committee, which I co-chair alongside the PSR's Chris Hemsley. The committee plays a role in shaping and setting expectations on the future of open banking, in consultation with the industry and other stakeholders including end user representatives. We want open banking to become sustainable and to scale beyond its current scope, with an industry-led entity leading and promoting open banking at its heart.

We have also been considering about whether changes to the broader regulatory regimes may be necessary. We conducted a call for input on open finance and, in November last year, held a policy sprint on open finance policy sprint. We have been working with the UK Government on potential legislation around smart data, which is expected to give consumers and businesses more control over their data and has the potential to extend the benefits of open banking to other sectors of the economy.

We also support firms that innovate and provide new services and products in other ways. Our Sandbox provides firms with access to regulatory expertise and gives firms the ability to test products and services in a controlled environment. Our Innovation Pathways service involves guiding firms on regulatory matters through one-to-one discussions with a dedicated case manager assigned to provide feedback on their business model. We have supported many firms using open banking technology through these initiatives.

Open banking and open finance cannot succeed without the cooperation between industry, regulators, end users and other stakeholders. This is why we welcome dialogue and close collaboration from across the UK and internationally. I very much look forward to speaking with many of you at the Eurofi conference this year.

JACQUES BEYSSADE

Secretary General - Groupe BPCE

Open finance - A market reality, let's foster it!

With its "Digital Finance Strategy for the EU", the European Commission sends a strong message to consumers that the promotion of data driven innovation will benefit them and will lead to better products, services, and prices, as well as better personalization, and better access financial services. Cooperative banking actors, such as Groupe BPCE, place their customers at the center of their values and strategy. We, therefore, welcome a holistic European approach to data. This is essential to preserve our competitiveness while at the same time avoiding further fragmentation of national regulations.

In that regard, the open finance framework announced by the Commission should be fair and viable for all stakeholders. In order to do so, it is crucial to learn the lessons from the revised Payment Services Directive (PSD2), the right of access and the liability regime that were introduced. This directive has indeed been a first attempt to share and use customer-permitted data in the financial sector. While the emergence of some third-party providers (TPPs) has been facilitated by PSD2, it should also be noted that banks have borne most of the costs related to accounts management, payments processing, and investments in infrastructure to share payments data with TPPs.

Additionally, innovation remained limited for most customers. Broadening the scope of shared data beyond payment data via new access rights, following the example of PSD2, would therefore be an unfair option, both for banks in terms of level playing field, and for customers, who would bear the final costs without any certainty of further innovation.

To ensure an optimal framework for all stakeholders, it is essential to be aligned with current regulatory developments and business practices. The Data Act, for example, introduces a principle of compensation for the data holder. This fair distribution of value constitutes a good incentive, as compensation allows the data holder to maintain the infrastructures available to the data user by covering the cost of collecting, structuring, storing, and sharing the high-quality data needed for innovation.

Furthermore, imposing a right of access is not the unique option to increase data sharing. The open finance framework should preferably promote voluntary initiatives in the banking sector, like the development of models based on an open architecture to facilitate the collaboration with external partners, including Fintechs. Bank as a Platform (BAAP) and Bank as a Service (BAAS) are two examples that should be considered in their capacity to enhance the sharing of financials data and services. With BAAP, customers of the bank could benefit from an enriched banking offer, with the integration of financial and extra financial innovative services from external partners.

The open finance framework should preferably promote voluntary business initiatives.

With BAAS, the bank provides its core banking or services to third parties (e.g. payments, fight against fraud). Here again, this would benefit customers through embedded finance. Where a right of access approach would only allow financial services providers to develop a small number of new and targeted services, a platform approach offers a greater potential and creates value for the overall ecosystem. Groupe BPCE and its entities are part of this movement on both BAAP and BAAS models.

Data sharing is already the subject of an important payment industry workstream, bringing together all stakeholders from the financial sector. Notably, the work of the SEPA Payment Account Access Multi-Stakeholder Group aims at facilitating the voluntary sharing of high-added value payment related data (premium services) beyond the minimum required by PSD2. This would be achieved through the establishment of common rules, practices, standards, and principles related to compensation and reversibility for example. The open finance framework should help to promote this collaborative and market driven approach, supporting the emergence of strong European market players in the field of digital finance and that would maximize innovation collectively and benefit European customers.

As the trust of customers is key for enabling open finance, data protection should be the key priority. The anteriority of PSD2 over GDPR has given rise to some interplay difficulties. Any future framework should be aligned with the values and vocabulary of the GDPR and aimed at maximizing the user's control. However, the risk of "consent fatigue" of customers should also be mitigated. This could be done by using all the GDPR legal basis.

And, when consent is the most appropriate one, user-friendly tools and interfaces should continue to be adopted at the initiative of all stakeholders, such as the Groupe BPCE Privacy Center, that helps the customer assume his central role when it comes to data sharing.

ALEXANDER VOLLERT
Chief Operating Officer - AXA Group & Chief Executive Officer - AXA Group Operations

Opportunities and challenges of the future Open Finance framework

As insurers, we rely on information to build our risk expertise and accompany our customers in moment that matters, for claims payment or assistance for instance. Emerging technologies, such as artificial intelligence, blockchain or cloud computing, bring new opportunities to develop data-driven insurance solutions.

Access to more diverse datasets can help improving customer experience when switching services and or by benefiting from more tailored and responsive services. For instance, last year, AXA has launched a Digital Commercial Platform offering insurance and risk management services. One objective of this on-going project is to ultimately offer the possibility to our corporate consumers to monitor the safety of their assets and building across the world, by analysing in real-time data from connected devices and third parties' digital solutions. It would enable to alert them in case of a problem and identify flaws to prevent potential damages.

Providing relevant data to consumers on their insurance contracts can also help improving their experience thanks to more transparency and customization. For example, AXA has developed a solution called Computable Contracts enabling customers to quickly know if they are covered or not. This helps reducing the information asymmetry between insurers and insured and ultimately closing the protection gaps.

The Commission has taken important steps to encourage data sharing in Europe, including with the Data Governance Act or the Data Act. Building on these cross-sectoral rules, the Commission will soon publish an Open Finance framework to foster financial data sharing.

From my perspective, the opening of insurance data is not just about enhanced data flows. It may also drive important structural changes to the way we deliver insurance and to the current EU competitive landscape. Therefore, "open insurance" solutions as a component of open finance can be the premise of exciting projects benefiting to EU customers, under the appropriate safeguards. I identify three main pre-requisites to support the uptake of collaborative data exchanges across Europe.

The Open Finance framework could foster data-driven innovation to the benefit of EU consumers.

Firstly, given the sensitive nature of insurance data, including life or health data, all actors should be subject to clear and harmonized legal conditions regarding data sharing and usage. Building on existing rules, it is important that consumers have absolute confidence in their personal data security and full control over what data is shared with whom and for what purpose.

Secondly, since the use of data is foundational for insurers, we expect open finance rules to ensure fair competition conditions between all players, including new market entrants. It is crucial to respect the principle of "same activities, same risks, same rules" regarding data access and usage.

Lastly, upstream efforts to deploy adequate technical infrastructures for secure and efficient data sharing initiatives should be taken into consideration when designing the scope and implementation timing of open insurance measures. The standardization of APIs and certain datasets would be a necessary first step ensure a consistent approach across EU countries and unlock data-driven innovation in financial services.

So far, open insurance solutions have been successfully driven by industry-led initiatives where insurers decide on their cooperation partners and what generated data they are willing to share. However, depending on the intent of EU public authorities, compulsory data sharing scheme could be introduced in parallel to, or in combination with, these voluntary approaches. In this case, it would be crucial to clearly define these data sharing rules.

Any open insurance solution should, first and foremost, meet consumers' needs. Therefore, rather than introducing a broad industry-wide framework, a step-by-step approach focusing on specific use cases would enable insurers to develop solutions bringing clear benefits to EU consumers. In addition, to fully leverage the potential of open insurance, EU authorities should adopt a cross-sectoral data sharing approach, rather than focusing on insurance data only. From an insurer's perspective, it would also ensure reciprocity in terms of data exchanges and thus, fair competition conditions, especially vis-à-vis new market players.

Finally, when defining the scope of data sharing rules, a distinction should be done between personal raw data controlled by the consumer, and insurers' proprietary information created by processing or enriching customer data. While all actors would benefit from an easier access to standardized raw personal data, upon customer's explicit consent, any mandatory data sharing scheme encompassing proprietary data, such as risk profiles, underwriting or claims performance models, would introduce an unlevel playing field.

Summing up, adequately designed, the publication of an Open Finance framework, could foster data-driven innovation in financial services to the benefit of EU consumers.

TARUN KOHLI
Head of Delivery Services - Swiss Re

Open finance can be a game-changer for the insurance industry

Open finance, the standardised and secure exchange of personal and non-personal data between financial institutions and trusted third-party providers, is of growing relevance for the insurance industry. It has the potential to improve pricing and underwriting, help fraud detection and prevention, identify trends that improve safety and reduce accidents – in short, to lift our industry's growth prospects via innovation squarely focused on benefiting consumers.

The upside to tapping data from beyond our industry ranges from the prosaic to the profound, from simply pre-filling questions on forms to streamline applications to more complex processes like supporting delivery of tailored services or acting as a risk-scoring proxy. Ideally, what will emerge will be a seamless, safe transfer of data across platforms to enable our risk management tools to operate more effectively.

Such a shift towards open frameworks also may raise concerns over data security risks or cyber threats, as well as interoperability challenges. A shift toward open finance in insurance demands a reckoning with how this will impact liability, ethical issues like potential for financial exclusion of some groups, and broader consumer protection risks. Also, a lack of common standards, combined with inconsistent data quality, are hardly trivial hurdles to taking advantage of open finance's full promise.

With this in mind, the development of open finance frameworks must carefully address the benefits and risks that inevitably accompany this shift. We must create a level playing field for all participants, one that facilitates healthy competition between insurers, third-party data sources, and large technology companies that will contribute to lifting the quality of our industry's protection products.

Open finance adoption globally has been uneven, with both market-led as well as regulatory-driven approaches like those advancing in Brazil and Australia.[1] In Europe, there's no legal framework yet, with data sharing until now developed via market-driven new business models and by private sector initiatives. The European Commission has announced plans to issue a legislative proposal for an open finance framework in Q2 2023.[2] A step-by-step approach focused on developing use cases could help maximize the benefits while minimizing potential risks.

Open finance frameworks must balance data protection and competition to foster healthy innovation

Telematics insurance is an area that could benefit from open frameworks. Full portability of data generated by connected or automated cars could address data bottlenecks between insurers, car manufacturers and original equipment manufacturers (OEMs) that now limit insurance innovation. Vehicle manufacturers often act as in-vehicle data gatekeepers, limiting sharing by consumers. Absent progress here, insurer access to in-vehicle data is incomplete and reliant on agreements. Swiss Re's Luminar partnership - to access data generated by Advanced Driver Assistance Systems (ADAS) and autonomous vehicles - is one example of equipping underwriters with data to make better decisions about risks associated with highly automated cars.[3] More open frameworks could accelerate such efforts, with benefits accruing to consumers in the form of greater safety and risk pricing.

Additionally, Swiss Re's Rapid Damage Assessment (RDA) platform[4] relies on catastrophe modeling to estimate potential losses from events like hurricanes, earthquakes, and wildfires. Tapping sources like satellite imagery, social media and other public data sources to understand historical weather patterns, topography and building codes via open frameworks improves our models' accuracy and speed.

As our sector digitalises, open frameworks can help us leverage vast new sources of data to improve decision-making. Interoperability between insurance and non-insurance firms will foster greater competition and innovation. Simultaneously, policymakers must ensure a favourable risk-benefit profile.

The promise of open finance is clear: Seamless, better-connected worlds that lift convenience for customers, lead to a safer environment, and promote growth by helping us manage risks more effectively. That's why it's critical to strike a fair balance between data protection and competition while encouraging innovation, efficiency, and consumer protection.

[1] Brazilian Private Insurance Authority (SUSEP) initiative, Open Insurance — SUSEP - Superintendência de Seguros Privados (www.gov.br); United Kingdom Government Smart Data review initiative, https://www.gov.uk/government/publications/smart-data-review; Australia's Customer Data Right, https://www.accc.gov.au/focus-areas/the-consumer-data-right.
[2] https://commission.europa.eu/document/download/9143c562-f4c7-4a41-ab46-c2f5aa35adcd_en?filename=cwp_2023.pdf
[3] https://www.swissre.com/reinsurance/property-and-casualty/solutions/automotive-solutions/evaluate-vehicle-sensors-real-life-safety.html
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DIGITAL EURO: USE CASES AND DESIGN

EVELIEN WITLOX

Digital Euro Programme Manager - European Central Bank (ECB)

A digital euro: the next step in the advancement of our currency

The world is changing towards ever more digitalisation and so are people's payment habits. As cash usage as a means of payment is declining, Central Bank Digital Currencies (CBDCs) are the next logical step in the advancement of currencies. According to the Bank of International Settlements (BIS), there are around 85 central banks in the world working on their own CBDC projects. The European Central Bank (ECB) is no exception. We have been investigating for more than a year how to develop a digital euro that would ensure access to central bank money in the digital era. This would at the same time strengthen Europe's monetary sovereignty and prevent undue dominance of private providers.

A digital euro would be a digital central bank liability for retail payments that would offer an additional payment solution for citizens and businesses to use throughout the euro area. It would complement cash and central bank deposits. In essence, a digital euro would bring the most appreciated features of cash to the digital era. Hence, it could be used for all daily transactions in several payment segments, including e-commerce. The ECB is prioritizing three digital euro use cases that are currently served by separate solutions, mostly without pan-European reach and provided by non-European firms. For now, these include :

(i) person-to-person payments made between individuals,
(ii) consumer-to-business payments, including e-commerce and purchases made in a physical shop,
(iii) payments to/by the government (e.g. to pay a tax). In the future, additional use cases could be added, such as machine-to-machine payments.

For each use case, we aim to design online and offline functionalities, which would increase the currency's resilience and privacy options. As a central bank, the ECB has no interest in users' personal data. This is why, within the limits of pending legislative developments, we are considering solutions that would preserve privacy by default and by design, giving people control of their payment data.

In essence, a digital euro would bring the most appreciated features of cash to the digital era.

A digital euro would be distributed via supervised intermediaries, including banks, that would be the direct counterparts for digital euro users. For instance, supervised intermediaries would be the actors taking care of opening digital euro accounts or wallets for end users.

To be effective as a monetary anchor, which unifies the entire euro payment ecosystem, a digital euro will need to be widely used and accepted. Consequently, a digital euro will need to be easily accessible to everyone who wants to use digital euros. A digital euro will be designed to be inclusive. Therefore, it will be user-friendly and take on board those who cannot afford a credit card or who do not have a bank account. In line with its public good nature, a digital euro would also be basically free. This principle is at the core of the digital euro's fee model, which, at the same time, would generate incentives and network effects for distributers and merchants. Pending legislative developments, this model foresees offering comparable economic incentives for distributors while the Eurosystem would bear certain investments and operating costs, as with the production and issuance of banknotes. Overall, the wide distribution of a digital euro will make the euro area a more competitive space by adding a truly pan-EU means of payment.

To ensure a harmonised user experience, this model will be framed within a digital euro scheme for the distribution of a digital euro, which is currently under development with all market stakeholders involved. The creation of such a scheme needs to set technical rules, standards and procedures that will ensure that, same as banknotes today, citizens can pay with a digital euro independently of the providing intermediary of both the payer and the payee throughout the entire euro area.

In conclusion, the digital euro represents taking European integration a step forward by increasing Europe's strategic autonomy and monetary sovereignty. While the use of cash as a means of payment is declining in Europe, a digital euro would work as an effective option to serve as a monetary anchor in the digital era. In this regard, decisions taken by European legislators will be key in shaping the next steps in the evolution of the digital euro.

The ongoing investigation phase will conclude in autumn 2023 when the ECB Governing Council will decide whether to move to a next phase. Such a decision will be independent from issuance, which will be decided only at a later stage in the process.

BURKHARD BALZ

Member of the Executive Board - Deutsche Bundesbank

The digital euro - same but different

The future issuance of a digital euro is currently under investigation in the Eurosystem. Such a digital euro would be for use by private end users and companies, i.e. as a retail CBDC. It should be free of charge for citizens and widely accepted in payment transactions throughout the euro area.

Up to now, central banks have been offering a similar but analogue product: cash. Basic features and benefits of cash should also apply to a digital euro. With the digital euro, however, the role of the central bank will not end with the printing, issuance and withdrawal of the (digital) banknotes, as it does with cash. Nor can a digital euro change hands without a technical device such as an app or card. Due to its digital form and the infrastructures needed for processing payments, a more complex business model is required than for cash. While the Eurosystem has a more important role than before, private intermediaries will form an integral part of the overall ecosystem. The digital euro could create new space for competition in payments – and at the same time offering new business opportunities for market participants.

Like cash, the digital euro as means of payment could be considered a public good that will not be handed out directly to the end user by central banks, but distributed through intermediaries. After all, the Eurosystem does not operate its own ATMs for cash either. The involvement of intermediaries in getting the digital euro into circulation ought to be in the interests of both central banks and private solution providers. The Eurosystem will focus on its core tasks and avoid extending its footprint in the ecosystem too much. For efficiency reasons, it will be the private sector – already at the interface with end users – that runs distribution. For intermediaries, there may be benefits to retaining the key point of contact with end consumers who want to make payments, serving them and generating revenue from a stable client relationship.

The latter is important, of course, because without economic incentives intermediaries will not be eager to offer attractive services. They should therefore not consider the provision of digital euro services as a sort of obligation, but should explore the economic potential by developing and competing for creative solutions. However, the Eurosystem had made clear that, like cash, the digital euro, at least with regard to the basic functionalities, should be offered free of charge. This implies that intermediaries will not be allowed to charge private users for services like providing access to digital euro, apps, or for transferring the digital euro to other holders. Nevertheless, income should also be generated from simple payments by end customers, not just via more abstract benefits in terms of the banks' overall range of services, i.e. customer loyalty, cross-selling and the like.

For all participating businesses, there are good economic reasons to bet on the digital euro.

Thus, as it is common practice in payments today, the (commercial) receiving side would have to pay fees for incoming payments and these fees will be distributed between the involved parties. Additional value-added services around payments will of course also be possible.

Now, where is the incentive for the receiving side if it is supposed to pay fees and so partly finance the system? For merchants, this is not an altogether unusual situation; they already pay service providers for processing cash or non-cash payments. However, the digital euro is expected an attractive alternative to other non-cash payment services. Stronger competition on merchant fees is expected to emerge, both for payments in digital euro and indirectly for other means of payment.

Similar to cash, it seems straightforward that the Eurosystem would bear its own costs, balancing the overall cost in the entire ecosystem. The Eurosystem will be responsible for the settlement of payments in digital euro and also for managing the digital euro scheme. It could be expected that fees would not be charged for either service, given the currency's status as a public good. The Eurosystem is confident that the digital euro will see uptake and that favourable conditions and new services will be created for merchants by the industry.

Thus, for all participating businesses, merchants and payment providers alike, there would be good economic reasons to look forward to a digital euro, even for plain vanilla payment services, and regardless of additional value added services the industry might develop. Of course, not everything will stay the same with the digital euro – nor should it. New players and incumbents with a purely domestic focus today are invited to compete for end customers. They could quickly gain scale through the European reach of the project. Competition could become stronger and broader.

All participants in the digital euro ecosystem should internalise this outlook and start working on convincing solutions for customers, whether for merchants or for private users. It would be wise to move early and to get ahead of the game.

TIM HERMANS

Executive Director - National Bank of Belgium

Towards the digital euro: our European digital public money

The ECB and the other central banks of the Eurosystem are currently conducting the investigation phase for the potential issuance of a digital euro. This phase, launched in autumn 2021 for a period of two years, aims to seek consensus on technical issues and to study the implications of issuing a digital currency on payment infrastructures, financial stability, and financial inclusion.

Simultaneously, a regular dialogue on a digital euro has been established between the Eurosystem and all market participants (See "Digital euro Project governance and stakeholders (europa.eu)", ECB, 2022), including payment service providers, consumer representatives and merchants through the Market Advisory Group or the Euro Retail Payments Board at European level and the National Retail Payments Committee at the Belgian level. The work carried out by the Eurosystem, coupled with the lessons learned from the consultations, has thus allowed progress to be made in the design of a potential digital euro.

Among the decisions taken so far, the "transfer mechanism", i.e., the procedure by which transactions and their validation are carried out, is a key building block. As such, the Eurosystem has approved the further exploration of an "online third-party validated solution" and an "offline peer-to- peer validated solution". In addition, it was decided that transactions would be settled at the Eurosystem level for online transactions and at the local storage device level for offline transactions. Transaction, liquidity, and user management tasks are to be carried out by supervised intermediaries (payment service providers), who would be the direct contact entities for private individuals, merchants, and companies seeking to handle a digital euro.

When it comes to privacy, the Eurosystem will further explore (i) selective confidentiality for low-value online payments and (ii) an offline functionality which ensures that the users' balances and transaction data remain private. Further work is still needed to explore how both options could be activated, either under the current regulatory AML/CFT framework or under a new tailored regime.

The Eurosystem is conducting the investigation phase for the potential issuance of a digital euro.

Lastly, quantitative limits on holdings and remuneration-based tools were discussed, so as to prevent the rise of a structural substitution of commercial bank deposits, which could have an adverse impact on monetary policy, financial stability and credit flow within the real economy. Moreover, in order to prevent the potential quantitative limit on assets from becoming a transaction limit, the Governing Council agreed on the possibility of using the so-called "waterfall" and "reverse waterfall" functionalities, hence ensuring that end-users have the possibility of making/receiving a payment beyond the quantitative limit, using the linked commercial bank money account as a source/recipient.

On top of the above-described potential building-blocks of the digital euro project, in-depth work is also taking place in relation to the collaboration with selected market players for the construction and design of several user interface prototypes (front end infrastructure) according to the wide range of use cases, e.g., peer-to-peer online transactions (CaixaBank), peer-to-peer offline transactions (Worldline), e-commerce transactions (Amazon), point-of-sale payments in physical shops (EPI & Nexi). The user interface prototype development exercise serves as a learning exercise. There are no plans to re-use the prototypes in later phases of the digital euro project.

In parallel to this, the Eurosystem has launched a market research exercise to gather feedback from relevant stakeholders and to obtain non-binding information on potential technical solutions, their possible costs and related planning considerations. This information will help the Eurosystem to gain a better understanding of the market's knowledge and experience of solutions and technologies suitable for the potential implementation of a digital euro. The Eurosystem aims to entrust the development of the various components of a digital euro either to the market, to the ECB or to the Eurosystem national central banks for in-house development, considering, inter alia, the responses to the market survey.

Finally, the Eurosystem will decide in autumn 2023 whether to proceed to the experimentation and preparation phase. Should it decide to do so, this subsequent phase is expected to last approximately three years and aims to develop and implement the technical solutions and commercial arrangements needed to deliver the digital euro. In the meantime, the European Commission is working on creating the legislative basis for a digital euro.

PIERO CIPOLLONE
Deputy Governor - Banca d'Italia

Retail CBDC as a safeguard against bank runs

Introduction
When retail CBDC was first proposed, many warned against it because it makes bank runs 'just a click away'. Then the Silicon Valley Bank and UBS collapse happened, which made it clear that bank runs are already a reality even without a CBDC. With electronic payments people do not need to line outside a bank for a bank run to occur anymore. All they have to do is connect to a bank account and they will wire money elsewhere in seconds.

Against this backdrop, I would argue that CBDC, if a bank run does occur, can make things better. Indeed, a CBDC would actually help to mitigate the potential trade-off that a Central Bank might face between financial stability, which could be jeopardized if no liquidity is provided to the failing bank, and control of monetary aggregates, which might be endangered by the additional influx of Central Bank money.

A toy economy
To make my point, I use a toy model to compare the consequences of a bank run with and without CBDC.

Here is my toy model. There is a Central Bank (CB), two commercial banks, Bank A (CBA) and Bank B (CBB), and a private sector (PS) that includes all households and firms. There is no government, and commercial bank money is the only means of retail payment available. Banks hold reserves for their deposits to the tune of 10%. The CB has a bond worth 20 issued by the PS as assets and CBA and CBB reserves (10 each) as liabilities.

CBA and CBB are identical. Each has loans to the private sector worth 90 as assets and reserves held at the CB worth 10; they have deposits worth 100 as liabilities.

The PS has assets worth 200 (aggregated deposits) and liabilities worth 20 in bonds (bought by the CB) and 180 in loans from commercial banks.

CBDC does not cause bank runs; it mitigates the trade-off faced by a CB when a bank run occurs.

The monetary base (M0) is 20; deposits are 200; M1 is 220. Banks do not hold spare reserves at the CB; thus the maximum amount of M1 is equal to the actual one.

A bank run when no CBDC is available
Assume a bank run occurs at CBA. Because there is no CBDC, the PS has no place to hide but in CBB. Thus the PS shifts its deposits from CBA to CBB, which in turn parks them at the CB. At this stage, Bank A is solvent but illiquid; obeying the Bagehot rule, the CB steps in with Emergency Liquidity Assistance (ELA), thereby preventing CBA from failing. The new state of the economy is:

Figure 1: Status of the economy after ELA (no CBDC is available)

CB	
A	L
20 A	~~20 R~~
90 ELA	110 R

CBA	
A	L
90 L	~~100 D~~
~~10 R~~	90 ELA

CBB	
A	L
90 L	100 D
10 R	
100 R	100 D

PS	
A	L
200 D	20 A
	180 L

In this equilibrium M0 is 110. Total deposits are 200; M1 is therefore 310, larger than before the bank run. It is important to notice that CBB has excess reserves worth 90; thus the maximum amount of M1 is 1210 (110+110/0.1), much larger than the actual amount and than the pre-run amount. In order to preserve financial stability, the CB has to expand its balance sheet, thereby increasing the actual and potential amount of money in the economy.

A bank run when CBDC is available.
Now let us assume that CBDC is available. When a bank run occurs, the PS could park its deposits in CBDC rather than at CBB (I assume it does so since CBDC is a risk-free asset). As in the previous case, the CB steps in to provide ELA to CBA, which is illiquid but not insolvent, thereby preventing it from going bankrupt. The status of the economy is now:

Figure 2: Status of the economy after ELA (CBDC is available)

CB	
A	L
20 A	~~20 R~~
90 ELA	10 R
	100 CBDC

CBA	
A	L
90 L	~~100 D~~
~~10 R~~	90 ELA

CBB	
A	L
90 L	100 D
10 R	

PS	
A	L
~~200 D~~	20 A
100 D	180 L
100 CBDC	

The fact that the PS uses CBDC to park its funds implies that the amount of deposits in the banking sector declines and that there are no reserves in excess to be used to expand deposits and lending.

In this new equilibrium, M0 is still 110 (assuming CBDC is the monetary basis). Total deposits are 100 and M1 is therefore 210. The provision of liquidity to the illiquid bank does not imply an expansion of the money in the economy. Thus the existence of CBDC allows the CB to achieve both financial stability (CBA) and price stability (M1 does not increase, in fact it actually declines). This mitigation effect is even more evident when one looks at the maximum amount of M1 that can be created. In our example, the M0 would still be at 110 and the maximum amount of deposits would stay at 100, so that the maximum amount of M1 is still 210, much less than in the case without CBDC (1210).

Conclusions
This paper suggests that CBDC does not cause bank runs; it actually helps when a bank run occurs. Its existence mitigates the potential trade-off faced by the CB when dealing with a bank run: provide liquidity and thereby risking to lose control of money supply, or let the bank fail and put financial stability at risk

In more practical terms, this exercise suggests that limits on CBDC holdings, while protecting financial stability in normal times, might jeopardize it when a bank run occurs. Thus one could even consider removing them in specific situations such as a bank run.

CHARLOTTE HOGG

Executive Vice President and Chief Executive Officer - Visa Europe

Protecting consumers is key to digital euro project

The digital euro project holds great opportunity for Europe, and it can spur payment innovation and meet its intended public policy objectives—preserving the role of public money while addressing declining use of cash payments. Implementing a retail central bank digital currency (CBDC) is an immensely complex task and requires cooperation and partnership across the entire payment ecosystem.

A key part of this task is understanding the anticipated role of existing payment service providers. We see the role of payment networks, such as Visa, very clearly: we support the broader policy objectives of the digital euro and will extend the same protections and benefits that consumers currently enjoy to the digital euro.

Designing a system that significantly alters the payment landscape while mitigating financial system risk is a delicate dance, but achievable if certain principles are followed. We find the G7 Principles for Retail CBDCs provide a good guide for policymakers, particularly their focus on competition, resilience, cybersecurity, and privacy.

Fostering competition is the most fundamental principle for the project and for consumers: robust competition pushes service providers to bring their best capabilities and drive innovation. The best way to encourage competition for the Digital Euro is to leverage the existing and widely used acceptance infrastructure for digital payments. Further, by creating an open platform built on existing acceptance infrastructure, policymakers can tap into the already very competitive, innovative, and secure payment system.

Policymakers must also create a regulatory framework that ensures a level playing field for the payment ecosystem, both between providers (banks/fintechs) and currencies (commercial bank money/digital currencies). Regulations for the digital euro ecosystem should not sit separate from current rules governing the payment ecosystem: current rules and expectations should be extended to the digital euro. This includes considerations for licensing, oversight, pricing, and consumer choice. Ultimately, when the rules are fair and competition is healthy, consumers benefit the most.

Operational resilience and cybersecurity are also fundamental to the project and should be top of mind for every design consideration. A diverse payment system is a resilient payment system: having many providers with competing services creates natural redundancies and fail-safes and at the same time benefits consumers. This includes important value-added services such as enhanced risk analytics, which already serve a critical role in safeguarding consumers today.

CBDC design should protect consumers and through competition, resilience, cybersecurity and privacy.

Further, payment security requires significant, ongoing investment in public and private infrastructure. Initiatives to provide payment services for free or on a cost-recovery basis may put future innovation and security at risk. We believe that no service should be expected to be given at or below cost, including those provided by the Eurosystem. Integrating the digital euro into the existing payments regulatory framework will not only contribute to the overall success of the project but will also ensure the coexistence of central bank money and commercial bank money. As ECB Executive Board member Mr. Fabio Panetta stated, the digital euro by design should not "crowd out existing private financial instruments."[1]

Privacy is also critical for both protecting consumers and maintaining trust in the payment system. Because the digital euro is intended to compliment and not replace cash, consumers will expect some of the same anonymity that cash holds. Of course, anonymity must be balanced with financial integrity considerations, but by default consumer data should be anonymized whenever possible.

Looking at additional ways to protect consumers, the digital euro should provide a clear framework for dispute resolution. Dispute resolution is integral to the current payment system and a key reason the success of digital payments. Consumers fundamentally expect that digital payments come with certain protections, and they will have these expectations for the digital euro.

Of course, dispute resolution is complex and like payment infrastructure requires ongoing investment. Policymakers have an important role to play in defining scheme rules but should ultimately leave the task of dispute resolution to the private sector, as providers will have clear market incentives to handle disputes efficiently and in the best interest of their customers.

Policymakers have a unique opportunity to meet policy objectives and foster innovation. Ultimately, we see the changing role of payment networks in the digital euro project as another important step forward in the ever-evolving payment system. We intend to work closely with the entire ecosystem to ensure consumers are as protected making purchases using the digital euro as they are making payments today.

[1] Fabio Panetta, "Bringing European payments to the next stage: a public-private endeavour," 16 June 2022..

SANTIAGO FERNANDEZ DE LIS

Head of Regulation - Banco Bilbao Vizcaya Argentaria (BBVA)

A digital euro: leveraging synergies with instant payments

Central banks around the world are exploring the possible issuance of retail CBDCs, arguing a number of different reasons, such as a response to the threat from global stablecoins, preserving access to central bank money and the monetary anchor in a future cashless society, promoting financial inclusion and innovation in payments, with the background of the competition between central banks in CBDC issuance.

It makes sense for Europe to be prepared for the possible issuance of a digital euro: a decision that would be taken in due course and taking into account all the relevant factors. Nonetheless, one reason seems to be gaining particular weight in Europe as a driver for a retail CBDC: the current role of foreign players in the EU retail payments market and the lack of an independent pan-european payment solution. This would explain the focus of the digital euro project on more conventional use cases — peer-to-peer, in-store, e-commerce and government payments — rather than on more innovative use cases, such as DLT-based programmable payments for the digital economy, which are the target of some global stablecoin initiatives.

It is certainly true that a digital euro could be the foundation of a pan-european payment solution that is independent from foreign providers and contributes to the strategic autonomy of Europe, a policy objective that has gained importance in the current geopolitical context. However, a digital euro is not the only way to achieve that goal: solutions based on instant payments can also cover the same use cases as a digital euro and do so across the EU.

Indeed, some Member States already have very successful instant payment solutions, like Bizum in Spain, which has more than 23 million active users and is now expanding into in-store payments. Moreover, the future regulation on instant payments, which is now being negotiated in the Parliament and the Council, aims to accelerate the rollout of instant payments and contribute to Europe's strategic autonomy.

Instant payments would make the deployment of the digital euro faster and more cost-efficient.

Therefore, synergies between the digital euro and instant payments should be taken into account. The digital euro could leverage on the infrastructures and solutions already in place or being developed for instant payments — rather than building new ones from scratch —, and focus its efforts on where there is currently a gap: enabling the interconnection and interoperability between domestic instant payment solutions. This would facilitate the deployment of the digital euro in a more cost-efficient way and allow it to gain traction more quickly. Furthermore, it would enable pan-european payments in either digital euros or commercial bank money, increasing consumer choice and overcoming the existing fragmentation in instant payment solutions.

Banks would play a key role in such an ecosystem, as distributors of the digital euro — in charge of customer onboarding, KYC, management of accounts/wallets, etc. — and providers of all the associated payment services and tasks. This involves significant costs for which intermediaries will need to be compensated to make the whole environment sustainable.

The compensation model should be aligned with that of existing payment services, where there is intense competition in the provision of acquiring services to merchants, as well as incentives for the issuing side of the market, subject to appropriate competition safeguards such as in the Interchange Fee Regulation. Incentives for issuers are essential in any payments market to build network efforts, but will be even more important in the distribution of the digital euro if it is aimed to be free for basic use by citizens.

Costs are of course a key feature for consumers, but not the only one: privacy stood out in an ECB public consultation as the most important feature of a digital euro for citizens, and will likely be a subject of intense debate looking forward. Therefore, it is worth noting that existing payment solutions already provide very high privacy standards, ensured by GDPR, while complying at the same time with AML/CFT rules. This should also be the basis for the design of the digital euro: with privacy at the core but without compromising AML and fraud prevention efforts.

In addition, access to payments data allows banks to offer greater personalization and new value-added services, such as financial advice or sustainability-related recommendations.

Therefore, consumers should always be able to decide whether their data from digital euro transactions can be used for additional purposes, as it is currently the case with other other payment solutions. This is consistent with data privacy principles, by providing individuals with control over their data, as well as with the EU objective of promoting data-driven innovation in Europe.

PSD2 REVIEW PRIORITIES

ONDŘEJ KOVAŘÍK

MEP, Committee on Economic and Monetary Affairs - European Parliament

PSD II - Moving from Open Banking to Open Finance

Since PSD II has come into full application we've witnessed some dramatic shifts in the payment landscape in Europe. In many ways it has already achieved its principle objective of opening up competition in the payments sphere.

Through PSD II we see more innovative players entering the market, particularly making use of the ability to access financial data through Open Banking. This has allowed particularly fintechs to thrive, and disruptive companies to challenge incumbents in the financial services space. This is overall a net positive effect for consumers, who have more choice.

In turn, we have seen the need for traditional banks to adjust their models to try to meet their customers' needs, and higher expectations brought about through the increasingly digital payments landscape.

At the same time, there are discrepancies across the EU when it comes to the implementation and enforcement of the PSD II provisions. In my view this is something that legislators and regulators need to take into account when tackling the review of the Directive and the move from Open Banking to Open Finance.

Some member states see thriving payment sectors, and we've also seen this in the UK, which has implemented PSD II and indeed was an integral part of the forming of the Directive before it left the EU. We can take lessons from the UK in a number of respects as we aim to reduce fragmentation in the payments markets. We want to ensure a better flow of payments, more cross-border opportunities for businesses and consumers and also further increase competition in the payments space.

As the evolution of the payments space continues, the question of consumer trust in financial institutions, whether traditional or innovative, is of critical importance if we want to have a successful transition from Open Banking to Open Finance. We need to ensure that consumers feel secure in giving their permission for their data to be shared, and specifically what data can be shared, between payment service providers. PSD II has been positive in this respect, ensuring that consumers are in control of their financial data and who it can be shared with.

We need to harness the opportunities of digitalisation in the payments sector.

Strong Customer Authentication (SCA) has been another positive step overall. Although at times cumbersome for both businesses and consumers, consumers are becoming more and more aware that they have more security particularly when it comes to online payments and online banking. It's a good base going forward. At the same time, issues need to be addressed in this respect. For example, SCA is designed to make fraud more difficult. However, while it has achieved that in reducing fraud that was prolific at the time the Directive was agreed, new types of fraud are coming onto the scene, and any evolution of the legislation needs to address new fraud that we see, particularly in the digital arena.

The concept of Open finance broadens the scope of Open Banking. Clearly it's about what data a consumer chooses to share, and if we get it right we have the opportunity to adopt principles-based, future-proof legislation, which is able to adapt to the evolving financial services and payments landscape.

If consumers feel able to trust that their data is secure, and that when they give permission to access it financial companies demonstrate that they can be trusted to use it in the consumers' best interest, these savings could be better channelled. This also means consumers believing that the trend of digitalisation is an opportunity rather than a threat.

In this respect, financial literacy, particularly as regards digital finance but also in traditional finance, is important not just to channel savings to investments, but also to help consumers across demographic and socio economic status in Europe better understand opportunities when it comes to payments. Younger generations are more likely to instinctively pay online, but we cannot afford to leave behind those from the older demographics who may mistrust increasing digitalisation. We need to ensure that member states and financial institutions have incentives to reach out to help them understand digitalisation in the sector, and also how they can safely use payment services online without fear of fraud or data breaches as concerns their personal finances.

I would conclude by pointing out that as co-legislators we have a tough task ahead of us to bring all of these new elements together as we work towards reviewing the PSD. We need to reduce fragmentation, build a true single market in payments, thereby reducing costs for consumers.

Furthermore, we need to harness the opportunities of digitalisation in the payments sector and ensure that this is done without leading to more social exclusion. It will be a tough job, but I believe if we can stick to focusing on principles and objectives rather than prescriptive legislation, it's a job that we can successfully complete.

NILS FRIBERG
Deputy Director -
Ministry of Finance, Sweden

Swedish experiences from PSD2 – What has been the main benefits?

The payment market in Sweden is highly digitalized. Swedes prefer to pay electronically and often shop online. As a result, the use of cash is declining and regulation on electronic payments has thus come to play an ever more important role for the proper functioning of the Swedish payment landscape.

The aim of the Revised Payment Service Directive (PSD2) was to adapt the legal framework for electronic payments in the EU to the constant development on the payments market. The main objectives were to create a level playing field for all payment service providers hereby increasing competition, consumer protection and market integration within the union.

Among many important improvements of the directive, two new categories of rules stands out: The regulation of Third-Party Payment Services and its Providers and the introduction of Strong Customer Authentication.

It can be argued that the former category established a new mindset in the market. The banks that control the underlying infrastructure of the market for electronic payments (the payments accounts) were obliged to open up for Third-Party Providers to use that infrastructure in creating new innovative payment solutions. This was in line with the aim of the directive to even out the playing field and create a better competition environment in the payments market.

However, it should be noted that the PSD2 did not create what we call Open Banking, it responded to concern raised by market actors and brought forward a legal framework for services related to payments. In Sweden, Third-Party Payment Services Providers were already established and offered Payment Initiation Services and Account Information Services when the revised directive was enacted. Nonetheless, regulation of such services and its providers was a boost for consumer protection since they had to obtain authorization and were put under supervision. It was probably also a boost for the Third-Party Payment Services Providers themselves that they were regulated, since consumer confidence in their services increased.

We have probably not yet seen the full effect of these regulations and there are still improvements to be made.

Payment Initiation Services (i.e. a method where an actor initiate a payment on behalf of a payer from the payer's bank account) have had many benefits for e-commerce. It is an alternative to card payments, which has been the dominating payment method on these platforms. However, we might not have seen the full potential in these services yet. When payment patterns and the underlying infrastructure changes through an increased uptake of instant payments and the possible introduction of Central Bank Digital Currencies (for example a Swedish E-krona or a Digital Euro) – CBDCs – the environment for these services are likely to change significantly. Since instant payments and CBDCs enables funds to be available immediately at the payee´s account, Payment Initiation Services built on such infrastructure can also be an important payment method at Point of Interaction, contributing to increase competition in payments.

Strong Customer Authentication (SCA), the second category of rules mentioned above, is an authentication method based on the use of two or more elements categorised as knowledge, possession and inherence that are independent. New rules brought forward in the PSD2 requires Payment Services Providers to use this authentication method in all electronic transactions, with some minor exemptions. This was in line with the aim of the legislator to increase consumer protection.

It is safe to say that the introduction of SCA in 2019 has made electronic payments safer and reduced fraud rates. In Sweden credit card fraud rates has declined substantially between 2019 and 2021. Although no definite conclusions can be drawn, it is highly possible that this development mostly is the result of the introduction of the rules on SCA in the directive.

However, simultaneously with the development of innovative payment methods also fraudsters and fraudulent procedures develop. Therefore, regulations and methods for fraud prevention needs constantly to be reviewed, evaluated, and developed. One of the main challenges in fraud prevention today is "social engineering", i.e. techniques aimed at talking a target into revealing specific information or performing a specific action for illegitimate reasons. Today's rules on SCA are not fully up to date with these kinds of frauds. The effectiveness of SCA presume that the account holder does not reveal for example personalised security credentials, while social engineering fraud is based on appealing someone to reveal such information. Therefore, the issue of social engineering needs to be addressed in one way or the other in the next revision of the PSD2.

To conclude, the key features in PSD2 has contributed to bring forward a more even level playing field and increased consumer protection in the EU payments market. However, we have probably not yet seen the full effect of these regulations and there are still improvements to be made to keep up with a developing market.

JUAN ORTI

Country Manager Spain & Head of International Card Services Spain and Benelux - American Express

Making instant payments a success

The European Commission's proposal from October 2022 (Regulation of the European Parliament and of the Council amending Regulations (EU) No 260/2012 and (EU) 2021/1230 as regards instant credit transfers in euro) to make instant payments the new normal has the potential to spur considerable innovation in the way we make payments, by offering faster and more convenient options to consumers and businesses. Imagine, for instance, being able instantly to transfer funds to a friend or a family member or settle bills in a matter of seconds. This is of course happening already in pockets; the Commission's proposal, if adopted, would turbo-charge it.

As a licensed Payments Institution operating in Europe for many decades, American Express strongly supports the European Commission's legislative proposal to make instant payments in euro available to all citizens and businesses in the EU. This initiative has the potential to increase competition in the European payments ecosystem, provide consumers and businesses with more choice in payment options, and stimulate innovation across the industry.

But for instant payments to truly take off, a number of conditions must be met. First, mandatory adherence and rapid roll-out of instant payments must be required among all EU credit institutions. Only if all banks participate in this scheme can Payment Initiation Service Providers (PISPs) start offering account-to-account payment services across the entirety of the EU. This broad participation would be a significant driver of competition in the payments ecosystem across Europe.

Second, direct access for non-banks to the interbank payment system is necessary to boost competition further. Banks act as gatekeepers for access to the system, often posing a barrier for Payment and E-Money Institutions to offer innovative payment solutions to consumers and businesses. This direct access should be facilitated through an amendment to the Settlement Finality Directive, while ensuring that compliance and oversight requirements are not overly burdensome. The UK's example of opening up the interbank system to innovative fintechs has already shown much promise and could be a model for the EU to follow.

Third, we must put in place the strongest possible measures to ensure that fraud is prevented, including through an IBAN verification service that matches the IBAN and the name of the beneficiary of the payment. This will be a key tool in preventing fraud in instant payments, and is likely to more than cover the costs necessary for its setup, when considering the number of fraudulent transfers it would prevent. However, it is essential that the IBAN verification service is standardised across the EU to facilitate usage and that charging consumers for the use of this service is prohibited.

Direct access for non-banks to the interbank payment system is necessary to boost competition.

Fourth, we continue to see issues with IBAN discrimination, which also affects the uptake of instant payments. With payment initiation services, instant payments can often not be initiated to a bank account in a different Member State because some banks' systems are not adapted to allow transfers to or from non-domestic IBANs. To unleash fully the power of cross-border instant payments, it is therefore crucial that the European Commission and national regulators put an end to the discriminatory treatment of IBANs from other EU Member States.

Finally, compliance with international standards is an important factor to consider in the implementation of instant payments. This means ensuring that any new European system follows established guidelines and protocols that are recognised globally, such as the ISO 20022 message format, so that it can easily connect and interact with other countries' payment systems. Mandating compliance with international standards would ensure that instant payments in the EU are interoperable with systems used in other countries, and thus facilitate their use for customers and businesses making cross-border payments.

The European Commission's legislative proposal to make instant payments in euro available to all citizens and businesses in the European Union is a bold move that will bring about much-needed competition, innovation and choice in the payments ecosystem across Europe. It is a timely response to the growing demand for fast, convenient and secure payment solutions in the digital age.

Instant payments in euro will enable consumers and businesses to make and receive payments in real time, 24/7, anywhere in the EU. This will enhance customer experience, strengthen sovereignty and support small and medium-sized businesses.

JOACHIM SCHMALZL
Executive Member of the Board - Deutscher Sparkassen- und Giroverband (DSGV)

Provide the space for innovation in payments

We welcome the fact that PSD2 has created a framework that increases legal certainty for all parties concerned when using third-party providers. The German Savings banks were in an intensive dialogue with third-party service providers during the implementation of the PSD2 interface, both during the tests and later, and are also now working in various initiatives to expand this interface and offer additional services.

We also believe that the added value of information bundling for customers is already very high and is also in demand (already today, more than 265,000 customers use our multibanking function to manage almost 700,000 external bank accounts via our service). We assume that the usage would be even higher if not only account information but also telecommunication data, insurances, shopping baskets of e-commerce shops etc. could be made available.

The foundations laid for opening the customer interface to payment accounts and the experience thus gained offer a valuable basis for developing a future Open Finance Framework: it is in the interest of all financial institutions to protect and utilize their investment in APIs and, where appropriate, allow them to be used for further applications beyond payments. This also goes for the security procedures and solutions established for strong customer authentication. Sometimes we hear calls for a uniform technical standard for the PSD2 interface. We understand the approach, but here we should trust the market, which already has corresponding developments in the pipeline. It is crucial not to hinder market driven initiatives (like the SPAA on European level) to further develop API-business models in a constructive dialogue of all stakeholders.

The PSD2-review should take a fairer approach, with a fair distribution of value and risk and that allows all market players to monetise services. This is a fundamental prerequisite for the success of future legislation in that regard. In this context, the role of BigTechs in particular must be kept in mind. The promotion of business models of FinTechs should not accidentally lead to non-European BigTechs gaining access to data and infrastructure of European banks free of charge and thus expanding a competitive advantage. The recently published study on the application and impact of PSD2 offers some interesting numbers on this and shows the described imbalance in the effect of PSD2. From 2018 onwards, there was a significant increase of licensed BigTechs in the EU payments market whereas the number of new FinTechs entering the market, that were not already established before PSD2 fell from 2018 onwards.

The PSD2-review should take a fairer approach that allows all market players to monetise services.

The recent proposal of the European Commission for the Data Act under which data holders are entitled to a reasonable compensation for making their data available to third parties can be an example. This fundamental principle should equally apply to account servicing payment services providers (ASPSPs, banks) when making their data available to third party providers (TPPs). Placing a further one-sided regulatory burden on banks while favouring certain individual business models will not foster competition or strengthen European sovereignty in the digital sphere.

The increased linking of payment services with other digital services and functions offers numerous opportunities – but also goes hand in hand with greater complexity and interaction with other legal requirements. Finding a sensible form of interplay between payment law and other laws, some of which are still in the drafting phase, is becoming more and more challenging. Greater focus on the principle of "same services, same risks, same rules" could prove helpful here.

With respect to the EDPB Guidelines, we would welcome clarification on the interpretation of the data minimisation obligation to the effect that banks comply with the data minimisation principle when providing access to accounts in the same manner as if the PSU directly requested access to its account. We remain concerned that the different requirements for data provision under PSD2 and the GDPR lead to uncertainty for all parties involved.

Additional legal requirements aimed at promoting individual business models or products will set the wrong incentives, tie up much-needed resources and undermine the actual goal – namely to encourage offers that create added value for as many payment service users as possible while enabling freedom of choice and an equitable allocation of costs. Legislation governing payments should instead set a product-agnostic framework that offers civil law and regulatory certainty, without bias, for a variety of payment solutions.

The review of PSD2 should take account of this, which, given the payment services covered, is more likely to succeed by stabilising and refining the current rules than by substantially expanding them.

CROSS-BORDER PAYMENTS AND GLOBAL INFRASTRUCTURES

JULIAN REISCHLE

Director General Payments and Settlement Systems - Deutsche Bundesbank

Working together for more efficient cross-border payments

Three years have passed since work on the G20 roadmap for enhancing cross-border payments began. After taking stock of the current cross-border payments landscape in the first phase of the work and then identifying key areas for improvement in the second, the time has now come to take up work in the key areas that have the best chance of significantly improving payments across borders. During this current phase, the involvement of all market players and the public sector is necessary to ensure the best possible outcome for all stakeholders.

First, the public sector has to work on regulatory harmonisation, including harmonisation of oversight and regulatory frameworks. With a harmonised regulatory landscape, straight-through processing of cross-border payments could be made substantially easier. In the end this could significantly improve speed and lower costs. However, it is important to promote an efficient legal, regulatory and supervisory environment for cross-border payments without compromising their secure end-to-end processing.

Second, operators should improve their payment system services – especially regarding opening hours and access – and aim to interlink with other payment systems. Thanks to the emergence of fast payments, 24/7/365 payments are becoming the norm, so adjustments to the opening hours of RTGS systems may be necessary. Furthermore, the extension of operating hours could help to increase or create overlap between settlement systems, therefore helping to improve the settlement speed of payments transmitted across multiple time zones.

In order to improve cross-border payments, market players and the public sector must act together.

Regarding the interlinking of payment systems – especially for faster payment systems, there are a couple of interesting projects on the way. For example, Project Nexus aims to interlink fast payment systems to shorten transaction chains, therefore lowering costs and increasing the speed of cross-border payments. In the future, interlinking CBDCs could further enhance the efficiency of cross-border payments. Projects like "Icebreaker" (for retail CBDCs) and "Jura" (for wholesale CBDC) could provide a window into how the future may look. However, it must be ensured that risks (e.g. contagion risks or operational risks due to the use of new technology) are properly mitigated before further increasing the integration of the global payment landscape.

Third, payment messages should be harmonised and exchanging data across borders should be made easier. More and more countries are switching to the ISO 20022 standard (with the Eurosystem adopting the standard for its T2 platform on 20 March this year); however, there are still different national and regional implementations and market practices in place. These differences as well as different data protection laws are inhibiting data exchange across borders, which in turn could hamper anti-money laundering procedures and customer due diligence checks.

Even harmonised payment areas like the Single Euro Payments Area could profit from the G20 work on the roadmap. While SEPA is already deeply integrated and cross-border payments in euro within Europe are for the most part very efficient, consumers and businesses in SEPA could benefit from more efficient payment channels to the rest of the world. Furthermore, the work on the roadmap offers the opportunity to improve existing payment infrastructures, for example by adapting to standardised APIs as laid out by the work on Building Block 14 of the roadmap.

In order to make the vision of the G20 programme work and to achieve its targets, involvement of all stakeholders is necessary, thus ensuring that implemented improvements cover a wide range of interests and market and consumer needs are met. Regulators have to work on harmonising regulation, central banks and other infrastructure providers may have to improve and interlink their systems and banks and non-banks have to actively participate in and shape the discussions – in addition to adjusting their internal systems to possible changes. This is why the G20 seeks to offer a platform for a multitude of discussions during the current stage of the roadmap. For example, the FSB's Payments Summit offers a stage for high-level discussions regarding cross-border payments, while technical experts can hammer out the details in groups like the service level task force (which seeks to enable interoperability by developing a common understanding about service level agreements) and the expert group on the harmonisation of the ISO 20022 standard.

Last but surely not least, it is important to monitor the progress in taking actions with regard to the roadmap. This is carried out via key performance indicators related to the 11 targets for cross-border wholesale, retail and remittance payments. To ensure sufficient data quantity and quality, all stakeholders have to contribute. This way, we can all work together towards a common goal: cheaper, faster and more transparent cross-border payments.

ISABEL
SCHMIDT

Co-Head of Global Payment Products - BNY Mellon

Enhancing cross-border payments – where are we now?

Three years into the G20 Roadmap, the focus is now on moving from exploration to execution. Isabel Schmidt shares her insights on progress and the focus for the future.

Removing long-standing frictions in x-border payments will bring widespread benefits– supporting economic growth, international trade, global development, and financial inclusion. In turn, efforts to unlock faster, cheaper, more transparent, and inclusive x-border payments have become a truly global priority.

To tackle this, the Financial Stability Board (FSB), the Committee on Payments and Market Infrastructure (CPMI) and its partner bodies developed "The Roadmap for Enhancing Cross-Border Payments" to engage actors across the public and private sectors.

With the full backing of G20 Leaders, the first two years of the roadmap focused on assessing the existing landscape and identifying ways to improve it. In October 2022, the FSB published the next phase, focusing on three key themes: 1) payment system interoperability, 2) legal, regulatory, and supervisory frameworks, and 3) data exchange and message standards.

Improving interoperability

Efforts are being made to drive interoperability by interlinking payment market infrastructures, which can help to shorten transaction chains, reduce costs and increase the transparency and speed of payments.

The Immediate Cross-Border Payments (IXB) pilot project, for example, plans to connect real-time payment systems in the US and Europe to facilitate instant x-border payments. Key domestic payment systems – such as SEPA– are also being extended, with the aim of fostering competition and driving innovation.

While such progress is promising, these efforts do raise questions around scalability, as well as technical feasibility. For example, if 20 markets were to be interlinked, as many as 400 point-to-point connections would need to be built – and there is significant complexity and cost constraints associated with that.

One potential way forward is to build hubs that interlink payment systems – either one to many or many to many. The Bank for International Settlements (BIS) is driving progress on this front with Nexus, and it is likely that Swift will play a role going forward.

Collaboration is essential for the roadmap to be a success – and it cannot succeed without the support of both public and private parties.

The first pillar of the roadmap is also focused on supporting the extension of RTGS operating hours. FIs in the US, for example, currently operate on a 22/5 model – with the Federal Reserve Banks set to soon take this one step further by moving to a seven-day accounting cycle. While it won't be without its challenges, extending operating hours in other markets may help to eliminate payment delays, reduce settlement risk and improve liquidity management. The implications go beyond the operations of core payment systems to include areas such as liquidity management and FX markets.

Developing frameworks

There is evolving clarity regarding the legal, regulatory, and supervisory environment for x-border payments – creating uncertainty for payment actors and potential delays.

One example is the sometimes-inconsistent implementation of anti-money laundering (AML) and counter-terrorist financing controls across jurisdictions, which can introduce frictions that hinder efforts to improve x-border payments.

The roadmap is promoting the use of technology for AML/CFT, with a strong emphasis on ensuring data privacy, as well as consistent management of cyber and technology risk to keep the global network safe from bad actors, but progress is highly dependent on active engagement and alignment of policy makers and implementing bodies. Considering geopolitical dynamics, progress could be achieved through the concept of "safe corridors", as suggested by the roadmap.

Harmonised standards

As of March 20, the Swift network went live with a new global messaging standard, ISO20022. While the industry has made significant progress on aligning to a global standard and creating a strong foundation for interoperability, inconsistencies remain. Even within the context of a single set of Usage Guidelines for x-border Payments (CBPR+), ISO20022 is being interpreted and used differently – leading to manual intervention and payment delays. Similarly, while many payment infrastructures are now using the ISO20022 standard framework, the versions are not consistent, and interoperability is a challenge for players that participate in multiple networks.

In support, the CPMI recently released a consultative report on how the adoption and use of ISO20022 for x-border payments can be harmonised.

Down the road(map)

While there is a general sense of optimism at the developments, there is concern about the amount and scale of change. With so many different schemes underway, there is a potential risk of fragmentation – and effort is required to manage this. Collaboration is, therefore, essential for the roadmap to be a success – and it cannot succeed without the support of both public and private parties.

MARC BAYLE DE JESSÉ
Chief Executive Officer - CLS Bank International

Measuring PvP success in addressing FX settlement risk and remaining challenges

Arguably, the most important success factor for the FX market is addressing the risk of loss of principal (or settlement risk) effectively. Payment-versus-payment (PvP) mechanisms like CLSSettlement have supported FX market growth by mitigating this risk for the currencies they settle, while also delivering substantial benefits such as liquidity optimization and operational efficiencies. CLS's robust PvP settlement service has helped enable market growth, and FX turnover has multiplied by a factor of five since CLS went live in 2002.

As a result, CLSSettlement volumes have grown steadily with average daily values settled exceeding USD6.5 trillion in H12022. Much of this growth is from 30,000 indirect participants, including the buy side, that access CLSSettlement through its 70+ members, which comprise the world's largest financial institutions.

Being a critical service provider to the FX market, CLS must be proportionately resilient to its key role as a global financial market infrastructure. CLS has a strong track record of service provision and has continued to invest heavily in cybersecurity, risk management and controls and its underlying technology to ensure it meets the highest levels of operational resilience.

In recent years, policymakers and regulators have renewed their focus on FX settlement risk. Specifically, they are concerned about sectors of the market where PvP is unavailable, particularly in emerging market (EM) currencies. CLS fully supports wider adoption of PvP and applauds the efforts of the Global Foreign Exchange Committee, whose FX Global Code encourages its use, as well as the Financial Stability Board's Cross-Border Payments Roadmap, which has a dedicated building block to further PvP adoption.

To better understand settlement risk, CLS, in collaboration with its members, analysed multiple member banks' trades to determine how they were settled, to provide a good indication of the market's management of settlement risk and the range of mechanisms used to settle FX flows.

The analysis showed that of the FX transactions eligible for CLSSettlement (which comprise 80% of all FX transactions)[1], on average 51% of the traded notional is settled through CLSSettlement, while much of the remainder comprises inter-branch and inter-affiliate trades (35%) or trades where settlement occurs via a single currency cashflow or over accounts within the banks' direct control (together, 8%). This leaves around 6% of trades exposed to settlement risk that could be settled via PvP in CLSSettlement, primarily comprising smaller trades across multiple corporates and funds that do not trade high volume.

Addressing settlement risk effectively has been largely achieved for CLS-eligible currencies.

CLS's findings are complementary to – but not directly comparable to – the BIS Survey, which showed that the share of FX transactions settled without PvP is one fifth of the market (including the 6% mentioned). The BIS Survey scope is wider and includes both CLS-eligible and -ineligible currencies, EM currencies in the main that have seen significantly increased trading volumes in recent years.

The 6% that could be settled via PvP is the target of CLS's efforts to increase adoption of CLSSettlement. Addressing settlement risk beyond CLS-eligible currencies may require an alternative solution. Given its systemic importance, adding new currencies to CLSSettlement is an extended effort that is subject to several requirements, including ongoing support from the central banks on both sides of the currency flow and in some cases changes in the target jurisdiction's laws and regulations.

Given these complexities, CLS is exploring several avenues to expand PvP coverage, including a possible new PvP service for certain currencies. However, geopolitical factors have led CLS to reassess the pace at which this moves forward. For now, CLS is focusing on growing CLSNet, its automated bilateral payment netting calculation service for over 120 currencies.

CLSNet already helps to mitigate operational risk associated with trading EM currencies. It supports netting to reduce the payment obligations exposed to settlement risk while improving operational and liquidity efficiencies. The majority of the interbank transaction flow through CLSNet is in the deliverable EM currencies that pose the most settlement risk for CLS's members. As a result, the flows in CLSNet increased exponentially over the course of 2022 and have continued to increase in 2023.

Successful settlement risk mitigation has been largely achieved for CLS-eligible currencies. But with the growth in EM currency trading, the remaining challenge is how to achieve settlement risk mitigation for currencies ineligible for PvP settlement. For these currencies, until a new PvP solution can be developed, mitigating operational risk, optimizing liquidity and creating operational efficiencies through a centralized, standardized and automated process, like CLSNet, is the industry's preferred approach.

[1] 2022 BIS Triennial Central Bank Survey of FX and OTC derivatives markets (BIS Survey).

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INSTANT PAYMENT ATTRACTIVENESS FOR EU CITIZENS

GIUSEPPE GRANDE
Deputy Head of Market and Payment Systems Oversight - Banca d'Italia

Why instant payments are set to become the new normal

In Europe, instant payments, which allow end-users to transfer money within ten seconds at any time of any day, continue to grow. In February 2023, the average number of transactions in euros conducted daily on the pan-European platform RT1 passed the 2 million mark, which is more than 40 per cent higher than a year earlier. Nevertheless, this form of payment still accounts for a relatively low share of total settled credit transfers. According to the European Payments Council, at the end of 2022, only 14 per cent of direct credit transfers were instant payments.

Two factors are holding back their development: the fragmentation of the market on the supply side and the slow pace of change in people's habits. The different automated clearing houses (ACHs) that have adhered to the SCT Inst scheme are not able to offer full pan-European reachability on their own. Therefore, in line with objectives shared with the European Commission (EC), the ECB's Governing Council has acted to make PSPs reachable even in the absence of a connection between ACHs by requiring all PSPs and ACHs to have an account on the Eurosystem's TIPS instant payments platform (without the obligation for the PSPs to send payments to that account).

The development of a true pan-European market, made possible by the leveraging of the functionalities offered by TIPS, not only enhances the accessibility, safety and cost-efficiency of instant payments, but also paves the way for a reduction in fees, leading consumers and businesses to no longer consider instant payments as a premium service to be used in special circumstances. In this sense, the EC's recent proposal to require PSPs to ensure that the price of instant euro payments does not exceed that of non-instant transfers, and that the provision of transfers is accompanied by the provision of instant payments, is to be welcomed.

Ensuring a level playing field, increasing confidence and building on central bank money.

Leaving fees aside, people may be deterred from accessing instant payments by the perceived riskiness of the instrument. Data from a sample of Italian banks in 2021 show that, in fraud on credit transfers, the share of instant payments was much higher than that of non-instant payments. However, it is reassuring that a very large share of these frauds (92%) has been blocked or the funds recovered, thanks to a protocol between banks defined by the Italian Banking Association.

In this vein the EC has recently proposed introducing an obligation for service providers to verify, at the user's request, the correspondence between the account number (the IBAN code) and the name of the beneficiary provided by the originator. Awareness-raising campaigns for a safer use of digital channels and tools, as experienced in Italy thanks to public-private cooperation, provide another valuable means to prevent fraud.

While obstacles to a level playing field need to be overcome, other factors can stimulate the development of instant payments. Public authorities can foster them in their role as regulators, service providers and catalysts for change.

The first factor is technological progress. Mobile phones have become the main tool for using digital services. Sending and receiving instant payments can be greatly enhanced by functions such as mobile proxy look-up services, request-to-pay schemes and near field communication technologies.

Second, although it makes little sense to talk about 'use cases', because instant payments can be used in any circumstance and for any type of retail payment, there are some areas where their growth potential is greatest. One of these is payments at the point of interaction (virtual or physical). In Europe, the development of safe and efficient instant payments from customers to merchants has considerable room for growth as an alternative to cards and international circuits. Cross-border payments are another very promising field of application.

Fast payment systems (FPSs) are particularly suitable for interconnecting different currency areas, as they (i) operate 24/7, 365 days a year; (ii) process transactions in a matter of seconds; and (iii) normally use international messaging standards. This objective is being pursued by initiatives from both the private sector (e.g. the IXB pilot by EBA Clearing, TCH and SWIFT) and the public sector (e.g. TIPS's participation in Nexus, the BIS project to link FPSs with multiple currencies). Another example of synergies is a digital euro, which is meant to complement physical cash without replacing it.

A digital euro and instant payments would become complementary forms of digital payments, drawing on the same pool of people's skills and, potentially, of technologies available on the market.

Finally, instant payments are closely linked to financial innovation, and, just to give an example, are an alternative to crypto services in providing payment solutions.

We still have a long way to go to make instant payments the 'new normal', but we have made considerable progress in that direction and we have our common objectives clearly in sight.

TIM
HERMANS
Executive Director -
National Bank of Belgium

Instant payments as a new standard

In the payments landscape, instant payments (IPs) stand out by allowing funds to be transferred 24/7/365 and in less than 10 seconds. In this regard, IPs constitute a significant breakthrough for consumers, businesses and administrations as they can access their funds without delay. This is a clear advantage in a context of rising interest rates where cash flow management is a key concern. IPs also create great opportunities for payment service providers (PSPs) and fintechs to develop new payment solutions.

Use cases of IPs are much broader compared to traditional credit transfers. IPs should therefore be considered, not only as improved credit transfers, but as an additional payment method for many business cases. In the person-to-person sphere, IPs are used to split a bill, to pay second-hand items or to make a transfer to a relative facing an urgent and unexpected need of money. In the business-to-business sphere, IPs are used, among other use cases, for intercompany transfers driven by short-term treasury needs or for urgent correction of a payment error.

When it comes to the person-to-business sphere, notably payments at the point of interaction (PoI), the immediacy of the transactions is particularly appropriate to offer convenient payment solutions. Both at physical points of sale and in e-commerce, the deployment of IPs offers alternatives to card schemes and thereby reduces the high level of concentration currently affecting this market, especially for cross-border payments.

The offer of new payment services based on IPs is driven by private players. These, whether established or new entrants to the payments market, have the opportunity to challenge the dominant position of incumbent players who enjoy a lack of competition in some payment areas, mainly cross-border payment at the PoI. The payments industry is very innovative, IPs are logically central to its future.

In the Single Euro Payments Area (SEPA), the deployment of IPs has been made possible by the entering in effect, in November 2017, of the SEPA Instant Credit Transfer (SCT Inst) scheme of the EPC. Pan-European reachability has been achieved thanks to the creation of infrastructures such as TARGET Instant Payment Settlement (TIPS) developed by the Eurosystem and RT1 developed by EBA Clearing.

The payments industry is very innovative, IPs are logically central to its future.

In Q4 2022, around 61% of European PSPs joined the SCT Inst scheme and almost 14% of credit transfers are being processed instantly. It is a great step forward, but insufficient for the full materialisation of the benefits of IPs for the market. This is because a significant network effect applies to the payments market. As a matter of fact, the ability to successfully execute one type of payment does not only rely on the payer and its PSP but also on the ability of the payee's PSP to receive the payment in question.

When analysing the barriers to the widespread adoption of IPs in Europe, the fact that the level of adherence to the SCT Inst scheme have plateaued over the past four years suggests that many PSPs do not have sufficient incentive to adhere to the scheme. The insufficient level of adherence restrains the development of IP-based payment solutions, whereas the limited number of IP-based payment solutions does not incentivize PSPs to adhere. And when PSPs adhere, they often charge a premium service rate to IP users, encouraging them to turn to other payment methods. Fear of fraud and errors may also, to a lesser extent, discourage users from sending IPs. And when users initiate an IP, the rejection rate is higher than for other payment means, due to the technical challenges posed, notably the limited time for processing, particularly in the application of AML/CFT procedures.

Overcoming obstacles for faster uptake of IPs is a political priority in Europe. In October 2022, the European Commission published a proposal to amend the SEPA Regulation with the aim of fostering the adoption of IPs. The proposal provides that all PSPs that offer regular credit transfers in the SEPA must also offer IPs without surcharges. It also introduces the obligation for PSPs to offer to payers a concordance check between the IBAN and the name of the payee prior to the placement of the payment order. The proposal further introduces prescription regarding AML/CFT procedures by requiring PSPs to perform a regular pre-screening of their clients against EU sanctions lists. These checks made prior to the introduction of a payment order limit the check required during the 10-seconds limit of IPs and should consequently lower the rejection rate. The co-legislators are currently analysing and discussing the Commission's proposal.

Instant payments as the new normal should also be applicable to the digital euro, should it be created. Instant payments rails might thus provide technical convergences on which the digital euro might leverage, with a key difference though, IPs are currently settled in commercial bank money, while payments in digital euro would be settled in central bank money.

MARIANNE DEMARCHI
Chief Executive Europe - SWIFT

Enabling a better cross-border payments experience for all

The financial services landscape looks a little different to how it used to. New firms, business models and job titles now exist, evolving as fast as the markets themselves, fuelling innovation and leaving a whole host of new opportunities in their wake.

These changes have affected individual behaviour too. People are no longer limited to living in the country they work in, but instead, can run their own business from anywhere in the world. New ways of working have been driven by advances in technology, changing regulation and accelerated by the pandemic – affecting the global flow of money and the types of financial services people need. In light of these changes, international consumer and SME payment volumes have skyrocketed.

A growing market

Recent research estimates that the combined consumer-to-consumer, consumer-to-business and business-to-consumer cross-border payment segments are worth over $4tn and are expected to grow by 11% compared to last year. Data from the Swift network echoes this sentiment too, with payments under $500 currently growing twice as fast as those worth more.

Today, small businesses can reach more markets from their desks than they can from most airports, and that's partly thanks to the expansion of marketplaces like Amazon, AliExpress or Etsy. Not all businesses have the means to trade internationally, but marketplaces make it easy to capitalise on consumer demand and enable small businesses to sell their goods or services abroad. Combine that with the fact that marketplaces relieve the administrative burden associated with overseas trade, and making this move becomes a no-brainer for businesses wanting to broaden their horizons.

And it's not just SME behaviour that's changed, consumers are sending money abroad more often too. Whether it's migrants sending wages back home to support family or international students funding tuition abroad, cross-border transfers have become a normal part of everyday life for many.

Growing competition

This demand hasn't gone unnoticed. Over the past 10 years, fintechs have been emerging thick and fast, all looking to capture a piece of this market. They're backed by serious investment too, with BCG reporting that investors funnelled $11bn into payments-related fintechs in the first half of 2022 alone. And customers have clearly found their offering attractive. Fintech adoption rates have been steadily increasing and recent research found that 75% of surveyed people had used a fintech money transfer or payments service before.

Many banks are already collectively defining the new standard for low-value cross-border payments.

While the fintech offering may look a little different to what banks have traditionally provided, they still use many of the same networks and payments routes to process transfers, including the correspondent banking network. So where do the differences lie? Often, it's in the experience. Fintechs have simplified the process of sending money abroad, with a minimalist approach to user experience that requires as few steps as possible for customers to make a payment. Payments are competitively priced too, with all fees displayed upfront to give total transparency on the cost of a transfer before it's sent, avoiding any unexpected surprises when the money arrives.

Building on strengths

Banks already possess a lot of the ingredients needed to succeed in this market, including customer bases millions strong and unparalleled reach that facilitates the global movement of value. At its core, this reach is built on strong bilateral relationships that have been in place for years. And robust compliance coupled with the highest standards for financial crime prevention put customers in the safest place possible, wherever their money is heading.

As banks continue to evolve their offering to add transparency, predictability and an improved user experience into the mix, they further strengthen their relationships with their customers. And by collaborating and adopting a community-driven approach, they are most likely to succeed, both for the currencies we know today and a future that could see central bank digital currencies (CBDCs) enter the frame. With the rapid adoption of Swift Go, many banks are already collectively defining the new standard for international consumer and SME payments within an interoperable framework that lowers costs, connects multiple payment methods and channels, and delivers instant and frictionless transactions to end-users.

From instant and frictionless payments to central bank digital currencies (CBDCs), a range of new and emerging digital developments have the potential to transform the face of the cross-border landscape, alongside the industry-wide transition to the data rich ISO 20022 standard. But change doesn't happen on its own – and Swift is working closely with the financial community to build a better cross-border payments experience for all.

PERRINE KALTWASSER

Managing Director of Risks, Compliance and General Secretariat of the Financial Conglomerate - La Banque Postale

Instant payments are also an issue of European sovereignty

Banks have played a leading role in the development of SEPA payment instruments in France and Europe, but the launch of instant payment by the EPC in November 2017 did not have the success expected. Although the use of instant payments is already widespread in some Member States, such as the Netherlands, Estonia and Spain, others have been slower to adopt this technology. At the beginning of 2022, only 11% of credit transfers in the EU were made via instant payments (3% in France).

At the same time, applications allowing real-time transfers between individuals, or used to pay professionals, have experienced strong developments in recent years. Soon, all money transfers from individuals will be made in real time. The need exists, and banks must adapt to it or expose themselves to leave the market to fintechs. When it comes to usage by companies, the added value remains to be found.

In practice, we consider that the large-scale development of instant payment requires a combination of three key success factors: real value for customers, value creation for PSPs and a relevant regulatory framework.

As far as individuals are concerned, looking for immediacy and simplicity in their transactions, the issue seems clear: instant payment will necessarily replace the traditional credit transfer, but for this clientele, the question of price is crucial compared to other payment tools. This is why, at La Banque Postale, we chose to make it free in 2022.

Regarding companies, professionals and public institutions, the case is less clear. In a rapidly changing ecosystem with a lot of dedicated offers, these actors may only marginally adopt this new solution if failing to clearly see its benefits. Banks should be able to improve their reporting, adopt relevant pricing and offer more value-added services (which can be created in cooperation with fintechs) to attract customers to this payment solution.

La Banque Postale, pioneer on free instant payments for retail clients in France.

Secondly, while the European authorities put forward objectives linked with banking players' profitability, liquidity and solidity, they continue to enforce regulatory changes that put pressure on their business models. Banks will only promote instant payment, even in the wake of binding regulations, if it is relevant for them. A payment system cannot be built and run for free. It must therefore create value for PSPs: the economic model should be sustainable to finance IT developments and investments for banks, and the costs of compliance monitoring and anti-fraud measures in real time for these operations.

Finally, the regulatory framework should favor the large-scale development of this payment solution. However, the optional membership of banks to the SCT Inst scheme, particularly in reception, raises a concern in terms of reachability of all banks in Europe. The Commission's proposal is interesting on this topic, even if in France, 95% of payment accounts held by French payment services providers can issue and receive instant payments. In addition, current anti-money laundering policies for cross-border transactions are still a significant barrier to transparent and seamless instant payments. Still, we welcome the Commission's position to facilitate these payments by making less burdensome anti-money laundering controls in Europe.

La Banque Postale has chosen to actively promote the instant payment, in line with its principles as a citizen bank. It promotes immediacy, efficiency and quality of service to the benefit of its customers. To develop its use, we were the first major French bank to make this product free of charge for retail customers.

Beyond the needs of a demanding and competitive payments market, the development of instant payment in Europe is also a way to support Europe's ambition to regain sovereignty in the field of payments.

Instant payment is a major progress, bringing efficiency in many use cases, whether they are linked to P2P payment, e-commerce or even payments at physical points of sale, currently paid for in cash or by card. It is in some way comparable to cash since the payee receives the money immediately and irrevocably. This is why La Banque Postale has supported from the beginning the European Payment Initiative, which based its development on it.

In this regard, we question the relevance and usefulness of a central bank digital currency, as proposed by the ECB. In our opinion, such an initiative does not respond to a real consumer demand or a new use case. In addition to directly competing with an efficient and market-driven payment solution, this initiative could potentially weaken European banks by shrinking their balance sheets and affecting their revenues while generating additional development and operating costs. On top of that, while the European card world is already dominated by international card schemes, the launch of a digital euro could open up European payments to major technological players based outside the European Union.

4

THE EU AND GLOBAL SUSTAINABILITY AGENDA FOR FINANCE

- Avoiding greenwashing
- Transition of financial activities towards net zero
- ESG implications for asset management
- Global convergence of sustainability reporting standards
- Climate-change insurance needs

Q&A

HESTER M. PEIRCE

Commissioner - U.S. Securities and Exchange Commission (SEC)

Climate, crypto, convergence, conflict

What are the main challenges with achieving a single global definition of ESG for financial products? Is this feasible, and if so, how?

A common global definition of ESG for financial products is neither feasible nor desirable. Key challenges are the breadth of the potential topics covered by the term, the subjective and fickle nature of ESG assessments, and the troubling implications of a single standard. "Environmental," "social," and "governance" are three unrelated topics, each of which includes a potentially unending—and potentially contradictory—set of issues. What qualifies as E today may not next year. An investment that scores well on environmental metrics might be negative from a social perspective and vice versa. Even within the environmental category, efforts to reduce greenhouse gas emissions may directly conflict with biodiversity, water use, and other issues.

How particular activities rank on an ESG scale changes with personal and societal realities, sensibilities, challenges, and opportunities. In a coal-reliant jurisdiction, natural gas might be a significant improvement and thus be deemed green, whereas a country with a vibrant nuclear industry might deem natural gas brown. Matters of great importance to a developed country might be less important to a developing country in which people struggle daily to feed, house, clothe, and educate their families. For the developed country, clean energy might be more important than continued wealth creation, whereas the developing country might prioritize low-cost energy production to alleviate poverty. Legal and technical obstacles stand in the way of universal ESG standards, but there is a more fundamental challenge: does any one source of authority have the right to set the priority scale for everyone everywhere? No one authority can know the facts on the ground in each jurisdiction the standard covers.

Forcing universal definitions on ESG financial products also could have other undesirable consequences. A concentration of capital in ESG assets—particularly if an ESG label comes with favorable capital treatment or other regulatory benefits—might cause systemic instability. And because resources will be diverted from other sectors, society inevitably will miss out on products and services, including perhaps solutions to the environmental and social problems that now seem (to a regulator's mind at least) insurmountable.

What is the US situation regarding ESG corporate transparency and the ESG agenda of the Securities and Exchange Commission ("SEC")?

Legal differences across jurisdictions frustrate attempts to establish global standards. In the United States, for example, the objective of the SEC's disclosure requirements for public companies is to inform investors, not to alter companies' behavior. Similarly, our review of disclosure documents for investment products is not merit- based; we seek only to ensure that investors are getting an accurate picture of their investment. Shifting resources away from or to particular industries is investors' responsibility. Any government intervention in this process is political and thus belongs to Congress.

Questions about whether we have strayed into the political realm have arisen in connection with ESG rulemaking. For example, we proposed last year to require public companies to make an extensive set of climate- related disclosures. Our staff is working through the many difficult issues commenters raised. Whether to include Scope 3 emissions is one such issue, but other challenges include the peculiarity of the financial statement disclosures, the length of the time horizons covered, the uncertainty that characterizes many disclosure items, and the indirect regulation of customers and suppliers. If the rule is adopted, the implementation process will likely require substantial effort, attention, and resources. The SEC's agenda also includes a plan to propose that public companies disclose matters related to human capital. In accordance with our limited mandate, the SEC should focus both rules on information that is financially material to public company shareholders. It should not seek to meet non- investors' information demands or to change corporate behavior through disclosure.

What are the key challenges to converging SEC climate disclosure standards and those proposed by ISSB and EFRAG?

Many globally active investors and companies hope that the SEC's climate disclosure rule will draw heavily from international standards, such as those proposed by the International Sustainability Standards Board or EFRAG. While regulatory convergence would be convenient for global entities pulled in many different regulatory directions, several obstacles stand in the way. Convergence even in accounting standard-setting, where the objective is clear and universally consistent, has proven to be difficult. Convergence in sustainability standard-setting, which is less precise, more subjective, and often more politically charged, is likely to be even more difficult. Moreover, each time a global standard is adopted or amended, the SEC would have to run it through our notice-and-comment rulemaking process, which would inevitably create departures from the international standard. Also complicating convergence are the different objectives that different standards seek to achieve. SEC standards are rooted in financial materiality to the disclosing entity, whereas international standards increasingly look at both financial materiality and "impact materiality." US law has not adopted this double materiality, and the SEC generally does not have the authority to adopt standards that turn on the materiality of the effects that a company's (and its suppliers' and customers') activities have on the environment or society.

Has the failure of certain cryptoasset service providers and stablecoins and the recent market downturn revealed specific crypto ecosystem fragilities? How are these issues addressed in the US?

2022, with its many notorious failures of well-known people and entities, was a difficult year for crypto. The industry learned some painful lessons, including that centralized crypto entities evince the same problems as centralized entities in other industries. Counterparty risk, poor collateral practices, undisclosed conflicts, unsegregated customer money, and fraud are not new problems and not unique to crypto. True decentralization, and the radical transparency that accompanies it, can solve some of those problems. Government regulation is another possible solution. Europe and other jurisdictions have moved quickly and productively on regulation. The United States, by contrast, has relied more on enforcement actions under existing rules than tailored rules or regulatory guidance. This approach perversely makes it more difficult for regulators, investors, and consumers to distinguish good actors from bad ones. Decentralized projects are likely to face particular challenges as current rules rely heavily on the existence of centralized companies.

To avoid a repeat of 2022, US regulators should engage with the public to design a regulatory framework that facilitates innovation, frustrates bad actors, allows decentralized, open-source technology to do some of the regulatory work, and respects fundamental American principles of free enterprise and efficient markets balanced with investor protection. That framework could include token disclosure requirements, trading platform registration, a path for regulated entities to assist customers in obtaining and managing crypto assets, and encouraging experimental application of the underlying technologies to the traditional securities markets.

AVOIDING GREENWASHING

NATASHA CAZENAVE

Executive Director - European Securities and Markets Authority (ESMA)

Addressing greenwashing to support a sound transition

Once a niche area, the transition to a more sustainable economy is now a central focus of corporates, governments and investors. Companies communicate more and more on their roadmap to net zero and decarbonisation plans. Investors – institutional and retail – are increasingly interested in sustainable investments and expect to have access to meaningful sustainability disclosures to make informed decisions. The EU has set an ambitious agenda to lead this transition in which the financial sector has an important role to play to help finance this transition and channel the funds adequately.

While there is a high demand for ESG and sustainable investments, there is also a healthy dose of scepticism. Regulators fear that this specific 'rush for gold', combined with the lack of clear and consistent disclosures for sustainable products may result in misleading investors around certain sustainability claims such as relevant characteristics of funds marketed as sustainable and in turn potentially undermine investors' trust. Ultimately, there is a real risk of mis-selling that could impact investors and threaten to derail the global decarbonisation journey.

In order to address these issues, the work of ESMA to date has included the development of a disclosure framework under the Sustainable Finance Disclosure Regulation (SFDR) and the Taxonomy Regulation, notably to clarify the requirements to be met by products labelled as sustainable. These elements have been central to our objectives set for the next five years, and ESMA's willingness to make a decisive contribution to the fight against greenwashing.

Against that background ESMA has expressed concerns about the use of the SFDR provisions as de facto labels. And while we would welcome further clarity around minimum sustainability criteria for disclosures of financial products, the review of the underlying legal framework by the European policymakers will likely require a significant amount of time. In the meantime the practical implementation is proving challenging and the risk of greenwashing is increasing. Thus, ESMA's focus has been put on a few important pieces of work, in cooperation with the European and national authorities (i.e. other ESAs and NCAs).

The first initiative was launched with a consultation on draft ESMA guidelines on funds' names using ESG or sustainability-related terms, in November 2022. Preliminary analysis of the stakeholder feedback shows a recognition of the investor protection concerns stemming from greenwashing risks.

In parallel, the ESAs have been jointly collecting input to get a better understanding, and practical examples, of potential greenwashing practices. We received about 140 responses spanning from across 20 EU Member States and various sectors. Overall, ESMA's preliminary analysis corroborates greenwashing as a source of a serious concern. These findings will inform the ESMA report expected by May 2023, as well as any relevant follow-up work.

Furthermore, the ESAs were also tasked with reviewing regulatory technical standards on principal adverse impact indicators and certain product disclosures regarding decarbonisation targets. This is part of a joint ESAs consultation paper, which will inform a report expected by the end of October 2023.

As the regulatory framework gets clearer and tighter, both supervision and enforcement are equally key in the process of fighting greenwashing. Some authorities, notably in the United States, Germany and the United Kingdom have already taken enforcement action for alleged greenwashing. ESMA and the NCAs have been advancing work in the context of Union Strategic Supervisory Priorities. ESMA launched a Common Supervisory Action (CSA) in January 2023 on the application of MiFID II disclosure rules regarding marketing communications and advertisements across the EU, to gather information about possible greenwashing practices. Another CSA will likely take place later this year with a focus on the integration of sustainability risks and sustainability disclosures by asset managers with a focus on SFDR.

These examples represent only a part of ESMA's overall work on sustainability. We are also actively working on the sustainability reporting framework. We firmly believe that we should not take investors' interest in sustainable products for granted: Negative macro-economic developments – compounded by concerns about greenwashing – could lead to a flow of capital away from sustainable finance. Therefore, the framework must provide certainty and preserve investor confidence.

Only so can we support the allocation of the much needed capital to sustainability goals. ESMA will spare no effort to ensure full transparency to investors.

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

Greenwashing: one of the barriers to the transition

The financial sector plays an important role in financing a timely transition to a more sustainable economy. Progress is being made with an increasing number of insurance and pension providers who are now offering products with sustainability features or making net zero commitments. However, in a context where the regulatory framework is yet to be completed and where there is constant evolution there is a risk that insurance and pensions providers make misleading claims about their sustainability credentials – i.e., what colloquially is referred to as greenwashing.

Greenwashing has an important impact as it can erode society's trust in the role played by the financial sector in financing the transition, making consumers less prone to invest their money in a sustainable way (for example in life insurance) or to purchase non-life insurance products from insurance undertakings with substantiated sustainability credentials. Indeed, the emergence of greenwashing cases, albeit none identified by the European Insurance and Occupational Pensions Authority (EIOPA) so far in the European insurance and pension sectors, is already having some possible spill-over effects.

A recent Eurobarometer survey carried out by EIOPA shows that in the European Union (EU) 63% of consumers do not trust sustainability claims made by providers. Further, greenwashing can create reputational and regulatory risks for providers, which for fear of being accused of greenwashing might reduce their sustainable offerings. Given its important impact, EIOPA is committed to tackling greenwashing.

The EU's sustainable finance regulatory framework already provides useful regulatory tools to tackle greenwashing. The Sustainable Finance Disclosure Regulation (SFDR) gives transparency to investors on how providers and products affect the environment or society. The Taxonomy Regulation (TR) gives clarity on what economic activities are environmentally sustainable. The new requirements in the Insurance Distribution Directive introduce sustainability objectives and preferences in the product manufacturing and advice processes. The Corporate Sustainability Reporting Directive (CSRD) will require the disclosure of detailed information on the impacts of entities on sustainability factors thereby substantially increasing the availability of sustainability data, including for the reporting obligations of providers.

However, there are some limitations – also because the EU has been a front runner in this sphere which is rapidly evolving. Both the SFDR and TR, in addition to their interrelation, introduce complex and sometimes unfamiliar concepts, which can be challenging for consumers to navigate and assess, and challenging for the industry to implement. Further, the SFDR was not intended to create labels but it is being used as a labelling regime, and the first CSRD reporting will only come in 2025 based on 2024 data. Additionally, while insurance providers will have to report a key performance indicator related to their underwriting activities under the Taxonomy Regulation, greenwashing in non-life insurance remains largely unaddressed by the current regulatory framework. These limitations coupled with a lack of clarity around what is and what is not greenwashing, can exacerbate potential greenwashing.

Tackling greenwashing is therefore imperative for restoring and strengthening consumer trust in the ability of providers to allocate resources sustainably and support a timely transition to a sustainable economy. The EU sustainable finance regulatory framework needs to be completed and to include a clear definition of greenwashing. Its implementation by providers and consequential supervision by competent authorities focused on the overall aims of the framework are crucial.

Tackling greenwashing to harness the financial sector's role in financing the transition.

EIOPA continues to take an active role in tackling greenwashing as this is essential to harness the financial sector's role in financing the transition. EIOPA is working with the other European Supervisory Authorities to respond to the EC's Call for Advice on greenwashing, which includes establishing a cross-sectoral understanding of greenwashing. EIOPA is also integrating the monitoring of and mitigating of greenwashing risks across all its supervisory tools and activities. Further, EIOPA took note of the recently proposed Directive by the European Commission (EC) on the substantiation of environmental claims to tackle greenwashing in business to consumer communications in all sectors of society.

JOS HEUVELMAN
Member of the Executive Board -
Dutch Authority for the Financial Markets

A consumer-oriented approach to enhancing sustainable finance legislation

Sustainability is one of the key priorities of the AFM supervisory strategy. Adequate and clear information on sustainability is essential for both the functioning of the sustainable finance market, and the objective to reorient capital flows towards sustainable investment. To ensure investor protection, maintain trust in sustainable investments and avoid unfair competition, greenwashing is an important risk that needs to be addressed.

Fortunately, existing rules that all information shall be fair, clear and not misleading also apply to sustainability claims. In addition, the disclosure obligations of the SFDR, CSRD and the EU Taxonomy will provide investors, supervisors, and market players with much-needed substantiation of sustainability claims.

Much focus has understandably been on these new mandatory sustainability disclosures. The standardized disclosure templates will allow stakeholders to compare and monitor progress, putting a strong check on the claims that are being made.

However, we should take note that the SFDR and CSRD are disclosure regimes. They do not stipulate what is sustainable and what is not. Nor do they provide limitations to usage of certain sustainability terms in marketing of products.

There is a persistent misconception among market participants that SFDR classifications, articles 8 and 9, can be used as a proxy ESG label for investment products. The SFDR, however, is not a labelling regime, nor was it intended as such. As such, SFDR classifications by itself are not a helpful guide for investors. And retail investors seem to agree. In a 2022 AFM consumer study, we found that only 3% of retail investors that seek to invest sustainably use SFDR classifications to guide their investment decisions.

When selecting sustainable investment products, most retail investors are primarily guided by marketing communication, prominent website information, or naming of products, the same study showed. Only a limited number of retail investors take the time to truly scrutinize mandatory disclosure documents. The study also found that consumer expectations on sustainable investments vary and often differ from most sustainable investments strategies offered, and that consumers find it difficult to select products that match their objectives.

We found that the most important objectives for sustainable investors are, in this order: 1) impact; investors want to make impact by bringing about positive sustainable change with their investment that would otherwise not have happened, also referred to as 'additionality'; 2) ethical; investors want to invest in companies that are in line with their personal norms and values, also referred to as 'value alignment' and; 3) return; investors regard sustainability as a way of achieving a better risk-return ratio.

To bridge the gap between the mandatory disclosures on sustainability, the expectations of sustainable investors, and the different sustainability approaches that are available in the market, there is a clear need for better consumer-oriented guidance. The need to provide clarity on the distinction between different sustainable investment approaches is heightened because the SFDR definition of sustainable investments leaves room for a broad interpretation of sustainability. We therefore need to introduce better, consumer-friendly classifications or labels.

The AFM strongly advocates a consumer-oriented approach towards better classifications and labels. This means taking into account their expectations and objectives. Much of the current legislative framework is geared towards value alignment strategies: investments in products that consist of companies that are already sustainable. Most sustainable investors, however, seek positive real-world impact.

The AFM strongly advocates a consumer-oriented approach towards better classifications and labels.

Classifications or labels should allow investors to recognize products that have an impact approach, either by investing new capital (direct impact), or through engagement strategies (transition). Moreover, they should allow investors to identify the distinction between these two approaches. This implies that market players should relate to these objectives when offering retail products and should make a convincing case that their product indeed suits these objectives.

To combat greenwashing and put a check on sustainability claims, the mandatory sustainability disclosure requirements of the SFDR, CSRD and the EU Taxonomy will be an important factor. However, to maintain trust in the market for sustainable finance, the AFM believes the legislative framework needs to be complemented by better, consumer-oriented categorization of products that takes into account the expectations and objectives of sustainable investors.

WANG LEI
Deputy General Manager -
Bank of China (Europe) S.A.

Impact and trends outlook of greenwashing regulation on banking sector

In recent years, there has been a growing awareness of the significance of sustainable development and the urgency of the decarbonization transition on a global scale, and the growing demand for sustainability-related products combined with rapidly evolving regulatory regimes and sustainability-related product offerings create a context that may be conducive to increased greenwashing risks. The European Commission (EC) has recognized the need for greater regulation of "greenwashing" risks and has taken action to request a Call for Evidence (CfE) from ESA. It can be foreseeable that the regulation on the risk of greenwashing is becoming stricter. In line with this theme, we have refined and elaborated several points of view as reference.

Firstly, data standards and risk identification shall integrate with the Taxonomy.

As the risk of green washing is becoming more and more prominent and regulation is in the schedule, it is a priority issue for the financial sector to refine and standardize the boundaries between green and non-green as soon as possible. The standards of EU sustainability have been becoming clear, standardized and rigorous. It has been put forward a tighter schedule and higher demands that financial sector needs to absorb and transform the Taxonomy into granular practical manual guidelines. However, recent EBA data shows that most of the exposure (65%) is to obligors whose main activity is in a NACE sector which is considered not to be part of the first two objectives of EU Taxonomy.

Therefore, we suggest that, on the one hand, the financial sector should strengthen the interface between green standards and NACE industry and risk data summation specifications; on the other hand, the banking sector should be fully prepared to integrate the greenwashing risk identification into all products and business lines.

Secondly, higher requirements are put forward on the internal governance and risk management of banks.

ESG represents a new transformation for internal governance and risk management in the financial sector, and greenwashing risk is an emerging type of risk derived from it, whose risk identification, assessment, measurement, monitoring, the deep involvement and strategic review of BOD, implementation by management and the roles of three lines of defense, shall be integrated and taken into account. In terms of internal management of banks, how to effectively implement risk monitoring and supervision through specification and qualification for the project of Bonds or ESG funds, and how to meet the standards throughout the loan life cycle for the LMA's Green loans and ESG-linked loans, etc., all of these measures must be formed with a "greenwashing" risk identification and assessment methodology and integrate it into each standalone-point risk for effective management according to the bank's strategy and risk appetite.

The third aspect pertains to information disclosure and market discipline.

It is foreseeable that further supervision of ESG transparency and market discipline in the EU which will promote the financial sector and their clients to effectively achieve sustainable goals and effectively prevent the greenwashing risks, while that would also increase the cost of meeting standards for the financial sectors. The EU has recently circulated the Corporate Sustainability Reporting Directive (CSRD), which regulates disclosure standards and key performance indicators and all members of states are required to transform it into delegated act within 18 months. In addition, the related European Sustainability Reporting Standards (ESRS) will also be implemented as a supplementary technical standards of the CSRD. We are also highly concerned about the legislative process and the phase-in requirements for banks to meet the standards.

It is a priority issue to refine and standardize the boundaries between green and non-green.

Finally, IT infrastructure and digitalization.

As aforementioned, the regulatory legislation and data standards are improving which raised a high standards and urgent requirements for our digital capacity and IT infrastructure. Hence, digital transformation is a fundamental and necessary support for green transformation ourselves as well as integration into the transformation of our customers. We will put our best efforts on the sustainable development.

MELISSA OCAMPO
Head of Sustainability Strategy, EMEA - SMBC Bank International Plc

Realising the potential of the EU taxonomy and avoiding greenwashing

SMBC Bank has set an ambition to make Sustainability central to our purpose and business strategy. For example, SMBC has made a strategic commitment to achieve Net Zero in our loans and investments by 2050 as a member of the Net Zero Banking Alliance, committed to the UN's Principles for Responsible Banking, and became a signatory to the Poseidon Principles to help reduce our maritime emissions intensity. These commitments are long term and built upon trust. Therefore, we recognise the importance of avoiding greenwashing in our business activities so as not to undermine these commitments.

European Union (EU) policymakers have rightly placed significant emphasis on driving investment towards toward truly sustainable economic activity, and they have committed substantial effort to defining this "North Star". As a global bank, we continue to consider this definition in the context of our broad international business, where we see different starting points and ambition levels. In a field as diverse and technical as sustainability, we believe 3 key ingredients are needed to direct capital toward truly sustainable economic activity: a supportive internal environment at the bank, a solid regulatory foundation in the market, and an ecosystem of enabling external partners.

Sustainability represents a vast transformation effort not just for banks, but for the whole economy. At SMBC, we are driving this transformation by building our technical capacity, focusing on corporate culture, and putting in place the necessary sustainable finance governance and oversight. Considering our technical capacity, we have invested in hiring a number of Sustainability experts within both our client-facing and support teams. This has allowed us to build technical frameworks and to stay abreast of leading practice through our involvement in several cross-industry organisations and initiatives.

Training across all levels of the organisation and very visible senior management support for Sustainability are helping to drive change in our organisational culture. For example, SMBC Group has recently appointed Paul Polman, a global sustainability leader and former CEO of Unilever, as a Global Advisor. Finally, oversight and governance are critical elements, with clear roles and responsibilities across the lines of defence for applying standards, escalating edge cases, and making empowered decisions.

As a large non-EU headquartered international bank, SMBC recognises the leading role that the EU is playing in the field of sustainability policymaking and nowhere is this more evident than in the technical rigour of the EU Taxonomy (EUT.) This is clearly a very useful resource for banks to point our capital toward the most sustainable assets and reduces ambiguity. One of the challenges this presents however, is that as an international bank it can be difficult to position EU Taxonomy aligned green assets alongside green assets in other jurisdictions.

We welcome efforts to harmonise taxonomy definitions across jurisdictions and the EUT provides a good starting point for this. There is also more that can be done to integrate the EUT operationally across the different markets we operate in; for example, there could be potential to capture when an asset passes some but not all screening criteria and relate these to assets held in other markets, subject to practical testing. This would allow investors to identify where investee projects are making progress but do not yet fully align to the EUT.

SMBC considers what is sustainable economic activity in the context of our diverse global business.

At SMBC, we also see opportunities for professional services providers to be key business partners in helping to realise the vision of the European Financial Reporting Advisory Group, with our biggest needs being in the areas of data and "operationalising" the assessment process. Data gaps continue to be a challenge, with some assets unable to be assessed for alignment as our counterparties cannot provide the needed data.

We believe EU Taxonomy focused products from existing data providers will be important to overcome this issue. Secondly, to empower client facing teams to understand what green assets are, we believe it would be helpful them to be able to assess Taxonomy alignment. We are considering how to streamline our alignment assessment process and how we can better use digital solutions, such as workflow tools to present the technical screening criteria in any easy to digest fashion.

Getting Sustainable Finance right is a process, and one that will likely outlast our careers. Having the fundamentals in place-- a supportive internal environment at the bank, a solid regulatory framework in the market, and an ecosystem of enabling external partners—will give us a strong foundation.

ANNA GREEN

Chief Executive Officer - Sweden Branch - Zurich Insurance

Joining forces to realize the true potential of sustainable finance

The green transition will require unprecedented action by governments, companies, and citizens as well as additional investment. Clearly, the green transition will not happen without the support of financial markets channeling capital toward low-carbon industries and providing for the massive investment required in climate mitigation and adaptation.

Greenwashing presents a significant obstacle to the green transition as it impedes efficient capital allocation and a shared understanding of what is at stake for companies. It also makes it more difficult for financial supervisors to assess climate-related impacts and decarbonization pathways and confronts companies with new reputational and liability risks.

At Zurich we are committed to playing our part in delivering the green transition – as an insurer, investor, and employer. We have set an ambitious target for impact investment and have already deployed $ 6.3 billion in impact investments. By 2025, fully 5 percent of our proprietary investment portfolio will be allocated to climate solutions and investments benefiting society. Greenwashing impedes our dialogue with companies about sustainability and creates a barrier to the measurable and comparable metrics we all depend on to make the green transition happen. If this challenge is not addressed, there is a risk insurance companies – and other investors – will not be able to make sustainable investments at the pace and volume required.

However, when it comes to tackling greenwashing, it is important to distinguish between what is intentional and what is not. Firms should not be unduly penalized for trying to do the right thing and making honest mistakes in interpreting evolving regulation. With some key elements of the EU's sustainable finance framework still to be finalized, ambiguity and lack of consistency in some of the legislation that has been passed, and a lack of sufficient guidelines for enforcement, there is a clear risk of diverging interpretations. The mismatch in timelines and application dates for the various initiatives under the sustainable finance framework has the potential to create a structural legal risk of greenwashing for insurers. Widespread scarcity of reliable company-reported and third-party data further adds to this risk.

For Zurich, this is yet another reason to ensure sound governance and internal controls of sustainability claims. In Sweden, we see industry surveys and awards on sustainability. Clear standards and homogenous implementation of regulation will support the minimization of unintentional greenwashing and allow for more transparent follow-up on validated progress. Many of our customers are multinational companies with a global footprint which adds even more complexity.

As we cannot tackle the challenge of greenwashing on our own, what can policymakers do to help the insurance industry - and financial services in general - to be more impactful?

For decarbonization to be effective, we need a framework that delivers appropriate standards, and tracks progress and performance against those standards.

Even when unintentional, greenwashing has detrimental impacts across the entire value chain and must be addressed appropriately. An effective response requires a transparent framework that allows for some flexibility, comparability, and consistency across jurisdictions. To reduce the risk of unintentional greenwashing, regulatory frameworks should be completed and fine-tuned, while financial markets participants should be granted an adequate consolidation period to implement the new provisions. In the long-term, we hope that a global baseline of sustainability-related disclosure standards will be a key element in establishing the basis for sustainability-related capital allocation decisions.

Greenwashing presents a significant obstacle to the green transition.

Second, policymakers can help address the scarcity and poor reliability of data hampering sound investment and underwriting decisions. This could be achieved, for instance, by increasing transparency on the methodologies underpinning data sets, ratings, and other analytical tools. All actors involved should target efforts to building internal skills and resources – a very well-timed initiative in the "European year of skills".

Finally, adequate market incentives and tools to channel savings towards activities that truly foster the green transition will become increasingly important. For example, enhanced eligibility of climate-themed funds for favorable tax treatment in savings products (such as life insurance products) could help complement other climate-change-mitigation measures, such as carbon taxes.

SHERRY MADERA
Senior Vice President of Public Policy and Government Affairs - Mastercard

Empowering the consumer must be next stage of Europe's sustainable journey

It is no secret that Europe is at the forefront of sustainable finance policymaking. The European Green Deal has brought significant focus on the financial sector to promote sustainable finance. The top-down approach to sustainability in finance is well served. What about considering sustainable finance from the bottom up? The financial and purchasing actions by consumers can be a powerful tool to effect positive sustainability outcomes.

What people are buying is changing. Recent data shows over two-thirds of Europeans would buy environmentally-friendly products regardless of an increase in cost. It is not just what people buy that's changing, but how they buy it.

Over half of eurozone inhabitants now prefer to use card or other cashless measures to make payments. Digital payment systems provide a viable gateway to educate consumers about the sustainability of their purchases. As the backbone of commerce, payment networks can be harnessed to play an increasingly important part in Europe's climate mission.

Encouraging sustainable finance from the bottom up

While Europe's top-down approach has revolutionised sustainable finance – I believe there is immense untapped value in considering purchasing power sustainability. Typical daily payments of Europeans may seem small-scale, but they totalled over 1.8 trillion euros in the third quarter of 2022 – the power of many that can effect change.

Let's imagine that all those transactions were supported by data showcasing how environmentally friendly the purchase was. This would empower consumers to make more sustainable buying decisions and – by requiring increased supply chain transparency - would encourage sustainability in merchants and manufacturers.

Increasing the focus on how consumers spend and make choices will promote innovation. Already the European Commission is developing a Digital Product Passport to embed previously unavailable data on a product's sustainability credentials throughout its lifecycle in its product codes. This supports the circular economy and builds trust with consumers. We see evidence of this in the popularity of clothing resale apps such as Vinted, Depop and Verstiaire Collective.

Innovation is also taking place in the payments value chain. Allowing a consumer to see the carbon impact their purchases are making is a step in the journey Mastercard is taking by developing its European-born Carbon Calculator. Wider adoption of tools across the whole retail and payments value chain can accelerate action.

Making progress through power of collaboration

We believe in thinking as an ecosystem and value chain to ensure big picture goals have big picture solutions. The progress Mastercard makes towards our own goal – to become net zero by 2040 – is only possible thanks to the collaboration we foster with our customers and our partners.

Through the journey we've been on so far, it has become clear that the payment ecosystem has a role to play in sustainability. Payment networks exist to service consumers – to make their journey safe, efficient and effective. Applying this philosophy to the growing demand from consumers for conscious sustainable choices is urgently needed – from bank to merchant – to make a difference that will stand the test of time.

One example is the Priceless Planet Coalition – which unites communities, companies, and consumers in the restoration of 100 million trees worldwide, and 150,000 in Europe, by 2025. There is much more the payments ecosystem can and should do.

Our focus should be on turning every swipe or tap into an opportunity to fight climate change.

Fostering an inclusive and sustainable economy

Ultimately, we must foster a digital economy that's both inclusive and sustainable. To achieve this, we must address the mindset that more economic activity and financial inclusion leads to increased environmentally-damaging consumerism. Instead, our focus should be on turning every swipe or tap into an opportunity to fight climate change and support sustainability in all its forms.

Empowering a conscious consumer can harness a billion-person community to support sustainability. Through the payment network – we have an immense opportunity to provide Europeans with the information they need to drive more sustainable behaviour. When it comes to supporting European and global sustainability goals, this bottom-up approach can augment existing top-down sustainable finance. Consumers are asking for these solutions, so let's equip them with what they need to make a difference and contribute to a greener tomorrow.

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TRANSITION OF FINANCIAL ACTIVITIES TOWARDS NET ZERO

DERVILLE ROWLAND

Deputy Governor Consumer and Investor Protection - Central Bank of Ireland

The importance of transparency and transition planning in meeting Net Zero

"Net zero" has become the clarion call of our times. It is a call that is used and understood by schoolchildren, media outlets, politicians and policymakers, and both financial market participants and their supervisors. While climate issues have up until recently not been considered material for the financial sector, it is now acknowledged we do not have the luxury of ignoring this crisis – climate change represents an existential threat to communities and ecosystems - and we are now in the phase of identifying solutions and acting on them. In this context, identifying the need to achieve net zero in a little over 25 years' time is in many ways the easy part.

Long-term damage can only be reduced through rapid and significant changes to technology, processes and behaviours. Decarbonisation cannot occur without strong political will to drive the massive levels of private and public investment needed. In addition, there needs to be clear transition planning to assist all actors in meeting the net zero target.

As a central bank and regulatory authority, we acknowledge that getting from where we are to where we need to be involves significant transition-planning for financial market participants. Policymakers, supervisors and indeed users of the financial system must play a significant role, through their guidance and participation respectively, in ensuring transition plans are successful. While on a macro level, transition planning has the ultimate objective of ensuring the future of our economies and financial systems in the longer term, at the firm level there are basic requirements that are a prerequisite to successful transition planning. Firms should therefore ensure that:

- There is board level ownership of climate risks affecting them;
- There is a willingness to measure, monitor and mitigate, and test their robustness against the climate and transition risks they face;
- There is an embedding of transition planning into the firms' operations and strategic approach; and
- There is a willingness to disclose their transition planning.

Firms must 'walk the talk' on transition plans so planning should be credible, robust and measurable.

Enabling the financial system to work towards an optimal transition is a major challenge and one that requires engagement from all participants within its eco-system. While relevant data and forward-looking assessments and projection are still at early maturity stage, there must be a willingness to move from qualitative to quantitative metrics. There must also be a move to embrace science-based targets. The financial system should seek to capture and analyse data in a way that establishes whether capital is flowing in sufficient quantities to enable the transition to a net zero sustainable future – we need to be transparent in respect of the carbon intensity and carbon footprint of portfolios. This requires leadership: firms need to "walk the talk" on their transition plans, so planning should be credible, robust and measurable.

In this context, we can draw on the progress that has been made in respect of:

- The publication of various target-setting transition plans and frameworks which can identify best practices for financial institutions to achieve net zero;
- Classification tools such as the EU Taxonomy, which comprehensively identifies the economic activities that are sustainable and those that can assist in transitioning to a low carbon economy;
- Net zero portfolio alignment tools, as well as climate investment strategies such as the Paris Aligned Benchmark and the Climate Transition Benchmarks, which provide for strict annual decarbonisation objectives, as well as consideration of products like the newly agreed new EU Green Bond Standard;
- Transition pathways for sectors, which set out credible plans and targets to decarbonise over the medium to longer term; and
- Assurance and certification assessments – in order to ensure that what is being reported is accurate and can be trusted.

It should also be noted that that the transition to a sustainable future will not occur without the necessary participation by private investment in green and transition finance. Trust in the system is of fundamental importance in order to ensure this participation. There is an onus on all participants to ensure that the framework in which we operate is fit for purpose and eliminates greenwashing.

The need to achieve net zero is stark – the challenge lies in combining our efforts to successfully meet that end-point. In recognising the evolving nature of the tools at our disposal there is a clear need for both policymakers and the financial system to require transparency in how we aim to meet net zero, to embrace transition planning, and to continue to develop frameworks which can help guide efforts to achieve net zero.

EVA WIMMER
Director General - Federal Ministry of Finance, Germany

Transition of financial activities towards net zero in the global context

The transition of our economies towards climate neutrality is in full swing. And yet, to achieve our net zero goals, we need to accelerate our efforts and help to mobilize private capital. While many tools exist to define what makes an economic activity sustainable, companies are largely left alone on their journey from "brown" or "yellow" to "green". In this context, the concept of transition finance has rapidly gained traction. At the center of the discussion are transition plans, which are increasingly viewed as a cornerstone of transition finance.

At the international level in particular, many actors are already addressing this topic intensively. These include the Financial Stability Board, the OECD, the G20 Sustainable Finance Working Group, the EU-International Platform on Sustainable Finance and standard setters like the ISSB. Additionally, work in the EU is progressing and several non-EU initiatives on national levels like the UK-Transition Plan Taskforce are also advancing rapidly. Transition plans can be important sources of information for both corporates and financial institutions to make business decisions. For supervisors, it can be a tool to assess financial stability risks, as environmental, social and governance (ESG) risks can have far-reaching implications on the stability of both individual financial institutions and the financial system as a whole.

However, at the moment, the lack of consistency and data in general presents a considerable challenge for transition planning in the financial sector in particular. Many financial market participants have set net zero emissions targets, for example through memberships in alliances such as the Glasgow Alliance for Net Zero (GFANZ). However, to mitigate their financed emissions the financial sector is dependent on the efforts of companies. So, in order to implement net zero targets, financial institutions need information from corporates on whether they are on a credible path towards climate neutrality and sustainability.

Transition Plans can close the gap between the financial sector and the real economy.

Hence, both transition plans of financial institutions and corporate transition plans are needed to holistically address short, medium, and long-term sustainability risks and opportunities. According to the OECD credible transition plans have e.g. the following key characteristics:

- Clear net-zero and interim targets
- Use of sectoral pathways
- Performance measurement and progress through metrics and KPIs
- Clarity on the use of carbon credits and offsets
- Strategy and actions on decarbonization, including on preventing carbon-intensive lock-in
- Integration with financial plans and internal coherence
- Sound governance and accountability
- Transparency and verification

Currently, regulatory requirements for transition plans are being developed separately for the financial and real economy. They should however, be designed in a way to complement one another. At the level of the European Union, it is being discussed to make transition plans mandatory for banks to address climate-related and environmental risks in the course of the revision of the Capital Requirements Directive (CRD) VI. Criteria for transition plans are also developed via the Corporate Sustainability Reporting Directive (CSRD) and its corresponding European Sustainability Reporting Standards (ESRS) which apply to both the financial sector and the real economy. At the international level, the International Sustainability Standards Board (ISSB) addresses transition plans as part of its draft climate disclosure standard.

It is now up to public decision makers to tie together existing works on transition plans and to close the gap between information needs of the financial sector on the one hand and transition finance needs of the real economy on the other. This implies a careful analysis of the right amount of information needed to steer portfolio adjustments. When designing such frameworks, an additional burden on corporates, which are already facing an unprecedented wave of sustainability reporting requirements, should be avoided. Instead, transition plans should fit into existing and upcoming sustainability disclosure frameworks.

In a global context, the standards of the International Sustainability Standards Board (ISSB) will likely be of great importance. Furthermore, they should not simply be a report published for the use of financial market participants. Rather, it should be a tool of great use to corporates themselves which can help them to successfully navigate the transition towards a sustainable economy. If this is achieved, transition plans will be an entry ticket into a bright net-zero future of our economies.

SHINICHI TSUNODA

General Manager, Sustainable Business Promotion Department - Mizuho Financial Group, Inc. / Mizuho Bank, Ltd.

Japan's transition initiatives and related challenges

Over the past two years, decarbonization has gained momentum in Japanese industry. In October 2020, the Japanese government released a Carbon Neutral Declaration with an aim to cut overall greenhouse gas (GHG) emissions to zero by 2050. Towards achieving this aim, in June 2021 the government further outlined a Green Growth Strategy, which encompasses an industrial policy to create a virtuous cycle for the economy and the environment as well as an action plan for business areas with growth potential.

Despite these moves, Japan's decarbonization still poses an extreme challenge compared to other geographical regions. The government has set a 46% cut in GHG emissions relative to FY2013 as its mid-term target for FY2030, matching targets set in other regions; however, Mizuho Bank estimates that Japan's cumulative efforts will result in only a 41% reduction, even assuming that the government's Strategic Energy Plan comes to fruition. In the area of renewable energy, which enables local energy self-sufficiency, a number of initiatives are already underway, and additional suitable land is not readily available. Therefore, it is necessary to consider further strategies, taking into account Japan's particular disadvantages in comparison to other countries. There is room to innovate using new technology, but with only seven years remaining until 2030, it will clearly be an uphill battle to make further progress in decarbonization.

Given these challenges, promoting transition finance will be critical for the achievement of Japan's 2050 carbon neutral target. In December 2020, the International Capital Market Association (ICMA) released its Climate Transition Finance Handbook, which recommends the following four elements for transition finance disclosures:

1. Issuer's climate transition strategy and governance;
2. Business model environmental materiality;
3. Climate transition strategy to be 'science-based' including targets and pathways; and
4. Implementation transparency.

Further, in May 2021, the Japanese government formulated its Basic Guidelines on Climate Transition Finance. These guidelines address Japan's unique characteristics, such as by incorporating the government's sector-based roadmaps into the 'science-based' climate transition strategy disclosures. To date, the government has disclosed roadmaps for the electric power, oil, gas, iron and steel, cement, chemical, pulp and paper, shipping, and aviation sectors.

Mizuho taking proactive steps to advance transition finance and support clients' decarbonization.

Since the release of the ICMA handbook, Japanese firms have taken a leading position in fundraising under the transition finance framework, both in the number of deals and amount. One major reason for this is that firms have been provided with some clear benchmarks for deciding their decarbonization plans, due to the government clarifying its technological milestones up to 2050 in its sector-based roadmaps. Also, companies may feel an incentive to gain approval for aligning their decarbonization strategy with that of the government through using the government's transition finance framework.

Even so, the issue remains of how to address various uncertainties that exist in the development of transition finance. For example, the Japanese government estimates hydrogen demand to be 20 million tons in 2050, which is somewhat different from the Mizuho's estimate of 24 million tons. It also goes without saying that 2050 hydrogen demand estimates assume the establishment of new supply-side and demand-side technologies, such as those for hydrogen power generation, and hydrogen steelmaking. However, these technologies' realization is not guaranteed. Because of this, in moving forward transition finance, it is essential to carefully assess long-term business plans with attention to inherent uncertainties, including medium- to long-term policy and market developments and new technology development. In this way, advanced business assessment capabilities continue to be vital for financial institutions.

At the Mizuho, we are taking proactive steps in the area of transition finance, where we have become a global leader. We have already been maintaining a top position in the sustainable finance market, and we are establishing a similar position in the transition finance market as well. Aside from this, we have enhanced our framework for evaluating clients' transition strategies and initiatives, and in December 2022 we publicized our approach to transition support. We have clearly stated that we will allow for short-term increases in financed emissions as long as an appropriate longer-term decarbonization plan is in place.

As a financial institution, Mizuho has supported the development of heavy industries, mainly in Japan, since early times soon after our establishment. We will continue to provide transition support to clients, ranging from financial solutions to non-financial solutions such as consulting.

We will not be held back by short-term increases in financed emissions when they are part of us fulfilling our duties as a financial institution.

HACINA PY
Group Chief Sustainability Officer - Société Générale

Enabling transition to a low-carbon economy is an opportunity we should not miss

Societe Generale has been strongly committed for more than 20 years to the financing of renewable energy and positive impact finance. We are engaged in aligning our most carbon intensive portfolios to trajectories compatible with the Paris Agreement and have launched a transformation plan to accompany this major shift. More than ever, building solutions for the new paradigm requires cooperation with various stakeholders and a global environment facilitating a harmonious and swift move in this crucial decade. The current geopolitical context exacerbates the need to have a clear global plan and to accelerate the transition to a low carbon economy.

Defining and implementing transition pathways, starting with high emitting sectors, is prone to multi-faceted challenges: strategic, economic, geopolitical, social, and operational among others.

The challenge for banks to align their portfolios on 1.5°C scenarios is huge, as they finance an economy heading closer to 2.7°C. We are convinced that cancelling financed emissions through immediate withdrawals of high-emitting assets or termination of clients' relationships would be inefficient from the global decarbonization perspective. Banks should not only gradually reduce their financed emissions, but crucially "finance emissions reduction", to quote the GFANZ. The best path is to support clients across sectors by financing their investments towards activities consistent with the Paris Agreement and improving the carbon intensity of sectorial portfolios.

Economic incentives and enabling infrastructures are also needed. For the energy sector alone, the International Energy Agency's Net Zero Emission scenario estimates $3.6tn annual needs, a five-fold increase in investments by 2040 against 2021. The situation is comparable for other high-emitting sectors. Yet, financial institutions' offers and capacities are abundant, but we observe that low carbon projects, that can be financed, are missing. This starts with the need to change demand, to progress to an economy of usage, to switch to more electrification, which implies new public infrastructures, capacity building and skills development.

Public policies have a role to play to facilitate corporates' preference for investing in low-carbon solutions over existing technologies. Public support can take different forms such as public private financing, public risk-sharing, subsidies, or fiscal measures. The recently announced Net-Zero Industry Act in the EU is a step in the right direction.

Defining and implementing transition pathways is prone to multi-faceted challenges.

Geopolitically, current tensions are making common approaches more difficult and risk increasing disparities amongst jurisdictions. As an international player, while having in mind the global goal of the Paris Agreement, we must take particular care to support the transition of the economy globally, to leave no-one behind in the transition journey. To do so, the transition pace should be appropriate in developed as well as emerging economies, considering their specific needs.

At a social level, the shift to a carbon-neutral economy by 2050 is conditioned by its social acceptance. This is an area for public policies: seek just transition, address the social consequences of climate change mitigation measures, and ultimately avoid social crises. New collective narratives are also needed, starting with education and adapting marketing messages to ensure the adoption of sustainable consumption habits.

Operationally, the lack of comparable and audited data on companies' decarbonization pathways is problematic. Although we remain optimistic that disclosure obligations under the Corporate Sustainability Reporting Directive (in the EU) and under the International Sustainability Standard Board (ISSB) standard on climate financial risks (outside of the EU) will bring positive outcomes in that space, reconciliation of different and evolving requirements at the global level is critical to the operability of banks' transition pathways.

Challenges ahead of us create opportunities for the EU economy to rise stronger while following an ambitious transition path. Huge opportunities exist for banks and companies investing in future-proof business models, consistent with their purpose. EU banks' clients, both people and companies, employees and their other stakeholders are at the forefront of the decarbonization movement. Banks increasingly need to engage in a meaningful dialogue with them to build common standards and create new products, processes, and services.

At Societe Generale, ESG is at the heart of our strategy, in line with our corporate purpose guiding our actions, and leads us to accompany our clients in building a more sustainable world. We have taken public commitments both on the reduction of our own carbon footprint and on the adaptation of our portfolios, with a strong push on adapting our models to finance the transition.

With the support of policymakers to help us shift the economy with the relevant pathways and make them socially acceptable, we can achieve a lot.

THOMAS BÉHAR
Chief Financial Officer - CNP Assurances

Biodiversity preservation and transition to net zero are both needed

Climate change mitigation and adaptation are the core focus of the global risks' perceptions. It is a clear challenge for the next decades. Therefore, the burdens on ecosystems will grow up given their undervalued role in our planet's health. In January 2023, the World Economic Forum's Global Risks Report ranked biodiversity loss and ecosystem collapse as one of the top five threats facing humanity over the next ten years.

Scientific reports have been warning about the acceleration of biodiversity loss, which is reflected in the destruction of ecosystems, the disappearance of species and reduced genetic diversity within species. The IUCN (International Union for Conservation of Nature) red list is a leading benchmark used to monitor the state of biodiversity in the world. This red list has showed us that now one in four species of mammals, one in seven birds, and one-third of conifer species are threatened with global extinction. In the coming decades, one million species are at risk of extinction, i.e. an extinction rate 10 to 100 times higher than the average for the last 10 million years. Much like climate change, biodiversity loss is thus a major environmental challenge for current and future generations. It is also an economic challenge.

In March 2022, the Network of Central Banks and Supervisors for Greening the Financial System (NGFS) acknowledged that "nature-related risks, including those associated with biodiversity loss, could have significant macroeconomic implications, and that failure to account for, mitigate, and adapt to these implications are a source of risks relevant for financial stability".

In our corporate mission that designs our strategy, CNP Assurances defines the Planet as one of our stakeholder (like customers or staff). Our commitment is double: to combat climate change and protect natural world. In 2023, CNP published for the first time our overall performance covering both financial and non-financial indicators including biodiversity and climate change:

- CNP Assurances, a responsible investor with €347 billion in investments managed with ESG screening, has been a member of the Net-Zero Asset Owner Alliance since 2019 and is committed to making its investment portfolio carbon-neutral by 2050. As such, the Group is strengthening its sector-based policy on thermal coal by excluding, as from 2023, any new direct investment in companies deriving more than 5% of their revenue from thermal coal-related activities (versus 10% previously). This new and more demanding threshold will allow CNP Assurances to exit thermal coal definitively by 2030 in European Union and OECD countries and by 2040 in the rest of the world.

Biodiversity preservation is as important as the decarbonization of the portfolio

- In September 2021, CNP Assurances signed the Finance for Biodiversity Pledge and set new biodiversity protection targets over the next five years. These targets cover all asset classes from equities and corporate bonds to real estate, infrastructure and forests. Furthermore, at end-2021, 26% of our directly held equity and corporate bond portfolio comprised companies that are heavily or very heavily dependent on at least one ecosystem service. In other words, more than a quarter of the value of the securities held in the scope under review would be exposed to a significant risk if an ecosystem service were to disappear in the coming years. Dialogue with the companies and countries that CNP Assurances finances is crucial. It is a joint effort to reverse the deterioration of the environment. In 2020, biodiversity was discussed in 64% of CNP Assurances' direct dialogues with companies in which it is a shareholder.

The management of forestry assets are a concrete example of the link between these two fronts. In France, no fewer than 70 million tonnes are captured each year thanks to the forests. Thus, our forests are playing an active role in the fight against global warming. Reforestation and planting new forests are effective ways of combating global warming, especially when selected species are resistant to this change. In addition to preserving biodiversity, the challenge is to adapt forests and make them more resistant to climate change. With more than 57,000 hectares of woodland, CNP Assurances is France's largest corporate owner of forests. The charter signed with the subsidiary in charge of managing this asset sustainably includes an inventory of potential biodiversity, with the aim of improving it through actions such as the conservation of microhabitats, the creation of ecological corridors, and cessation of forestry work during the reproduction periods.

Assurances is committed to measuring the biodiversity of 100% of its forestry assets and to setting aside 3% of the forest area for ageing plots and areas undergoing natural evolution by the end of 2025.

CNP Assurances makes the choice to do both: helping preserving biodiversity and limiting global warming.

MATTEO DEL FANTE

Chief Executive Officer - Poste Italiane

The road most travelled – Climate risk is not a construct

A construct is an idea or a theory containing different concepts and elements, that are usually not regarded as empirical but widely influenced by social, political, and biased views. Consequentially, a risk construct is based on the idea that any risk assessment cannot be definitive or absolute – but rather partial, in progress or susceptible to the latest socio or geopolitical view.

The main risks we are exposed to nowadays are real and tangible, like climate change, loss of biodiversity and the associated adaptation risks (of which mass migration is one becoming more and more evident), all the above interpreted within a construct framework and not as events to act upon, because still considered adaptable and mitigable through market-based mechanisms, different risk weights or asset pricing. A construct is interpretable, beyond the event itself, through political or regulatory decisions. Climate change action requires much more robust interventions and a much longer time horizon than our five years plans. So, a potential fallacy lingers over us, just as threateningly as increasing CO2 emissions.

In 1985, Baruch Fischhoff, one of the founders of risk management as social discipline, wrote that "people disagree more about what risk is than about how large it is". This is where we stand: in presence of clear signs that, whatever definition and classification we propose through different taxonomies, climate change is happening and it is scary, as recently confirmed by the latest UN Intergovernmental Panel on Climate Change (IPCC). The threat is clear, the associated risks are self-evident, and we are not yet making progress. Thanks to data science, we know the paths to mitigate the main risk, being it the Co2-driven rising temperature (target: 1.5C by early 2030) of our planet. Ad we have more evidence of the associated dislocations of people and resources, and the incremental need of financing for the ambitious, if not unprecedented, transition plans we all have, in Europe and globally.

We are therefore precisely at the point where we need to avoid building another risk construct, a fallacy of interpretation stopping us from seeing the real problems and their magnitude. This is a huge and collective change and here are some ideas from our experience in Poste:

- Build a stronger social purpose of financial services: Our starting point is what we believe is right for the people we serve: we see growing demand towards greener and more sustainable services. So, in Poste, we started greening and transforming our offer, embedding in our proposals, being a financial asset, a service or even a physical service, not a 'green' add-on but making our net zero targets an essential component of the value chain. This, in our experience, begun from transforming our physical platforms. In its 161 years of history, Poste built the widest office network in Italy and one of the largest in Europe (over 12,500 offices around the whole country). We kept our physical footprint, leaving offices open even in the more remote locations, and we are not only greening our fleet and real estate, but we are using digitalization and dissemination of services to foster social cohesion, reducing digital divide but also reducing the implicit Co2 footprint of our clients and suppliers. Our investment activities and life pension operations are integrating their decisional framework not only to invest in ESG labelled assets, but also to quantify impacts and be more proactive both as equity and bond investors. Getting closer to the society we serve and reinterpreting and making the challenges of net zero a familiar and shared objective will make the difference.
- Be the link between regulatory bodies and the public: We are learning that climate and transition challenges are not akin to any other risk: we are not dealing with regulating financial products, new asset classes or financial offers, but with how climate disruption will have real impact on people's lives. Therefore, we are learning to shift from a defensive approach towards our financial regulators to wanting to be partners with them. We all need to be engaged in a frank and open dialogue, not only among experts and practitioners, but also downstream: we are producing more and more communication with our clients, that is our investors, retail customers and citizens, as represented in our Integrated Annual Report. And this approach needs even more forms of networking, working groups and taskforces where regulators and institutions engage with each other. At Poste Italiane, we have access to vast amount of data via our clients and we believe that there is a role that financial services have in providing real-time feedback to regulators. This capacity to address concerns from the public and use the information to inform our dialogue with regulators and legislative powers will bring over time a sense of trust and common mission.
- Make adaptation matter – The most important challenge in these transition years is to adapt our activities to a new framework and new realities imposed by climate and social events. The recent droughts in Northern Italy and Northern Europe have had an impact on our clients, on their capacity to generate revenues and we are now openly talking about climateflation, meaning that the lack of water or reduced capacity of basins have had an important impact on price levels for agricultural products and reduced hydro energy production. From a financial perspective, we need to keep serving those communities in what is a transforming journey.

The "risk construct" may lead us to believe that being compliant on paper, with all the necessary ESG ratings and awards and with all the required statements and assessments requested by the European regulators, is enough. In fact, compliance should not be an excuse not to think harder about the implications and consequences of these transitions also from a governance point of view. Corporate responsibility transparency and accountability are becoming as important as the development of new financial products. The change of "G-ear" as in governance is even more relevant for new generations of young colleagues and customers, all very aware of social and environmental challenges ahead of us. We do not believe that offering either recyclable credit cards or sustainable finance products is enough, but only part of a more general strategy and a radical change of thinking about how we can work together. Towards, as the Brudntland Report titled in 1987, 'Our Common (n.d.a. and transgenerational...) Future'.

ESG ISSUES IN THE ASSET MANAGEMENT AREA

MARCO ZWICK
Director - Commission de Surveillance du Secteur Financier (CSSF)

SFDR: what is it, and what should it not be considered to be?

The European Sustainable Finance Disclosure Regulation (SFDR) defines disclosure obligations for financial product manufacturers designed to ensure adequate information of end investors about sustainable investment objectives, in support of Environmental, Social and Governance investment principles, and requires the integration of sustainability risks in investment processes operated by financial market participants (FMPs).

The over-arching general regulatory obligation is not new for FMPs and is certainly not specific for ESG labelled products: (i) be precise and transparent on the investment objective of the product from its inception throughout its lifetime, (ii) disclose in a clear, fair, not misleading, simple and concise way to end investors the product features and potential negative consequences on environmental , social and governance factors caused by investment decisions and advice, (iii) design a product in a way to reflect faithfully the disclosure made, and (iv) implement risk management and compliance arrangements that guarantee the permanent management of the product in line with the pre-agreed investment objectives and restrictions. In other words: Explain without ambiguity what the product does (and what it does not do), and put investment and risk governance arrangements in place to ensure that promises made to investors are being honoured.

Irrespective of labelling a financial investment product as Article 6, 8 or 9 under SFDR, these general principles should guide FMPs in their product design, investment process and marketing/distribution activities. SFDR is thus not a "labelling regime", but a disclosure regulation. SFDR is one major, albeit not the only, component of a regulatory framework aiming at avoiding mis-selling, also often named "green-washing" in the ESG space. Supervisory authorities, whose mission statement includes investor protection, will continue to focus on the correct implementation of SFDR by FMPs, by reviewing and analysing their product pre-contractual and marketing documentation before public release or ex-post, but always with the focus that FMPs should deliver what they have promised to end investors.

SFDR is not a "labelling regime", but a disclosure regulation.

All efforts deployed in relation to the implementation of SFDR level I, the Regulatory Technical Standards under SFDR level II, Taxonomy Regulation, and the development of a EU Ecolabel for retail financial products, pursue the same objective of channeling private savings to investment products following a sustainable finance strategy within Europe and beyond (commonly referred to as *"transition to a climate-neutral, climate resilient, resource efficient and fair economy as a complement to public funding"*). The intention to further stabilise, strengthen and harmonise the EU sustainable finance regime is supported by the need to clarify several fundamental concepts, such as the definition of a sustainable investment – which will logically also form the basis for defining "green-washing" –, the setting of investment thresholds to disclose under SFDR Article 8 and 9, and the resolution of inconsistencies existing between SFDR and the Taxonomy Regulation.

Acknowledging the fact that SFDR, ESG and Taxonomy still present significant legal, technical and operational challenges for FMPs and for supervisory authorities, we need to keep our attention focused on those factors which are urgent and which really matter as they will determine the success of making sustainable finance attractive to investors. One of these factors consists in the workability of the sustainable finance rulebook which would need to be further enhanced at EU level, so as to provide clarity on the interpretation and implementation questions raised by various stakeholders, including by not limited to investors, FMPs and supervisory authorities. The credibility of the sustainable finance rulebook risks to be negatively impacted by the lack of clarity on fundamental concepts which, in addition to creating legal uncertainty, complexifies disclosure by industry participants and supervision by national control authorities.

These challenges should, however, not overweight the benefits of a harmonised EU regime. One prominent example is the creation of European ESG disclosure templates which represent a notable step towards targeting standardised and comparable disclosures to end investors. By acknowledging at the same time that disclosure templates still need to be simplified to ease a comprehensive disclosure to end investors and most importantly retail investors.

To make this strategic European project successful, care must also be taken to remedy those initiatives which may create market fragmentation, such as the introduction of national "top up" SFDR and ESG rules and regimes, or differences in the application for different products under (the same) SFDR. Because such fragmentation puts into question not only the good functioning of the European passport for investment products, but of the EU Single Market as a whole.

JULIA SYMON
Head of Research and Advocacy - Finance Watch

ESG rating regulation – A missing element of the EU sustainable finance agenda

Environmental, Social and Governance (ESG) ratings are widely used in the context of sustainable investing, despite the fact that no consistent definition or methodology exists for determining such ratings. An on-going debate concerns the lack of clarity about the objectives of these ratings and ESG investing in a broader sense.

In its Sustainable Finance Strategy, the European Commission recognised the growing impact of ESG ratings on the operation of capital markets and on investor confidence in sustainable products. A long-awaited proposal for regulating ESG rating providers is expected to be published on 13 June 2023.

No common underlying methodology

At present, there is no consistency on the market as to what the ESG ratings are aimed at measuring - impacts of products and businesses on environment and society, financial risks from ESG factors to products and companies, opportunities arising from ESG factors or all of the above. In turn, this undermines the concept of ESG investment.

Citizens and investors tend to care about the impacts of business on the environment and society and therefore often think of ESG ratings as reflecting those impacts. However, in most cases ESG ratings providers aim to capture only sustainability-related risks, i.e. financial consequences of sustainability factors for the companies and products. Further, there is neither transparency nor a consistent approach to how the Environmental, Social and Governance component scores are eventually aggregated into the final ESG ratings.

Ultimately, a 'standard' ESG rating does not exist. Every such rating is a different measure, defined by the specific provider. Unlike credit ratings, which compete in providing best estimates of probability of default of the rated entity despite using proprietary methodologies, ESG ratings do not have any common underlying metric. This makes a comparison between ESG ratings coming from different providers at best very difficult to impossible.

A recipe for greenwashing

Despite the confusions and absence of clarity, ESG ratings have proliferated: investors use them to make investment decisions, companies - to claim positive contributions to the environment and society, and; even supervisors explore these ratings when analysing climate-related risks incurred by the financial institutions.

Transparency, supervision and robust governance are key to combat greenwashing.

The lack of clarity and diverging expectations on the objectives of ESG ratings is a recipe for greenwashing practices. Investors are misled by sustainability characteristics of the products they purchase and are increasingly losing trust in ESG investment as a tool to achieve positive environmental and societal impacts.

Companies using ESG ratings to design their sustainable product offerings increasingly struggle to substantiate such claims. Thus, there is a need to improve the quality of information on which investors, businesses and other stakeholders base their decisions. How such decisions are made, including the information used, is key to facilitating the transition to a sustainable economy.

What must the new legislation achieve?

Every ESG rating should follow three founding principles: 1) it must have a clear objective and be transparent about the methodology it uses; 2) it must be founded on reliable and identified data; 3) it must be unbiased. These principles are fundamentally important if ESG ratings are to be a reliable guide for investment decisions in the context of sustainable transition and, in particular, in the context of the EU ongoing work on defining and combating greenwashing. Thus, the backbone of the upcoming EU regulation should be:

1) **Transparency:** including minimum requirements for methodologies and data sources, clear description of objectives; and differentiation among the Environmental, Social and Governance components. It is misleading, therefore, and should be forbidden, to provide only a single metric without differentiation.
2) **Supervision:** including an authorisation process, a governance structure, resourcing arrangements, and procedures to prevent conflicts of interest.
3) **Prohibition of conflicts of interest:** such as prohibiting provision of ESG ratings and other related services to the same issuers, prohibiting ESG rating providers from holding equities in the entities being rated; mandating that providers have adequate internal control structures.

ESG rating regulation should carefully consider the existing and evolving ecosystem of sustainable finance. On the one hand, ESG ratings evolve alongside multiple voluntary ESG labels, ESG product characteristics defined by the Sustainable Finance Disclosure Regulation (SFDR), as well as definitions of sustainability preferences as per MIFID and IDD. On the other hand, ESG ratings which claim to assess financial materiality of ESG risks for an entity should arguably be considered as part of the traditional credit ratings, which are required to take into account all material risks.

The article is based on an upcoming Finance Watch publication.

DAVID HENRY DOYLE

Vice President,
Head of Government Affairs &
Public Policy EMEA -
S&P Global

Unlocking the potential of the EU Sustainable Finance Information System

The EU Sustainable Finance Agenda has created a new sustainability information system. This system is complex due to its reliance on a number of pioneering and interconnected regulatory mechanisms including SFDR, CSRD, and the Taxonomy. However, this system holds the potential for ground-breaking insight: knowledge and tools to understand and manage how investments impact the environment and society. What steps are needed to unlock the potential of this system and to scale up real-world investments?

Two key challenges must be tackled to realise the potential of the EU system. First, guidance is needed on how essential components are intended to function in the real world. Second, a high degree of quality and integrity should apply to the production and use of sustainability information within the system. Information providers, companies, financial market participants, regulators, and policy makers must all work together to tackle these two challenges.

On the first challenge, to reach a 'steady state' and become fully operational users must understand how to apply the central mechanisms of the system. As with any new system, users have encountered difficulties when translating theory into practice. Firms are grappling with new rules on disclosures, thresholds, definitions, timelines, and product classifications. Even when provisions are clear, the time and resources needed to adjust processes are significant. When the rules are not clear firms are left with uncertainty which can lead to paralysis.

Elements of the system which have been identified as problematic should be tackled with urgency. Implementing guidance on how to interpret and apply key definitions should be prioritised. Clear explanations on how to apply accounting rules, interpret technical screening criteria, and determine significant harm under the Taxonomy and SFDR are needed. Where necessary, amendments to specific provisions should be considered to prevent unintended consequences. For instance, under SFDR the complex definition of Sustainable Investment and the potential for product classification categories to be misapplied as marketing tools have been identified as deserving attention.

> **The EU Sustainable Finance Agenda has created a new sustainability information system.**

The second challenge relates to information quality. The success of the system will rely on the availability of high quality, assured, and accessible sustainability information. The system should apply high standards of quality and integrity to the data it generates through disclosure and uses as input data. However, much of the information required is not yet available due to a mismatch in timelines for financial and corporate disclosure regulations.

Solutions are on the horizon. The CSRD will – in time – provide many of the standardised and assured data points necessary for firms to fulfil their reporting obligations. Upcoming disclosure requirements for companies subject to the Taxonomy and CSRD should therefore be timely, clear, and attainable. Once established, ESAP should render that disclosure accessible in a machine-readable format.

However, given the specialised nature of sustainability data and the global nature of financial markets it is likely that information intermediaries will continue to play a role. In this context, sustainability information products have come under scrutiny. These products offer a range of analysis, research, technology, and data solutions on sustainability matters. It is important that they also have high quality production methods.

Again, solutions to meet this challenge are available. International standards for sustainability information providers have already been developed. IOSCO's Sustainable Finance Taskforce launched a dedicated workstream in 2019 which fostered a productive dialogue between policy makers and sustainability information product providers. This resulted in the publication of a detailed set of IOSCO recommendations for ESG ratings and data providers in November 2021 covering methodologies, transparency, governance, and managing potential conflicts of interest.

IOSCO's final recommendations for ESG rating and data providers are welcome. The recommendations focus on the promotion of high quality ESG ratings and data products. Consistent implementation of the IOSCO recommendations will support the production of high-quality products and will help to avoid fragmentation across jurisdictions. S&P Global will continue to contribute to this important dialogue as the EU looks to implement IOSCO's recommendations through potential regulation.

All new systems encounter implementation challenges. A system as complex as the EU Sustainable Finance Agenda requires active steps and interpretative guidance to remain aligned to its ultimate objective: facilitating capital to flow to real world projects aligned to the objectives of the EU Green Deal. Clarifying the rules and safeguarding the quality of information powering this system will be of paramount importance.

LAURENCE CARON-HABIB
Head of Public Affairs - BNP Paribas Asset Management

How rules on funds' naming can clarify the SFDR framework

1 January 2023 was a key milestone in the implementation of the EU sustainable finance regulatory agenda with the entry into application of the so-called Level 2 measures of the Sustainable Finance Disclosure Regulation (SFDR). Accordingly, asset managers now have to disclose key indicators as defined under the pre-contractual templates for their Article 8 and 9 products and from June 2023, they will have to produce extra-financial data as required in the templates for annual reports. Mandatory Principal Adverse Indicators (PAIs) at entity level will also be requested in a quantitative manner by mid-2023.

BNP Paribas Asset Management welcomes all measures resulting in further transparency and better comparability between products for end-investors. The SFDR, as well as the Taxonomy Regulation and recently adopted Corporate Sustainable Reporting Directive (CSRD) should contribute significantly to the transition towards a more sustainable economy through enhanced harmonization and standardization, both at entity and product level. At the same time, it appears that structuring concepts and definitions to be applied by financial market participants have not yet been clarified by European policy makers, this leading to some degree of confusion and possibly additional claims on greenwashing.

BNP Paribas Asset Management believes that work should be pursued for establishing a framework addressing end-investor protection and meet their expectations in terms of sustainable preferences. ESMA's proposals on fund's naming guidelines can be a positive step forward in the fight against greenwashing, provided that a relevant approach is applied. BNP Paribas Asset Management recommends that instead of introducing absolute thresholds for the use of ESG and sustainable-related terms in funds' naming, a relative approach should be adopted. It would consist in making the use of ESG and sustainable-related terms linked to the proportion of sustainable investments in one fund compared to its benchmark or investment universe.

For example, if an investment universe has 40% sustainable investments, then a fund investing in that universe would qualify as sustainable if it has more than 50% sustainable investment (using the same methodology). This selective approach would allow to neutralise the lack of clear definitions as mentioned above and most importantly reward funds with highest standards in their selection.

Fund's naming rules can be a positive step forward provided that a relevant approach is adopted.

In addition, it is quite important that asset managers have the possibility to develop their own methodology for identification of sustainable investments while complying with common principles on calibration and criteria. Assessing sustainable investments at entity level is also essential, instead of having a look-through approach on the activities of this entity. Otherwise only taxonomy-aligned products would enter in the sustainable investment category while data on taxonomy remain scarce at this stage and taxonomy alignment is very low for most companies (today less than 1% of issuers are 100% taxonomy aligned). With such a narrow definition, investors will all invest in the same products, which would create a bubble on a few assets while not financing sufficiently the broader needs for the transition. This would be totally in contradiction with the initial purpose of the EU Green Deal.

BNP Paribas Asset Management also believes that regulators need to work on how derivatives can be included in sustainable strategies when these contribute to the ESG dimension of the investment funds. It is notably important that their use remains authorized and that they can be taken into account for the calculation of the minimum proportion of investments used to meet the sustainable investment objectives. In that case, as for the methodology and criteria used for selecting sustainable investment, high transparency standards should guarantee that manufactures design their sustainable strategies according to the objectives assigned under the SFDR.

BNP Paribas Asset Management is convinced that retaining such principles, alongside with the introduction of minimum criteria for Article 8 products and the streamlining of extra-financial information to be reported, would represent a great foundation for introducing a labelling scheme at EU level, easily accessible to all investors, including retail ones.

More globally it could be considered as a valuable option when assessing the SFDR as currently designed and thinking on how it could be improved for the benefits of both market participants and end-investors.

SUSTAINABILITY REPORTING STANDARDS GLOBAL CONVERGENCE

SUE LLOYD

Vice-Chair - International Sustainability Standards Board (ISSB)

High-quality disclosure must not be the exception, but the rule

Fundamental to our work at the International Sustainability Standards Board (ISSB) is the belief that better information creates better decision making. In building ISSB Standards we are focused on providing transparency and efficiency in company disclosures to investors.

As we all know, sustainability factors have swiftly become a mainstream part of investment decision-making: at the ISSB we are building a common language for sustainability disclosures, to be used globally. The information provided by our Standards will empower economic decisions by requiring information that helps investors assess sustainability-related risks and opportunities.

In February, we finalised decisions on the technical content of our first two Standards (S1 and S2). S1 and S2 are now going through a thorough drafting and formal 'balloting' approval process ahead of their issuance towards the end of Q2 2023, and will be immediately available for use, although, jurisdictions will opine on when they require companies to apply these Standards. In building these Standards we focused on providing companies an efficient and effective reporting system that meets investors needs on a globally comparable basis. It is critical that our requirements can be applied in developing and developed economies and by both large and smaller companies. This is why we have embedded proportionality into our Standards, alongside the launch of separate initiatives focused on capacity building.

We are aware that many companies will need to meet multiple jurisdictional requirements for reporting. This is why we have taken a "building blocks" approach to our Standards. We have designed our Standards to be used in conjunction with the requirements of jurisdictions, or in conjunction with requirements of the Global Reporting Initiative (GRI).

In December, alongside the European Commission and EFRAG, we announced that we are working toward a shared objective to maximise interoperability of our respective standards and aligning on key climate disclosures when possible. This joint work focuses on detailed terminology within the standards, and as such will be completed with the finalisation of both sets of standards.

Companies will have what they need to begin applying ISSB Standards very soon. We have chosen this timeline to address the urgent need for these standards, consistently communicated to us through market engagement. Meeting this need has been a core priority for the ISSB from the outset.

S1 and S2 build on existing materials. Those that already apply the TCFD Recommendations and the SASB Standards, will already be in a strong position to apply the ISSB Standards. Having said this, we know that sustainability disclosures are new for many companies around the world, which is why we are introducing programmes to support companies that are just beginning to report on this information.

At COP27 we launched an initial Partnership Framework with support from around 30 partner organisations. This framework is designed to support preparers, investors and other capital market stakeholders as they prepare to use our Standards. As part of our next phase of work, we will also be working directly on capacity building around the world. We know that there is a lot of education and training required for companies, for regulators, for audit firms, and also for investors, on how to prepare this information and how to use the information that will result from the ISSB Standards.

While many of our capacity building efforts will happen outside of S1 and S2 through our Partnership Framework and ongoing outreach and education, the Standards themselves have built in measures to ensure companies are given room to scale up their capabilities.

We use a proportionate approach in S1 and S2 that considers a company's skills, capabilities, and resources. The Standards will also provide reliefs on the provision of some disclosures, allowing companies additional time to provide Scope 3 GHG emissions disclosures, for example. To enable companies to provide disclosures on sustainability-related risks and opportunities beyond climate, the ISSB points to sources of guidance in the absence of a specific ISSB Standard – primarily the SASB Standards, but also the CDSB Framework application guidance, investor-focused standards, industry practice, and to the extent they meet investor information needs, metrics set out in the GRI and European Sustainability Reporting Standards (ESRS).

To conclude, we are embarking on a shared journey towards a common language on sustainability disclosures for investors. Companies will likely rely more on estimation in the early years, and approaches will become more sophisticated over time.

Over the coming years, the ISSB is committed to supporting capacity building efforts, and providing requirements that enhance global comparability, and produce high quality disclosures for investors, enabling more informed decision making and more resilient global markets.

DANIELA STOFFEL

State Secretary - Ministry of Finance, Switzerland

Switzerland, one of the leading countries in financial transparency on climate

In order for the financial center to optimally support the achievement of sustainability goals and adequately consider sustainability risks, it is dependent on high-quality sustainability data from the real economy: The more comparable, more accurate and meaningful this data is, the better it can be taken into account in advisory processes, their balance sheets and in the financial system as a whole, and the lower the transaction costs for international and national investors are.

Data providers, such as stock exchanges that collect and refine the data, play an important role. Sustainability reporting also leads to a better reputation in general. Companies that actively contribute to sustainability goals can create a competitive advantage.

Credible climate transparency is closely aligned with international standards. This leads to a level playing field, making it easier for international investors to assess risks and opportunities. At the same time, international standards also avoid duplication of efforts, as companies do not have to implement different requirements in parallel. For this reason, Switzerland relies on the internationally widely recognized recommendations of the Taskforce on Climate-disclosures (short TCFD recommendations). These recommendations have met with broad approval from companies both from the financial sector and the real economy.

With that intention in mind, in November 2023 the Federal Council adopted an Ordinance on mandatory climate disclosures for large Swiss companies: public companies, as well as banks and insurance companies with 500 employees or more and at least 20 million francs in total assets or more than 40 million francs in turnover, will be required to publicly report on climate issues based on the TCFD recommendations. This public reporting is based on a concept of double materiality. It includes, on the one hand, the financial risk that a company incurs through climate-relevant activities.

On the other hand, companies must disclose what impact their business activities have on greenhouse gas emission. These minimum requirements are intended to ensure that disclosures are meaningful, comparable, and, where possible, forward-looking and scenario-based.

Companies that actively contribute to sustainability goals can create a competitive advantage.

To give companies sufficient time to implement these requirements, the entry into force of this regulation has been set to 1 January 2024. By making the TCFD recommendations mandatory for large companies from all sectors of the economy, Switzerland becomes one of the leading nations in terms of climate transparency.

What challenges does Switzerland face with corporate disclosure?

Corporate disclosures are an area that evolves very dynamically. The Ordinance is not in force yet, but it is already clear that it needs to be reviewed by 2027. As a complement to the national implementation of the TCFD recommendations, international standards on sustainability disclosures are being drawn up. This task has been taken on by the newly formed International Sustainability Standards Board (ISSB). In order to ensure coherence with national disclosure obligations, Switzerland is following the ISSB's work closely.

A particular challenge we face is the different materiality. ISSB standards are focusing on a financial materiality, whereas the Swiss Ordinance and the Code of Obligations require a double materiality (financial AND impact materiality).

The second challenge is the extraterritoriality of EU disclosure regulation and the current developments in the EU regulation. The EU is by far Switzerland's most important trading partner, which is why regulatory innovations for the EU internal market undoubtedly also have an impact on Swiss companies.

Last year, the Corporate Sustainability Reporting Directive, CSRD, was approved in the EU. This directive also applies to Swiss companies that generate a net turnover of 150 million euros in the EU and have at least one branch or subsidiary in the EU (third country regulation). In the area of sustainability reporting, the CSRD brings in particular an extension of the scope of application to companies with an average of 250 employees or more. This would also affect some small and medium-sized enterprises. For these in particular, the question arises to what extent and in what form the publication of sustainability information makes sense.

The preparation of a sustainability report entails additional work and thus higher costs. Currently it is being examined if Swiss law needs to be adapted.

LAURENCE RIVAT

EU Corporate Reporting Policy Leader - Deloitte

Using sustainability reporting to drive behavioural change

Deloitte supports corporations issuing high-quality, transparent, relevant and comparable sustainability information that is connected to financial reporting.

The standards for this information should be global and leverage efforts currently underway for consistent reporting.

This will help direct capital to long-term sustainable business, by showing how corporations are creating long-term value and by providing insights into their business models, the broader risks and opportunities they face, and the impact they have on people, profit and the planet.

Worldwide adoption of the ISSB standards as the baseline will facilitate globally consistent and comparable information, and help address global sustainability priorities such as climate change. Pathways to adoption will vary around the world and we recognize the need for flexibility according to market and regulatory circumstances. In some regions a mandatory approach may be appropriate. This is the path chosen by the EU, where policy on the green economy is well advanced, and with the CSRD mandating sustainability reporting and limited external assurance.

In August 2022, Deloitte commented on the draft European Sustainability Reporting Standards (ESRS) developed by EFRAG[1]. We acknowledge the significant efforts made, and work carried out, by EFRAG in a limited time frame. We noted that EFRAG has incorporated many comments raised by stakeholders during the consultation period into the draft ESRS submitted to the European Commission.

The [draft] ESRS set a high bar for sustainability reporting, which we expect will incentivise companies to think about their sustainability practices, hence having the potential to promote changes in behaviours. Still, the [draft] disclosure requirements remain extensive, and in parts very granular. They will lead to major challenges for all undertakings in scope of the CSRD when implementing them, even more so the current non-NFRD undertakings. Further guidance in areas such as implementing the double materiality principle, and, with respect to the financial sector, how to report value chain information, would be helpful.

Benefits from sustainability reporting standards will arise depending on implementation support.

We appreciate the efforts made by EFRAG, the ISSB and the GRI to work together, so as to promote the interoperability of their standards. We look forward to the outcome of such efforts when the final standards are issued, as this is critical for international players. We continue to support continuing such initiatives going forward.

As the [draft] ESRS will be "new" and have been developed in a very short timeframe, implementation and interpretations questions will inevitably arise. It is paramount for the success of the sustainability reporting to put in place robust mechanisms enabling stakeholders to raise their issues and obtain swift answers.

We are aware of the continued time pressure on EFRAG to achieve its work plan, due to the CSRD requirements. There are urgent priorities beyond standard-setting, for example the desire for further guidance to support the ESRS implementation. It is important that EFRAG should have means available, proportionate to the tasks and ambition set for the organisation by the EU co-legislators.

Finally, it may be easy to fixate on the mechanics of sustainability reporting – getting lost in the weeds of detailed narrative disclosures and metrics. But sustainability reporting is not, and never should be, viewed as an end in itself. Rather, it is a means to encourage behaviour change, bringing transparency as to whether and how companies are putting sustainable development at the heart of their business.

Deloitte conducted interviews with leaders from around the world, gathering perspectives on the challenges in delivering ESG information and the actions required to catalyse behavioural and systemic change. Conversations identified six recurring themes or conditions that need to be in place to drive from the current position of incomparable and unreliable data to one where ESG reporting really does catalyse demonstrable actions at pace:

1. A globally consistent baseline
2. Relevant and reliable data
3. Integrating sustainability into company business models
4. Incentives and penalties
5. Stakeholder engagement
6. Industry and global coordination

Further information on what Deloitte heard can be found at https://www.deloitte.com/global/en/about/people/social-responsibility/sustainability-reporting-conditions-for-change.html.

[1] The August 2022 Deloitte Comment letter on the draft European Sustainability Reporting Standards (ESRS) can be found at https://www.iasplus.com/en/publications/global/comment-letters/other/efrag-eds

HIROTAKA HIDESHIMA

TNFD Taskforce Member, Counsellor on Global Strategy to President and the Board of Directors - The Norinchukin Bank

ISSB and other relevant standards: further developments scheduled ahead

Beyond Climate

The G20 Chair's Summary and Outcome Document for the G20 Finance Ministers and Central Bank Governors Meeting in February 2023 stated: "Sustainable finance is critical in achieving sustainable, resilient, inclusive and equitable economic growth which meets the needs of the present without compromising the ability of future generations to meet their own needs. Towards achieving this goal and also in promoting orderly, just, and affordable transitions, we will take action to enable enhanced financing for SDGs, including and beyond climate, in line with the G20 Sustainable Finance Roadmap.

Building on public and private initiatives, we ask the Sustainable Finance Working Group to develop an analytical framework for enabling finance for SDGs, with initial focus on nature-related data and reporting and social impact investing, taking country circumstances into consideration". The G20 Sustainability Finance Working Group (SFWG) has reported to the Ministers and Governors that they "will work on developing an Analytical Framework for SDG-aligned Finance to complement the SFWG Roadmap by:

- Conducting a stocktaking analysis of the measures taken so far to identify and report nature- and biodiversity-related risks and opportunities, including how the issue has been approached in practice, and the initiatives presently underway (e.g., by TNFD). Based on the stocktaking analysis, the SFWG will make recommendations to the stakeholders on how to improve data and reporting on nature-related information in the future, keeping in mind country-specific circumstances.
- Conducting a stocktaking analysis of social impact investing with a focus on investment instruments (e.g., impact investment bonds) and, as appropriate, make recommendations to governments and international organizations/networks on how to scale up the adoption of social impact investment instruments."

The G20 Chair's Summary and Outcome Document also stated that they "look forward to the early finalization of standards by the International Sustainability Standards Board (ISSB) for climate-related financial disclosures, and its work beyond climate".

Nature-related TNFD framework is to be released in September. Any implications for EFRAG via ISSB?

The ISSB announced on 14 December 2022 that "consistent with its approach of building upon the work of market-led initiatives grounded in current-best practice and thinking, the ISSB will consider the work of the Taskforce for Nature-related Financial Disclosure (TNFD) and other existing nature-related standards and disclosures where they relate to the information needs of investors. This will include considering the TNFD's recent work on the intersection of climate and biodiversity disclosures in scoping the ISSB's research on complementing its climate-related disclosures to address disclosures related to natural ecosystems."

The work of the TNFD

The Taskforce on Nature-related Financial Disclosures (TNFD) was formally launched in June 2021, to widespread support from financial institutions, corporates, governments and civil society. The G7 Finance Ministers and G20 Sustainable Finance Roadmap have endorsed the TNFD. The G20 and G7 Environment and Climate Ministers have also recognised the establishment of the TNFD. Other individual leaders have also endorsed TNFD, including Mark Carney, UN Special Envoy on Climate Action and Finance; UN Secretary General Antonio Guterres, President of France, Emmanuel Macron, and then Prime Minister of the UK, Boris Johnson. In November 2022, the TNFD released the third version of its beta framework for market consultation, building on v0.1 released in March 2022 and v0.2 released in June 2022. The next version of the beta framework will be released in March 2023 (v0.4), before the release of version v1.0 of the full framework for market adoption in September 2023.

A market-led approach, combined with input from leading science and data bodies, means the TNFD framework is scientifically rigorous and easy to adopt for both businesses and financial institutions. TNFD is creating an integrated framework that builds on existing standards, metrics and data. The TNFD Co-Chairs, David Craig, former founder and CEO of Refinitiv, and Elizabeth Mrema, Assistant Secretary-General of the United Nations and Deputy Executive Director of the UN Environment Programme (UNEP) and former Executive Secretary of the United Nations Convention on Biological Diversity (CBD), lead the Taskforce.

The TNFD consists of 40 individual Taskforce Members representing financial institutions, corporates and market service providers. The members come from AP7, AXA, Bank of America, BlackRock, BNP Paribas, FirstRand, Grupo Financiero Banorte, HSBC, Macquarie Group, MS&AD, Mirova, Norges Bank Investment Management, Norinchukin Bank, Rabobank, Swiss Re, UBS, AB inBev, Acciona, Anglo American, Bayer AG, Bunge Ltd, Dow INC, Ecopetrol, GSK, Grieg Seafood, Holcim, LVMH, Natura & Co, Nestlé, Reckitt, Suzano, Swire Properties Ltd, Tata Steel, Deloitte, EY, KPMG, Moody's Corporation, PwC, S&P Global, and Singapore Exchange.

CLIMATE CHANGE INSURANCE NEEDS

PETRA HIELKEMA
Chairperson - European Insurance and Occupational Pensions Authority (EIOPA)

The role of insurers in tackling climate change: challenges and opportunities

Climate change is a global challenge posing material risks to society and the economy. Its consequences are becoming more and more apparent particularly on physical risk exposures, for instance in terms of increasing frequency and severity of natural disasters, such as floods, droughts or wildfires. Regarding Europe, EIOPA's dashboard on the insurance protection gap for natural catastrophes shows that currently only around a quarter of the total economic losses caused by extreme weather and climate-related events are insured, leading to a substantial insurance protection gap. The insurability and pricing of climate-related risks become increasingly critical concerns for insurers and policymakers, and if no countermeasures are taken, the protection gap is expected to widen.

The expected growth in physical risk exposures and insurance claims due to climate change will increase risk-based premium levels over time, potentially impairing the mid- to long-term affordability and availability of insurance products with coverage against climate-related hazards. Moreover, the increased frequency and severity of natural disasters associated with climate change can make it more difficult for insurers to predict the likelihood of future losses accurately and to price insurance products appropriately. In this context, EIOPA will regularly re-assess the appropriateness of the requirements of the standard formula regarding natural catastrophe risk, and if necessary, provide suggestions for potential changes in Solvency II.

The insurance industry has a unique role to play in addressing climate change by making society and the economy more climate resilient. Insurers can develop innovative insurance products that incentivize climate-related risk prevention, for instance through offering lower premiums to policyholders implementing climate-related adaptation measures. Such measures, like anti-flood doors or early warning systems, can reduce the policyholder's physical risk exposures and insured losses. Adaptation measures can therefore be a key tool to maintain the future supply of insurance products with coverage against climate-related hazards and help reduce the climate-related insurance protection gap in Europe.

Insurers play a critical role through innovative products incentivising climate risk prevention.

With its concept of impact underwriting, EIOPA aims to foster the development and discussion about insurance products implementing climate-related adaptation measures in Europe. To better understand the industry's current underwriting practices regarding climate change adaptation, EIOPA conducted a pilot exercise with volunteering insurance undertakings in 2022. EIOPA found that progress is being made to increase policyholder resilience against climate change by implementing dedicated adaptation measures in insurance products and offering premium-related incentives, but the overall EU insurance market still appears to be at a relatively early stage.

EIOPA sees further room for improvement especially regarding standardising the implementation of climate-related adaptation measures in insurance contracts, for instance through dedicated risk-based certificates and programs. In its discussion paper on the prudential treatment of sustainability risks, EIOPA outlines regarding underwriting activities the framework to analyse the potential for a dedicated prudential treatment of climate-related adaptation measures in the solvency capital requirements for non-life underwriting risk.

While climate change is a growing risk for the insurance industry, it also creates opportunities. By taking a proactive approach to risk management, insurers can not only protect policyholders from losses but also ensure the long-term availability of insurance products and reduce the overall cost of insurance. It is however important to highlight that reaching the objective of adapting the society and economy appropriately to climate change requires further accompanying actions beyond the scope of the insurance industry, for instance in terms of developing and enforcing public building codes reflecting the dynamics of climate change appropriately. Besides considering Public-Private-Partnerships, public actors can also engage in improving the collection and sharing of climate-related loss data and raising awareness about climate change, thereby encouraging insurers and policyholders to adapt to climate change.

By working together, public and private actors can improve the overall understanding of climate-related risks and promote a more sustainable and resilient future. To foster climate change adaptation in the EU, EIOPA will continue its work on impact underwriting, including to raise the public awareness about climate risks and related prevention measures as well as promoting the use of open-source modelling and data.

ROMAIN PASEROT

Deputy Secretary General and Head of Capital and Solvency - International Association of Insurance Supervisors (IAIS)

Resilience to climate change: the role for insurance supervisors

Last month the Intergovernmental Panel on Climate Change (IPCC) published its latest scientific assessment of climate risks. It makes for grim reading and, for insurance supervisors, reminds us that risks from climate change are very real for the insurance sector. The report shows the global temperature has already risen 1.1 degrees Celsius above pre-industrial levels and is expected to reach the 1.5-degree threshold sometime in the first half of the 2030s. This will not only have social impacts, it will also materially change our economic life. Indeed, the IPCC reports that "human-caused climate change is already affecting many weather and climate extremes in every region across the globe."

As the global insurance standard setter, the International Association of Insurance Supervisors (IAIS) is focused on how the insurance sector assesses and mitigates these risks. Climate change will drive, and amplify, existing risk factors which will in turn impact insurers' assets and liabilities. As supervisors, we are concerned with both the prudential and market conduct impacts as these risks crystallise.

Given the economy-wide nature of climate change impacts and the significant efforts needed to reach net zero, we expect risks to emerge across all insurer business lines. The lack of progress on implementing net zero policies means the risks for insurers are growing. A "too-little-too-late" scenario is the worst of all worlds for insurers; it means transition risks which will bite notably on the asset side, will be more rapid when they come. Also, it increases the physical risks for both the assets and liabilities of insurers. For instance, the IPCC report notes that adaptation, a risk mitigant for insurers, becomes more difficult the longer it takes for substantive action towards net zero. Additionally, the IPCC has highlighted an increased likelihood of compound and cascading risks that are more complex and difficult to manage. This will also present additional risks for insurers as they seek to assess their exposure.

The IPCC report comes as the IAIS is currently consulting on the first of three consultations to embed climate risk within its supervisory material. The consultation, which builds on Application and Issues Papers we have published over the last few years, closes on 16 May. It proposes changes to the Introduction to the Insurance Core Principles--the global standards for insurance supervision--which positions climate risk within the international framework for insurance supervision.

The lack of progress on implementing net zero policies means the risks for insurers are growing.

Additionally, the IAIS is consulting on whether to make changes to our supporting material on governance, risk management and internal controls. Finally, the consultation includes questions seeking stakeholder feedback on our overall climate-related work as we seek to develop a globally consistent supervisory response to climate change within the insurance sector.

At the end of the year, we will publish a further consultation to provide guidance for supervisors on conducting climate scenario analysis and will consider the risks of greenwashing and market conduct issues related to climate risk. In 2024, we will close with a third and final consultation that deals with issues such as valuation, disclosures and enterprise risk management. Last month, working with the Financial Stability Institute, we also launched training for insurance supervisors on conducting climate scenario analysis which will be a key tool for understanding the risks insurers face. This work has highlighted the benefits of global cooperation between insurance supervisors to share and learn from each other on these critical issues.

According to the UN, almost half of the world's population live in regions that are highly vulnerable to climate change. Insurance can be used to support such vulnerable groups to address the economic hardship of unexpected losses. However, the Global Federation of Insurance Associations recently estimated the natural catastrophe protection gap at US$139bn annually. This is expected to grow as climate change increases the frequency and severity of natural catastrophes, exacerbated by the continued economic development in high risk areas. As the impact of climate change are felt, this will result in a significantly higher exposure and it is also possible it will lead to an increased protection gap.

With this in mind, the IAIS recently formed a task force, which will publish a report later this year, to consider the role supervisors could play in addressing protection gaps. Faced with increased climate risk, it is possible some insurers will increase premiums and reduce coverage. For supervisors it is essential to understand and address risks to ensure insurance markets work effectively and that they facilitate good consumer outcomes.

To conclude, climate change will be a significant risk driver for insurers in the coming years. As the insurance standard setter, we are playing our role ensuring a global response to address the growing risks from climate change.

MARTIN LANDAIS

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

Insurability of climate risks: perspectives from the French compensation scheme

To address the considerable challenges related to climate change, the expected contribution of the insurance sector is crucial. Natural catastrophe losses at an unprecedented scale are set to make 2022 one of the costliest years on record. In France, according to the French insurance federation France Assureurs, total weather-related claims amounted to EUR 10 billion last year.

The risks associated with the increasing frequency and cost of extreme weather events will have a direct impact on the offer and pricing of insurance policies. As a consequence, a key challenge for governments and regulators is to avoid a widening of the protection gap for natural catastrophes. A recent EIOPA study concludes that only 23% of total losses are currently insured in Europe. Alongside market options aiming to increase insurance and reinsurance capacity for climate risks, including Cat bonds, risk pooling or sidecars, public-private catastrophe risk management frameworks can work efficiently, in particular when the scale of risks requires a public backstop.

Such a public-private partnership was created in 1982 in France through Caisse centrale de réassurance - CCR, a State-owned reinsurer. France is indeed one of the very few countries with a system that guarantees all its citizens adequate compensation in the event of loss or damage caused by a natural disaster such as floods, mudslides, tidal waves, drought and landslides. This unique compensation scheme, known as the “régime CatNat”, is based on a public-private partnership, which combines private insurance with a non-mandatory state-guaranteed public reinsurance that provides cedants operating in France with coverage against natural catastrophes and extreme risks.

This system combines two principles: i) solidarity, based on an additional premium set by the government at a mandatory uniform rate on every P&C’s insurance contract and ii) responsibility with a minimum compulsory deductible also set by the French government. In order to solve the risk of insurers’ insolvency in participating in the Nat Cat system, the government provides private insurers the option of being reinsured against these risks by a public reinsurer which benefits from a non-limited guarantee of the French State, acting as a lender of last resort.

A key challenge for governments is to reduce the protection gap for natural catastrophes.

This compensation scheme has been working well until now: the guarantee of the French State was called only once in 40 years, in 2000, for a very limited amount of public money. Nevertheless, the intensity and frequency of extreme events is bringing new challenges.

First, the definition of what constitutes an insurable risk is evolving. The French national meteorological service and the public reinsurer CCR published a study a few years ago concluding that the loss ratio for insurers would increase at a different pace depending on the natural phenomenon and the region. The loss ratio for floods would increase by 38%, against 23% for droughts and 82% for sea flooding. Regional disparities in the evolution of the claims rate raise the problem of the affordability and availability of insurance products for certain territories: in France, the areas located on the Atlantic coast are particularly exposed with a loss ratio ranging between +60% and +120%.

Second, there is a need to adapt the regulation to existing gaps in the current insurance coverage. Among those gaps, the cost and modalities for insuring risks associated with drought and subsidence is the most dynamic climate risk in terms of cost for the French compensation scheme, with a total amount of one billion euros each year on average. The objective is to avoid placing an excessive financial burden on the natural disaster compensation system and to strike a balance between the financial resilience of the system and the improvement of the coverage of victims.

Third, the long-term resilience of the insurance scheme requires to dramatically promote prevention in the context of increased climate risk exposure. At the international level, many works have been engaged on disaster risk finance and adaptation, in particular by the OECD and in the context of the G7 and G20. Those works suggest that the financial management of catastrophe risks presents an important public policy challenge for governments across the world. In this context, the French government decided in 2022 to set up an ecological planning process. It includes a multiannual plan for adaptation with measures to limit the negative effects of climate change on socio-economic activities.

Part of the current work at the French Treasury is hence to address prevention gaps and to strengthen the role of the insurance system to tackle them. Our central goal is to uphold the core principles of the NatCat scheme based on solidarity and responsibility, at a sustainable cost for policyholders.

STÉPHANIE YON-COURTIN

MEP, Committee on Economic and Monetary Affairs, European Parliament

How to best tackle the environmental transition for the insurance sector?

The latest IPCC report reminds us again about the urgency to act against climate change. Global greenhouse gas emissions have continued to increase. We are already witnessing the effect of climate change on our citizens and our economies, with climate risks materialising in adverse impacts, losses and damages to nature and people.

This is precisely where insurers come into play. As insurers face increasing climate risk exposure, they need to be prepared and to protect the insured against materialising environmental risks. Climate change is one of the most prominent worries of European citizens, which have been calling the European Union (EU) and national governments for ambitious actions.

The European Union has been a pioneer in tackling climate change with the adoption of its groundbreaking Green Deal legislation. EU regulators continue to further address climate risks in the entire EU law framework, following a cross sectorial approach. Achieving a sustainable economy has been additionally enshrined in the establishment of a strong sustainable finance framework, where new legislation has been adopted (e.g., Taxonomy regulation), and current legislation has been amended (e.g., the banking framework, the sustainability reporting framework).

Today's Solvency II Directive already enables insurers to take into account environmental risks but this could be done more efficiently. The revision of this framework is vital to ensure better inclusion of the prudential treatment regarding sustainability risks.

Climate risks are to be assessed in the long term, but short termism in market behaviour still remains too often the norm. Insurers already have possibilities to take into account and assess climate related risks in their activities. Nevertheless, this is still insufficiently enshrined in some insurance practices. EIOPA revealed in a 2021 report that climate risk assessments using scenario analysis are only done by few insurers in their Own Risk and Solvency Assessment and mainly on short time rather than long time horizons.

The revision of the Solvency II Directive aims therefore to promote a risk based and forward looking approach, were investors are incentivised to take into account long-term risks but also to pursue long-term investments. The European Commission's proposal goes into that direction, but the EU should be more ambitious.

We as regulators need to be ambitious and pragmatic in our approaches.

In my view, a renewed and effective framework implies clarity, workability, coherence and ambition.

Firstly, simple, clear and workable rules are key to ensure their smooth application by insurers and supervisors. An important feature to maintain this, is learning from past experiences to better manage climate risks in the future. Many companies are already leading the way in enhancing the use of their existing tools through retroactive analysis. This is why I am the view that those generalised practices should be enshrined in law.

Secondly, ensuring a coherent framework is a prerequisite for ensuring legal certainty to those that will apply the sustainable finance framework. This is why I support the inclusion of transition plans in the Solvency II Directive, in compliance and coherence with other relevant legislation (i.e., the Corporate Sustainability Reporting Directive and the currently negotiated Corporate Sustainability Due Diligence Directive).

Thirdly, the new framework needs to be ambitious. We need to incentivise market operators to change their habits in a durable way and cannot ignore certain issues, notably the treatment of non-taxonomy compliant activities in insurance practices.

An ambitious renewed Solvency II framework means setting up ESG stress testing, better integration of climate risks in corporate governance policies, strengthening the analysis of climate scenarios and the mandate of the European Insurance and Occupational Pensions Authority on the evaluation of sustainability related risks.

Very importantly, an ambitious framework does not mean overburdening our companies. We want companies to embrace the green transition and not run the other way. Ambitious means, that we as legislator are required to ensure coherence, consistency and usability between all the different incoming legislation. The need to avoid unnecessary and additional red tape is for me the key to making this review a success.

Both the private and public sectors need to be positive drivers for change in the European Union. Insurers will play a pivotal role in insuring those increasing climate related events. We as regulators need to be ambitious and pragmatic in our approaches. Ambitious, to fight climate change, and pragmatic, to avoid protection gaps. Although it is a complex exercise, finding a balance between ambition, workability and clarity is key.

CYRIL ROUX
Deputy Chief Executive Officer - Groupama

Climate change isn't easily embedded in insurance products

Don't look up! This American movie, viewed from Europe, can lull us into believing that climate change denialism is the preserve of nitwits, conspiracy nuts or some US (ill-named) conservatives. But I contend that even our polite company fails to grasp fully the extent and speed of climate change. The human psyche struggles against such a reckoning; even the GIEC has consistently been behind the curve over the past two decades.

A case can be made that reinsurers are the financial businesses with the most at stake here, as they bear the brunt of the insured weather related losses. Their cumulative losses on natural disasters over the past decade show however that they have been behind the curve as well. It should be no surprise then that direct insurers, so far, have also failed to convey the pace and scope of climate change to their policyholders via insurance pricing or via denial of cover. This is in part due to the effectiveness and underpricing of reinsurance that they have benefitted from until last year. It is also due to the way insurance operates. By mutualizing the policyholders worst exposed to weather events with those less exposed, insurance undertakings blur the stark reality of physical exposure that the unvarnished price of risk would convey.

We insurers do so because mutualisation is the name of our game. But that means the price transmission mechanism is blunted. It cannot be very effective in any case because insurance policies cover a lot more than weather-related risks. Even when the latter shoot up, the former increase more modestly in prices. Furthermore, even a fast pace of climate change is still a multi year process, when insurance policies are annual. Add broad-based inflation to the mix, and policyholders can be forgiven for not extracting from their yearly insurance renewal notices proper information about their ever increasing exposure to climate change.

Denial of insurance cover would give a welcome jolt to the worst exposed. But this is exceedingly rare because insurers have internalized their role as public interest entities and also because public authorities would not countenance denial of cover to significant swathes of the citizenry or industry. The experience of compulsory motor third party liability insurance is telling : public authorities will not allow insurers not to cover bad drivers, or even allow insurers to price their policies for their actual risk; on the contrary, they force mutualisation through a number of public mandated schemes. Likewise, uninsured industries will be indemnified whether or not they are insured for the risk that befalls them, if that is seen as a public good, either through after the fact public subsidies (e.g. for crops) or through tilted judicial decisions (business interruption cover during the Covid epidemic).

Insurers cannot deny cover not price in full the risks worst exposed to climate change.

No doubt denial of cover would be an effective way to convey the reality of physical or liability exposure to climate change. Nice try if you can get it but alas, as the song doesn't go, you can't make it, even if you try.

To change tack, insurance regulators and insurers can find some way to embed climate change in their calculations within the solvency 2 paradigm. Solvency 2 works with best estimates of future claims arising from policies underwritten. Trends of increasingly costly and more frequent weather events need to be embedded in these best estimates. These increased estimates lead to higher solvency capital requirements and ultimately to higher premiums. Serious caveats apply however. Trends are hard to discern for a number of risks, such as European storms; while data is severely lacking for other risks, such as fires. Modeling of the future path of weather events is tentative at best. And solvency 2 has a one year horizon; this is fitting for a business which can reprice risks annually, but, accordingly, little deviation in solvency capital requirements will show from one year to the next. A doubling of risk by 2050 computes to a yearly rate of increase well below current yearly inflation rates.

As institutional investors insurers are well placed to account for climate change. This is neither virtue signaling nor wokism, but hard-nosed common sense. Better not to invest in what will become stranded assets in the foreseeable future. Double materiality isn't do-goodism either: when a business doesn't account for the detrimental effect it may have on climate, it lets others in society, such as NGOs, or public authorities acting on behalf of their citizens, to reduce or stop its activities.

When the US Congress acts on TikTok for what it sees as legitimate social concerns, it may one day act on energy, construction or transport companies for other legitimate concerns, such as avoiding the climate spiraling out of control. This is ESG investing 101.

In the end, climate change will upend our previous ways of doing business after all.

GERARDO
DI FILIPPO
Group Risk Management - Assicurazioni Generali

Measurability: an indispensable approach to address sustainability initiatives

Sustainability is defining every facet of society and the economy. Environmental disasters, social divides and new vulnerabilities that are perceived in a post-pandemic and increasingly militarized world, have led to a prioritization of sustainability topics on policymakers' agenda and the way of doing business.

In past years, climate-related events alone have caused losses of around 0.3% of GDP per year globally, and a two-digit loss is forecasted until 2050. Economic losses due to extreme weather events have also almost doubled from 1,678tn$ to 2483tn$ in the first two decades of the century and Eurostat has estimated a loss of 145b€ in a decade in Europe.

Behind these numbers, an even sharper economic and social divide has emerged between regions that are more affected and those that appear to be less, but also between wealthier and more fragile parts of the population. The IPCC estimates that between 3.3 billion to 3.6 billion people as being among the most vulnerable, with people in the developing world hit hardest.

People's lives will not only be affected by environmental topics, but also by other phenomena that will have the potential to add new threats. Among these is demographic, with increased longevity observed over time, but with low birth rates in more advanced economies. The need to care for healthy aging, maintain a sufficient and wealthy working population, and support family-friendly policies is hence a societal priority.

Management of sustainability topics should focus also broadly on natural ecosystems, which are massively at risk in several regions with outcomes like disruptions in animal habits, species extinctions and food and freshwater scarcity (for instance, in Italy the salinification of the Po river due to reduced water flows is one recent example of a lack of freshwater for agricultural needs) as well as on social aspects, where for example migration flows are expected to increase due to climate change, resources scarcity and geopolitical tensions.

In this evolving, complex and still not fully understood context, the role of insurers remains unchanged; providing protection to people and society. However, the way this role is played will require changes. Starting from the climate change risk, that is the most urgent today, if on one side insurers should contribute to the global effort to reduce GHG emissions to reach the Paris Agreement targets, on the other hand they cannot limit their activities in paying losses from climate events ex-post, as this will result to be financially unsustainable. And very likely not sufficient.

Through measurability, sustainability management generate economic value for business and society.

Instead, insurers can play an active role in contributing to loss prevention and adaptive initiatives related to climate disasters, to avoid that the level of economic impacts become unaffordable for private industry as well as for governments, with ultimate repercussions on citizens.

The insurance industry is well placed to support short-term initiatives, such as information and alert systems for populations affected by climate perils, as well as more comprehensive and long-term initiatives, involving coordinated approaches on the population, ecosystem and technological evolution, that must be coupled with proper regulations, incentives and education.

This requires that plans definition and execution with the contribution of policymakers, public institutions, financial institutions and other public and private companies.

For example, the following burden-sharing scheme can be considered:

1. Primary insurers provide a policy
2. Reinsurance market increases capacity
3. Risks are further mutualized on capital markets through CAT bonds
4. National bodies is involved
5. Top-up intervention through EU funds is added

Moreover, joint investments allows to pursue the highest value combining the right risk return profile for private business, whilst reducing part of investments and risks carried out by the public sectors.

This virtuous cycle allows to render coverage affordable, through deeper penetration of insurance and sensible reduction of risks.

But all of the above is still not sufficient per se: the effectiveness of such initiatives must be measurable, by comparing the benefits in terms of expected loss reduction with the costs needed to implement them, and evaluating ex-post the real benefits obtained to adjust the approach where necessary. This step is essential to prioritize the initiatives to be taken, making them more concrete and ensure that the right set of actors are involved in their implementation.

Moreover, the measurability of the initiatives will ensure that they will be selected and prioritized through a proper business case, exploiting the opportunities, and not only the risks, related to sustainability adaptation, attracting and facilitating private and public investments.

In this way, sustainability management will be truly become a game-changer to be nurtured over time in order to generate economic value for the business and society.

BRUNO LEPOIVRE

Head of ESG for non life branch & NZIA representative - Crédit Agricole Assurances

Saveguarding French farming through a public-private partnership

There is no longer any region or agricultural sector in the world spared by the consequences of climate change, not even in a mild climate country such as France. In its 2020 study on the impact of climate change, the insurers' association France Assureurs predicted a doubling of the frequency and intensity of climate-related losses by 2040. As a banker and insurer in the agricultural world, we are at the forefront of observing that, unfortunately, these forecasts are already coming true and are having a major impact on crop production and on farmers' income. Since 2016, each year has seen an extreme weather event. There events have even occurred in parts of the country and in crops thought to be immune from such phenomena.

The stakes are high because the assets involved are considerable: 28 million hectares of cultivated land for a total of €37 billion of exposed capital.

The history of France's model is a peculiar case, having gone from a fully state-funded model to an all-insurance one and finally to a Public-Private Partnership. For 50 years, exceptional crop losses were covered solely by the state (except in the case of hail), via an Agricultural Disaster Fund. This fund was an imprecise and complex protective mechanism that had no budgetary visibility. The increase in risks and the occurrence of extreme events such as the dramatic 2003 heat wave have highlighted its drawbacks and limitations.

Insurers were thus invited to create crop insurance in 2005, which guaranteed a level of yield against a decreased yield level caused by climatic events. This type of insurance in individualised and efficient but is distributed to less than one hectare out of three for several reasons: financial (farmers' ability to pay), administrative (subsidised contracts but considered complex) or even psychological (poor understanding of the risk). In addition, some sectors remained eligible for the Agricultural Disaster Fund, which excluded insurance from this sector.

Moreover, as the system had never found its financial equilibrium (over 12 years, the loss ratio for the companies was more than 105%), reinsurers threatened to leave it. Insurers thus found themselves exposed to increasing volatility, with a risk of accumulation, while not being able to recognise equalisation reserves in IFRS accounting norms. A reform had become necessary.

The Common Agricultural Policy devotes less than 1% of its budget to risk management.

Since January 1, 2023, a new system is in place. Its principles are based on risk sharing and complementarity between the farmer, the insurer and the State. Common risks are assumed by the farmers. Significant hazards are covered by crop insurance, for farmers who have chosen to subscribe. Finally, exceptional hazards trigger state intervention, via national solidarity, including for uninsured farmers. It is doubled for insured farmers. What is new is that in both cases, the loss assessment methods, the compensation principle and the historical reference are the same, which was not the case before. The world of insurance and the world of state intervention now operate according to the same principles. Moreover, as of 2024, insurers will be the sole managers of both public and private systems.

We need to go further through innovation and pooling of resources. With the surface area covered increasing from 30% to 100%, the industrialisation of contract and claims management becomes an objective. Technologies such as satellite imagery, crop modelling and big data processing could be used to create and exploit very local references, in order to adjust offers, rates and expertise to various situations.

The adjustment of the technical results of this business line is also necessary. Basically, it is a matter of shifting from information asymmetry in favour of the insured, who knows much better his land and his practices than the insurer can, to a more balanced knowledge of risk. Data platforms and associated digital services, Artificial Intelligence and image recognition make this detailed knowledge of risk possible. Like Research&Development on risks and prevention measures, they could be shared between public and private players, within the framework of the co-reinsurance pool provided for by the law. These possibilities can be extended to the European level, where the «crisis management fund» could be reactivated and articulated with national risk management systems, or even transformed into a Special Purpose Vehicle (SPV).

The Common Agricultural Policy devotes less than 1% of its budget to risk management. Is it fine-tuned enough for the challenges of climate change?

JEAN-JACQUES BONNAUD
Treasurer - EUROFI

Climate related insurance affordability: think global, act local

Climate related risks are growing in Europe - flood, disease, storms, coastal submersion, wildfires etc. They have severely impacted the claim capacities of insurance and reinsurance companies despite meaningful rises in premiums, which have been estimated to an average of 40% at the last Monte Carlo Reinsurance negotiations in January 2023. Claim capacity reductions are not only hampering the affordability of insurance contracts for households, but also for some big municipalities too, which are all struggling to find adequate coverage for property casualty risks for instance in France.

The reaction of the insurance world, in addition to premium increases, has been to transfer part of the risk by reducing the reach of contracts and related time limits for reporting a claim. They also resort to reinsurance mechanisms to absorb extreme losses.

But the problem is deeper. What is at stake is not a temporary increase of natural disasters but the repetition of the disasters and the increase of their magnitude. The ever-increasing replication and amplification of natural events, challenge the availability of risk anticipation data, and accentuate the insurance unaffordability for both underwriters and insurers.

In addition, the territorial concentration of these events and related damages, limits the possibility to mutualise the risks which usually enables insurers to diversify insured portfolios. Insurability is questioned twofold. We can add that since those risks do not recognise national borders, competitiveness issues emerge in the EU, resulting from the differences in the provision of national solutions, and from national consumers and household's cultures and behaviours regarding insurance.

Now, the situation now calls in all countries for developing various types of public authorities' involvement. The challenge is to maintain a reasonable level of premia notably by extending the mutualisation benefits stemming from reinsurance, while avoiding any unbearable rise of related costs. Some countries have hence favoured reinsurance cost sharing and subsidisation mechanisms.

An example of such a public private cooperation can be found in the French "Cat Nat" system initiated in 1982. A public financial vehicle called "Caisse centrale de réassurance" contributes to further mutualising risk while a portion of the mandatory tax bearing on all the property insurance policies, and more recently on car insurance contracts, is dedicated to alleviating these reinsurance costs.

The objective is to extend climate related insurance coverage while leveraging the insurance sector knowledge of its clients, its local-risk expertise, and its capability to incentivise prevention actions among underwriters and local authorities.

However, non-mandatory insurance schemes, like the one for agriculture in France, suffer from a too weak number of voluntary underwriters. In this context the Government is combining incentivising underwriting by farmers, while providing state assistance for the most poorly insured ones. In the same vein the French parliament proposed to impede French insurers to exclude from their contracts the impact on houses of geological consequences of drought, although their frequency increase is alarming.

Interesting examples could be drawn from the US or Japanese experiences. Many governments in Europe have similar systems involving the public sector through varied forms of cooperation. But it is not the case in all Members States.

Furthermore, in addition to normal but heavy duties of States in security matters regarding floods or big fires which already require massive cooperation, national or local authorities should play in Europe a growing role regarding prevention policies by devising incentive schemes, imposing preventive technical study standards preliminary to building in risky locations, as well as financial support for adaptation of public works where required.

At the same time, it is worth noting that even in the context of public private reinsurance schemes most often claim management remains on insurers' side. The objective is to leverage the insurance sector knowledge of its clients, its local-risk expertise, and its capability to incentivise prevention actions among underwriters and local authorities.

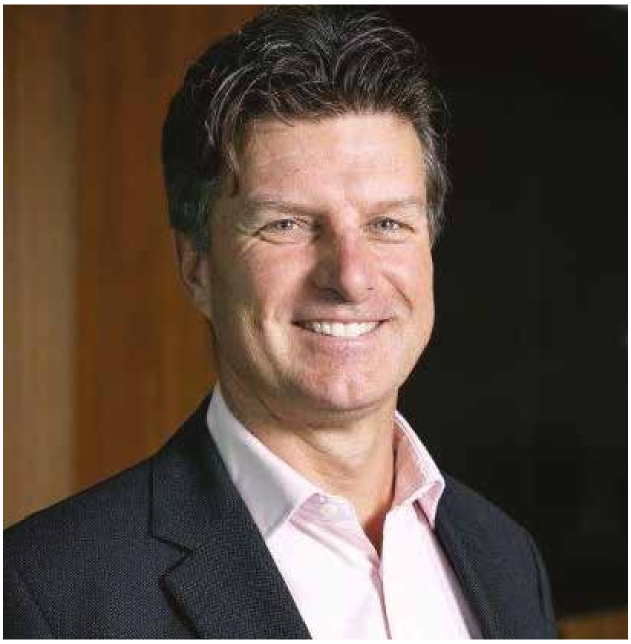
In this context a new role should be given to European authorities in order to favour cooperation and foster information sharing regarding reinsurance schemes, adaptation, as well as meteorology or geology forecasts, since many risks are cross border. Similarly in the context of the EU free provision of service principle, a systematic sharing of the geocoding of risky territories should contribute to maintaining fair competition across the EU. Finally, it should also be envisaged building a common fund to address exceptionally expensive reinsurance costs and coordinating enhanced cooperation with neighbouring countries.

Similarly, globally, the UN should accompany emerging countries in these areas, bearing in mind migration flows which are likely to be impacted by climate change. In a situation comparable to a Tower of Babel, these are prerequisites for the insurance industry to contribute to an ambitious international strategy to damp climate change impacts.

5

CMU NEXT STEPS AND CHALLENGES

- CMU short and longer term next steps
- Retail and SME market development
- Strengthening of EU clearing
- Digitalisation of securities processes
- Securitisation in the EU



Q&A

PATRICK THOMSON
Chief Executive Officer, EMEA -
JPMorgan Asset Management

Increase investor confidence and regulatory consistency to further the CMU

What are the main on-going trends in the asset management sector and what role is it playing in the overall development of EU capital markets? How can regulation effectively support these evolutions?

The asset management sector is a crucial component of both European and global capital markets, with a number of EU countries ranked amongst the top ten largest fund domiciles in the world. As providers of investment products and services and allocators of long-term capital, the sector plays a key role in enabling economic growth and generating returns for the investing public. Therefore a clear and consistent regulatory framework, which provides predictability for all market participants, will be essential to help ensure the sector can continue performing this role and facilitate further development of the European capital markets more broadly.

Regulatory predictability is particularly important in light of the highly uncertain macroeconomic environment we are navigating. As policymakers tackle the various headwinds, volatility in the markets will continue. While this heightens the importance of effective risk management, it may also present opportunities for investors.

Looking forward, the growth of ETFs is likely to continue. The popularity of ETFs has increased exponentially, due to their operational and cost efficiency. Active ETFs, while still in their infancy as a market segment in the EU, are increasingly attracting investor attention.

As part of the sector's ongoing evolution, we believe there remains potential for significant consolidation in the sector, as asset managers seek scale and portfolio diversification to offer better investment returns. Furthermore, we expect to see the continued prominence of sustainable investing, which has been a key determinant of investor flows in Europe over the last couple of years.

Is the CMU agenda moving in the right direction? What are the key issues to address for the future stages of the CMU?

JPMorgan Asset Management is a strong proponent of the Capital Markets Union (CMU) agenda and its overarching objectives. The CMU is an ambitious project with great potential, and we commend policymakers for the steady progress made to date. We believe that creating stronger and deeper European capital markets will help support the real economy, reduce reliance on bank lending, and create more long-term wealth for European citizens.

We need concerted effort by policymakers to achieve the best outcomes for investors and EU economies. If effectively calibrated, initiatives under the CMU umbrella could be instrumental to this end. Still, moving away from a bank-dominated model has been a slow process despite the continued growth of the asset management sector since the idea of the CMU was conceived more than 10 years ago. Thanks to a well-calibrated and bespoke regime, both EU and non-EU financial services firms have been able to provide services cross-border, thereby bringing new competition, choice and investment to European markets. However, to further improve the operating environment, it is important that the EU focuses on maintaining its openness and seeking opportunities to improve the competitiveness of its capital markets.

As policymakers further the CMU, they should consider how to reduce frictions affecting cross-border flows, both intra-EU and between the EU and the rest of the world.

What are the key drivers for developing retail investor participation in the EU and how should they be addressed in the upcoming Retail Investment Strategy?

To activate the EU's full investment potential, we need to reach out to citizens and support their engagement with their financial future. EU citizens would benefit from greater access to the long-term returns that investing brings, helping them achieve lifetime goals while at the same time providing greater growth capital for the economy.

There is no silver bullet to achieving greater retail investor participation. Rather, a comprehensive package of policies is required that promotes financial education and financial advice, investor choice, and transparency.

Moreover, financial literacy should also be a key area of focus. Gaining a better understanding of investing increases accessibility, engagement and builds confidence, particularly for first-time investors. We need to provide the millions of people we serve across the EU with clear, simple and easily digestible information, and in a digital way. It is also imperative that we provide appropriate, tailored support according to the different needs of the investing public and the different stages of an individual's life. Considering the varying degrees of financial literacy across the EU, we need to ensure that policy encourages a more effective financial advice regime which enables investors to make informed decisions on whether and how to invest or not, thereby increasing trust in capital markets. Investor protection should also remain front and centre of the Strategy.

Regarding distribution, we would urge policymakers to take a balanced and considered approach which seeks to ensure the consistent application of rules across different distribution channels and product types. When considering value, we must also recognize that there will be different costs associated with different levels of service, and that a focus on costs exclusively may not result in optimal outcomes for end investors.

There is a strong correlation between healthy retail investor participation and deeper, more liquid capital markets. Therefore, we urge policymakers to propose an ambitious and positive vision for the Retail Investment Strategy.

Do existing EU investment product frameworks cover the main needs of retail investors and what improvements can be expected from the amendments of the AIFMD and ELTIF reviews?

A key element to fostering greater retail participation is to ensure that EU citizens have access to a wide range of suitable investment opportunities. This will be highly dependent on a regulatory framework that promotes open and competitive capital markets, whilst ensuring strong investor protection.
This has already been observed in the case of UCITS, which is widely acknowledged as the international gold standard – a retail product which has democratized saving and turned Europe into the global destination of choice for funds. We welcome the recognition of this by EU policymakers in the review of the AIFMD and UCITS frameworks, and the importance of preserving the well-calibrated regime that has underpinned this European success story. We also welcome the proposed harmonization of the availability of liquidity management tools across the EU, which we believe will directly contribute to improving financial stability.

With regards to ELTIFs, we were impressed with the ambitious approach taken by European policymakers. We are optimistic that the revised rules, which address some of the challenges in the original framework without compromising investor protection, could mean more meaningful consideration is given to this product by retail investors.

Can labels bring clarification to the sustainable investment universe? Are additional regulatory requirements needed to develop sustainable investment?

The sustainable investment landscape continues to evolve rapidly. With the exceptional investor demand for products in this area showing no sign of abating, the heightened regulatory scrutiny is understandable, to ensure the products investors choose are aligned with their expectations. In this context, we believe it has become more important than ever that investors receive jargon-free and simple communication to help them make informed decisions.

We believe the EU's existing comprehensive regulatory framework, which has been developed and introduced over a short period of time, already enables EU regulators to effectively oversee a firm's practices closely. Should there be an emerging view that this is not sufficient, we would encourage policymakers to ensure the existing set of rules are applied consistently and any potential areas of ambiguity or uncertainty be addressed.

Indeed a dedicated a labelling regime could be another way to address some of these challenges and we believe there is merit in this being considered further by the EU. Should this be taken forward, we would encourage – in so far as possible and is appropriate – global consistency. Providers are increasingly making product decisions with international considerations in mind. However, fragmented regimes across jurisdictions risk increasing costs and reducing scale, ultimately having a negative impact on access and choice for investors.

At this stage, we would caution against any wholesale revision or the introduction of substantive new regulatory requirements, which we believe would be premature, could be highly disruptive for the industry, and would introduce further complexity for investors.

CMU: WHAT CAN BE ACHIEVED BY Q1 2024?

RODRIGO BUENAVENTURA
Chairman - Spanish Securities and Exchange Commission (CNMV)

From Capital Markets Union to Capital Markets Growth

The CMU project has been flying around since 2015. There were two main goals: to make capital markets more integrated and to make them larger, attracting more companies to them. I think the time has come to concentrate on the second objective.

The word "Union" is starting to become misleading of the true priority, growth, for three reasons.

First, because it implies that regulation or supervision of securities markets are still fragmented. Maybe this was the case in 2015, but it is not anymore in 2023. Since 2015, we have in place a fully harmonized regime, through regulations, for registry and settlement (CSDR), prospectuses (Prospectus Regulation), EMIR Regulation, and trading and reporting (MIFIR). We have a single settlement point in the Euro area (through T2S). We have also made good progress on true convergence of supervision of issuers of securities. ESMA has reinforced powers and brings deeper convergence each year. Financial reporting and prospectuses, the two main avenues through which issuers inform the markets they tap, are so closely aligned across Member States that even ESMA recognises this through its public reports. Some areas do require further progress, like a single point to access information on issuers and products or the consolidated tape. But those are information systems, not a transformational initiative of market structure or integration.

Second, because the word union resonates unhelpfully to Banking Union, in which the priority was to centralize the supervision of the largest players, as a response to the sovereign debt crisis due to the link between banking and sovereign risk. Nothing of this sort is needed today in capital markets. We are not facing any "market failure" in terms of wrong way risk or supervision shortcomings that would require to reshuffle the deck of supervisory competences.

And third, because in practice companies and investors are already freely picking their market of choice. There are Spanish companies that issue and list bonds in Ireland, or that decide to register their shares in the Netherlands or in Portugal. We have companies from Luxembourg, Romania or France listing their shares in Spain. We have CSDs and CCPs from all these countries providing services to issuers and investors seamlessly in other Member States. And we have 50% of the investment funds bought by Spaniards coming from other Member States.

The comparison with banking markets is striking. We just need to compare where investors place their savings (in funds investing all over Europe) to where depositors hold their deposits (almost exclusively in banks of their own country). Or compare where companies that go public have their shareholders (all over Europe and the world) with where companies obtain their bank financing (almost exclusively in their own member state).

Although EU capital markets are reasonably integrated, way more than banking markets, they are scaringly small. We still have 3 times less market-based financing than the US. The primary equity markets have run dry in the last two years in many countries. With governments having to consolidate public finances in the next decade and banks facing new and increased risks, that is a truly risky situation for the European economy. Without larger and deeper capital markets, EU companies will not be able to finance the huge investments they face to accommodate the two large transformations: digital and green. We need to pursue, urgently, deeper capital markets, not more integration. It's more market-finance growth, not "union" what matters now.

How to do that, is sufficiently understood by the Commission and the co-legislators. The plan is there, we just need to deliver it. We need to make it cheaper, simpler, and quicker for companies to tap the markets (through the Listing Act and similar initiatives, including tax incentives). We need to make it easier, safer, and simpler for retail investors to invest in bonds and shares, either directly or through investment funds (through the AIFMD/UCITS and Retail Investment Strategy initiatives).

We need to make it cheaper and simpler for institutional investors to access the already highly comparable information (ESAP). And, very importantly, we need to break the equity-debt asymmetry that companies face when deciding how they finance an investment (through the DEBRA initiative). This tool, DEBRA, is probably more important for the attraction of EU companies towards equity markets than any of the other "classical" CMU initiatives.

And we need to do that quickly and boldly. With ambitious timelines and enough determination. But in order to be effective, I think we need to concentrate and focus now on the G (of growth).

CARMINE DI NOIA
Director for Financial and Enterprise Affairs - Organisation for Economic Co-operation and Development (OECD)

Capital markets are the tools that will enable the twin transitions

Before starting to build a house, it is wise to have a design drawn up. That plan helps guide the process and provides a yardstick against which to measure progress. The EU has such a plan for its twin green and digital transitions, the proverbial house in question. It is ambitious, and rightly so given the size of the challenges ahead. It involves significant cuts to greenhouse gas emissions, a decoupling between economic growth and resource use, and a ramp-up of Europe's technology development, to highlight a few key points.

An equally important part of housebuilding, however, is to have the right tools with which to execute the design. When it comes to this aspect, the EU toolbox looks somewhat smaller than the envisioned house calls for. The green and digital transitions will require truly enormous investments. The European Commission estimates that delivering on the European Green Deal will require an annual increase in investment of more than half a trillion Euros over the coming decade. The majority of that money corresponds to the decarbonisation of the economy, a task that will certainly require new technology. From an investment perspective, that means funding uncertain ventures.

The question to consider is therefore how to mobilise these funds, what tools to use. Market-based financing is suitable to funding innovative ventures with uncertain returns because it offers risk-willing, long-term capital and disperses risk across a large universe of investors. That is why the OECD works to promote their development. Indeed, capital markets have already played important roles in previous large-scale transitions in history, such as the expansion of railway networks. Importantly in the context of the green transition, research shows that higher shares of equity financing are associated with lower per capita carbon emissions.

As OECD work has highlighted, market-based financing can also often offer more flexibility when it comes to debt, in particular in times of crisis when bank lending tends to contract. A lack of access to such flexible capital, debt and equity, can constrain innovative companies from developing new technologies, to the detriment of both economic growth and decarbonisation.

In other words, capital markets have a key role to play in enabling the EU's twin transitions. Unfortunately, Europe is presently punching below its weight when it comes to market-based financing. The EU economy is one of the world's largest, but you would not know based on its capital markets. The EU's share in global capital market activity is significantly smaller than its share in global GDP. That is true for total market capitalisation, for IPOs, for SPOs and for corporate bond issuances. The US' public equity markets are more than four times larger than the EU's, a gap considerably larger than that between the two regions' GDP. In the list of the top ten jurisdictions globally by number of IPOs in the past decade, there is only one EU country (which also happens to host this edition of Eurofi – Sweden). This may help explain why there is also just one EU firm in the world's top ten most valuable public technology companies (six are in the US and three are in Asia).

A key priority, then, should be to increase the dynamism of the EU's capital markets. A first step towards that goal is to begin weaving together something that can actually be called "EU capital markets" in the first place, rather than the current mosaic of national markets with different supervision, regulations, taxation and insolvency systems, to mention a few obvious obstacles to increased cross-EU activity. The Capital Markets Union sets out an ambitious agenda in this respect, and its successful implementation will be key to ensuring that EU companies have access to the capital they need to invest and grow.

The EU economy is one of the world's largest, but you would not know based on its capital markets.

However, equally important is to acknowledge that EU capital markets do not operate in a vacuum, but form part of a much bigger global market. The total market capitalisation of companies listed on EU exchanges represents 10% of the global total. That leaves 90% of the world's market capitalisation outside of the EU. Ambitious regional standard-setting is good, but it should not come at the expense of global capital market coherence. Such fragmentation is not in the long-term interest of EU Member States and their citizens.

Still, there is reason for optimism about the green and digital transitions. Europe is full of capable people eager to begin building towards the EU of the future, our common house. Let's make sure they have the tools to do so.

BENOÎT DE JUVIGNY

Secretary General -
Autorité des Marchés Financiers (AMF)

Supervision: the key remaining factor to complete a fully-fledged CMU

The completion of a fully-fledged Single Market for capital is essential for the European Union to compete and lead globally. It has become even more important in a redesigned setting of the Union, and at a time where the financing needs of EU companies dramatically need to be met to sustain and develop the European economy.

Progress in this respect has been desperately low. Eight years after the launch of the first CMU action plan, enhanced supervision at EU level remains a missing piece of a well-functioning Single Market for capital. This is problematic on multiple levels; more consistent interpretation and application of the rules across Member States (MS) is always necessary to ensure a level playing field for all market players and eliminate arbitrage opportunities. But beyond that immediate shortfall, the lack of a truly unified supervision at EU level creates an incentive for colegislators to go into incredible details, thereby contributing to the overall regulatory fatigue and hampering the quality of EU legislation.

Supervisory convergence is useful and is under way, but it leads to an enormous burden on national competent authorities (NCA) and ESMA, which is disproportionate to their available means. Above all, given the growing digitalization of financial services, the loopholes of the EU supervisory structure creates room for non-compliance and ends up being detrimental to investors, mainly retail. In the long run, this is an issue for the whole European project.

Yet, previous legislative attempts towards more integrated EU supervision have not received enough political backing from MS, despite a broad consensus on the need for a consistent implementation of rules across the EU.

In view of the development of digital distribution, if no progress can be made to reinforce supervision at a European level, then *a minima* one should reconsider the functioning of supervision in the context of cross-border activities within the EU and the balance of powers between 'home' and 'host' national supervisors. As digitalization grows, it appears necessary to strengthen conduct supervision in cross-border retail financial services.

Indeed, the supervision of cross-border provision of financial services to retail within the Single Market is currently exclusively performed by NCA. In practice, there are however limits to the effectiveness of the supervision undertaken by 'home' NCA on the conduct of firms in 'host' MS. Experience shows that, as far as consumer protection rules are concerned, home NCA tend to lack the proper expertise to perform this task, notably in terms of knowledge of the local market in other jurisdictions (language, marketing and sales behaviours). This renders difficult for home supervisors to properly monitor cross-border activity of firms in host MS. It is undesirable that firms that offer cross-border services are less effectively supervised than those operating in their 'home' jurisdiction.

ESMA published a peer review on supervision of cross-border activities in 2022, and made use of ESMA Regulation (Art.16) to follow up on recommendations made to address the shortcomings observed at the home NCA level; but these tools are too heavy to implement.

Therefore, a new balance of responsibilities should be considered, to enhance consumer protection while retaining the full benefits of the Single Market. Concretely, the EU supervisory framework should be reviewed to provide broader abilities for a host NCA to effectively exercise supervisory powers where financial firms undertake meaningful activity in its jurisdiction, including under the freedom to provide services (as well as an effective system for the exchange of relevant information between authorities). The intervention of host supervisors and ESAs should be facilitated to let them to intervene in timely fashion in the event of serious risks to investor protection and the proper functioning of markets.

Moreover, the principle that the host NCA's responsibility with regard to conduct supervision is triggered by a physical office (i.e. a branch) in the host Member State should be revisited, given the rapid rise of digitalization of financial services. The host supervisor's understanding of local market specificities puts it in a better position to identify possible issues with the conduct of financial firms in their jurisdiction – as well as to devote resources to an issue affecting local consumers and manage complaints.

Finally, the principle whereby an investment firm should provide at least a part of its services in the MS where it is authorised must be clarified and enforced, to avoid regulatory forum-shopping which undermines the Single Market.

The forthcoming *Retail Investment Strategy* is an opportunity to formalize these proposals. But in any case, these adjustments can only be a second best to compensate the absence of an integrated EU supervision. The direction that should ultimately be followed to complete the CMU remains that of a true European supervision.

STÉPHANIE YON-COURTIN

MEP, Committee on Economic and Monetary Affairs - European Parliament

What is next for the European Capital Markets Union?

As we are celebrating the 30th anniversary of the European Union (EU) single market, where are we truly in achieving the four freedoms of movement? Well, we still are not there yet. One often forgets that free movement of capital is still a work under construction.

Having an integrated freedom of movement of capital is a central piece of the puzzle when it comes to fulfilling the internal market. This is precisely why the Capital Markets Union (CMU) initiative was launched in 2015, but Europe is still struggling to finalise it.

Compared to other continents, the EU is falling behind when it comes to developing its financial markets. Our main weaknesses are no secret. To name a few, our markets still remain highly fragmented, our financial sector is highly overbanked and the retail investors are not incentivised to invest.

Regulation and its successful implementation represent only a small part of the solution. This makes the CMU project a common one, as it must mobilise citizens, businesses, supervisors and many more.

Current files on the table precisely aim to knock down fragmentation between our capital markets. The European Single Access Point and the revision of the Markets in Financial Instruments Regulation (MiFIR) have been great achievements in that sense.

In the CMU, more than 99% of EU companies are SMEs. Yet, the current framework is not incentivising them to diversify their sources of financing. The Listing Act proposal is a great example of legislation aiming at increasing the attractiveness of our framework for smaller companies. We need, among others, to reduce the administrative burden for companies to list on the stock exchange. SMEs, which are the heart of our European economy, are the first ones to be prejudiced by unnecessary red tape.

Additionally, we should not lose sight of our European objectives. Above the long-lasting will to complete the CMU, many additional challenges are guiding its construction. Today we not only need to channel private investments into the green and digital transition, but we also seek to achieve strategic autonomic.

Following this approach, the new clearing proposal comes in timely to reduce our exposure to third country Central Counter Parties (CCPs).

We are going in the right direction but it is not going fast enough, as we are still far from achieving the CMU.

The question is, what meaningful step should we take moving forward? The long awaited Retail Investment Strategy is more than just an important upcoming piece of legislation. This represents our last chance to act. How can Europe compete globally if it is still lagging behind in achieving a Capital Markets Union? A lot needs to be done. The strategy will thus need to address a wide range of issues and we cannot let the inducement debate overshadow other equally important topics.

A particular emphasis should be put on facilitating access to financial markets, reducing red tape, better regulating investment advice and most importantly, emphasise the urgent need to promote financial literacy. Europe is lacking when it comes to financial education and we need to change that. As compared to other countries, where finance is introduced at early ages in the school system, financial education remains almost non-existent in the European Union. Financial literacy is the key to removing obstacles standing in the way of retail investors' engagement, be it their lack of trust or fear of the unknown.

Furthermore, the success of the CMU will depend on broad access to financial advice, especially on local level. Local networks ensure access to finance in all parts of European territories (regions, small cities, villages, etc.).

It is true that the current business models need to be improved through adequate investor protection, bias free advice, promoting an open economy and transparent, comparable and understandable product information. Enhancing our current system will serve the long-term interest of the end investors and enable them to have, affordable and personalised financial advice as well as equal access to a broad range of financial products, with safeguards.

The success of the CMU will depend on broad access to financial advice, especially on local level.

Meaningful change does not happen quickly. European history has proven to us the virtue of following the Union's famous step-by-step approach, but we waited long enough.

Our current priorities should be the setting stones of tomorrow's Capital Markets Union, be it strategic autonomy, the green and digital transition, our companies' competitiveness, consumer protection and supporting financial literacy.

It is our collective responsibility to ensure that this strategy will be a success. If we want a true Capital Markets Union, there is no more time to waste. Citizens, businesses, national and European regulators will all need to grab this opportunity to aim for one possible outcome: its success.

CHRISTIAN CASTRO
Head of Public Affairs - CaixaBank

Progress and challenges in the Capital Markets Union

In a nutshell, the main aim of the Capital Markets Union (CMU) is to ensure that "capital markets in Europe" get closer to a "European capital market". This means breaking down barriers to the cross-border flow of investments and savings across the EU. Why to do this? To benefit consumers, savers/investors and companies by increasing the opportunities they have to invest and borrow, lowering costs and increasing risk sharing. All this should ultimately lead to a more integrated, more diversified and less fragmented EU financial system.

The CMU initiative was initially launched in 2015, with a new action plan announced in September 2020 by the European Commission. The plan included 16 actions to achieve three main objectives. First, in light of the Covid-19 pandemic, to strengthen existing funding sources (for example to SMEs) and to consider ESG goals and digital transformation, the first objective was to support a green, inclusive and resilient economic recovery. Second, with a focus on retail investors, which low participation in capital markets remained a concern, the second objective was to make the EU an even safer place for individuals to save and invest long-term.

Finally, in order to address barriers in the areas of taxation, non-bank insolvency and company law, the third objective was to integrate national capital markets into a genuine single market.

Both the overall guiding objectives and the corresponding policy actions are deep and broad ranging. Include aspects such as information accessibility and regulation of long-term investment funds, alternative investment funds and financial instruments. As a result, the CMU clearly is one of the central projects in the EU, also connected with the need to complete the Banking Union.

Within these policy objectives and actions, certain aspects are related to long-established national practices and existing historical divergences in legal frameworks. Accordingly, as usually occur in many areas of European and international regulation, to strike a right balance between harmonisation/standardisation and due consideration to countries' common heterogeneity, for example with regards to their economic structures and legal tradition, is a challenge in itself.

Among these challenges, a key remaining structural barrier to overcome is the existing heterogeneity in national insolvency law across EU members. Progress on this side should help to cross-border investments while increasing regulatory consistency across the EU. Some specific areas where further improvements could be made include adding clarity on definitions (eg: insolvency proceeding), the protection of creditors' interests, and avoiding unwarranted complexity in the timelines for the proceedings.

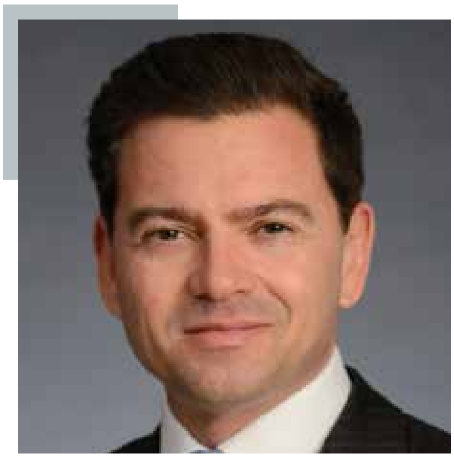
In addition, as previously mentioned, the CMU should translate into tangible benefits for investors, also contributing to advance towards a broad and inclusive investors base. To that purpose, the Retail Investment Strategy (RIS), which the Commission has planned to present in the first half of 2023, seeks to ensure that retail investors can get full the benefits from capital markets and coherent rules across legal instruments. More concretely, such benefits should materialise in adequate protection, advice, and information, as well as in efficient costs and access to a variety of financial services and products.

In this context, investment advice results indispensable to ensure that financial services and products do meet the specific needs of retail investors, including their risk appetite and investment horizons. And, to achieve this, it is particularly important to ensure that different types of financial advice are maintained. Financial advice should be able to adjust to the different profiles and characteristics of investors.

The CMU should increase opportunities to invest and borrow, without affecting retail customers.

Consequently, any potential regulatory change on this front should be extremely mindful of practical effects, implications, and unintended consequences. As such, potential regulatory proposals should be carefully assessed, and special attention should be given to the distinctive characteristics of different types of financial services and products.

Ultimately, the whole set of possible policy actions should ensure a proper and gradual transition, without abrupt moves, which is critical to avoid affecting retail customers. Measures that may well end up in lack of information and in a lower quality of invertors' saving and investment decisions, should clearly be avoided. All the latter is especially relevant for the most vulnerable segments of the population.



CHRISTIAN STAUB
Managing Director Europe -
Fidelity International

CMU retail participation - The 'how' still needs to safeguard the 'why'

In the City, they sell and buy
And nobody ever asks them why[1]

From its inception the Capital Markets Union (CMU) has been particularly clear on the social purpose of capital markets and the financial firms that operate within them. As the economist John Kay reminds us, financial services are only ever intermediating "other people's money" - that is, channelling funding from citizens with savings and investment needs (to support risk management and retirement) into economies (to support jobs, growth and sustainable ambitions). [2]

By speaking of the need for policy to foster "retail participation" in the capital markets in the same breath as the need to improve SME access to funding, the CMU has aspired to operate on the same understanding - that financial firms are the 'servants of the people' not 'masters of the universe'. SME funding is, after all, "other people's money" and the people should know and celebrate the fact.

It is a shame, then, that the retail participation leg of the CMU has drifted into the Retail Investment Strategy (RIS), which has itself been allowed to drift into a seemingly single issue debate over the cost of investment advice.

The following five Ps might help correct this drift.

At the political level the RIS needs to move away from the cost of advice. For one thing, marginally cheaper advice won't foster retail participation by bringing the currently unadvised into the advice world. The majority of the unadvised are either unaware of advice in the first instance, or think it is something that 'other people' do. Worse, the proposed retrocession ban risks pushing the currently advised out of the advice world, with knock-on effects for the distribution of sustainable and productive products such as the ELTIF. Both are key EU political projects and yet both types of product are distributed predominantly by advice. We would prefer to see stronger focus on value-for-money and better disclosure across both products and distribution services.

In the meantime, we think non-advised online digital access points are the real key to the retail participation the CMU seeks. Online is where customers are and where digital access points can coach them towards better financial health - managing debt, establishing cash saving, moving into investment as appropriate, and protecting the whole with insurance. Non-advised / robo-advised platforms are therefore where the RIS should also focus, both addressing blockers to online customer-journeys (especially paper-based fund disclosure) and leaning into accelerators of change (digital ID; robo-suitability; and tailored or 'personalised' communication).

The key accelerator here remains Open Finance because of the way it will enable customers to view their financial health as a portfolio of assets and liabilities - from consumer debt through cash savings to pension and private investments. This helicopter view is itself an important element of financial literacy, but it is currently the preserve of advised (and often only wealth-advised) customers. Open Finance can change that, throwing the same portfolio view open to all.

Online tools can then coach consumers towards financially healthier portfolio mixes incorporating on-risk investment where/when appropriate. Tools can also help consumers shape bespoke portfolios (around environmental or social sustainability goals), as well as to exercise their power as equity shareholders (via proxy voting).

We hope there is still time in the political cycle to re-energise meaningful 'retail participation'.

Of course, such innovative forms of online engagement will require innovative forms of investor protection. For example, BaFin speaks of the need to safeguard the consumer's 'data sovereignty' in environments where vendors arguably know more about their customers than customers know about themselves.[3] But it is important to remember that in an era of smart phones, smart cars and smart fridges, digitally savvy customers are smarter too.

We hope there is still time in the political cycle for RIS to make these crucial pivots - for example towards the Open Finance Experts Group's vision of Open Investment data transforming financial advice.[4] With a pivot we can still drive meaningful retail participation in the CMU project. Without it, we risk re-consigned capital market investment to something that only 'other people' do:

But since it contents them to buy and sell
God forgive them, they might as well

[1] Humbert Wolfe, The Uncelestial City (1930).
[2] John Kay, Other People's Money: masters of the universe or servants of the people? (2015).
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GELSOMINA VIGLIOTTI

Vice-President -
European Investment Bank (EIB)

The EIF, on the forefront of European risk investment in innovative SMEs

The European Union (EU) financial system has historically been and still is bank-centric. Despite a positive market development in Europe, venture capital and equity investments are much higher in the United States and some Asian countries. The number of IPOs in Europe is low, listed European firms disproportionately rely on banks for funding, and innovative European companies are likely to be acquired by American or Asian firms.

These are symptoms of an underdeveloped capital market and raise concerns about the effects of Europe's overreliance on banks. The traditional argument favouring alternative funding is that the dwarfism of capital markets constitutes a bottleneck to enterprises' ability to access resources and absorb shocks.

Some ancillary arguments accompany this observation: economies that rely heavily on bank financing present lower growth rates, rebound slowly from downturns, are more prone to crises and less innovative. [1]

One additional argument against over-reliance on bank credit has become relevant nowadays. During the COVID-19 years, public and private debt expanded[2]. This was the result of companies' need to bridge their financing during the pandemic and of State support policies. In the current environment of rising interest rates, this large debt stock raises concerns about sustainability.

The response to the double challenge of funding bottlenecks and debt sustainability lies in the diversification of funding sources and in the growth of cheaper, risk-prone, and patient capital markets. Beyond easing the debt burden, this will provide financing better suited to innovative companies that will push forward the green and digital transitions.

In this context, completing the Capital Markets Union (CMU) is an urgent need. The free flow of capital across EU countries is a founding principle since the Treaty of Rome, but the CMU is more than that. Europe needs a unified and lively market, with harmonised supervision and insolvency rules, where there are no regulatory barriers, and where information can be easily accessed across countries.

The European Commission's 2020 action plan pushed forward some positive changes in recent years. But further reforms are needed, especially in the fields of debt bias of taxation systems, data access, harmonization of solvency rules, strengthening of pan-European governing and supervision, and financial literacy and engagement.

However, reforms alone cannot unilaterally transform a market. Market actors need to witness how investing across the EU is feasible and economically attractive. International financial institutions play a crucial role as market enablers and investment catalysts.

Since its creation in 1994, the European Investment Fund (EIF), the subsidiary of the European Investment Bank (EIB) that specialises in providing risk finance to small and medium-sized enterprises (SMEs) and mid-caps across Europe, has embodied this role. It aims to satisfy existing, and future market needs by designing innovative financial products addressed to its financing partners, acting as financial intermediaries.

The EIF carries out its activities using its own resources or those provided by the EIB, the European Commission, EU Member States, or other third parties, including private investors.

These resources are deployed across Europe[3] to finance high-growth innovative companies in various stages of their life, from seed investment to scale-up and maturity, through participation in venture capital and equity funds. With these resources, the EIF also seeks to fulfil policy priorities aligned with the EU's objective of enabling the green and digital transition and pays particular importance to additionality, supporting the closing of funds across the EU.

We hope there is still time in the political cycle to re-energise meaningful 'retail participation'.

As many SMEs seek financing through more traditional routes, the EIF also provides guarantees and securitizations. These products are uniquely placed to support the economy through their ability to transfer risk while enhancing banks' capacity to manage their balance sheets efficiently to continue lending.

The EIF's efforts since its creation have been enormous. It has invested more than €38 billion in equity products and invested more than €82 billion in guarantees and securitisations, leveraging in total more than €530 billion.

Companies in different stages of their lifecycles need different financing tools, and evidence from many crises shows that the diversification of funding sources improves resilience during cyclical downturns.[4]

The EIF's actions diversify the availability of financing sources and are entirely in line with the objectives and spirit of the CMU, which is far from complete, but a bit closer thanks to the EIF activity.

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RETAIL INVESTMENT STRATEGY

VERENA ROSS
Chair - European Securities and Markets Authority (ESMA)

Retail Investment Strategy: creating a safe environment for retail investors

More than five years into its existence, the MiFID II framework has proven to be a significant milestone in the development of an effective investor protection regime across the EU, introducing key requirements in areas such as product governance, cost transparency and suitability. Still, certain limits have also been exposed, warranting targeted amendments across MiFID II and other related pieces of regulation, which I hope will be part of the Retail Investment Strategy (RIS).

As ESMA, we fully subscribe to the objectives of empowering retail investors to take advantage of capital markets and of enhancing consistency of investor protection rules across markets, as was originally envisaged under the CMU Action Plan. In my view, we should use this opportunity to build investors' trust in capital markets and make the framework fit for the digital age. In this short article, I would like to highlight two important aspects in this respect.

First, the retail investor protection framework will need to do a better job at addressing conflicts of interests and the related issues of high costs and biased advice. Despite the enhanced inducements requirements in MiFID II and the introduction of the concept of independent investment advice, for which inducements are banned, the EU retail investment landscape remains dominated by non-independent advisors predominantly recommending inducement-paying products. Several studies demonstrated that more expensive products are distributed to retail clients in inducement-based models, and I thus believe this deserves further attention. Indeed, as we conclude in our own ESMA analysis[1], costs remain a critical component in determining final retail investor outcomes in the EU and have only marginally declined over time. This of course affects investor trust. European consumer organisations even qualified inducement-based advice as a mere "sales pitch".

Opportunity to build investors' trust in capital markets and make the framework fit for digital age.

The limitations of the framework identified in ESMA's 2020 Technical Advice were more recently confirmed in a study prepared on behalf of the European Commission, which showed that disclosures on inducements seemed to have only limited effect on retail investors' decision-making. While mentioning the experience of the countries that have already prohibited inducements, ESMA did not recommend an EU-wide ban because its impact across the EU could not be sufficiently assessed in the time we had been given for our advice. In my view, another look at the topic is fully warranted and needed now.

As to the actual intervention options, an inducements ban is often mentioned as the most effective way to address the conflict of interest between firms and product manufacturers, contributing to bias-free advice and lower costs for investors, and this is currently supported by the European consumer organisations. Many others warn that such a move would lead to an "advice gap". Should the RIS take the direction of a ban, accompanying measures would be advisable to ensure investors' access to high-quality, unbiased investment advice. For example, the introduction of a simplified, and thus less expensive advice framework could be considered whereby simpler, low-risk products can be recommended to clients using such a service.

A second key aspect is the importance of adapting the MiFID II framework to the digital age. While not a recent phenomenon, digitalisation of investment services has picked up enormously and created opportunities for investors by making these services broadly accessible. Think, for instance, of the abundance of user-friendly investment apps allowing investors to instantly visualise information about their investment portfolio. Digitalisation provides firms with new opportunities vis-à-vis retail clients, by facilitating interaction, tailoring information to their needs and profiles. Overall digitalisation can make the provision of information more effective, also helping to manage the risk of information overload. Digital regulatory disclosures enable layering of information, so that investors focus on vital information but can also dig deeper on aspects they are interested in when making investment decisions.

Digitalisation has however also brought about new investor protection risks, such as those related to aggressive digital advertising and engagement practices. Due to their constant exposure to investment information, retail investors may feel pressured to take decisions that are not in their best interests; based on push notifications generated by investment apps and unreliable investment information provided on social media.

While the investor protection framework is and should remain technology neutral, clarifications may be needed to ensure that all digital advertisement and engagement practices are fair, clear and not misleading. Moreover, it should be made even clearer that firms remain always responsible for what is done on their behalf, also through social media and "finfluencers".

[1] Costs and Performance of EU Retail Investment Products 2023.

FAUSTO PARENTE

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

Retail Investment Strategy: are we tackling the main issues?

The European Commission is currently in the process of developing a legislative proposal to support its Retail Investment Strategy. One of the key objectives is to promote more transparency, simplicity, fairness and cost-efficiency for retail investment products across the internal market, which EIOPA strongly supports. If insurance products are appropriately designed and distributed, this can be a lever in enabling consumers to participate in capital markets and address growing savings gaps. The main question has been, however: how to best achieve this objective?

So far, the primary focus amongst stakeholders has been on whether the Commission plans to take more stringent measures to tackle conflicts of interest which are damaging to interests of consumers, such as a total ban on the payment/receipt of inducements. This has led to an impassioned debate amongst different stakeholders.

The question raised in this article is "Are we tackling the main issues?": from an EIOPA perspective, we view the current debate as too polarised around the issue of banning or not banning inducements, with a disproportionate focus on the "point of sale". As we stated in our technical advice to the Commission in April 2022, we see the need for more to be done to tackle damaging conflicts of interest arising throughout the product lifecycle of an insurance-based investment product. As an anecdotal example, in a recent public event we held on "Five Years of the Insurance Distribution Directive", an audience poll clearly supported enhancing product oversight and governance (POG) requirements when asked about the IDD provision that can bring the most benefit for consumers if effectively applied.

Banning the payment/receipt of inducements can help to address product bias, but it is unlikely to completely eradicate poorly designed products from the market - it should not be seen as a "silver bullet" solution. One only needs to look at the jurisdictions where more stringent measures on conflicts of interest have been taken, where additional flanking measures have been necessary such as "fair value" measures, enhanced POG obligations, introduction of a consumer duty, a simplified advice regime etc., to see evidence of this.

Insurance-based investment products should be cost-efficient and offer value for money to consumers.

EIOPA is firmly of the view that insurance-based investment products should be cost-efficient and offer "value for money" to consumers. "Value for money" is already embedded in the IDD POG regime. On that basis, we have published a Supervisory Statement and a Methodology to be used by NCAs in assessing value for money in the unit-linked market. We are pleased to see a number of national supervisory initiatives following in a similar direction. We are now following up this work by working to determine whether it is possible to have "reference benchmarks" which would aim to guide insurance manufacturers in determining what constitutes a cost-efficient product.

What is crucial from an EIOPA perspective is to fully take into account the heterogeneous nature of the insurance distribution market in Europe and the way that consumers engage in this market. And heterogeneity can present challenges in ensuring that any harmonised approaches apply evenly across all national markets and consumers are treated in a consistent manner: For example, because there are a very large number of small insurance intermediaries which are natural persons and tied agents in the insurance sector, we are of the view that insurance undertakings (who have easier access to cost data) are better placed than insurance intermediaries to carry out a value for money assessment and this can produce far more meaningful outcomes for consumers.

Finally, it is important to note that however significant the reforms made to the regulatory framework for retail investment products, these will only be truly effective if these are bolstered by a strong supervisory framework. Implementation is key. National authorities need to have access to the necessary data and have the required tools, powers and resources to supervise and enforce effectively, which means being able to intervene early to prevent the risk of material consumer detriment arising. This can be done by tackling issues at an earlier stage, "upstream", such as at the product testing phase where the IDD already provides that insurance products should not be brought to the market "if the results of the product testing show that the products do not meet the identified needs, objectives and characteristics of the target market".

In conclusion, if we are to effectively tackle the main issues underpinning the Retail Investment Strategy, we need to adopt a broader focus across the product lifecycle, which places supervisory implementation as much at the centre as addressing any perceived gaps in the current regulatory framework.

JOS HEUVELMAN

Member of the Executive Board - Dutch Authority for the Financial Markets (AFM)

RIS success depends on low costs and high trust for all

The European Commission's landmark Retail Investment Strategy will likely contain improvements to product disclosures, quality and independence of advice, value for money, enforcement, and financial literacy. At the heart of the strategy is the ambition to get more European citizens to start investing while future-proofing the consumer protective framework.

Inducements

People will need to trust financial institutions before they start investing. They should be able to rely on financial institutions having their interests at heart and that financial products are sound and of high quality.

Remuneration matters a great deal in terms of incentives. A commission-based distribution model leads to an unacceptable risk of perverse incentives, mis-selling, and unnecessarily expensive products. The inducement ban in the Netherlands has decreased costs as advisors sold cheaper alternatives. We have also seen the quality of financial advice improve because of various investor protection measures, along with the ban on inducements. Advisors have to critically examine their value proposition to their clients, instead of relying on provisions. This ultimately benefits the client.

There is a persistent misconception that inducement-based advice is free. First, the (relatively high) provisions that product manufacturers pay to advisors are not charity; they are charged to the retail client through opaque cost structures. Second, retail investors pay dearly for unsuitable products that they have bought because of bad advice. It is true that the use of advice has decreased, but this trend had started before the ban was introduced and was not accelerated by the ban. The possibility of an advice gap is the most common argument against a possible inducement ban, but wrong advice is clearly worse than no advice at all. We have not seen evidence for such a gap,[1] and the Dutch association for financial advisors reports that three out of four consumers is a client of an independent financial advisor.[2]

Brokers may similarly appear to offer a free service, but investors may be worse off if they pay higher transaction prices because the broker receives payments from third parties to carry out the order at unfavourable prices – a practice known as payment for order flow.

Cross-border enforcement

Digitalisation has further diminished national borders and helped to create a single market for financial services. Supervision of that market, however, is still largely carried out

> **To ensure the success of the RIS, division of home-host NCA competences must be more effective.**

by national authorities, operating in different jurisdictions and with supervisory approaches. Cross-border enforcement is not discussed as passionately as inducements, but it is crucial for the framework's success. Consistent and high-level supervision is key to ensuring that the legislative framework is complied with and followed in practice. From an operational viewpoint, home member state supervisors may find it difficult to effectively address transgressions in other markets with which they are not familiar. Information sharing between authorities can be unnecessarily cumbersome. To make the RIS future proof and ensure that the framework delivers optimal outcomes, the Commission should critically look at making the division between home and host supervisors more effective and increasing the powers of host member state supervisors.

Disclosures

Product disclosures are a cornerstone of investor protection, but they are too lengthy, detailed, and complex for consumers. Most people do not read these documents or find it difficult to relate information to their personal situation. Significantly improving disclosures requires design based on consumer behaviour. Behavioural research shows that past performance is one of the most prominent pieces of information on which investors base their decision. Although understandable, past success offers no future guarantees. If firms want to maintain their clients' trust, they must be clear about this and offer realistic expectation of the possible returns.

Value for money

Addressing unreasonably high costs is key to delivering the best outcomes for ordinary people saving for retirement or other long-term goals. A difference of one percentage point annually in costs may not seem like much but will significantly impact long-term returns. Cost efficiency is the result of a holistic package of consumer protection: strong product governance, incentives for distributors that favour the client, clear disclosures and a competitive market. If the European Commission can make these work together, the RIS will be a success.

[1] *Decision and CentER Data, "Zakelijker verhoudingen: de markteffecten van het provisieverbod," 22 March 2018, http://decisio.nl/wp-content/uploads/Decisio-Periscoop-Evaluatie-Provisieonderzoek-Definitief.pdf*

[2] *Adfiz, "Advies in Cijfers, 2022-2023," p. 5, https://www.adfiz.nl/media/5079/advies-in-cijfers-2022-2023-webversie.pdf*

JÉRÔME REBOUL

Managing Director, Regulatory Policy and International Affairs - Autorité des Marchés Financiers (AMF)

Retail investment strategy : focus on the right issue

Striking the right balance between investor protection and the need to provide access to capital markets so that European savings efficiently finance the economy is at the core of EU regulators' concerns.

There is, therefore, a general agreement on the broad objectives of offering better choice, better information and value-added advice to retail investors. In addition, there is a broad consensus on the fact that changing market practices in the area of retail financial products - eg the growing role of influencers and digitalization of distribution - justify to take another look at the regulatory framework in this area.

Any new proposal should however take into account the existing industrial landscape. In this respect, radical proposals such as a general ban on inducements may seem theoretically attractive, but would probably have significant detrimental effects in reality. In countries where this practice is widespread, such a ban would drastically reduce access to the advice offered in banking branches for low to middle income households, that would then be left to influencers - who offer free 'advice' and are not subject to specific rules of conduct. On top of that, banking networks would have an incentive to distribute only in house products which would everything else equal be detrimental to competition.

This is not to say that we should not be interested in preventing conflicts of interest or reducing the overall cost of savings products. A strong regulatory framework already exists on both these topics. It might be enhanced by enlarging the duties of services providers to consider the pricing of their product to assess whether clients get sufficient value for money. Initiatives to encourage competition are also welcome.

But there are more pressing issues given the fundamental challenges posed to the Single Market by current industry developments. While digitalization and cross-border provision of financial services grow, investor protection must be further ensured to allow for safe cross-border investments.

A strong and harmonised supervision of market participants in all Member States should be a key objective going forward, to ensure a consistent level of protection to investors within a digital market. Some issues remain to be addressed in the light of recent market developments. Over the past years, the AMF received numerous complaints from retail clients of EU investment firms based in other Member States and operating on a freedom to provide services basis, about aggressive, if not illegal, marketing behaviours from those firms selling complex products to French retail clients.

Investor protection must be further ensured to allow for safe cross-border investments.

This shed light on the difficulty to allocate powers between home and host authorities in a context of the cross-border provision of investment services, and the lack of effective coordination mechanisms to respond quickly to providers acting irregularly under the EU passport. Although overall the passport has contributed positively to the Single Market it is still not underpinned by a single supervisory model; this allows for regulatory arbitrage between Member States and differences in investors' rights in the various jurisdictions.

In the absence of unified supervision, improvements should be made to the passporting framework to strengthen coordination measures between home and host authorities. Notably, there should be an effective system for the exchange of information as well as broader abilities for a host authority to effectively exercise supervisory powers where firms undertake meaningful activity in its jurisdiction, including under the passport.

Host supervisors and ESAs should be enabled to intervene timely in the event of serious risks to investor protection and the proper functioning of markets. Also, clarifying the criteria to determine in which jurisdiction an investment service should be deemed to be provided is essential in the context of digitalisation, as the increasing use of technology makes it difficult to allocate the provision of an investment service to a given host Member State. This is key to determine which rules apply and which authority is responsible for their enforcement. As a principle, an investment service should be deemed to be provided where the retail client targeted by the service is located.

On another front, the framework protecting retail investors should also be strengthened to take account of evolving practices regarding digital advertising and financial solicitation. Indeed a rise in misleading digital promotional communications from professionals, but also from third parties paid to promote certain investments (some of whom are influencers) has been observed.

To guarantee the protection of retail investors, it is proposed to make the advertising chain responsible, from professionals to advertisers. It is also necessary to take into account the development of indirect advertising comparable to financial solicitation and thus to improve the EU framework applicable to digital financial solicitation.

GUILLAUME PRACHE
Managing Director - Better Finance

Retail investment in the EU: the egregious example of listed bonds

Since 2021, EU citizens as "retail" investors" have seen the real value of their financial savings collapse, victims of the unprecedented "financial repression" (in short, the voluntary engineering of very negative real interest rates) operated by EU policy makers.

This very detrimental environment for savers and individual investors is compounded by the failure of meeting two critical and related objectives of the CMU started in 2015: fostering retail investments into capital markets, and rebalancing the funding of the economy between banks and capital markets.

Indeed, the share of retail investments into equities is almost flat since then, despite a very favorable price impact. And the retail bond market is all but disappearing (from 7,5% of total EU households' financial savings in 2008 to 1,6% in 2021), even though today retail investors would often be much better off going to bond markets than to their home bank:

Ex: nominal returns for a one-year term (before transaction costs) *:

- French Sovereign bond 3,47% rather simple, not "advised."
- Best non-domestic € bank term account 2,65% simple, no access and not "advised"
- Money market fund 2,20% complex, little "advised"
- Best domestic (BE) € bank term account 1,50% simple and "advised."
- BE inflation (Eurostat HICP) 5,40%

Why ?

First, because of the lack of independent advice.

"Non-independent advice" (sic, MiFID jargon) is dominant, except in the Netherlands. Various independent studies have shown how detrimental it is for retail investors.

The labeling of retail distributors itself is very misleading and not compliant with EU Law which requires clear, fair and not misleading information: when a retail distributor is essentially compensated by sales commissions, calling him an "investment advisor" is like calling a car dealer a "transportation advisor". Nobody dares to do that. Most of the time retail investors are faced with an investment dealer, not and investment advisor.

Most of the time retail investors are faced with an investment dealer, not and investment advisor.

Second because of lack of retail access.

The bond secondary markets are opaque and very illiquid (large bid/offer spreads, few trades, at least from what retail investors can see) - even for the main EU sovereign ones - compared to listed blue chip equities. Also, very few retail intermediaries (banks, brokers) promote them and facilitate their trading.

The primary bond market is even worse, in particular regarding disclosure requirements and minimum investment sizes. The summary prospectus is still very long and written in legal verbiage, and is lacking for bonds with individual issue prices of € 100,000 or more. And too often bond issuers set the minimum initial investment price at ... € 100,000. Sometimes the issuer even has to issue a PRIIPS KID on top of the summary prospectus, whereas it would be much more effective to have only one summary document, as closely aligned as possible to the PRIIPS KID for clarity and comparability purposes.

Issuing Member States bear an important responsibility in favoring financial intermediaries versus citizens as investors in both the primary and secondary sovereign bond markets. The ECB, which owns a large share of EU Sovereign bonds, could also play a big role with regard to bond dealers and other intermediaries.

Re-opening the plain vanilla investment grade bond markets to citizens is good for them and for the bond markets.

Third, because of the promotion of complex products vs. simple ones.

So far, policy makers and supervisors have not fulfilled their legal duty to promote simplicity, as they "shall take a leading role in promoting ... simplicity ... in the market for consumer financial products or services across the internal market".

For example, some retail intermediaries are more involved in promoting retail "EMTN" products based on hyper complex highly customized indices designed only for – but unintelligible to – retail investors, and misleadingly portrayed as "market" indices (such as the "S&P Eurozone 50 Net Zero 2050 Paris-Aligned Select 50 Point Decrement Index" – which has had a negative return over the last 5 years, when the broad European equity index has returned close to +30 %**). Conversely, they rarely "advise" plain vanilla instruments such as simple bonds and bond ETFs. Such "structured" products are not allowed for sale to Belgian retail investors, but they are - for example – to French ones.

The success of the CMU and of adult investor education both require access to independent advice, and also to simple products and to clear, fair, not misleading, short and comparable key product information. The European Commission's "Retail Investor Strategy" has fortunately identified these issues. It remains to be seen if other EU policy-makers really want to stop impoverishing citizens as pension savers, and to achieve the main CMU goals.

**As of 9/3/2023*
*** 5 years ending 31/01/2023*

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ANDREAS WIMMER
Board Member - Allianz

Quo vadis EU Retail Investment Strategy: evolution versus revolution

The EU Commission Retail Investment Strategy (RIS) intends to ensure that retail investors take full advantage of capital markets and that rules are coherent across different EU legal instruments, while enhancing pension adequacy in the EU. As a precursor it makes sense to understand how current regulation has contributed to investor protection and where it should be changed to fulfill the EU Commission's ambition.

The existing regulatory framework implemented in 2018 already introduced a high level of protection to retail investors when investing in capital markets. Relevant indicators of sales quality have increased since the implementation of IDD, including a steady material reduction of customer complaints across key markets in the past years. In light of those indicators, a comprehensive overhaul of the regulatory framework seems unnecessary. Having said that, no regulation is flawless and should evolve with business, society and technological development.

Until now the debate has focused predominantly on remuneration in light of a potential EU-wide ban on inducements for retail investment advice. Much has been said about the implications of such a ban in the recent debate between policymakers, consumer organisations and industry stakeholders. Evidence from various markets indicate that a ban on inducements would restrict retail investors' access to financial advice, thereby having a counterproductive effect on retail participation in capital markets. It would shift the provision of advice towards a fee-based remuneration model and effectively deprive customers with low-to-medium income of relevant advice. Such detrimental effects have been observed in markets where a ban was introduced, like the Netherlands and the UK.

While innovative distribution models and technology enabled advice may play a larger role in the future, they remain currently very limited in practice and would not be sufficient to mitigate an advice gap triggered by a ban on inducements. Market research suggests that there is still a very high demand for human advice: in a representative sample of new life insurance customers in Germany, only 10% opted for fully digital advice as recently as in 2022.

The RIS success depends on a design that meets insurance customers' needs while allowing innovation.

In markets with advice gap, large numbers of retail investors can end up with inadequate products (e.g. high-risk/volatility, crypto assets) partially driven by information from unregulated advisors like "finfluencers". This would be especially problematic in most EU markets, where old age provision relies materially on a well-functioning third pillar. In contrast, the UK and the Netherlands operate pension systems that are built around mandatory and automatic enrolment for occupational pensions so that the third pillar doesn't play a critical role for the overall old age provision framework.

To achieve the target proposed by RIS and improve consumer participation in the capital markets, it is crucial to address other key challenges that deserve at least as much consideration as remuneration in the policy debate, chief among them:

- Moving to digital-by-default in insurance distribution, to abolish the requirement to provide all information on paper, which fails to reflect the continuous digitalization of sales processes in the sector, relevant to cater for the younger cohorts of the population while ensuring no one is left behind.
- Reducing information overload stemming from the cumulative impact of sectorial disclosure obligations, which can, especially in life insurance business, be particularly overwhelming and burdensome (e.g. Solvency II, PRIIPs, SFDR requirements, as well national requirements).
- Improving transparency of costs, and especially distribution costs, in a targeted and meaningful way for retail investors, also to the benefit of a competitive distribution market.
- Reinforcing value for money standards, already embedded in current regulation, to increase consumers' confidence in the products on offer. Value for money should ensure a holistic assessment to reflect subjective and objective factors and focus beyond pure investment returns.

In insurance, there is no evidence that an all-encompassing solution imposing a commission ban would prove beneficial for customers across Europe. Reducing customer choice of available advice in favor of fee-based remuneration model would work against the target of encouraging consumers to invest and undermine the key objective of increasing retail investment across the EU.

The RIS success depends on a design that meets insurance customers' needs while allowing innovation. Market research suggests that the existing framework is already a solid basis that has improved consumer protection materially. As such we believe that an evolution of the current framework towards more cost transparency, digitally enabled and streamlined documentation and reinforced value for money standards would be the best way forward – a revolution is not required.

ELISABETH STERNER

Head of the Nordic Region - BlackRock

Empowering retail investors: a matter of trust and choice

Increasing retail participation in capital markets has been a long-standing EU policy objective. Despite many positive initiatives, there is still work required to create a culture of investing in Europe. Success in coming up with effective measures to increase retail participation requires recognising the interaction of many factors, including diversity of investors, different levels of financial education, distribution models, and the myriad of European and national rules including domestic tax incentives.

This can be done by learnings from markets and countries that have managed to create a strong investment culture among the public. Nordic countries such as Sweden stand out in Europe with a well-functioning equity market and broad participation by retail investors, through funds, ETFs and direct equity investments. The introduction of the 'Investeringsparkonto' (a type of savings account) in 2012 is widely recognised to have contributed to this, in part thanks to its simplified and automated tax system, calculated quarterly on the value of holdings (no tax on profits, interest, or dividends). This makes it simple for Swedish citizens to participate in the capital market.

To empower retail investors, we need effective policies built on these success stories, to demystify and make investing easier for the public. By building trust and providing choice, we can empower retail investors to reap the full benefits of the capital markets union (CMU). At BlackRock making investing accessible, affordable, and transparent to more people is core to our mission. Increased retail participation has positive effects on the entire financial ecosystem and is a key building block for wealth creation for EU citizens.

Trust in the financial services sector – and the advisory process in particular – is key to achieve this. While a recent study suggests that there is increased trust of financial services amongst retail investors (60% in 2022 compared to 44% in 2018)[1], these numbers suggest that there is still much work to do. Harmonizing distribution rules across investment and insurance products to deliver comparable outcomes for investors would represent an important step in aligning the interests of intermediaries and investors.

Another aspect to increase trust is clarity on fees. There is a need to provide complete but intuitive disclosures across the value chain on the reporting of costs and performance to illustrate the added value of investing. Clarity will give consumers confidence that the costs they incur add value to the returns they seek to achieve.

By building trust and offering choice, we empower retail investors to reap the benefits of the CMU.

Still talking about trust, our investor surveys[2] have consistently shown that people feel more confident about investing when they receive professional support. However, the current regime for regulating the provision of investment advice in the EU is not as effective as it could be. To increase trust in the advisory process, we need to adopt a consistent supervision approach that expands on the EU's current high-level framework of investor protection to deliver better outcomes for investors. We can also strengthen trust in financial advice by ensuring a high level of quality. This can be done by encouraging convergence and promoting best practices including the development of a pan-European certification for financial advisers for consumers to rely on. With the growing trend for retail investors to trade directly through platforms, we believe that there are also benefits in creating a simplified guidance framework to allow platforms to better support their clients. Appropriate supervision and/or certification of social media "finfluencers" could also complement that objective.

To increase participation, we need to reduce the complexity of investing by making choices clear and accessible, for example by focusing on the benefits of saving regularly into diversified investment products. As a first step into markets, we encourage the use of diversified and default investment solutions, such as ETF savings plans, where citizens invest a regular amount (however small) every month to benefit from cost averaging and long-term compounded interest.

Finally, technology will continue to play an important role in increasing trust and making choice accessible. Digital tools can serve as enablers to deliver at scale, complement existing advisory models and enable more effective investor communication. A digital-first environment will help ensure that regulation works with and supports the movement towards improved disclosure standards, account opening, portfolio allocation, and advisory and trading practices.

All in all, to increase retail participation, the public and private sectors need to work together to increase protection, access, and trust in the system that will empower new generations of investors.

[1] Enhancing Investors' Trust. 2022 CFA Institute Investor Trust Study.
[2] BlackRock People and Money Survey.

SERGIU CRISTIAN MANEA

Chief Executive Officer & Chairman of Management Board - Romanian Commercial Bank (BCR)

How to make retail investors more confident

In its 2020 CMU Action Plan, the Commission reiterated the importance of increasing retail investor participation in capital markets. Currently, most discussions center around measures to protect, teach and inform investors. The main idea is to empower investors to make informed decisions, correctly assess opportunities and risks and consequently be more confident in their ability to invest.

We are fully supportive of this objective and, in our view, one of the most important aspects to increase investors' level of information is the fostering of financial literacy. Let's make it an integral part of the standard educational curriculum. The issue has been gaining speed under Commissioner McGuinness, notably under the EU's financial literacy competence frameworks. It is now vital to ensure a high uptake of the frameworks by Member States. Moreover, we hope that policymakers, in the next legislative cycle (2024-29), will not allocate less importance to this crucial topic.

However, any effort to increase financial literacy will only pay off in the long run. This means that it will not immediately change the current situation, where many citizens simply do not have the necessary knowledge to confidently take their own investment decisions. Fortunately, we already have an excellent remedy at our disposal – professional, easily accessible investment advice for retail clients.

Under the current MiFID system investors have the choice to obtain advice which either comes at often heavy upfront fees or is financed through inducements. For many retail investors, the choice is clear: they cannot or do not want to pay an upfront fee, which is why they opt for inducement-based investment advice. Nonetheless, some stakeholders have been pushing for an outright ban on inducements lately.

What are possible consequences? A ban on inducement-based advice would reduce the choices for retail investors and likely create a situation, where potential retail investors are scared away from the capital market instead of supporting its development - something completely counterproductive to the CMU's intentions.

This outcome could be amplified when financial intermediaries start focusing on higher-end clients and neglecting smaller retail investors. It can also reduce competition among intermediaries, which can lead to higher fees and reduced access to investment products. Furthermore, such a step could push retail investors towards free information sources such as online platforms and influencers, whose credibility for financial advice is highly questionable.

Let's help retail investors make the right choices, which is impossible with a ban on inducements.

The alternative of paying for professional advice will be shunned by most small retail investors. Consequently, in countries where the investment services market has just begun to develop (eg RO & BG), a ban would simply put a dramatic stop to their growth and preclude this most vulnerable group of clients from using one of the best available solutions to improve their financial health.

Therefore, while a ban on inducements may seem like an attractive solution to some, we urge to carefully consider the likely negative effects and explore alternatives, which promote instead of hampering the access of retail investors to the capital market. Ideally, the existing status-quo remains in place, leaving the choice between inducement-based vs. fee-based advice.

Apart from that, an important aspect to improve is the quantity of information. Typically, the regulatory approach regarding retail clients is to assume that more information is generally better. Accordingly, the MiFID framework defines detailed information requirements for a limited scope of accessible products. Experienced retail investors give regular feedback that they neither appreciate this overload of information, nor the limited product offer, and therefore the entire investment experience. Less and at the same time more relevant information would surely be more beneficial for them.

Against this background, the introduction of a new investor category, the Qualified Investor (QI), should be revisited, in our view. The idea first came up in the wake of the EU High Level Forum and subsequent Action Plan in the years 2019-20 but has never been implemented in the MiFID framework. The new category would allow to differentiate between sophisticated retail clients (who may not need the full set of information every time they become active) and less sophisticated clients (who should always be provided with all information). QIs would also be given the opportunity to invest in a broader scope of products.

In summary, our common goal should be clear – to empower retail investors and help them make the right investment choices. The Retail Investment Strategy (RIS) should be about delivering the right information to investors – which will prove to be impossible with a ban on inducements. We look forward to the publication of the RIS and stand ready to give advice so that it lives up to its expectation: creating a better investment environment for retail investors.

EU CAPITAL MARKET COMPETITIVENESS AND INTEGRATION

HARALD WAIGLEIN

Director General Economic Policy, Financial Markets and Customs - Federal Ministry of Finance, Austria

Competitiveness? We are doing quite well.

Facing the task to analyse the competitiveness of EU capital markets, I had to sort my thoughts and started by consulting the digital algorithm of my searching engine. The first result was the World Competitiveness Centers' ranking of the International Institute for Management Development (IMD). The IMD-competitiveness indicator combines 333 competitiveness criteria with statistical data (2/3) and survey data (1/3), the latter obtained through a business executives' survey.

Details indicate that IMDs assessment of the overall "competitiveness"-performance is determined by economic, political, social and cultural dimensions. In their view, governments need to provide an environment characterized by efficient infrastructures, institutions and policies that encourage sustainable value creation by enterprises. For them, the countries which are on top of the list, each have a unique approach of becoming competitive.

Among the 63 countries assessed in 2022, Denmark reached the first place in the overall assessment, Sweden is number 4, the Netherlands 6, Finland 8, Norway 9, Ireland 11, Luxembourg 13 (while in the economic assessment Luxembourg reached the first place). Germany is number 15 in this list, followed by many other EU member states.

The closer one looks into the results, the clearer the picture becomes. No real surprise for persons with an economic background and interest in economic questions like the participants of the EUROFI. In particular, CEE- and Baltic- member states as well as some of the bigger countries in the south had potential for improving. Why am I writing so detailed about this ranking?

In my view, the EU does quite well. Though the ongoing global turbulences the financial sector proves to be stable. Financial market participants are much better capitalized than ten years ago, the internal governance has improved considerably and the Single Supervisory Mechanism functions well. Micro- and macroprudential measures stabilize the whole system.

Capital market participation could undoubtedly contribute to the competitiveness of the EU.

Digitalization is prominently on the agenda, though we have to await the transposition of relevant legislative acts as well as the results of the discussions concerning the digital Euro.

Does the EU have a unique approach in becoming competitive? Of course, the diversity and broad range of competences is unique. We prove to have common understanding, are able to finding solid solutions and overcome differences, where necessary.

I also have the impression that especially capital market participants see the distinctive approach of the EU in climate-risk-related matters. The EU is committed to implement sustainable solutions which are also important in a long-term perspective thus enabling new investment opportunities by this approach.

Regarding the capital market related initiatives of the EU, I have the impression that we enabled relevant improvements. The legislative projects of the last legislative cycle are implemented. The EU was able to get quite well through the tense and regrettable process of the withdrawal of the UK-membership. The EU also responded swiftly when energy market disruptions occurred. The rise of the reference interest rate of the European Central Bank should bring down the high inflation, one of the economic effects of the Russian offense and the war in the Ukraine.

The Capital Markets Union-related initiatives of the on-going legislative cycle should make EU-companies more visible, improve the transparency of business behaviour, especially when it comes to sustainability criteria, enable more attractive products and liquid markets and further improve the EU-competitiveness.

However, more has to be done, sound and effective solutions have be implemented, especially when it comes to medium-sized or small Member States and companies. In my view, especially smaller and medium-sized companies also need local infrastructure to grow, adapt to evolving challenges and to receive investments by way of the capital market. I have the impression, we should start reconsidering how centralization of revenues while de-centralizing tasks can be prevented and implement suitable EU-solutions.

The upcoming retail strategy will furthermore have to prove to what extend it is able to make investments in capital markets more attractive and profitable for retail investors. While we have indications that customers become more attracted by investment products and financial education improves, progress in the capital market participation of customers could undoubtedly contribute to the competitiveness of the EU.

NATASHA CAZENAVE
Executive Director - European Securities and Markets Authority (ESMA)

Strong standards remain the foundation of vibrant & competitive capital markets

With the major geopolitical and market developments we have experienced since the Capital Markets Union plan was first launched in 2014, the arguments for competitive, vibrant, and integrated capital markets in the EU have only been strengthened over time.

There is a renewed urgency for building a resilient and diversified European financial system, capable of providing the capital our economies need to fund their growth and to withstand sudden economic shocks. Well-functioning capital markets are also critical to the success of the EU's green and digital transitions, as public funding will not be sufficient. Crucially, our capital markets must work for the direct benefit of EU citizens and ensure that retail investors can safely participate in these markets.

Regulatory changes to this aim have been incremental over recent years. Co-legislators are currently discussing the proposal to create a European single access point where investors can find financial and non-financial information, as well as discussing the more recent Listing Act proposal, which aims to simplify the listing and post-listing process to make public capital markets more attractive for EU companies. A new framework for European Long Term Investment Funds was also recently adopted, which aims to foster long-term investment in the real economy.

Moreover, the ongoing MiFIR review foresees the introduction of the long-awaited consolidated tape, which will centralise market data covering the price and volume of securities being traded across the EU. Importantly, the EU is committed to be at the forefront of both the green and digital transitions, making significant changes to foster an ambitious European wide approach from the outset.

However, while the EU has made inroads in bringing forth regulatory reforms in key areas of financial services, progress must equally be made in areas beyond for the CMU to be a success. In particular, there is a need for more efficient and harmonised insolvency laws (upon which the Commission has recently proposed a new Directive), addressing the debt-equity bias in terms of taxation, and finding a common approach for retrieving withholding taxes on investments.

When markets operate effectively, it makes them competitive and attractive for firms and investors.

From ESMA's perspective, we do not believe that there is a trade-off between regulation and growth. Well-designed regulatory frameworks bring about well-functioning, transparent and stable markets. When markets operate effectively, it makes them competitive and attractive for both firms and investors. We endeavour to achieve this by ensuring that rules are clear, consistent, and proportionate. In particular, we do our utmost to foster a convergent approach to supervision of those rules across all 27 Member States. ESMA uses a broad set of tools to achieve this, for example, by setting common EU supervisory priorities, conducting common supervisory actions or establishing voluntary supervisory colleges. Yet, there is scope to enhance ESMA's capabilities further in this regard.

Improving ESMA's ability to issue true no-action letters is one example of how better regulatory flexibility and EU-wide decisions can safeguard market efficiency.

At the same time, it's important to be clear that fostering competitive markets must not mean tearing up the rulebooks to do so. If the stress events we have experienced these past months has illustrated one thing, it is that turmoil in one country can rapidly affect another. In an interconnected global financial system, the chain is only as strong as its weakest link. It is therefore fundamental that we remain faithful to global regulatory cooperation and apply strong globally aligned standards.

Finally, we are conscious of the debate as to the direct role that regulators might play in promoting competitiveness in markets. At ESMA, while being mindful of the global nature of financial markets and the potential for regulatory decisions to impact market behaviours, we believe regulators should focus on our core duties of preserving financial stability, orderly market and investor protection. Therefore, our view is that any additional mandates to promote competitiveness are not warranted.

Capital markets play a key role in allocating capital and diversifying risk. Building deeper, more integrated, and stronger capital markets, with citizens and companies at the centre, is therefore in the broader public interest.

Pursuing a regulatory agenda to address these goals, while retaining a commitment to financial stability, investor protection and adherence to international standards, will ultimately build more stable, efficient and competitive capital markets in the EU.

FRANCESCO CECCATO

Chief Executive Officer - Barclays Europe

Moving beyond incremental reform to a true CMU

It was a positive development that the Commission's last Capital Markets Union action plan, published in 2020, proposed a relaunched CMU that has a stronger focus on EU market integration, SME financing and retail investment. Legislative proposals have followed, including the establishment of a single access point to company information and a review of three key capital market legislations: AIFMD, ELTIF and MiFIR. Further actions proposed or planned include a proposal for an EU Listing Act, targeted harmonisations of the corporate insolvency framework, an open finance framework and initiatives to develop financial literacy.

However, now reduced to a trickle of incremental reform, the CMU risks becoming a missed opportunity that avoids the difficult questions and does little more than tinker at the edges of the problem. Regulatory proposals have had little success so far in helping advance the creation of a unified capital market in the EU, and despite the incremental reform, EU equity markets are making slow progress overall, with the EU's equity finance gap continuing to widen compared to global peers.

The EU is performing far below its potential, reflected in the declining proportion of global equity market capitalisation of listed shares. This fall is a result of a combination of factors – an ongoing trend of company delistings, fewer IPOs and most recently, lower company valuations linked to the uncertain economic outlook. As a result, the EU as a whole is becoming less and less attractive as a place for businesses to access deep pools of capital and go public.

Comparing the EU with the US, from the investor side the picture is mixed, but overall investment in domestic equities in Europe is far less substantial than in the US. EU pension funds lag behind the US as a source of domestic equity investment. The picture is comparatively more encouraging for insurance companies and investment funds, but a limited focus on EU equities is evident across the board. Education to build confidence and trust in equity markets is critical to developing an investor culture entailing significant investment from individual EU consumers. Without this, EU capital market growth will remain dependent on non-EU stakeholders and will be impeded. The CMU's ambition in its last action plan to develop financial literacy should be broadened and furthered with this in mind. On the legal and regulatory side, the impediment lies in the continued struggle of the CMU to achieve its "single market" ambitions. This needs to be fulfilled in the following ways:

- Harmonisation of the corporate insolvency framework was a hoped-for ambition of the last action plan but has not been delivered as yet. This is particularly important in addressing the challenges of fragmented legal regimes that hinder the debt market and should be a priority for CMU.

The CMU risks becoming a missed opportunity that avoids the difficult questions.

- Building on company law frameworks such as the "societas europaea" and the takeover bids regime, the development of a system of pan-EU company law.
- Development of measures to increase capital markets financing and move away from reliance on bank financing, to improve competition and dynamism within the markets, and increase financial stability. A move away from reliance on bank loans is likely only to be fully successful if there is a harmonisation of insolvency and property laws across the EU to give clarity to investors.
- Reform of the European Securities and Markets Authority into a single, strong centralised securities regulator, similar to the Securities and Exchange Commission in the US, and removal of decentralised regulatory control from member state regulators.
- Reform of foreign and direct investment regulation to address barriers which disproportionately inhibit investment in the EU from outside, and indeed even as between EU countries.
- Finally, there is work the banking industry can do to support all of this. There is an extent to which a true banking union is a pre-requisite for a true Capital Markets Union. In other words, the market needs to see the development of banks that are truly integrated pan-EU firms which can act as the facilitators of capital flows between savers and the real economy. In possession of the correct regulatory licenses, EU banks can already facilitate this by providing a marketplace for corporates and investors.

Capital Markets Union is a critical initiative for the European Union and given a sufficient level of political priority can deliver substantial economic benefits for European citizens.

STÉPHANE BOUJNAH
Chief Executive Officer and Chairman of the Managing Board - Euronext

The EU must end the era of unilateral disarmament

The strategic autonomy of Europe requires competitive capital markets to transform EU savings into investments and to attract foreign capital. But the EU cannot depend on foreign third parties to power European markets and ensure the financing of the European economy. Improving the competitiveness of capital markets in the EU cannot rely on a single financial centre, but depends on interconnected and integrated markets. The financing of the EU economy must be supported by an ecosystem of strong EU-based players who are not sub-groups of the "EMEA – Europe, Middle-East and Africa" division of global companies.

Progress is needed to increase equitization of the European economy. Since 2016, the cumulated market capitalization on EU markets has represented on average 80% of GDP compared to 160% in the US, and 130% in the UK.

Competitiveness must be a central part of the CMU objectives. But regulation must not translate in a 'race to the bottom' with other jurisdictions. It should rather be part of an effort to develop EU markets and empower EU-based participants. That is why Euronext has championed a competitiveness test to assess unwanted consequences of new EU regulations.

Much of the current EU legislative agenda encompasses these objectives. The clearing reform proposals under EMIR 3.0 can improve the competitiveness of European CCPs, with a prioritisation of the measures required to enhance the attractiveness of clearing in the EU. On the primary markets side, the Listings Act proposals focus on simplification and harmonization within the Prospectus and Market Abuse Regulations.

However, some proposals are detrimental to the long-term competitiveness and strategic autonomy of EU markets. A consolidated tape (CT) can help market participants and investors better navigate the EU trading landscape. Euronext is establishing a Joint Venture with 13 other European exchanges to prepare a tender application as a CT provider. However, policymakers must avoid imposing superficially attractive, yet ultimately damaging, solutions such as the introduction of a real-time pre-trade data tape, which would only increase the opportunities for latency arbitrage and lead to value destruction in local markets.

Strong EU finance-makers are the key to the competitiveness and strategic autonomy of Europe.

A CT is not a silver bullet to resolving issues of trading fragmentation and declining transparency. These challenges require significant intervention on market structure. We have not seen such an ambition. On the contrary, some current proposals would increase dark and discretionary trading, notably by allowing systematic internalisers to trade further away from market prices. This would move trading away from the lit orderbook, hamper price discovery and hurt investors. It will mostly benefit non-EU participants and increase the dependency on foreign third-parties.

It is up to EU companies to offer the right set of services to attract issuers and capital. This is what Euronext has been trying to achieve since the IPO in 2014. The Group has expanded significantly and operates regulated markets across 7 European countries. On 27 March, Euronext migrated the trading of equities listed on the Italian exchange on its single European liquidity pool, enabled by a single order book, empowered by the Euronext proprietary technology platform, Optiq®. Issuers and investors can now access a single liquidity pool with an aggregated market capitalization close to € 7 trillion, which is twice the size of the London Stock Exchange one. In 2022, more than 25% of European equity flows have been traded on Euronext platform, and average daily value of traded equity have been close to € 11 billion.

Euronext does facilitate access to public capital, in particular SMEs, by nurturing local ecosystems, through its pre-IPO programme TechShare launched in 2016, and through the Euronext Tech Leader index created in 2022. This is a stark difference with many non-EU actors, which cherry pick the most profitable businesses with large blue chip companies and do not bother with SMEs, technology companies and local ecosystems.

Euronext is also expanding the capabilities of EU-based finance-makers by internalizing the clearing of transactions, within Euronext Clearing, a EU-controlled CCP. This strategic move will reduce dependency on non-EU third parties and increase the strategic autonomy of EU markets.

Competitive, strong EU-based finance-makers are the key to the competitiveness and strategic autonomy of Europe. The EU must be more ambitious and promote the building of a continent of finance-makers, not just a territory of finance-takers. The world around Europe is changing, and the EU must end the era of unilateral disarmament, in particular when it comes to financial regulations. Policymakers need to carefully consider the unwanted consequences of any regulatory changes, whose effect would be to destroy EU financial markets as we know them. Any damage to the EU finance industry capabilities will be lasting, hard to reverse and detrimental to the financing of the European economy.

JAN BOOMAARS
Chief Executive Officer - Optiver

A new playbook for Europe's capital markets

Next year, EU citizens will elect the next Members of the European Parliament (MEPs). With these elections, the European Commission also gets new political leadership.

Rather than following the same playbook for capital markets, the focus should be on creating a true single market for financial services, finding innovative ways to bring more retail investors into the market and taking an evidence-based and proportionate approach to rulemaking that champions a diversity of market participation.

Much has been achieved for financial markets in the EU – increased transparency from MiFID II, important investment product regulations, simplified listing rules, a harmonised anti-money laundering rulebook and progress toward banking union. But too often competing objectives have stifled progress, especially on CMU. For instance, in crafting prudential rules for investment firms, policymakers set out to create a bespoke regime for a diversity of market participants. Instead what we got is a one-size-fits-all application of banking rules to firms with no banking activities. This contradicts the notion of a CMU with diverse market participants and should be addressed in the next mandate.

Beyond that, next year's leadership should focus on a small number of goals with the greatest potential to transform capital markets. In that spirit, I offer three recommendations.

Create a truly single market

On paper, the EU boasts a single rulebook for financial services. But in practice, each member state implements EU rules in its own way; applies varying levels of supervision; imposes different compliance obligations; or sets different standards for market access. So in reality we have a landscape fragmented into 27 different parts. Investors face difficulties when they confront diverging tax regimes, insolvency laws and post-trade practices. For example market making activities face different regulatory treatment across member states. In effect, we have a single rulebook but no harmonised supervision or enforcement of that rulebook.

Giving ESMA more teeth is one way to improve this. ESMA's decisions rely largely on member state supervisors, making it difficult for it to enforce the single rulebook and ensure supervisory convergence. Ultimately, ESMA needs broad powers to police, enforce and make technical rule changes when needed. We could start by giving ESMA direct oversight over EU trading venues and exclusive product intervention powers.

Encourage Europe's retail investors

Increasing retail participation is a win for EU citizens, markets and the economy. It gives individuals access to broader, more competitive investment choices, contributing to their retirement savings. Markets grow more efficient, stable and robust with a greater diversity of market participants.

> **We have a single rulebook for financial services, but in practice we still have 27 markets.**

The world often looks to the US for lessons on how to stimulate smaller investors. That's a mistake. Retail investors in the EU are different, so why treat them like they're the same? An area where this could be particularly relevant is in improving investor education. Armed with data on retail trading trends, regulators could pursue evidence-based initiatives, like adding basic financial knowledge to school curriculums or encouraging institutions to use social media to promote financial literacy.

Products and practices that lead to poor outcomes should be eliminated. Germany's single market-maker venues, for example, which studies show lead to worse prices for retail investors, should be required to operate on level footing with other EU venues.

Finally, structured products, which are more costly, less liquid and transparent, and expose investors to greater counterparty risk than comparable exchange-traded products, should be restricted for retail. Spain is contemplating banning CFDs for retail. That's the right response in spirit, but EU-wide restrictions would accomplish the same, while contributing to a harmonised EU rulebook that's easier for retail investors to navigate.

Pursue evidence-based rule-making

EU rules often end up being more complicated than is necessary and too frequently apply a one-size-fits-all approach that is not appropriate for the diversity of market participants. Of course this is a function of competing political interests, but the results do little to improve capital markets or encourage trading and investment in the EU.

The objectives behind EU rules are usually sound, but they get distorted by politics. A more proportionate, evidence-based approach would help grow capital markets with a diversity of market participants. Rulemaking based on empirical data and research means informed decision-making, bespoke rather than prescriptive rules, and transparency to boost trust and confidence in the financial sector.

All of these objectives together would create a virtuous cycle between regulator and regulated. Focus on these and Europe's capital markets will be in a healthier place when the next class of MEPs wraps up their terms six years from now.

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MIFIR REVIEW

VERENA ROSS

Chair - European Securities and Markets Authority (ESMA)

Contributing to strong EU capital markets – success factors for MiFID II/MiFIR

It may not seem so long ago but already more than a year has gone by since the European Commission presented its proposal for the MiFID II / MiFIR Review in November 2021 as part of the Capital Markets Union package. Many things have changed since then. ESMA remains strongly supportive of the main elements of the proposal, notably on increasing transparency and enhancing investor protection. As the co-legislator will need to find compromises in the legislative negotiations before a final agreement can be reached, the key factors for the success of the future regulation should be kept in mind.

From its inception, one of MiFID II / MiFIR's key objectives was to establish a more transparent financial system following the lessons learnt from the great financial crisis in 2008. Since the MiFID II/MiFIR implementation, this has been one of the main elements that ESMA has worked and continues to work on.

Providing transparency includes ensuring that the information available is accurate, meaningful, comparable and accessible. The consolidation of all transparency information from various data sources into one single consolidated tool, that would be available to end-investors and reduce costs for them, would be a catalyst to achieve these goals. A CTP would contribute to democratise access to market data and increase data quality. While it was originally foreseen already by MiFID II/MiFIR, the fact that a CTP has so far not been established has been a vital missing piece in building a truly integrated single capital market.

Considering ESMA's foreseen mandates within the MiFID II/ MiFIR Review to appoint, authorise and supervise the CTP, we have been closely monitoring developments in the Level 1 negotiations. We welcome the improvements introduced by the co-legislator to the proposal, notably the introduction of a staggered approach for the different asset classes and the separation of the selection and authorisation procedures. Nevertheless, while ESMA very much shares the ambition to have a rapid establishment of the CTP, in our view, some essential pre-conditions for the successful establishment of the CTP remain to be addressed. One such condition relates to the timing of certain Level 2 measures specifying key aspects of the CTP, such as the revenue redistribution and the bond transparency regime, which would need to be in place before ESMA launches the selection procedure.

A CTP would contribute to democratise access to market data and increase data quality.

In addition, we would recommend increasing the time available for the overall selection procedure to provide all potential applicants with sufficient time to participate in the procedure and for ESMA to appoint the successful candidate to provide the CTP.

The success of the CTP will be determined by a number of factors. Firstly, an appropriate calibration of the transparency regime will be paramount to appropriately define the scope of the tape. Currently, concerns remain that the proposal introduces some overly complex requirements, particularly for bonds, and we would recommend a simpler approach. Secondly, the CTP will rely on the ability to receive and publish good quality data. Further work is needed in this area, in particular on the quality of data for OTC transactions. In this regard, the European Commission has recently adopted reviewed RTS, prepared and submitted by ESMA, to address data quality concerns, which we welcome. The remaining key dimension is ensuring the alignment of the data to be published across trading venues, investment firms and the CTP. For this purpose, we consider that ESMA is well placed to ensure consistency of data standards and formats.

In addition to promoting transparency, another key objective of MiFID II / MiFIR has been to improve investor protection. It is therefore welcome that the Review includes proposals to tackle the conflict of interest between firms and clients present in payment for order flow (PFOF), as PFOF incentivises firms to choose the execution venue offering the highest payment, rather than the best possible outcome for clients when executing their orders. A PFOF ban can therefore in ESMA's view contribute to enhancing outcomes for investors.

I am hopeful that the MiFID II / MiFIR Review can increase the competitiveness of the EU's capital markets, as markets that are functioning efficiently, transparently, with integrity and in an orderly fashion are attractive for firms and investors. To achieve this, ensuring that the Review delivers on the elements outlined above to further promote transparency and investor protection will be crucial.

PROF. DANUTA HÜBNER

MEP, Committee on Economic and Monetary Affairs - European Parliament

The future of the CMU requires us to be bold and ambitious in the MiFIR Review

European co-legislators are currently negotiating the MIFIR review, which modifies the rulebook governing participation in European capital markets and aims at reducing market fragmentation and market data costs, harmonise and simplify the transparency rules in Europe, enhance the levels of investors protection and increase the competitiveness of EU markets.

One of the core elements of the review relates to the staggered introduction of a consolidated tape (CT) for each asset class. Going further than the Commission and the Council, for the equity CT the European Parliament (EP) sets the scope to cover real-time, pre-trade data up to the first five layers of the order books, in addition to post-trade data. Smaller trading venues are excluded from the mandatory contributions of data to the CT, although a dedicated revenue participation scheme is established to promote voluntary opt-in.

To ensure that data quality is improved and data costs are reduced, both the Council and the EP mandate ESMA to develop RTS on the quality and substance of market data, and on the criteria for the provision of market data on a reasonable commercial basis (RCB).

Significant changes to market structure and transparency rules applicable to market participants are also being discussed. The EP proposes to empower ESMA to define the threshold for the use of the Reference Price Waiver (RPW) and for Systematic Internalisers (SIs) quotes and execution. Above said threshold, midpoint matching will be allowed without complying with the tick size regime, in line with other international jurisdictions. In its proposal, the Commission set said threshold at twice the standard market size, while the Council does not have any minimum size.

The EP maintains the Commission's proposal of a single volume cap set at 7%, and it asks ESMA to assess the threshold and the methodology used to define it every two years. The Council, conversely, set a 10% cap only to the RPW.

On non-equities, the Council and the EP both establish five categories of deferrals for bonds and derivatives, with varying length of deferrals based on the transaction size and the liquidity of the instruments (to be calibrated by ESMA).

Seeking to simplify and introduce greater clarity in market structure, the EP also amends the definition of SIs - moving it to a qualitative basis - and both the EP and the Council 'decouple' the SI status and the post-trade reporting requirements.

The EP maintains the horizontal ban on the payment-for-order-flow (PFOF) arrangements proposed by the Commission, while the Council give Member States discretion on whether to implement the ban or allow PFOF within their national market.

We must not lose sight of what is at stake - MiFIR will shape EU capital markets for years to come.

Additionally, the EP introduces new elements stemming from the energy crisis which neither the Council nor the Commission included: it 'tightens' and harmonises the rules on circuit breakers, and calls for a review of the position limit and position management regimes and the criteria for the ancillary activity exemption, as well as for an assessment of the viability of minimum holding periods for energy derivatives.

Overall, it is clear that the co-legislators share the main objectives of the review. The emergence of a CT will give investors a single view of the EU markets and will contribute to the reduction in market data costs and fragmentation. Properly calibrated transparency rules will ensure that the EU market structure gives our firms the ability to compete globally and to increase their attractiveness.

Differences remain in how these changes should be implemented. While the Parliament favours an ambitious CT and a higher degree of caution with respect to market structure (i.e. the maintenance of artificial limits to certain execution methods), the Council proposes a CT model limited to post-trade data and aligns market structure rules with those of other international centres.

There are several points in common, such as the dedicated treatment of smaller exchanges on the CT, inclusion of RCB provisions, harmonisation of deferrals, decoupling SIs status from reporting obligations. On these matters, the discussions will focus on the exact calibration of these measures, and differences do not seem irreconcilable.

Throughout the negotiations, co-legislators must not lose sight of what is at stake. The MiFIR review will shape EU financial markets for years to come, channelling capital where it is most needed. Efficient capital markets will be key in financing the sustainable and digital transition, and fostering economic growth. It is therefore essential that the EP and the Council find the best way to strengthen the competitiveness and attractiveness of the EU Capital Market Union.

CARLO COMPORTI

Commissioner - Commissione Nazionale per le Società e la Borsa (CONSOB)

MiFIR Review: the positive outcome of a long and puzzling story?

The MiFIR Review is hopefully coming to an end with an intensification of negotiations around few critical points, presented here below.

Projects are already underway for the establishment of a consolidated tape in both the equity and the non-equity space, sign of strong demand to find all needed information in one single place for such asset classes. In February, 14 European exchange groups, geographically representing 26 different Member States, agreed to participate in the future selection process for the provision of a consolidated tape for equity, in the form of a joint venture. This initiative seems to give substance to the expectation of a rapid and effective implementation, given the experience matured by the participating exchanges in providing market data and the degree of comprehensiveness that their number has the potential to ensure.

These developments come at the right time despite concerns about the latest developments of negotiations, i.e. the removal of a fall-back clause if lacking a private solution, and the narrowed scope in connection with the opt-in mechanism for smaller trading venues. On the latter point, both the ECON and the Council, though with different nuances, seem to strike an appropriate balance between opposite positions. On the one hand, it is acknowledged that especially smaller regulated markets and SME growth markets might be put at a disadvantage if giving up the commercial value of transaction data. On the other hand, it is also recognised that equity trading is characterised by high concentration, for which the contribution of smaller exchanges is of a limited marginal value.

Consensus seems to be reached on the sequence of implementation, starting with bonds, followed by equities and ETFs, and finally derivatives. On whether including pre-trade information alongside post-trade data, the solution agreed at Council level envisages the publication of the best bid and offer available at the time of the executed transactions. Going beyond will ever be possible, after an initial implementation, if supported by a clear business case. It is important to ensure that the final agreement does not discourage these initiatives.

Another area on which co-legislators seem to agree is the double volume cap, where the single threshold will bring the benefit of streamlining the previous process though abiding the objective to curb dark trading, which remains an important goal to be achieved, also in comparison with the US.

A further delay could hinder the realisation of other important goals within the CMU action plan.

The mechanism of deferrals to the post-trade transparency regime is also due to benefit from a simplification by allowing consideration of both size of transactions and liquidity of asset classes and a higher level of harmonisation. In that respect, the data available at ESMA level will help the authority to determine the most appropriate degree of calibration, to reduce the discretion in delaying post-trade transparency.

The trilogue will also discuss the pre-trade transparency waiver granted to systematic internalisers (SIs) for transactions executed at midpoint, with the general approach text having removed the large in scale threshold and the ECON more prudently keeping the concept of a certain size, in order not to harm transparency.

Although the identification of a designated reporting entity for transactions in which SIs are part will solve practical problems faced so far, it should not inadvertently and unjustifiably lead to complete de-regulation of SIs for non-equity instruments, as this would undermine the degree of transparency in the non-equity space. It is rather preferable that SIs remain subject to identification through qualitative criteria as well as to an opt-in mechanism. Additionally, it is worth considering to ask such entities to report to NCAs on the policies applied in the management of orders received, that concurs to levelling the playing field between Sis and trading venues.

Another point possibly needing further reflection during the trilogue could be the derivatives trading obligation and the provision of a smoother mechanism at ESMA level to temporarily suspend the DTO and/or for issuing proper no-action letters in exceptional situations.

While it is possible to recognise, in light of the achievements referred to above, that the negotiations so far helped in better catering for the real needs and focusing on appropriate solutions though not exacerbating the burden on the regulated entities, it is now time to finalise the MiFIR text. A further delay could hinder the realisation of other important goals within the CMU action plan.

NIELS
BRAB

Head of Group Regulatory Strategy & Chief Regulatory Officer - Deutsche Börse Group

Make MiFID II/ MiFIR fit for the EU strategic autonomy

Global realities continue to challenge the strategic autonomy of the EU and require new answers to defend our values and to preserve our ability to shape the future of our society in a sustainable manner. With high inflation, questions around the future of monetary policy and an overall challenging macroeconomic reality, key EU leaders are reemphasising the need for stronger EU capital markets.

The MiFID II/ MiFIR Review provides a key opportunity to make the framework fit for an EU strategic autonomy, improving competitive realities at a critical juncture in history. As Trilogue negotiations are kicking-off, policymakers should use the chance and realise that the debate goes way beyond complex abbreviations, waivers, and deferrals – it is time to fundamentally reflect on how EU capital markets should evolve and how we will really get there.

If the EU is serious about the CMU endeavour, it is clear that there must be a fit for purpose regulatory framework that promotes strong primary and secondary markets, with competitive EU financial market infrastructures as the backbone. And: We should not lose sight of some of the key lessons learnt since the MiFID II/ MiFIR application in 2018. The EU has witnessed hyper market fragmentation, lower levels of transparency and a drop of market share on exchanges as the key drivers of our equity markets – empirical realities that strongly contrast with the original objectives.

The creation of an EU Consolidated Tape (CT) could certainly add significant value to provide a full overview of the EU's trading landscape – but we should not forget that the discriminatory rule books of certain alternative execution venues will continue to mean that investors would often not even be able to access such venues. And while a lot of voices have been calling for the creation of a CT, European exchanges acted and recently announced to participate in the future selection process on a CT for shares – symbolic of their serious commitment to improve the EU's ecosystem.

However, with the legislative discussions overshadowed by PFOF and the CT, let us not forget to address market structure – the very starting point to the design of our markets and their future success story at global level. Simply copying some of the proposals discussed in the UK, which are still far from any potential implementation, will not do the trick. A fundamental vision that matches the EU's strategic autonomy aspirations is needed.

A new vision with EU interests at the heart is needed to succeed in an unfolding new world order.

The much-debated single volume cap is key in this regard. ESMA should be tasked to determine an appropriate threshold, based on an in-depth analysis that also assesses how dark trading affects the efficiency of the price formation process. And the SVC should not only capture trading venues using waivers (incl. the reference price waiver and the negotiated trade waiver) but also any non-transparent venues, such as SIs, dark pools or other relevant set-ups (e.g. frequent batch auctions).

Moreover, the threshold for the suggested minimum quoting and trading size for SIs should be determined with a view to creating a level playing field. It should be at least four times the standard market size, which would help to refocus SI activities on their original purpose, the execution of large orders.

In line with this and to increase transparency, thresholds for order handling provisions, the execution at midpoint and the application of the tick-size regime for SIs cannot be dropped but are to be applied in a well-calibrated manner. All these provisions need to be combined with much stricter governance and due diligence requirements and a thorough enforcement by supervisors to address regulatory arbitrage whilst ensuring compliance.

Especially the market events over the last couple of months have reminded us of some of the key lessons learnt during the financial crisis: Transparency is key. Reporting is key. Supervision is key. And: Neutral and independent market infrastructures, such as exchanges, will foster the integrity of our markets in a more aspirational way than entities mixing proprietary trading activities with the execution of customer flows.

Finally, let us remind ourselves of some of the core realities in our markets: EU companies are leaving the listed universe and move abroad. The participation of our citizens is shrinking in relative comparison to 3rd country investors who have long understood that the participation in our value creation is certainly positive.

There are many more proxies we could list to illustrate empirical realities around the erosion of our ecosystem and how it negatively affects the EU's interests. All of this should make us reflect on the question if we have followed the right strategy over the past two decades of legislative attempts to boost our capital markets – or if a new vision with EU interests at the heart is needed to succeed in an unfolding new world order within which the EU runs the risk of becoming the playground.

JAMES MCKEONE

Vice President and Head of European Data Product - Nasdaq

The Capital Markets Ecosystem: unlocking innovation through regulation

Regulation can be a powerful catalyst for driving innovation, and when done well, it can contribute to a more efficient capital markets ecosystem. Right now, the European markets are at an inflection point driven by the reform of the directive and regulation on Markets in Financial Instruments (MiFID/R).

The anticipated outcome is to create more opportunities to finance major investor-, market- and demand-driven initiatives, such as the transition towards a more environmentally conscious and digital economy.

For example, it is estimated that to reach Net Zero by 2050, Europe will have to finance an estimated cost of €28 Trillion, and market financing needs to take the biggest share. To allow for progress, the European capital markets must evolve, underpinning the importance of the Capital Markets Union project and regulatory framework resulting from the MiFID/R review. This reform may be the last chance to get things right for the establishment of a well-functioning European capital market.

Doing so will help the capital market ecosystem address significant priorities such as enabling the green and digital transition. Nasdaq's distinct position at the intersection of the market gives us a unique perspective on the current challenges and opportunities, and we are supportive of productive changes to the market structure. But to allow for real progress, the market organizations must incentivize all players while ensuring a sound environment for financial investments.

The various parts of the MiFID/R framework are all key and interact with each other: market organizations; the functions performed by various intermediaries and market participants, like the systematic internalisers; the control of dark trading; incentives to market transparency; market data quality; and a useful consolidated tape (CT). All these various pieces need to be appropriately calibrated to deliver the anticipated result and advance the expected financing objectives.

The tape will constitute a great tool to verify the quality of execution and market dynamics.

A crucial aspect of market structure is addressing how to ensure the best result for investors via incentives and appropriate regulations. It is not clear that the current provisions will incentivize market transparency. For instance, the cap on dark trading is narrow and could apply to only one of the transparency waivers. Additionally, systematic internalisers are unlikely to be limited in their ability to execute transactions away from transparent venues even if those transactions, being limited in size, could be successfully executed on transparent venues and contribute to the price formation process.

If the market structure does not incentivize transparent trading and neglects price formation, the tape cannot ensure the best result is delivered to investors; however, a CT can be useful if well-designed and appropriately used. What are the key characteristics of a useful CT? First, it must include all transactions. With any exemptions, many transactions could escape the tape. Transactions executed in non-transparent protocols must be on the tape. A CT would have limited significance if it only gathers data from easily accessible, transparent venues.

Data quality is also very important as a tape can only be attractive if it displays reliable and timely data. The tape must also remunerate data contributors adequately to ensure upstream investments and quality data. There are several challenges, which can be overcome with the support of all market players and the involvement of regulators.

Also fundamental to a CT are its use cases. A European CT will always be delayed. The laws of physics and European geography create inherent latency. The information displayed will be later than various venues and trading protocols. Consequently, a CT should not be used for trading as it will not be a true representation of the trading possibilities available in the market. Best execution should continue to be required on the best available opportunities at the time of execution. The tape will constitute a great tool to verify the quality of execution and market dynamics.

The tape is not a simple endeavor and will become an important element of European capital markets. Nasdaq as well as thirteen other exchanges recently announced a joint venture to participate in the future selection process for the provision of a CT for equities in the European Union. The participating exchanges are cornerstones of financial markets across Europe and are well-positioned to advocate on behalf of industry stakeholders and collaborate with regulators to develop a strong pathway forward for investors.

The time for action is now. Through a productive, data-driven regulatory framework, industry participants can work together and find a path forward to modernize the European capital markets and ultimately create opportunities to further finance key initiatives, ensuring economic growth and stability.

NICHOLAS BEAN

Chief Executive Officer - Bloomberg Trading Facility BV

Imperfect trilogue risks persisting an imperfect MiFIR

As the MiFIR review enters its final phase several critical issues for its success remain in flux. The trilogue parties need to avoid a fatigue of negotiation during the finalisation of the level 1 framework - most notably in relation to consolidated tape providers (CTPs), transparency requirements and market data costs.

Consolidated Tapes

The 2021 legislative proposal positively modified MiFIR to optimise it in respect of its objectives. It recognised that consolidated tapes (CTs) did not emerge due to a lack of commercial incentives for prospective providers and mitigated this by the one tape per asset class model in addition to the abolition of the requirement for a CTP to give away its product for free after 15 minutes of publication.

However, the proposal also unexpectedly introduced new challenges - effectively two steps forward and one step back. In particular, the stance that only Equity regulated markets (RMs), and not Fixed Income venues (MTFs), should receive a share of the profits of CTPs.

Beyond the obvious inequality of this proposal, it is also counterproductive to bringing a bond CT to market. Revenue sharing has a role in the commercial viability of Trading Venues (TVs) and Approved Publication Arrangements (APAs), and in particular APAs at a time when the proposed designated reporting entity regime threatens their revenue model. Furthermore, it is a key mechanism for ensuring that market data contributors provide reliable data of good quality.

Presumably this approach relates to concerns that revenue sharing may drive up costs of a bond CT product - although why this concern only applies to a bond CT and not an equity CT is wholly unclear. However, mitigation could be easily achieved by stipulating that revenue sharing shall be consistent with a cost recovery mandate plus a reasonable margin, where ESMA would be given extra policing powers.

Making CTPs responsible for applying waivers and deferrals is another item for which the objective is unclear and thus detrimental to the policy goal of seeing a CT emerge. TVs and APAs are obliged to perform this function. But what value is a CTP adding in also fulfilling this responsibility? Indeed, a CTP can only do so if it has the ‘raw’ data, which the TV and APA will not be providing. If the expectation is that the TV and APA should provide the CTP with the ‘raw’ data then what value is the TV and APA providing in relation to transparency? Essentially there is no practical way for a CTP to exercise this obligation - and it creates the kind of uncertainty which is unattractive to potential CT operators.

Transparency

Another key area that the legislative proposal sought to fix was the overly complex and burdensome fixed income transparency system. In general, this regime has not lived up to expectations, so it was surprising to see no ambitious reforms proposed. Rather, the focus was on increasing post trade transparency largely by eliminating supplementary deferrals.

Listen to the bond market, or be prepared to miss objectives.

Notwithstanding the missed opportunity for complexity reduction - it is worth noting that the focus on post trade transparency does bring the greatest benefit to investors. While ESMA has made valiant efforts to extract value out of pre-trade transparency there can be no hiding the fact that the regime was designed for equities, and it is right that the trilogue parties should look to overhaul the regime for fixed income.

The current regime just does not reflect the practicalities of fixed income trading. The Request For Quote (RFQ) trading system services the bulk of fixed income trading by investors and inherently affords liquidity identification and price formation within its pre-execution phase. The co-legislators are therefore right to suggest curtailing fixed income pre-trade transparency to central limit order book and periodic auctions systems. This will enable ESMA to focus its valuable resources on the simplification of the post trade regime.

Market data costs

A final key issue for the trilogue parties to address is the matter of market data costs. Too little attention has been paid to this issue in the process so far, which is surprising given the resonance it has for market participants. Establishing in Level 1 that Reasonable Commercial Basis means that the price of market data shall be based on the cost of producing and disseminating such data and may include a reasonable margin, is key. Yet this clear principal also needs to be made workable in practice following the review’s implementation.

In conclusion, the whole market, law makers and participants alike, are keen to avoid yet another MiFIR adjustment in the near term. We need to learn from our recent history and listen to the wisdom of our collective experience five years on from MiFIR’s go-live. The trilogue parties must ensure that the key issues identified above are addressed in light of that wisdom to guarantee the best possible outcome for this review - that being boosting the competitiveness of EU capital markets.

STRENGTHENING EU CLEARING

KLAUS LÖBER

Chair, Central Counterparties Supervisory Committee - European Securities and Markets Authority (ESMA)

Getting EMIR right

EMIR 3 is both an essential and a necessary review of the CCP regulatory and supervisory framework. Four years after the end of the negotiations on EMIR 2, significant events have impacted the European Union: the withdrawal of the UK, a global pandemic and war at our borders. All these developments have also had a direct impact on CCPs and the clearing ecosystem and have uncovered a number of weaknesses which need to be addressed.

First and foremost, the Commission has made important proposals to adapt to the new reality where the UK has now left the Single Market. In our assessment published in December 2021, ESMA identified a number of substantial risks and vulnerabilities attached to the continued recognition of three clearing services in the UK. While the report concluded that the costs of withdrawing recognition would outweigh the benefits, it also outlined a number of possible measures to incentivise EU clearing participants to reduce their exposures towards Tier 2 CCPs and to rebalance these towards EU CCPs.

Among the options considered, the active account requirement, now embedded in the Commission's legislative proposal, plays a central role. It would provide a balanced approach to ensure that an increased proportion of critical clearing services takes place in the Union, while maintaining EU markets open to the world. ESMA stands ready, with our expertise and EU-wide view on markets, to support its implementation.

Should potentially systemic risks be transferred to the Union as intended, it would be logical and critical to further strengthen supervisory convergence within the EU, as disruptions at CCPs based in one Member State could have substantial negative effects across the continent. The Commission's proposals in this regard are vital, as they would expand the scope of the CCP Supervisory Committee's competences and enhance the tools promoting supervisory convergence. The proposal to grant voting rights to ESMA and to chair the EMIR colleges would also go a long way in ensuring consistency, as ESMA is the only Authority participating in all colleges and thus able to provide a genuine EU-level perspective.

EMIR 3 is both an essential and a necessary review of the CCP regulatory and supervisory framework.

The active account requirement is aimed at addressing the substantial systemic nature of certain clearing services. However, it is not meant to address the risks linked to the exposures of EU clearing participants to Tier 2 CCPs, in particular in crisis situations. We believe that stronger cooperation arrangements and meaningful powers in the field of crisis management, as well as a revised approach to comparable compliance would help address concerns.

Second, the Commission's proposal rightly aims to address risks and vulnerabilities that we have identified throughout two almost consecutive crises. While the inner ring of the clearing ecosystem appears to have resisted well to the shocks that materialised, the same cannot always be said for the outer ring where clients have experienced difficulties in meeting abrupt and sudden margin calls resulting from price movements and increased volatility. While ESMA is making important progress in reviewing tools intended to limit the procyclical nature of CCP margin calls, the preparedness of clients remains essential. We believe that ongoing international work on anti-procyclicality, as well as the Commission's proposal to expand the margin simulation tools to the client clearing level, will go a long way in helping them prepare.

The recent energy crisis has also highlighted some tensions where financial and energy markets meet. The Market Correction Mechanism (MCM) Regulation has shown how issues in the underlying spot markets can end up as higher exposures in financial derivatives markets. Commodity markets, and in particular energy markets, have their own particularities, such as a strong proportion of non-financial counterparties (NFCs), but these specificities cannot come with weaker requirements. The proposed empowerment for ESMA to define what is expected in terms of admission criteria and ongoing membership requirements is in this regard welcome.

The Commission also clarifies in the EMIR 3 proposal that CCPs which offer clearing in both financial instruments and non-financial contracts should be subject to EMIR requirements in their entirety. We believe that similar activities that carry the same risks require the same regulatory treatment and, therefore, that the current EMIR approach should be extended to all non-financial contracts, such as forwards on certain commodities, regardless of whether a CCP also clears financial instruments.

We look forward to supporting the co-legislators in fine-tuning and improving the Commission proposal but would urge them not to turn a blind eye to the issues that we observe in our daily work.

JOHN BERRIGAN

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

Strengthening the Capital Markets Union: the Clearing Package

In December last year the European Commission put forward a package of measures to foster the Capital Markets Union (CMU), covering clearing, listing and corporate insolvency rules. Clearing is key for the success of the CMU: if it does not function properly, financial institutions, companies and investors face more risks and higher costs.

The proposed clearing package pursues 3 objectives. The first one is to have a competitive and modern clearing system in the EU: only well-developed and dynamic central counterparties (CCPs) can support trading in capital markets effectively. Second, it aims at increasing the safety and resilience of the EU clearing ecosystem, by strengthening the supervisory setting for EU CCPs and drawing some lessons from the recent stress events in energy markets. Third, the package supports the EU objectives in terms of open strategic autonomy. Clearing is a global business: that is why EMIR is an open framework and should remain so. But open strategic autonomy also means addressing the risks that can stem from excessive exposures by EU market participants to individual CCPs outside of the EU. Such a level of exposure, with no EU authority being in the driving seat in case of stress events, can pose risks to EU financial stability.

To these ends, the package includes amendments to the European Market Infrastructure Regulation (EMIR) and other pieces of EU law, and a Communication setting out the Commission's vision for central clearing in the EU for the years to come. To support a competitive and modern clearing system, the proposed measures streamline the administrative procedures EU CCPs have to go through when they want to launch a new product on the market. 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. This needs to be fixed if EU CCPs are to be competitive internationally and to keep up with the increasing demand for clearing.

The package paves the way for a safer and more competitive EU clearing ecosystem in the future

On the supervisory side, the focus of the proposals is on improving monitoring and control of cross-border risks and strengthening the EU dimension of supervision. If clearing activities in the EU are to increase, it is even more important that the cross-border risks, which run across the clearing chain (CCPs - clearing members - clients) and across different Member States are properly supervised.

The recent energy crisis confirmed the importance of having the full picture of what is happening across the clearing chain. For this purpose the proposal includes, for example, a cross-border monitoring mechanism involving the European Supervisory Authorities, the European Central Bank, the Single Supervisory Mechanism, the European Systemic Risk Board and the Commission. It also establishes joint supervisory teams for EU CCPs under the lead of the national supervisor, building on the current supervisory system while promoting a more European approach to supervision on the field. As regards the lessons from the energy crisis, the proposal strengthens the transparency of CCPs' margin calls to help clients better predict such calls and the related liquidity needs.

To support the EU open strategic autonomy, the proposal requires market participants that are under the clearing obligation in EMIR to clear a portion of their derivatives through active accounts at EU CCPs. The derivatives targeted are those belonging to the clearing services of two UK CCPs that ESMA assessed as posing excessive risks to the EU: according to ESMA, these clearing services are of such substantial systemic importance that they could pose risks to the financial stability of the EU or of one or more of its Member States. So, the requirement for active accounts targets these financial stability risks and aims at reducing the excessive exposure of EU players to the UK CCPs. The calibration is left to ESMA, as it can access appropriate data, and needs to take into account properly any costs and impacts, in order to achieve a balanced result.

Finally, in the Communication accompanying the legislative measures the Commission encourages EU public entities that clear, or wish to clear, their transactions to do so at EU CCPs. This would give a signal of confidence in EU CCPs and support the aims of the CMU. Likewise, the Commission commits to clearing at EU CCPs where the offer is available.

This package can pave the way for a stronger, safer and more competitive clearing ecosystem in the EU for years to come. The impacts of the package do not depend only on making legislative changes, but also on the engagement and commitment by all actors involved, both public and private. Regulators and policymakers can set the conditions for an enhanced clearing landscape in the EU. But it is for market participants to take up the opportunities offered by regulation.

The Commission supports swift progress by the European Parliament and the Council towards the adoption of the measures and stands ready to facilitate the inter-institutional negotiations.

CLAUDINE HURMAN

Director of Innovation and Financial Marketing Infrastructures - Banque de France

Reducing EU dependency to offshore CCPs: the end of the beginning

Three years after Brexit, the EU clearing landscape is clearing up. After years of technical work, public consultations and policy discussions, the proposal for the review of the European Market Infrastructures Regulation (EMIR), published by the Commission last December, is a welcome decisive step towards the reduction of the overreliance of EU entities on third-country CCPs. It is, perhaps, the end of the beginning.

This long process was yet necessary to find a balanced answer to a complex and crucial question. A consensus has emerged among EU member states and market participants on the unsustainability of a status quo. The heavy concentration of euro interest rate and credit derivatives markets in two offshore CCPs has always raised important financial stability concerns, and Brexit sharpened these concerns for the EU. In the past years and up to very recently, markets' high volatility and margins' procyclicality have become a pain point and a liquidity issue. In the clearing field, it is true that the concentration of volumes is a factor of efficiency. However de-netting costs are temporary and can be overcome.

We have a living example with the progressive migration of the clearing of CDS from an offshore CCP to the continent, following a strategic business decision, with milestones set, no cliff-edge effect and market participants adapting to change. What can be done by the market through a business decision can also be achieved in other systemic clearing segments through regulatory incentives. We should not be afraid of this: it works.

And this is exactly what the Commission proposes: to endow the EU with a long-term strategy to progressively strengthen the EU clearing sector, while mitigating costs for market participants. This strategy relies on two pillars.

> **A roadmap to reach a balance between the objectives to pursue, which we must collectively seize.**

The first pillar aims at giving the market a push to initiate a sustainable rebalancing of exposures. Past experience proves that such movement cannot be entirely market-led and voluntary: in spite of repeated calls from the EU authorities, migrations of trades to clearing in the EU have been limited, and the increase of EU CCPs' market share has been slow. It has even reversed since 2022 for OTC interest rate derivatives. This is notably due to the tension between the short-term costs of dividing the liquidity pool, and the long-term benefits of deconcentrating exposures. Therefore a decision is needed.

The Commission proposes to provide such a push by requiring EU market participants to hold a defined share of their activity on substantially systemic products in "active" accounts with EU CCPs. This requires quantitative targets to be achieved in order to reduce the systemicity of offshore clearing services. This requirement aims to decrease the level of reliance to offshore CCPs to a level that is acceptable for the EU from a financial stability standpoint. While this target level is still to be defined – on the basis of technical work to be conducted by ESMA in cooperation with EBA, EIOPA, the ESRB and the ESCB –, it can capitalise on the substantive work carried out in the past to assess such systemicity.

Reaching non-systemic levels for clearing in offshore CCPs is a final target, to be achieved by a gradual increase of the requirement. Such roadmap would allow to limit short-term costs, by initially setting the requirement at an ambitious yet sustainable level, and by also setting the final target. Prudential Pillar 2 measures are also there to ensure a consistent framework, to better reflect the assessment of risks related to excessive concentration in some CCPs as well as to ensure that risks are adequately covered by capital. This approach would also allow dynamic evolutions to smoothen long-term costs, by granting EU CCPs adequate time to enhance their offers, and to EU market participants to rebalance their activity and progressively increase the EU liquidity pool.

In order to complete the regulatory approach, the second pillar provides for measures to reinforce the clearing offer in the EU, by building up a polycentric clearing offer. It proposes to reduce the administrative burden on EU CCPs and their participants, for example by shortening and streamlining the procedures for validating CCPs' material projects, thus enhancing their ability to answer the needs of their clients. The build-up of this offer comes with an enhanced supervision, through a review of the EU supervisory framework, involving the extension of the assessment and validation powers of the supervisory Colleges and of ESMA. The unique EU cooperation framework for CCP supervision will be further enhanced to accompany the shift of clearing.

The Commission proposals provide a roadmap to reach a balance between the objectives to pursue, which we must collectively seize. This is a prerequisite for developing the infrastructures of the CMU, with a polycentric network of EU financial centres, and for achieving the strategic autonomy of the EU in the systemic clearing field.

DANIEL MAGUIRE

Head of Post Trade - LSEG & Group Chief Executive Officer - LCH

Supporting an attractive EU clearing ecosystem

As a global financial markets' infra-structure and data provider, LSEG is committed to supporting a healthy and resilient EU clearing ecosystem. Through our CCPs LCH Limited and LCH SA, we provide firms locally and globally with access to large pools of liquidity and solutions across asset classes, ensuring they benefit from our proven risk management capabilities.

At no time has the importance of access to cleared liquidity and robust risk management been more acute than during recent market events including tensions on Credit Suisse, the collapse of SVB, the Russian invasion of Ukraine, the UK 'mini budget', and the Covid pandemic.

Looking specifically at the EMIR proposals which are currently under review, we are supportive of the European Commission's objectives of making the EU clearing landscape more attractive and resilient, and broadening access to liquidity. As key players in that landscape, we support a more streamlined and harmonised EU supervisory framework, a more agile supervisory processes, and improved access to clearing for EU buy-side participants such as pension funds and insurance companies.

From a supervisory point of view, streamlining the approval process for new products and services and substantial changes to CCPs' risk models and parameters will help to address inefficiencies in the EU regulatory framework and increase the competitiveness and resilience of EU CCPs and their ecosystem. Faster approvals mean quicker adaptation to market demands, which in turn increases the competitiveness of EU CCPs and the attractiveness of the entire ecosystem. However, the current proposals have the potential to make the supervisory structure more complex by introducing new mechanisms and procedures. As such, we urge the co-legislators to consider a greater level of direct EU supervision, for example by the ESMA Supervisory Committee, to better address those complexities. We need more cooperation and streamlining, not replication and duplication. Further, an enhanced cooperation framework with third-country CCPs' supervisors is essential if financial stability concerns are to be addressed. Clear visibility for ESMA on recovery and resolution plans of tier 2 CCPs will be key to ensure transparency and trust in the ecosystem.

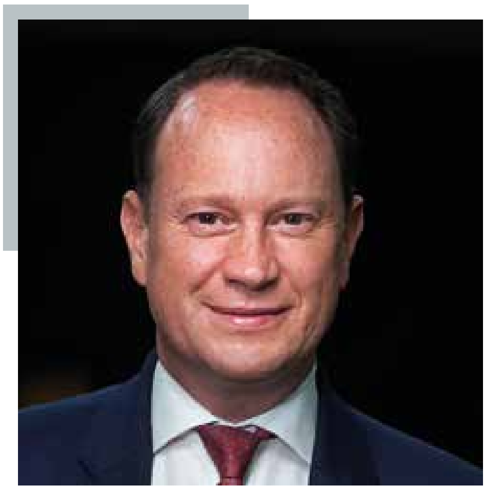
For EU firms, access to a global multicurrency CCP is essential.

From a market demand perspective, we fully agree that investment funds and insurance companies should benefit from reduced costs when using clearing services. The capital treatment of new access models, such as LCH's Sponsored Clearing for repos, needs to be clarified to further unlock clearing opportunities and provide broader access to liquidity for the buy-side.

Yet, while streamlining supervision and broadening access to central clearing can bring us closer to a more competitive and resilient clearing ecosystem, proposals that would reduce EU market participants' access to third country CCPs will drive us in the opposite direction. Requirements on EU firms to hold active accounts (with quantitative measures ascribed) in the EU are intended to improve the management of financial stability risks, but the contrary holds true; artificial fragmentation would disrupt a highly effective global derivatives market and damage EU firms', and by extension the EU real economy's, ability to access best priced liquidity and manage their risk in a safe and efficient manner, and on the same basis as non-EU firms and real economies. Furthermore, such measures would undermine the attractiveness of the Euro as a leading international reserve currency.

OTC derivatives markets are global by nature and the clearing services supporting these markets are global by nature too. This is the case for the Interest Rates Derivatives (IRD) markets. LCH SwapClear operates a global IRD clearing service in 27 currencies, of which the EUR is second to USD in terms of notional and risk registered. To put it into context, 70% of the EUR IRD notional registered at LCH's SwapClear originated outside the EU. For EU firms, access to a global multicurrency CCP is essential considering they tend to clear as much in non-EUR as in EUR, requiring access to global liquidity pools to hedge their risks and to service their customers in all currencies in an efficient manner. Doing so also supports financial stability and ensures the most comprehensive risk mitigation during severe stress periods, in line with the G20 objectives.

The EMIR proposals are moving in the right direction with regards to supervision, enabling broader access to central clearing, and increasing the competitiveness of EU CCPs. However, other requirements such as active accounts, if mandated, would undermine EU firms' ability to efficiently manage their risks, operate efficiently, and remain competitive in servicing their own customers. Failure to acknowledge these risks putting EU financial stability and competitiveness at risk.



ERIK TIM MÜLLER
Chief Executive Officer - Eurex Clearing

Building a more resilient and competitive EU clearing ecosystem

In the midst of a challenging macro-environment marked by geopolitical tensions, high inflation and low economic growth, it is critical that the EU continues its path of ensuring resilient and globally competitive financial markets and infrastructures.

Strong financial market infrastructures, such as central counterparties (CCPs), constitute the backbone of the Capital Markets Union and are an essential key ingredient for the EU's strategic autonomy. CCPs make a substantial contribution to the resilience of the EU's financial system through efficient risk management.

However, in addition to ongoing market-led efforts, targeted regulatory measures are necessary to further strengthen the EU clearing ecosystem in at least two critical dimensions: First, we need to ensure that clearing at EU CCPs becomes more attractive for market participants and more competitive in global comparison. Second, we need to guarantee that EU market participants do not remain overly reliant on off-shore markets and 3rd country CCPs, given that recent market events reemphasized the need to ensure financial stability while guaranteeing orderly monetary policy.

Against this background, I strongly welcome the European Commission's legislative proposal ("EMIR 3.0") to structurally strengthen the EU clearing ecosystem. In particular, I welcome that it requests market participants subject to the clearing obligation to maintain an active account at an EU CCP for systemically relevant products. Compared with other policy options that have been explored in protracted discussions over the last years, the active account approach is targeted and proportionate. It aims at rebalancing a proportion of clearing activities at Tier 2 UK CCPs into the EU to the extent that they are not considered systemically relevant anymore, whilst simultaneously allowing for flexibility to continue clearing in London. As such, it strikes a good balance between EU financial stability interests, the protection of EU taxpayers, and market participants' competitiveness concerns – helping the market to transition into a healthier environment with more competition and significantly reduced risk concentration.

Commission's proposal marks an important milestone paving the way towards an EU strategic autonomy.

If well calibrated and combined with clear guidance, such a requirement could lead to a more sustainable outcome where serious risks, notably around the Euro currency, are mitigated to a much higher degree. As regards the calibration, a risk-sensitive methodology paying due regard to EU dealers' activities around market making and non-EU client services would be appropriate. In addition, it is key to realise that many EU CCPs, including Eurex Clearing, do not charge account fees, meaning that even the smallest market participants can do so for free. In fact, Eurex Clearing continues its strong commitment towards a market-led solution, and therefore launched an additional incentivization programme that supports each individual buy-side customer with up to €50.000 just for setting up and using a second account – voluntarily and constructively supporting the shift of exposures from London to the EU.

Besides the active account, EMIR 3.0 also aims to address constraints that unnecessarily hold back the supply side of the EU clearing ecosystem. The streamlining of supervisory approval procedures for CCP services and products or risk model changes as well as the introduction of a 10-day non-objection procedure for non-significant changes are crucial elements in this respect. As the current regime has proven to hamper EU CCPs' time-to-market in global comparison, those changes will align the EU more closely with other jurisdictions. Clear and reduced timelines will not just benefit EU CCPs' competitiveness but also make a substantial contribution to the EU's strategic autonomy – given that new markets and new asset classes could in future also be based in the EU, fostering the international role of the Euro and boosting Euro-denominated markets with substantial supervision and enforcement rights for EU authorities.

Finally, the EMIR 3.0 proposal includes changes aimed at removing barriers to the use of central clearing by funds. These barriers arose as respective frameworks (e.g. UCITS, MMFR) did not take into account that CCPs would offer tailored solutions enabling non-banks to directly access CCPs. Especially the recognition of the risk-reducing nature of central clearing in funds' regulation by way of excluding cleared OTC derivatives transactions from counterparty risk limits is very helpful. Such clarifications will contribute to improved access options and greater diversification.

Overall, the Commission's proposal marks an important milestone paving the way towards an EU strategic autonomy. In light of a fragile macroeconomic environment, paired with a swiftly approaching expiry of UK CCP equivalence in summer 2025, it will now be critical to quickly implement EMIR 3.0, preserving its key building blocks to structurally boost the competitiveness of the EU's clearing ecosystem.

HAROUN BOUCHETA
Head of Public Affairs and Chief of Staff for Company Engagement & General Secretary, Securities Services - BNP Paribas

Ensuring the competitiveness of EU firms in the clearing space

In December 2022, the European Commission proposed a revised version of the European Market Infrastructure Regulation. Known as "EMIR 3.0", this proposal seeks to further enhance the competitiveness and attractiveness of EU CCPs. EMIR 3.0 includes measures to reduce what is considered by the Commission as being an excessive reliance of EU market participants on non-EU CCPs especially concerning euro-denominated IRS transactions on UK CCPs.

EMIR 3.0 is part of the broader Capital Markets Union (CMU) plan whereby the European Commission aims at (1) reinforcing the EU's global competitiveness and autonomy and (2) making the financial system more resilient so it can better adapt to the UK's departure from the EU.

With regard to EMIR 3.0, the careful framing of its proposals will be key to ensure that both objectives are met and that the EU clearing system is enhanced without the competitiveness of the EU financial institutions and clients being negatively impacted.

Given their global nature, any major regulatory measure on derivatives markets needs to be designed within a global coordination. The introduction of EMIR in 2012 has been considered a success notably because it has been agreed through the G20 and happened together with the introduction of similar regulations implemented in the other major jurisdictions. Even if EMIR 3.0 follows another way in terms of coordination, it is important to preserve the consistency of the global clearing framework across its evolutions.

The proposal introduces some useful improvements. EMIR 3.0 introduces useful and welcome improvements on various aspects: simplification of procedures for the authorization and recognition of smaller third-country CCPs, simplification for the extension and authorisation of EU CCPs activities and services, simplification of the mechanism for intragroup exemptions, eligibility of additional collateral such as bank guarantees and public guarantees and clearing exemption for third-country pension funds when exempted under their own rules.

The new version of EMIR should ensure that the EU clearing system is enhanced without the competitiveness of the EU financial institutions and clients being negatively impacted.

In addition, some requirements for clearing members and clients providing clearing services to ensure additional transparency and predictability of CCP models towards their clients should be regarded positively as well even though it would be useful to add in the regulation the same level of transparency requirements of CCPs vis-à-vis their clearing members. This would limit uncertainty for clients when CCPs need to urgently increase margin calls, especially on an intraday basis in time of crisis.

But there is a risk to create competitive disadvantages for EU firms. Two measures, though, might create competitive disadvantages for EU market participants: the proposed pillar 2 prudential measures and the active account proposal – depending on the way the second one is framed.

The pillar 2 prudential measures create an additional barrier to providing services to clients, which non-EU banks do not have. This means that EU banks will have their ability to provide services to non-EU clients curtailed.

The active account proposal would be a workable solution if it were designed as a qualitative requirement. However, if it imposes rigid quantitative thresholds, it would likely result into a spread between the EUR derivatives cleared at EU vs UK CCPs at the expense of EU clients and creates a major barrier for EU financial institutions to providing services to clients, which non-EU banks would not have.

For both the active account proposal and the pillar 2 prudential measures, the only way to ensure a level playing field between EU and non-EU clients and financial institutions would be to carefully calibrate any active account requirements and logically exclude from its scope non-EU clients and EU clients not subject to EMIR.

The process to recognise third-country CCPs would be improved . EMIR 3.0 also deals with issues related to third-country CCPs. Recent events have shown how important this question is. One example can be given by the de-recognition of Indian CCPs by ESMA with its detrimental impacts for EU players.

In the proposal, additional tools for the Commission and ESMA are proposed to be added to manage equivalence to EMIR and recognition of third-country CCPs. It is an improvement as long as it provides more flexibility for the Commission and ESMA to move forward in the recognition process without unduly penalising EU firms.

The Commission would have the possibility to grant an equivalence even if the third-country does not include a recognition regime similar to the EU one. In addition, powers of ESMA would be extended notably to provide more time for third-country CCPs to take the relevant remedial actions and to issue public notice if needed.

The future of EU clearing. The complex and global nature of derivatives markets has to be taken into account in this EMIR 3.0 proposal. Statistics indicate that the clearing of USD denominated IRS mostly takes place outside of the US because firms and their clients need to access to larger liquidity pools to be able to achieve cross-currency netting.

It shows that it remains complicated to predict how EMIR could change the structure of these liquidity pools but in any case it is of mere importance to better take into account the impact of the regulation on the competitiveness of EU firms and their clients.

GIUSEPPE GRANDE
Deputy Head of Market and Payment Systems Oversight - Banca d'Italia

The energy crisis in Europe and CCP margins

The extraordinary measures recently taken for energy and commodity derivatives must be read in the context of what happened in the global energy markets in 2022. After Russia's invasion of Ukraine at the end of February, prices skyrocketed. The shock was particularly severe in the European gas market, where prices jumped tenfold over the ten-year pre-war average, exceeding €340 megawatt hours (MWh) at the end of August. In Europe, the jump in energy prices fuelled fears of energy supply disruptions and market manipulation. It immediately had geopolitical and macroeconomic repercussions, the first of which was a rise in inflation.

In the energy derivatives markets, Central Counterparty (CCP) margins increased, and this created liquidity strains for non-financial corporations (NFCs), because NFCs typically have fewer assets and less liquidity, and thus the increase in margins forced them to reduce their positions or remain inadequately hedged.

In this context, at the request of the European Commission to facilitate the provision of collateral by non-financial counterparties that are active on gas and electricity markets cleared in EU-based CCPs, last autumn ESMA introduced a temporary, twelve-month extension of the collateral pool to public guarantees for financial and non-financial counterparties and to uncollateralised bank guarantees for NFCs acting as clearing members. In addition, on 20 December 2022, EU energy ministers reached a political agreement on a market correction mechanism (MCM) capping gas prices. The regulation entered into force on 15 February 2023 and will apply for one year.

These temporary measures are designed to respond to unprecedented stress conditions that are systemically relevant. The extension of collateral increases the ability of banks to provide liquidity to their customers and allows NFCs acting as clearing members to post unsecured bank guarantees. As for the MCM, it is an instrument against episodes of excessively high gas prices. It is appropriately set at a historically very high level and is dynamic in that it has a variable component defined as a €35 spread on the price of liquefied natural gas (which, unlike pipeline gas, is traded worldwide and whose price can therefore serve as a benchmark for global price developments).

Extending collateral, increasing the transparency of margins and mitigating their procyclicality.

The effects of the MCM are closely monitored in order to prevent any unintended market disturbances. According to ESMA, so far the MCM does not appear to have had any significant effect on prices, trading activity, liquidity and execution (i.e. change of trading venue) of gas trades. Furthermore, there have been no significant changes in CCP risk management or margin requirements that can be attributed to the MCM. However, too short a period has elapsed since its entry into force.

A worrying sign is that two exchanges (ICE Endex and EEX) have announced that they will also offer trading in gas derivatives on two trading venues outside the scope of MCM regulation. Any trade dislocation would be undesirable from a regulatory perspective, as it would be inconsistent with the objective of further developing European capital markets and would hinder financial supervision.

Temporary measures can help manage crisis situations, but structural ones can ensure more efficient and secure outcomes. The EC's proposal to revise the EMIR regulation (EMIR 3) seeks to address this need. Among other things, the proposal provides that bank collateral can be considered eligible as highly liquid collateral by CCPs, irrespective of whether it is posted by financial or non-financial counterparties, but provided that it is unconditionally available upon request. The proposal also allows firms to better understand their potential future liquidity needs in the instance of central clearing by requiring margin models to be more transparent for all. The amendment to strengthen the requirements for participation in a CCP entails that the NFCs that have direct access to a CCP will have to be better equipped to comply with such requirements.

Recent developments in EU energy derivatives markets have once again highlighted how insidious the risk of CCP margins being procyclical is, as they themselves may cause asset price volatility. The commitment of regulators to tackle the problem is evidenced by the recent work of ESMA and BCBS-CPMI-IOSCO. The lines of action cover a range of topics: the role played by the membership structure (in particular, the types of clients served by clearing members, and how the latter demand margins from the former), the metrics to evaluate the excess of procyclicality, its drivers, transparency to clearing members and clients, reports to the authorities, and the CCPs' risk models and containment strategies.

To make progress in the development of anti-procyclicality tools it is essential to keep CCPs, the clearing members and their clients as involved as possible. Their insights are key to understanding which aspects deserve more attention and which solutions work in practice.

SUYASH PALIWAL

Director, Office of International Affairs - US Commodity Futures Trading Commission (U.S. CFTC)

New challenges we face together

As the aphorism goes, history does not repeat itself, but often rhymes. We frequently talk about extreme incidents as 1-in-100-year events, but lately, they seem to happen every other year.

Last year, Russia invaded Ukraine. The extent of the devastation continues to unfold, but we can identify significant impacts on the financial system. Commodities markets experienced high volatility and price levels. The cleared derivatives system fared well and functioned as designed. Margin was called and paid. Price risk was efficiently and transparently shifted, and price discovery occurred.

In 2020, the pandemic gripped the world. Equity markets faced unprecedented volatility, yet, here also the derivatives system met the challenge.

These live, global, extreme-but-real stress tests vetted the post-crisis G20 reforms, demonstrating the resilience and endurance of the derivatives architecture. But, strains felt by market participants threw light upon areas ripe for a fresh look by regulators. Last year, we also saw startling events in digital assets, including the collapse of FTX. This sharpened regulators' focus on digital innovations, which continue to reshape the financial sector.

These topics, and an array of domestic issues, are top-of-mind for the US Commodity Futures Trading Commission (CFTC) in its exercise of authority over commodity and other derivatives markets.

Forewarned is forearmed

Margin is among the cornerstones of the derivatives architecture, and as a critical component of derivatives risk management, it has been a consistent topic of international discussion. When the volatility induced by the pandemic was at its peak in March 2020, derivatives margin, while functioning as designed and being paid, came into sharp focus. High margin calls prompted many to ask questions about how the derivatives ecosystem works. What are the potential impacts of margin's operations, the strains it can put on institutions, and tradeoffs inherent in providing and obtaining liquidity?

Since 2020, IOSCO, CPMI, and the BCBS have collaborated on a data-driven exercise to understand margin dynamics and liquidity impacts in March 2020. The CFTC continues to engage substantially, co-chairing the project with the Bank of England and working with experts from the ECB, ESMA, and leading EU national competent authorities, among others.

FTX's swift decline into insolvency last year stunned the financial sector.

Whether this prompts substantial change to a system that worked remains to be seen, and one-size-fits-all adjustments may not always be wise. Still, enhancing the preparedness of market participants so that they are forewarned of derivatives margin calls could benefit the system. To promote preparedness, we could seek to sustain or enhance transparency by those issuing margin calls, including central counterparties (CCPs) and intermediaries. And we may identify steps that market participants could take to foster a clear understanding of margin's responsiveness to market volatility and price levels.

Bankruptcy happened gradually, then suddenly

FTX's swift decline into insolvency last year stunned the financial sector. It also underscored the need for an effective regulatory perimeter and appropriate policy responses to protect customers and address the extant and growing risks in the digital asset space.

In the US, traded underlying assets are typically considered securities or commodities. Where digital assets are treated as commodities—an expansive term under US law—and not securities, they fall in a lacuna of US regulatory coverage: there is no US spot-market regulator for digital commodities. The CFTC has long been calling on the US Congress for authority over digital asset spot markets. If granted the authority, the CFTC could leverage its existing regulatory framework, which is grounded in risk management and market integrity, to effectively oversee these markets and better protect customers and the public. Relevant protections could include mitigation of conflicts of interest, customer fund segregation, governance and corporate controls, and other enhanced customer protections.

The home front

Here at home, the CFTC's domestic regulatory agenda continues at full throttle, including possible rulemaking on:

1. enhancing risk management and resilience across intermediaries, exchanges, and CCPs;
2. fostering sound and responsive practices on cybersecurity and the use of third-party vendors across all registrants;
3. strengthening customer protections;
4. promoting efficiency and innovation;
5. improving reporting and data policy; and
6. addressing any duplicative regulatory requirements and amplifying international comity and domestic coordination with both US federal and state regulators.

Looking ahead

New risks continue to arise at least as fast as the regulators address them. But optimism lies ahead in what we can achieve through sound regulation and cross-border cooperation. So when – and not if – history rhymes again, we are confident that the system will again demonstrate resilience.

IMPACTS OF DIGITALISATION ON TRADING AND POST-TRADING

CARLO COMPORTI
Commissioner - Commissione Nazionale per le Società e la Borsa (CONSOB)

DLT in the securities trading and post-trading: challenges and opportunities

The financial sector has always been at the forefront of reaping the benefits that innovation can bring. Major transformations occurred throughout all the value-chain, from the way in which investors interact with intermediaries to settlement of transactions. More recently, digitalisation has been a key tool for fostering efficiency, by reducing and managing risks (primarily operational and compliance risks) and providing better services to clients.

Innovation and its application to the financial sector has been incremental, with emerging disruptive digital technologies. New technologies have the potential to radically change the way in which services are performed.

In particular, the application of distributed ledger technologies (DLT) for the issuance, recording, storage, and transfer of financial instruments can change the way in which trading and post-trading activities are currently performed.

DLTs have specific features:

(i) the ability to record information in a safe and immutable format;
(ii) the transparency of data stored in the DLT for all the nodes participating to the DLT;
(iii) the possibility to reduce or even eliminate the need for a centralised authority, since trust is granted by the consensus mechanism.

Those features are appealing for the tokenisation of financial instruments. Recording all transactions in a decentralised ledger can speed up and collapse trading, clearing and settlement to nearly real-time. This could reduce counterparty risk and, consequently, the need for collateral. In addition, the use of DLT could enhance reporting and supervision functions, also by regulators, which can be granted special access rights to the DLT. Moreover, there could be benefits in enhanced resilience of the systems and in the implementation of smart contracts, that can reduce transaction and enforcement cost associated with contract performance.

It is key to start to figure out an exit strategy from the sandbox approach.

However, the EU financial services legislation separates the trading, clearing and settlement phases, requiring the presence of market intermediaries and market infrastructures, each of which has specific tasks and responsibilities that cannot be combined. This could limit the possibility to fully exploit the potential benefits of DLTs for trading and post-trading activities.

For this reason, the EU legislators adopted the regulation (EU) 858/2022 on a pilot regime for markets infrastructures based on DLT (applicable from 23 March 2023). It allows incumbent market participants, and new players to obtain a specific permission to operate under the DLT pilot regime as DLT market infrastructure (DLT MTF, DLT SS and DLT TSS), also combining trading and settlement tasks into the same market infrastructure (DLT TSS).

The DLT pilot regime adopts a sandbox approach to overcome the legal obstacles that have been identified in the EU legislation. This approach implies that there are specific limitations. First of all, it is applicable only to certain simple financial instruments (e.g. shares, bonds and other debt securities, units in UCITS funds). Moreover, there are specific thresholds applicable to the issuer and to the DLT market infrastructure to limit the magnitude of the testing. DLT markets infrastructures can obtain from their national competent authorities derogation from MiFID 2 and MiFIR requirements (above all the obligation of intermediation for accessing a DLT MTF) and from certain provisions of the CSDR, including the book-entry form and the need to make use of an authorised CSD for securities admitted to trading on a trading venue. This allows DLT SS to record financial instruments on the DLT and DLT TSS to combine trading and settlement of DLT financial instruments.

Finally, the sandbox approach prescribes that the DLT Pilot regime is temporary, the exemptions can last up to six years from the issuance of the specific permission to operate a DLT infrastructure. This method allows regulators to better assess the peculiarity of the application of the DLT to the securities trading and post-trading, before permanently changing the rules.

Considering the potential benefits of DLT for trading and post-trading market, and investments requested both from market participants and regulators involved in the DLT pilot regime, it is therefore key to start to figure out an efficient exit strategy from the sandbox approach. This would require re-assessing the legal framework, identifying the key risks that must be dealt with and verifying whether it would be possible to move from an entity-based approach, which essentially leverages on the presence of a gate-keeper, to a functional approach to regulation. In conducting such exercise, while striving to preserve the principle of technological neutrality, it might be needed to accept that in some instances the peculiar features of the technology involved would require to adapt the rules, so that it is granted the same level of protection with rules that are not completely identical to those applicable to traditional financial services.

CLAUDINE HURMAN

Director of Innovation and Financial Marketing Infrastructures - Banque de France

Central banks: the need to accompany the safe tokenisation of finance

The tokenisation of finance is a nascent trend based on the conversion of existing financial assets on distributed ledgers, or the direct issuance of financial assets in a tokenised form. The growing interest of the industry relies on the potential of distributed ledger technologies (DLTs): their ability to enhance cost-efficiency with a greater integration between front-end and post-market activities, to provide availability around the clock, and to improve transparency with a better tracking of transactions and ownership that could for instance facilitate the compliance with ESG criteria.

In the future, the development of DLTs could change the way trading and settlement of transactions are operated. In this context, it is essential for public authorities to understand market demand and accompany innovative approaches, but also to continuously assess and monitor the risks posed by this new turn for financial markets. In particular, the use of central bank money as the safest settlement asset for wholesale payments could play a key role in securing financial transactions processed on DLTs.

To this end, the Banque de France launched an experimentation programme based on Central Bank Digital Currency (CBDC) issued on DLTs in the form of tokens. Involving private and public partners, twelve experimentations have been conducted since 2020, based on two main use cases.

The first one concerns the improvement of the functioning of financial markets. Some financial instruments do not benefit yet from automated Delivery-versus-Payment (DvP) process, in particular complex and OTC products or mid-cap market segments. The use of DLTs could bring automation for a lean process management of such financial instruments issued on DLTs, while allowing their development on a larger scale. Should such market segments become systemic, central bank money would be the settlement asset to secure transactions and avoid counterparty and liquidity risks, as the reference settlement asset for listed segments traded on systemic market infrastructures.

A wholesale CBDC would play as a safe anchor in the realm of tokenization.

The second use case concerns the improvement of cross-border and cross-currency payments based on wholesale CBDCs. Cross-border payments remain slow and costly due to a lack of standardisation and harmonisation across jurisdictions. CBDC experiments in a cross-border context have shown how wholesale multi-CBDC platforms could optimise the long chain of intermediaries. Under such new paradigm, financial intermediaries would remain at the core of financial transactions while their roles may evolve. This calls for further experimental work to understand and anticipate these developments.

As the adoption of tokenisation increases, so will the challenges – specific to DLTs or not – that need to be addressed and closely monitored.

One of the main concerns is the risk of liquidity fragmentation, which arises from the possibility that multiple DLT networks will emerge and operate independently, resulting in siloed markets. On the other hand, the risk of a monopolistic situation arises from the possibility that a single DLT network becomes dominant in the market, leading to a concentration of power and control over the market. As a consequence, interoperability will be key to the success of emerging projects to allow for smooth exchanges between jurisdictions and between platforms.

Another challenge is the operational risk management and resilience of systems based on DLTs, including security and integrity of data. In addition, scalability issues increase operational risks as DLT networks are currently limited in their capacity to handle large volumes of transactions. DLTs also enable the use of smart contracts, which are self-executing programs that can automate complex financial transactions. Therefore, it will be crucial to take into account the operational risk, in particular the risk to data security and integrity, whether through coding errors, hacking or electrical problems. Standardisation will help to address these challenges by providing a common framework for the operation of DLT networks, thus facilitating the growth and development of future markets. Governance will also be key in particular within central banks, should multi-CBDC platforms emerge.

Any development of DLT-based market infrastructures will require the complementarity with the well-established payment systems which have proven their efficiency, rather than competition for added value.

The European Pilot Regime is in line with this approach. Based on the issuance and transfer of financial assets on DLTs, it will allow policymakers and regulators to gain a better understanding of the challenges associated with the development of tokenisation while ensuring the safety and stability of the financial system.

A wholesale CBDC would play as a safe anchor in the realm of tokenisation: it would ensure the continuity of smooth and efficient payments on safe and stable market infrastructures, while fostering innovative and user-friendly solutions.

JULIAN
REISCHLE

Director General Payments and Settlement Systems - Deutsche Bundesbank

DLT requires new functions for settlement in central bank money

The world of payments and settlements has always been characterised by constant change, innovation and progress. Money and its underlying payment rails have evolved over centuries from commodity money to coins and banknotes and finally to electronic transfer systems and digital banking. However, the invention of Bitcoin in 2009 marks another acceleration point on the path towards the digitalisation of money. In its aftermath, the payment landscape experienced a significant innovation boost. Of course, not every innovation has been beneficial, be it in terms of simplification, security, efficiency or even customer satisfaction. Nevertheless, it must be acknowledged that Bitcoin paved the way for what are now commonly known as crypto-tokens, stablecoins, decentralised finance applications and even, to some degree, central bank digital currencies (CBDCs).

It is worth taking a closer look at which innovations might stand the test of time once the market has matured. There is much to be said for distributed ledger technology (DLT), which could unfold its potential as basis technology for payment and settlement purposes. There has been broad industry uptake of DLT exploration activities. DLT basically has two promising benefits that make it an attractive investigation object for financial sector applications. First, the joint database enables mutually independent partners to settle financial transactions without the need for reconciliation processes.

Second, smart contracts permit a comparatively high degree of automation, as they allow transactions to be settled based on pre-defined conditions. DLT could therefore facilitate the settlement of complex business processes, which formerly required a wider range of time-consuming sequential interventions. This could not only save time, but also reduce transaction costs and increase security within the system. From a practical perspective, these benefits mainly accrue on the asset side, e.g. for central security depositors and custodians, especially for management along securities' lifecycle, i.e. post trade services. For plain vanilla cash settlement of large value payments, the perceived benefits are less obvious as centralised hub and spoke systems exist, which are proved in terms of throughput, latency and security. This realisation raises the question of what role central banks should play when it comes to DLT applications.

Central banks must contribute to safe, efficient and fit-for-purpose payment and settlement systems.

The answer is as easy as it is reasonable. Central banks must observe and accompany the adoption of DLT in the financial sector, with the overarching goal of keeping the settlement of large value payments in central bank money. Central bank money is the safest and most liquid settlement asset, fostering financial stability, facilitating monetary policy and ensuring trust among market participants. This certainly implies a policy reaction with regard to DLT: central bank money must be made fit for purpose. Specifically, the settlement of DLT-based transactions in central bank money should be possible. Otherwise, market participants might search for alternative settlement vehicles for their DLT-based business such as stablecoins or other private forms of money.

There are two different ways in which central banks could enable the settlement of DLT-based transactions for wholesale purposes in central bank money: the issuance of central bank money in tokenised form directly on DLT, referred to as wholesale CBDC; alternatively, a simple connection of DLT networks with conventional payment systems by building a technical bridge. The first option not only raises difficult questions in terms of policy and governance, it also involves some risks. The Bundesbank has, however, already successfully tested the second option, a trigger solution, as it is known, where a transaction on the DLT automatically initiates (triggers) the corresponding payment in the existing RTGS.

A trigger solution allows central banks to support DLT-based innovations – quickly, easily and almost free of risk. The connection of DLT networks with conventional payments systems combines the advantages of decentralised infrastructures with the reliability of the central bank. At the same time, it realises the benefits of DLT-based settlement on the asset side without the need for creating a new (tokenised) form of money on the cash side. Trigger solutions are therefore characterised by comparatively low technical and operational complexity. Since central bank money stays within the well-established infrastructures, even policy considerations seem manageable with potentially low effort. It therefore seems reasonable for central banks and policy makers to start with trigger solutions when considering the case for DLT settlement.

By providing a trigger solution, central banks would be contributing to safe, efficient and fit-for-purpose payment and settlement systems, but also to a safe and reliable financial system.

ROLAND CHAI

Executive Vice President, Head of Marketplace Technology - Nasdaq

Enhancing trust, transparency and resilience through technology change

Much has been made of a new wave of technologies sweeping global financial markets, their ability to transform the industry and disrupt the architecture underpinning international capital markets. Many are exciting and have the ability to do just that, but the ever-greater move to a real-time, 24/7 global trading and settlement cycle necessitates a relentless focus on cross-border coordination between market participants, regulators and infrastructure providers. Doing so will ensure that the technology is adopted in a way that enhances trust, transparency, and resilience of the system.

Smart contracts are a great example of a technology that is increasingly being deployed in various parts of the industry, which offers the potential to dramatically shorten the settlement process. For example, it's already being used within Nasdaq's Sustainable Bond Network, a platform where issuers can share all relevant sustainability documentation, data and qualitative information in a machine-readable format, which in turn empowers investors to discover, compile, and compare bonds and automatically generate impact reports.

Taking the technology a step further, we will soon start to see securities and collateral managed with smart contracts, able to manage securities transactions and generating substantial benefits for asset servicing including managing interest payments for securities or automating time-consuming legal processes. There are also implications for the payments industry, with providers such as Fnality establishing a network of regulated financial market infrastructures offering secure 24/7 central bank money-backed cash settlement of tokenized assets trades and cross-border liquidity.

Tokenisation or digitisation of existing securities is not a new concept when we look at the dematerialisation of securities. However, the ability to hold value in interoperable tokens, exchange them across jurisdictions and do this on a 24/7 basis along with a digitised payment infrastructure opens up possibilities of transforming markets.

We see the modernization of markets as a structural and long-term trend.

Significant debate remains on which technologies will prevail and how the standards of these technologies will interact. Organisations like ISSA and GBBC are paving the way by developing standards for interactivity and interoperability. Nasdaq is seeing amongst its customers across South America, Europe, Middle East, and Asia Pacific an accelerating trend to leveraging existing securities systems and payment rails to provide services for digitisation of equities and bonds. Customers are increasingly demanding that custodians and CSDs service all their investment and portfolio needs, including crypto and non-securities asset classes.

Artificial Intelligence has also long been spoken about for its ability to bring widespread benefits to capital markets, and more specifically the power to make exchanges reactive to prevailing market conditions. This includes the opportunity to make automated, intraday, symbol specific decisions rather than general, exchange wide decisions on a much lower cadence. And there is a slew of new smart ways to make and route orders. Nasdaq is actively exploring a reinforcement learning powered order-type, which actively learns in an interactive environment to improve fill rates and is employing AI in options listing operations to manage more effective listing of option strikes. There is the potential to bring similar improvements to Nasdaq's European exchanges.

In risk management, development of models and back-testing is greatly benefiting from machine learning and the vast capacities of the cloud to process data; and there is significant potential for market surveillance.

To successfully leverage AI, the cloud is a fundamental prerequisite to facilitating the technology, with the ability to run increasing amounts of data. Many financial firms are already harnessing that vision and there is the possibility that those who do so will have a substantial advantage in information and risk arbitrage over those that remain tied to legacy technology.

When it comes to implementing technology at scale, we are fortunate to benefit from decades of capital markets experience, both from operating our own 28 exchanges, CCP, and CSD, as well as from providing technology to 130+ organizations around the world.

Before widespread adoption of any new technology, there must be a relentless focus on what problem it's solving, and how the change maintains or enhances trust, transparency and resilience of the system. Indeed, there are many instances where existing technology and infrastructure is far superior, for example in the case of trading engines which remain by far the best option liquidity, price discovery and transparency.

We see the modernization of markets as a structural and long-term trend: it enhances market resiliency and scalability, makes markets even more accessible to market participants, and opens doors to new asset classes.

JENNIFER PEVE

Managing Director,
Head of Strategy and
Business Development -
The Depository Trust &
Clearing Corporation (DTCC)

Using the right technology at the right time will drive digital asset ecosystem

Emerging technology is driving market structure discussions globally, and it's increasingly clear that future financial markets will not be underpinned by just one technology as our use of these tools continues to evolve.

This rapidly changing ecosystem presents incredible opportunities to the industry predicated on identifying the right solution that generates client value. This means targeting new business models in underserved markets or assets, identifying enhancements to existing products and services, and/or finding opportunities to complement existing businesses with new features to enhance the client experience. Only when the opportunity is defined, can the appropriate technology be applied to enable and deliver that client value.

Much of this work, and technology enablement, also will depend on how quickly new technologies mature and are widely implemented. There have been several projects and initiatives that serve as excellent proofs of concepts regarding how the industry can embrace emerging technologies to streamline processes, broaden distribution, improve client service and ultimately reduce costs and risk.

While it's impossible to describe the myriad of ways that emerging technology is being used, there are three—blockchain, artificial intelligence and cloud—that are converging to create a new digital ecosystem.

First, firms are increasingly leveraging smart contracts to tokenize fixed income and alternative assets, such as private debt or equity markets. For example, some firms are executing pilot issuances across assets, with a majority leveraging bonds on a global basis. The tokenization of assets has the potential to enable faster, more transparent, secure and efficient processing for certain use cases today and will continue to be explored for asset issuance, new custody models and alternative payment/settlement rails.

But as the digital ecosystem grows, there are several protocols being used, inconsistent standards and varying regulatory regimes. All of which leads to fragmentation and siloes across the industry for digital assets. It's clear that the industry must work collaboratively to establish consistent standards, guardrails, network rules and protocols for digital securities to enable, rather than inhibit, the growth of this ecosystem.

It's increasingly clear that future financial markets will not be underpinned by just one technology.

Second, artificial intelligence is being used broadly—primarily in a way that is process-focused rather than asset-focused—and is enhancing the client experience and providing data insights for personalization and self-service. In addition to being used in algorithmic trading, AI also is assisting with reconciliation to help detect possible settlement failures before they occur and anomalies in data sets. The broad growth of AI and the development of large language models (LLMs) will offer opportunities for improving operational efficiencies and enhancements for clients in the future, but currently pose enormous—and yet unaddressed—challenges for maintaining privacy and ensuring proprietary information is not stored in chatbots.

Third, the effectiveness of AI depends on high-quality, unbiased data, and we're seeing cloud technology intensely leveraged to provide that data. For example, DTCC is using Snowflake's Data Cloud to support our Kinetics data business, which offers clients more immediate market insights across multiple asset classes and provides users with greater interactivity and access controls. Ideally, data from transactional systems that is placed onto the cloud becomes part of a data ecosystem that has analytical depth and breadth. That data can be analyzed by clients, often with applications that enable them to obtain data in near-real time, to develop strategic insights for more effective decision-making.

Clearly, challenges remain as the adoption and use of these technologies have not reached the maturity level to promote wide-scale use in financial markets. Looking to the future, the use of emerging technologies must be examined on a case-by-case basis, focusing on activity rather than asset classes.

As we have for 50 years, DTCC is exploring uses for emerging technology while working closely with regulators and industry stakeholders to help create the same confidence, operational and capital efficiencies in the digital asset ecosystem that investors rely on within traditional markets.

And as the industry moves forward, we must embrace one overarching theme: Any technology we use to enable growth and deliver client value must never introduce new risk into the system. We must understand the complexities and the interconnectedness of technology to establish governance models and move forward. By keeping that idea at the center of all we do, the opportunities are endless.

ARNAUD MISSET

Chief Digital Officer - CACEIS

Leveraging technology for clients through efficient partnerships with FinTechs

Technology has always been the cornerstone of Asset Servicing, with IT and best-in-class systems forming the backbone of the value chain for both marketplaces and players in the field. However, recent years have seen a quantum leap in technology offer and capacity, including DLT, data analysis, AI, alternative communication channels, and quantum computing. As client expectations have shifted, asset servicing companies are now expected to act as consultants, providing feedback and a detailed overview of new technology. It has therefore become crucial to reconcile these growing expectations with a suitable R&D budget and the capacity to deliver.

To address this challenge, it is essential to focus on what is core or and what is not, and what competitive advantages exist. For instance, DLT technology is such a potential game changer for the industry and should be managed internally in close relationship with regulators and participation in as many marketplace trials as possible.

Technology offers more efficient ways of working but still requires specialist staff with securities servicing industry experience, so asset servicers must rapidly integrate it into their product range. Meanwhile, data analysis capacity is at the heart of the asset servicer's value proposition and is a major differentiating factor that provides competitive advantage.

Sometimes data held with third-parties is inaccessible, so it is often preferable to perform data analysis internally with the asset servicing firm because they are often the 'one true source' of the data and are therefore in the optimal position to provide the most accurate and reliable information.

For technologies outside the asset servicing provider's core offer or those requested by a low number of clients or specific segments, it is essential to find a balance between client satisfaction and profitability. Instead of simply purchasing a solution and integrating it as a white-labelled product, which may impact profitability, industry players should leverage their combined strength. The asset servicing provider should seek out solutions and provide the underlying data, while tech companies render the service based on cutting-edge technology products.

Asset servicing players must shift focus from technology development to technology aggregation ...

This streamlined technology development and integration process benefits the entire community, with clients gaining a massive increase in the available product catalogue offered by the asset servicing partner, a very light integration process, and the assurance that due diligence for the technology selection was performed professionally. The asset servicing firm benefits from major savings in terms of IT development and the opportunity to build a strong partnership with FinTechs or tech start-ups. Finally, FinTechs benefit from potential access to the scale of the asset servicer company's client base as well as their sales teams' knowledge and experience. We often hear about win win strategy with sometimes a reality hard to show. Where appropriate, the combination of large-group and fintechs approaches allows each to capitalize on the strengths of the other and lay the foundations for a healthy and sustainable relationship.

The final customer is also an actor in the process with the possibility to participate in the scouting of FinTechs of interest to him and his peers.

A streamlined integration process and an industrialised model are key to unlocking the full potential of this technology partner solution. The brand awareness of the best-in-class FinTechs partners can also be leveraged as a marketing tool for asset servicing groups, further reducing the attractiveness of a white labelling solution. This goes hand-in-hand with standardised data feed protocols between the asset servicing provider and the FinTechs, automated contractual and payment processes, and centralised monitoring via the asset servicing group's client web portal or even via API access.

This dual model for technology integration is key to addressing the new challenges the industry is facing such as cost, constantly changing technologies, time-to-market, and open finance. Asset servicing models must adapt, and asset servicing players must shift focus from technology development to technology aggregation, enabling the entire industry to benefit from broader technology access and streamlined integration.

By working together and streamlining the selection and integration process, asset servicing groups can continue to deliver best-in-class service while staying on top of the latest technology, and meeting client expectations.

LAWRENCE LOW

Managing Director, Global Head of Regulatory Affairs - Standard Chartered

Technology and the transformation of securities markets

Technological innovations can be game changers in securities markets. From electronification to dematerialisation, new technology has made improvements to the trading, settlement and reporting of securities transactions. However, these have not been transformative - today, we see the promise and possibilities of tokenisation and distributed ledger technology ("DLT"). Whether these innovations signal the beginning of a new and completely different in securities markets remains to be seen – for while we expect adoption of these to bring positive changes to securities markets, uncertainties remain as the underlying technology is still evolving and practical challenges have yet to be overcome.

Efficiency gains

Tokenisation involves the digital representation of physical assets on distributed ledgers or the issuance of traditional asset classes directly in tokenised form. In combination with DLT and smart contracts, tokenisation has the potential to improve efficiency in securities markets by simplifying processes, ensuring greater transparency as well as reducing cost of and time for transactions.

These new technologies can reduce the reconciliation workload and shortening the clearing and trading settlement cycle. This could, in turn, lower counterparty risk resulting in greater capital efficiency. At the same time, the use of smart contracts could also reduce operational risk by enhancing automation of back-office processes such as the processing of corporate actions.

Further, tokenisation and DLT can integrate trading venues with real-time settlement. On-ledger trade execution could further reduce operational and capital costs while facilitating fractional ownership of assets, which can generate additional liquidity by connecting more issuers and investors. For now, adoption of new technology has in practice focused on optimising processes under current market structures rather than leading to new DLT-based market infrastructure.

The full benefits of these innovations have yet to be realised.

At Standard Chartered, we are actively partnering with regulators to pilot trial applications of DLT and tokenisation technology. For instance, within the framework of the Monetary Authority of Singapore's Project Guardian, we are participating in an initiative to explore the issuance of tokens linked to trade finance assets. The project aims to digitise the trade distribution market, by transforming trade assets into transferable instruments that are more transparent and accessible to investors. In parallel, we are also constantly engaging with providers to identify areas in which digitalisation could bring concrete business benefits to us and our clients.

Practical challenges that still need to be overcome

The full benefits of these innovations have yet to be realised and could take time as the use of the underlying technology currently entails a series of challenges.

DLT-based systems need to be interoperable with each other and with legacy systems, particularly as their deployment is gradual. Otherwise, each ecosystem becomes isolated and the trading of tokenised assets will be fragmented. To avoid this, the development of common technology standards will be key.

The management of potential privacy issues is also important. As trust and confidence are key pillars underpinning securities markets, it is crucial that DLT networks are designed to protect privacy where most needed. Further, regulators will need to develop a regulatory framework that provides safeguards to the users of the technology and their clients. For example, the identification of accountable entities is essential for regulatory and supervisory actions to be effective and enforceable.

Finally, the operational resilience of DLT-based systems remains to be proven over time. Given the systemic nature of the major capital markets, we need robust assurance that DLT-based systems can work in different contexts and at a different scale.

Experimentation and cooperation as the way forward

As advances are made and the technology continues to evolve, some challenges still need to be overcome. We believe that tokenisation offers the possibility of a major transformation in securities markets that could yield significant benefit for the real economy. For this to happen, an open dialogue between the public and the private sector as well as regulatory initiatives allowing to assess the possibilities and complexities of implementation will be of paramount importance.

At Standard Chartered, we stand ready to contribute to this debate with the aim of bringing most benefits to securities markets while managing potential risks.

SME EQUITY FUNDING: LISTING ACT AND ESAP PROPOSALS

ALEXANDRA JOUR-SCHROEDER

Deputy Director General for Financial Stability, Financial Services and Capital Markets Union - European Commission

Enabling SMEs to increase their equity financing

For a company, equity financing means raising money by selling shares in their business. Small and medium-sized enterprises (SMEs) become more resilient to external shocks such as changes in demand or in interest rates, or to contractions in bank credit linked to banking crises if they increase the share of equity financing in their overall funding. Also, especially for innovative SMEs, obtaining debt financing is harder, as they tend to have more intangible assets, which are difficult to use as collateral. From a macroeconomic perspective, private risk sharing, which works especially well with cross-border equity claims[1], helps dampen the effect of asymmetric shocks.

However, to date most SMEs fund themselves primarily from internal sources, while bank credit is their primary source of external funding.[2] Only 11% of SMEs indicate that equity funding was relevant to them.[3] And despite the creation of SME growth markets and a record number of SME IPOs in 2021, EU equity markets are still underused. Barriers often have to do with information asymmetries and comparatively higher costs for investors to serve SMEs. But company owners may also refrain from accessing external equity for fear of losing control over their business.

To address these issues, and to create incentives for a wider use of equity investment and for more diversified funding more generally, the Commission is taking important steps to ensure that SMEs can access the type and amount of funding that best correspond to their needs so that they can concentrate on their core business. This is especially important for companies that want to scale up.

The Commission is taking important steps to ensure that SMEs can access the type and amount of funding that best correspond to their needs.

Public funds are also needed to leverage private investment. The Invest EU Programme aims at mobilising over EUR 372 billion of financing, with a product mix that responds to the current needs including through dedicated products in venture capital in early to growth stage companies. But ultimately, in view of the size of the investments needed, the private sector will be called to provide the bulk of the money. Deepening the Capital Markets Union (CMU) is therefore essential to unlock such private investments. A number of recent CMU initiatives are particularly relevant in this context.

The European Single Access Point (ESAP) will be a one-stop shop for investors who are ready to invest across borders. By making it easier for them to find information, it will give companies more visibility, opening up more sources of financing. This is particularly important for SMEs, as they will more easily be on the radar screen of EU, but also international investors.

Furthermore, the Commission is addressing the tax bias that disadvantages equity financing. At present, the cost of equity is relatively higher than the cost of debt because the interest that companies pay on debt is tax deductible, whereas their costs on equity are not. That is why the Commission proposed up an EU-wide Debt-Equity Bias Reduction Allowance (DEBRA).

The Listing Act aims to make it easier and cheaper for companies, in particular smaller ones, to access public markets. It will simplify and ease both initial and ongoing listing requirements to reduce costs and increase legal certainty for issuers. It will streamline the listing process and make requirements on companies deciding to get listed more proportionate to their size. To allow certain founders of smaller companies and their families to retain control while raising funding on public markets, the Listing Act proposed a minimum harmonisation of national legal regimes relating to dual class share structures across the EU.

Although facilitating the access to market-based sources of equity funding is a priority, it is clear that banks and insurance companies must also play a bigger role. This is why, in the area of prudential regulation, we need to ensure that the rules do not unduly hamper equity investments by banks and insurance companies. The treatment of equity exposures was an important consideration in the review of Solvency II and in the Banking Package.

1. *A Capital Market Union for Europe, IMF*
2. *OECD SME and Entrepreneurship Outlook 2021, OECD*
3. *Survey on Access to Finance of Enterprises, results 2022*

KĘSTUTIS KUPŠYS
Member - European Economic and Social Committee (EESC)

The access of small and medium-sized enterprises to equity funding

Financial market infrastructure is essential to unlock the investments necessary for the green and digital transitions, to recapitalise the EU economy, increase resilience and gain in strategic autonomy. The Capital Markets Union Action Plan and ensuing legislative initiatives, such as most recently the Listing Act and the European Single Access Point (ESAP), are important steps in the right direction.

EU companies rely heavily on debt, and more diversified funding involving more equity would help them improve their financial situation and support investment. Furthermore, a more diversified funding strategy, involving both publicly traded debt instruments and equity, works as a stabiliser and a buffer against shocks. This is of special importance in times of corporate financial distress, economic uncertainty and when the cost of debt financing increases.

Unfortunately, the EU is not taking full advantage of its potential on equity funding. The number of listed companies in EU growth markets has barely increased since 2014, and SMEs, in particular, are still relying mainly on bank financing. To attract SMEs into equity funding, we need a well-functioning IPO market with a proper pre-IPO environment, along with equity research and an appropriate place in the portfolios of investors.

Bundling SME research with other services would increase the supply and distribution of reports. For that reason, the European Economic and Social Committee (EESC) welcomes the proposal to increase the unbundling threshold to EUR 10 billion. Independent research should also be encouraged, for which best practices in Europe should be observed.

To further ease access for family-owned companies to capital markets, we need EU-wide acceptance of a multiple-voting rights regime, as exists in most major global jurisdictions. The introduction of dual-class shares will help families to retain control after an IPO, making listing more attractive to them. The EESC agrees with the Commission that a detailed framework design should be produced at national level, while encouraging high-level EU harmonisation. However, the minimum 10% free float requirement should be flexible, as smaller markets can operate with a lower free float. This is essential to prevent abrupt de-listings.

Information and data, visibility of SMEs and financial education are key drivers of equity markets.

In the EU, the share of deposits in the total assets of households is three times that of the USA. It is the EESC's view that retail investors should have more choices to build their portfolios, and asset managers should be more confident on the prospects of the European equity markets. Beyond that, it is necessary to increase the financial literacy of EU citizens, and to create a stock ownership culture to ensure that everyone can benefit from new opportunities in capital markets. Without a doubt, this should be accompanied by a high level of investor protection and avoid any increase in the administrative burden on EU companies, while ensuring the availability of information and data for citizens and companies.

Transparency and disclosure are essential for investor protection and to create trust. However, excessive information in offer documents is not the preferred way forward. Streamlining the prospectus will significantly reduce costs and burden for issuers. Proportionality is key. The Commission proposal would allow all documents to be published in English only, except for the summary, which should also be provided in the local language. However, these documents should be accessible and reader-friendly for people at local level, so the possibility of issuing English-only documents could hinder the development of a national retail investment base. Other full-scale documents should be available in the local language, and specific incentivising measures in this regard should be implemented.

On ESAP, the Committee advocates for a more ambitious approach, by developing a tool that can process information and data and deliver sectoral and territorial reports. Interoperability with Eurostat or national registers should be guaranteed, and synergies between the Sustainable Development Goals and the Green Deal indicators should be ensured. Regarding consolidated tapes for financial assets, their success will rely on the ability to provide stakeholders with almost real-time data from EU trading venues. For both initiatives, it is fundamental to ensure the broadest access possible. To do so, consideration should be given to subsidising the cost for SMEs of gathering and submitting information, and the access to consolidated tapes should be free for all, and especially for SMEs and retail investors.

The Listing Act and the ESAP are remarkable steps forward in improving the access of SMEs to equity. However, to harness the full potential of equity markets, further measures are needed. The availability of information and data, the visibility of SMEs to investors, maintaining a high level of investor protection and increasing financial knowledge among EU citizens are all key elements.

PETER PALUS

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

CMU as the new Green Deal – Avoiding the trap of vaguely formulated goals

The paramount challenge for capital markets in the EU is that the key measures for their successful development are not focused on primary regulation of financial markets, but rather on areas with wider, more horizontal impact on the functioning of commercial enterprises/businesses. It is striking that 30 years after the establishment of the single market, there are still obstacles to the free flow of capital and unique benefits offered by the EU as the largest market in the world, such as economies of scale, are not used to the full extent.

Where to focus

From investors' perspective, it is crucial to ensure legally stable environment across the EU, free of unnecessary administrative obstacles for investment operations. This concerns areas such as insolvency, restructuring, commercial law and enforcement of law in general. The Commission's initiative in insolvency framework harmonisation is just a first step in a long journey. Further efforts are needed in the field of digital solutions connecting IT systems and providing equal access to investors across the EU. The lack of trust between Member States and towards EU bodies also needs to be addressed. Here, a better organisation of EU supervision is worth thinking about with the system applied to credit rating agencies serving as potential inspiration.

Last but not least, we need to overcome the tendency of Member States to increase attractiveness of their own investment environment at the expense of the EU as a whole. Only then we will be able to build a genuine Capital Markets Union.

Politically, different perceptions of urgency to overcome these challenges are the main obstacle. Both from the perspective of the financial market needs, as well as broader economic interests of individual Member States. What is becoming more and more evident, however, is that fulfilling our ambitious green and digital agenda will be impossible without broad mobilisation of private capital. This in turn will not be possible without effective allocation of capital through fully functioning capital markets across the EU. Here, we have a unique opportunity to address the needs of the Capital Markets Union with broader political ambitions of the EU.

We have a unique opportunity to address the needs of the Capital Markets Union with broader political ambitions of the EU.

Not taking advantage of this opportunity will be costly, as the EU might miss a train that will be impossible to catch later on in the context of increasing vulnerability and de-globalisation.

Green Deal as an inspiration

As alluded to already, current Commission's initiatives, such as European Single Access Point (ESAP), Debt-equity bias reduction allowance (DEBRA) and Listing Package, are going in the right direction, although in case of DEBRA specifically, challenges mentioned above are clearly materialising. Importantly, more fundamental changes outside the framework of financial services will be necessary, which will require significant political capital. In order to do this, clear quantification of objectives through performance indicators, such as KPI, are needed to better connect our policy goals with concrete measures. Otherwise, we will once again become victims of our own processes and the capital allocation across the EU will fail to improve. What's more, the EU will continue to lose out on valuable developing companies and start-ups, that will relocate to more attractive destinations. The cost of inaction in this scenario will be enormous.

The project of CMU therefore requires cross-sectoral support and a measurable path for its achievement. Luckily, the inspiration is right in front of us in green transition embodied in the European Green deal – an ambitious cross-sector initiative with clearly defined, measurable and comprehensive objectives.

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INVESTMENT PRODUCT FRAMEWORKS AND INVESTOR NEEDS

MICHAEL MCGRATH
Assistant Secretary General - Department of Finance, Ireland

Meeting investment needs: the building blocks of the CMU

2023 is a significant year. For Ireland, it marks fifty years of EU membership and the first home rugby Grand Slam win in 75 years. Across the EU, it is the thirtieth anniversary of the single market. In that time, huge achievements have been made, not least through the development of a vibrant fund and asset management industry. We now have an opportunity to build on these achievements to deepen and develop our Capital Markets Union.

Enabling financing and directing it to where it is needed

We are committed to building on the competitive and sound regulatory environment that has been developed for the fund and asset management industry. This is because investment products play a crucial role for retail and institutional investors and economic growth. And that is what the CMU is about: deepening our markets, enhancing our financial stability and providing greater support and appropriate capital levels to our companies. The last few years and even weeks have reinforced the significance of these aims.

The AIFM and UCITS Directives have delivered successful brands that are recognised globally, illustrating the importance of EU frameworks in achieving CMU objectives. Through the ongoing review of AIFMD and the consequential updates to the rules applicable to UCITS, we will continue to enable the success of UCITS and AIFs and reflect market developments through targeted amendments.

For example, we support the introduction of an EU framework for loan originating AIFs. Ireland was one of the first EU member states to introduce a domestic regulatory framework for loan origination, recognising the importance of the activity for raising financing. While regulation should support and enable activities, it must also address the associated risks. The Council's General Approach on AIFMD includes safeguards to manage the risks associated with loan origination, striking an appropriate balance. It is important that these safeguards are retained in the final agreement, in addition to the General Approach's clarifications on the rules for delegation which provide for increased transparency and supervisory cooperation without undermining the global funds model or the goals of the CMU.

Investment products play a crucial role for retail and institutional investors and economic growth.

Work continues at pace on the AIFM and UCITS Directives. Meanwhile, the revised ELTIF Regulation was adopted earlier this year, signalling a further step change and contribution to the CMU. Given the changes to the Regulation were designed to make the ELTIF product more attractive to asset managers and investors alike, we are confident that the ELTIF product will be a significant player in directing investment to areas of the economy where it is needed.

Going further, more quickly

Our ambition and commitment goes far beyond current achievements. We fully support the recent op-ed co-signed by the Presidents of the European Council, European Commission, Eurogroup, ECB and EIB which emphasised the urgency and collective effort needed to deepen the CMU, not least to drive forward the green and digital transition.

Looking ahead, we support the plans for the upcoming Retail Investment Strategy to ensure that investors can access a range of cost efficient and suitable financial services and products. The strategy aims to grow the EU's investor culture and maintain strong retail protections. It is critical that the strategy incorporates tangible actions. The focus on financial literacy within the CMU seems particularly pertinent to the Retail Investment Strategy: we must ensure that retail investors, as they become more confident and autonomous, possess the knowledge and skills necessary to assess investment options available to them.

The strategy is a good opportunity to address concerns and ensure the market works as well as it can for retail investors, boosting the EU's competitiveness while addressing related risks. Furthermore, the strategy may prove opportune to address cross-cutting issues, including the costs arising from regulation. We look forward to actively contributing to discussions.

Digital innovation will be key in ensuring accessibility to investment products that are easily understood and that deliver for investors and Europe's economy. The EU has shown itself to be a leader in the digital and sustainability fields. The EU and, crucially, financial services providers, must draw on this experience. We must challenge ourselves to ensure regulation enables innovation rather than stifling it, identifying and assessing the risks while striking an appropriate balance in addressing such risks.

Eurofi plays an important role in the policy making process by bringing together financial services providers, regulators, policy makers and legislators to generate discussion and foster ideas. I look forward to taking part in Stockholm.

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LUÍS LAGINHA DE SOUSA

Chairman of the Management Board - Comissão do Mercado de Valores Mobiliários (CMVM)

Value for money in the capital markets

The European Commission's Retail Investment Strategy and the Capital Markets Union seek to improve market outcomes and empower retail investors to invest according to their preferences and risk appetite, so they can take full advantage of the capital markets.

These objectives underline the relevance of the value for money concept applied to capital markets. Ensuring "Value for Money" means ensuring that financial activity fulfils its main purpose of channelling savings into value-generating investments.

We, in the CMVM, consider that a financial product offers value for money to the investor when the costs and charges are due and appropriate in relation to the expenses incurred by producers (and distributors) and to the expected benefits for the target market, considering its needs, characteristics and objectives.

Thus, a product with a certain level of cost/benefit or risk may offer value to an investor with a certain profile, but not to another.

But, are our investment product frameworks giving retail investors the tools they need to find value in financial markets?

No undue costs

A key rule is the prohibition on charging undue costs, which applies to both UCITS and AIFs.

Costs are, in fact, a key item in the assessment of value since, on the one hand, the return the investor gets is indissociable from the costs, and on the other hand, costs are mostly under the control of producers and distributors and they are pre-established, unlike market-dependent returns.

Despite the simplicity of this principle based approach, its interpretation and application is difficult because it is a rule without any clear pathway on how it might be implemented. This fact clearly demonstrates the value of the supervisory briefing on the supervision of costs in UCITS and AIFs, issued by ESMA in 2020.

Not surprisingly, in ESMA's Common Supervisory Action of 2021 on the costs & fees of UCITS, divergences were found between market participants on the very concept of what constitutes undue costs.

This is one example where further specification is necessary to ensure fair competition in the EU market, minimizing the risk of arbitrage, and a better result for investors.

Are retail investors getting the tools they need to find value in the capital markets?

Information quality

Clear, concise and comparable information on costs and expected returns is another important tool if we aim to maximize the value investors derive from financial markets.

In this regard, the PRIIPS legislation has established the provision of a pre-contractual key information document (KID) for several products. It is even applicable to UCITS funds, which for many decades have had their own pre-contractual information document. This is a relevant step towards harmonisation, despite the adaptation effort required by the industry.

The creation of standardised documents common to all EU countries is a regulatory advance at EU level and the KID allows, in fact, to transmit to the retail investor the most relevant information in a clear but summarized manner. The harmonised risk indicator is a very useful tool, allowing comparison between products. The return scenarios are also an essential element of information, which has been recently perfected so that its application to different products is the most appropriate.

The CMVM carried out a 'value for money' supervision exercise focused on the PRIIPs market in which, based on the information made available in the KID, it identified products with low expected benefits for the target market (return estimates of scenarios and relatively low guarantees) and relatively high costs.

Easily accessible information

The information summarised in the KID is important, but extracting the information in a manageable format is a resource-consuming task.

NLP (Natural Language Processing) tools could be used to extract information from KIDs, and tests in this field are already underway, including by ESMA itself.

But an even simpler solution would be to make it mandatory for the KID and other standardised documents to be published in a machine-readable format. This would contribute to the efficiency of the market in general, by making the comparability of financial products easier, and facilitate supervision by NCA.

Embracing innovation and technology in information disclosure could increase the simplicity and accessibility of information to a level that allows the retail investor to make better decisions, while also facilitating the work of those who inform and advise those investors.

A holistic approach that seeks to improve formats and content, and which allows products to be compared in terms of their value, regardless of each investor's perspective, has to be the way forward.

All these improvements can produce a significant and positive impact on increasing "Market Based Finance" across Europe. This is something that, although not often mentioned, is the enabler of a union of capital markets and ultimately of the Capital Markets Union.

BARBARA ANTONIDES

Manager International and Public Affairs - Dutch Authority for Financial Markets

Deep seated market trust is achieved when clients' interests are truly at heart

The CMU aims to create a single market and get money from investments and savings flowing across the EU. This is ambitious and important for the EU capital markets. Flourishing capital markets will benefit companies, investors and consumers.

Creating a culture of investing is not an easy task and legislation is a key instrument to enhance participation in capital markets, particularly from retail. In legislative proposals, it is important to strike the right balance between making capital markets more attractive (less regulatory complexity and administrative burdens), while at the same time safeguarding the interests of investors. The proposed measures regarding clearing services, insolvency rules and the Listing Act are welcome steps in the right direction. This article discusses proposed amendments to various legislative frameworks, proposes to consider an advise-light regime and emphasizes that clients' interest should be the core in financial services.

Legislative frameworks

The existing EU frameworks for financial instruments such as UCITS, PEPP and AIFMD contribute to standardization. Within these frameworks products can be designed that serve consumers' needs and interests. As a regulator we appreciate the prospect of further clarification and harmonization of delegation structures and liquidity management tools in the AIFMD and UCITS. Further clarification on delegation and substance is very welcome to reach the desired level playing field within the EU. Funds should have sufficient instruments to manage and mitigate liquidity risks. Having adequate and sufficient LMTs is key in addressing micro- and macroprudential risks.

Standardized portfolio investments might be a way to lower barriers for certain investors. Depending on clients' risk appetite, investment horizon and goals, a portfolio with a standardized asset allocation is an option. In NL, the guided execution-only is offered as an alternative to investors. Under strict conditions, simplified portfolio management could be achieved with a less extensive suitability test.

Firms should focus on low costs and ongoing expectation management in their product offering.

Costs

It is questionable whether regulatory changes are needed to facilitate the industry's creativity to make their propositions attractive for clients. A light-advice regime applicable to such products would be a cost-effective alternative to full-on advice (with all the costs and quality requirements).

Yes, we are focusing on the costs again. Basic mathematics demonstrate slight percentual differences in costs have a significant impact in the long run. A fee of 0.50%, median fee for equity funds according to Morningstar in NL[1], at first glance does not differ that much from for example 1.70%, not an uncommon percentage in the EU. It may not look like a big difference for the average investor. However, on the long-term investing horizon it has a significant impact. If you invest 1.000 euro in an equity fund with 0,5% costs and a yearly return of 5%, the nominal value of your fund after 30 years in NL would be: 3.750 euro. With 1.70% the value would be: 2.630 euro. That is a difference of more than 40%.

Clients' interest at heart

In addition to clear legislation, it is important that also the financial services industry puts the clients' interest first. Only when clients' interest is at the heart of business decisions can the needed investor's trust in financial services be preserved or (re-)gained. We cannot expect all investors to understand everything in the financial sector; information asymmetry in the financial sector will always be high. Therefore, it is key that especially consumers are able to rely on financial products that are well designed, that distribution channels function appropriately[2] and that correct and useful information is provided.

It is particularly important to carefully consider the design of a product. Clients' interest is key in the product development phase. A product should always live up to its expectations. For this reason, the intention to enable open end ELTIFs is viewed with some scepsis. Having exposure to infrastructural products enables diversification and may contribute to optimizing portfolio return, particularly for a long run investment for retirement. Yet, the characteristics of the underlying investments (e.g. bridges, tunnels) make it not that easy to liquidate these assets when investors of an open end fund want to sell their participation. Therefore, managing expectations on illiquid assets is key!

To conclude: one must be very careful, particularly when it comes to expanding the product offering to retail clients. Foreseeable issues are at hand and as we all know trust is hard to gain but easy to lose.

[1] https://newsroom.morningstar.com/newsroom/news-archive/press-release-details/2022/Morningstar-Publishes-Global-Study-of-Fees-and-Expenses-in-the-Fund-Industry-Finds-Fees-Continue-to-Fall-Yet-Room-for-Improvement-in-Industry-Structure-Remains/default.aspx

[2] In NL a ban on inducements was introduced in 2013 for financial advisors.

MATTHEW TAGLIANI
Head of Product and Sales Strategy, EMEA ETFs - Invesco

Policy must support the EU ETF sector by considering the impact of regulation

Exchange-traded funds (ETFs) are one of the most successful new product structures introduced in recent memory with global AUM exceeding \$9.6tn, of which more than \$1.5tn is in European-domiciled products[1].

ETFs are often held up as an example of the "democratisation of investment" due to their transparency, low cost, and single share class structure, in which all investors, big and small, receive the same pricing. The secondary market further enhances ETFs' appeal by providing both potential cost savings and incremental liquidity to investors.

But while ETFs have attracted significant investor assets, there remains one area in which ETFs, and their unique characteristics, are consistently overlooked – the drafting of financial market regulation.

European fund industry regulation continues to be drafted from the narrow perspective of actively-managed funds. When applied to passive ETFs, this can lead to incorrect assumptions about everything from how fund holdings are determined and how they can change, to the information available to the portfolio manager about underlying companies.

Indeed, the challenge of properly applying to ETFs a body of regulation that has been drafted from an active investor perspective has been exacerbated by the rapid implementation of ESG-related regulation in recent years, such as the EU SFDR. In general, these rules presuppose a degree of flexibility that is not only impractical in the context of passive ETF portfolios holding thousands of securities, but in many cases has been explicitly removed from the ETF manager.

As a simple illustration, consider a fund's name. With the growth of ESG investing, regulators have a legitimate interest in ensuring that terms such as "ESG", "sustainable", "green" etc. are not misused, hence recent regulatory initiatives governing the naming of such funds.

It is important to note here that the names of most ETFs are a formulaic combination of the name of the asset manager and the name of the benchmark the manager seeks to replicate. However, current discussions around the use of ESG-related language ignores this connection between passive funds and their benchmarks (whose names are not in scope) and only considers the fund holdings and fund name.

Taking the perspective of an active manager, the implication is that, if the fund failed to meet the requirements

Regulators must support access to one of the most significant democratising investment trends.

for the use of "ESG" in the name, then the portfolio manager can either change the fund holdings or change the fund name.

But neither option is available in the case of passive ETFs where the portfolio manager has little discretion to deviate from the target holdings. And to replace or remove the "ESG" in the name would mislead investors by suggesting the ETF is tracking a different benchmark. A lack of coordination between fund regulations (e.g., the EU SFDR) and benchmarks regulations (e.g., the EU BMR) has the potential to create serious challenges for ETFs and passive strategies.

Indeed, the consideration of ETF specificities is also largely absent in other parts of financial regulation. The impact on ETF primary market operations of the since-delayed-and-reviewed mandatory buy-in regime under the EU CSDR was not considered by policymakers ex-ante despite its well-known flaws.

Lessons must therefore be learned by policymakers in order to avoid similar policy failures in the trading and settlement space. This is particularly pertinent given the live discussions in Europe on the transition towards a T+1 settlement framework where ETF specificities must be taken into account in the policy development phase, particularly for EU ETFs investing in non-EU assets.

Additionally, in the context of the ongoing review of the EU MiFIR, only after significant industry engagement have policymakers begun to see the potential utility – for retail investors, global institutional investors, and regulators themselves – of a pre- and post-trade consolidated tape covering ETFs.

Not only would such a tape allow investors to make better informed investment decisions and support best execution, but it would allow the EU ETF sector to genuinely compete with other large jurisdictions, such as the U.S., by showcasing the true liquidity available in competing EU-listed products. It would also give regulators a more comprehensive overview of the market which would be of particular utility during periods of broader market stress.

To conclude, given that assets in passive funds now exceed those in active funds in key global markets[2] – with ETFs the primary driver of this growth – it is no longer tenable that policymakers continue to consider the impact of regulation on ETFs as an afterthought or, worse still, not at all.

Instead, regulation must support investors' access to one of the most significant democratising investment trends of the last 30 years by ensuring appropriate consideration of the specificities of ETFs and passive investing from the earliest stages of policy design.

1. Source: ETFGI, February 2023
2. Source: FT, June 2022

STÉPHANE JANIN

Head of Global Regulatory Developments and Public Affairs - AXA Investment Managers

Are European UCITS and AIF frameworks adapted to investor needs?

The success of EU-based investment funds has been recognized for decades. The first UCITS regulatory framework adopted in 1985 has led progressively to a golden and worldwide label. It was complemented later on by the development of various types of AIFs, following the adoption of the AIFM Directive in 2011.

In terms of facts, the data provided by EFAMA [1] show that assets under management for European funds reached over EUR 19 trillion at the end of 2022. In spite of the recent turbulences on financial markets, it compares favorably to the EUR 15 trillion at end 2018 (+26% in four years). And even in 2022, while the traditional funds invested in capital markets declined, it has to be noticed that some alternative asset strategies registered inflows (e.g. infrastructure funds or private equity funds). Ultimately, it explains why some EU-based asset management companies registered net inflows in 2022 overall [2].

Additional figures show that EU funds definitely answer various investor needs: at EU level, in terms of total Assets under Management, amounts originate on equal terms from Retail (48%) and professional investors (52%). And that answer to investor needs is more and more successful on a cross-border basis: in 2021, foreign clients of EU funds have represented 33% of fund assets, as compared to only 27% in 2017.

This is not surprising:

- For regulatory reasons: up to now, the EU was able to set a comprehensive and progressively harmonized framework which has evolved over time without harming the positive aspects of the previous versions, rightly balancing investor protection and investment returns;
- Due to EU business offer: the underlying assets are global in their nature (equities, bonds, real estate, infrastructure, private equity, etc.), geographies, as well as strategies;
- The structuring of funds can be very diverse, in terms of optimizing the combination between investor needs and profiles, investment strategies, and pace of subscriptions and redemptions among others.

From this investor need standpoint, the recent Regulatory actions by the EC have to be lauded: the targeted review of AIFM and UCITS Directives, as well as ELTIF Regulation, will certainly allow for even more progress in answering investor needs through EU funds while preserving financial stability (e.g. an EU regime for Loan-Originating Funds; wider availability of Liquidity Management Tools; facilitated access to private assets by retail investors through ELTIF 2.0).

To answer investor needs, EU officials must care about preserving the competitiveness of EU managers.

But beyond investor needs, we have also to make clear that EU investment funds are key funders of the EU real economy: European funds owned in 2021 more than 17% of the listed shares issued in Europe, and more than 13% of debt securities (both public and corporate) issued in Europe.

Latest significant step over the last decade: to accompany the decision by Member States and the EC to act on sustainability, EU fund managers have been developing an offer of sustainable funds, as a bridge between the wills of ESG-oriented investors and the need for financing green projects in Europe.

Still, to preserve that critical role of EU fund managers in answering investor needs as well as EU economic and sustainable needs, EU officials must care about preserving the competitiveness of EU investment managers. Even if the role of EU funds has increased within the region, at global level it appears that the market share of Europe (including the UK) has decreased to 31% in 2022, as compared to 38% in 2008 (-7%), to the benefit of Americas (+3%) and Asia (+4%) [3].

This is where EU institutions can play a critical role, with at least two actions in the short term:

- Regarding AIFM/UCITS Review at Levels 1 and 2. We must avoid the costly obligation of new reportings by EU fund managers to National Competent Authorities that our non-EU competitors would not support (i.e. avoiding a new reporting for each of the 33,000 EU UCITS funds, while we already provide the detailed inventory of each fund to Central Banks);
- Regarding the external ESG Data that we have increasingly to buy and make use of (in particular due to regulatory requirements). We urgently need a clear EU Regulatory action on external ESG Data providers (and not only on external ESG Ratings ones): to secure Data reliability for us; to set liability on providers; and to ensure transparency on fee grids. Thus, the EU would comply with IOSCO's Recommendations issued in 2021, which target explicitly both ESG Data Products Providers as well as ESG Rating Providers [4].

Otherwise, EU fund managers would have to bear growing unfair risks and costs, to the ultimate detriment of our investors that we are deeply willing to serve.

[1] Source: EFAMA: "Quarterly Statistical Release", 28 February 2023, and "Asset Management in Europe", 14 December 2022.
[2] For instance, AXA IM registered EUR 17 billion of net inflows in 2022.
[3] Source: International Investment Funds Association.
[4] "ESG Ratings and Data Products Providers", Final Report, IOSCO, November 2021.

GERBEN EVERTS
Executive Director -
European Investors

Investor protection: stop patronizing - introduce the safeguards investors want

We can't state that the existing EU frameworks are covering all significant safeguards and investor needs. We've entered into an era where we see more pan-EU financial flexibility, comprehensive digitalization, demographics requiring self-discipline and a higher educated population. The main issue is not that investors don't understand financial products. Investors don't trust products, nor the 'independent' intermediaries. Consequently, huge amounts of investors' savings are dead wood on a savings account washed away by inflation. New and existing companies are hesitant to issue equity capital and still depend on bank loans. The solution is not the introduction of listing requirements easier to comply with; (re-)building trust is what is required.

The capital markets union and retail investment strategy are important improvements if they would deliver, *inter alia* a full inducement ban, harmonized insolvency laws and pan-EU collective redress (compensation for losses due to fraud and intentional non-compliance with EU- and national law and regulation by listed companies and intermediaries). Despite many efforts and progress made, the European rulebook sprouted from building blocks regulating historic economic realities. Consequently, the rulebook is sell-side biased; retail investor protection is fragmented and weak.

Building trust is ever more important. The degree of uncertainty surrounding the global banking environment is doubtless to shake investor confidence, retail investors by no means excepted. Hence, I will not be far off the mark when I predict that maintaining (or: bolstering) banking stability will certainly be at the top of the EU's agenda; and rightly so. However, investor confidence receiving sensitive blows, is precisely a trigger to stress its preeminence in opening financial markets to retail investors. More equity capital, for listed companies and financial institutions, in an economic environment with high inflation and increasing interest rates, is urgently called for.

To garner confidence, ban inducements and introduce pan-EU collective redress.

In directing the focus to the ELTIF review, a preliminary observation is that very few ELTIFs have been created altogether. From the outset, it was feared that retail investors would insufficiently understand the features (lock-up period, and duration), and the risks. Thus, under the original construct, there was the obligation for the manager of the ELTIF to perform the distinct suitability test for retail investors. Whereas the MiFID suitability regime remains (as a mere consequence of ELTIFs classifying under the MiFID), the specific ELTIF-test has now - rightly - been withdrawn.

A closely related aspect is that the specific requirement of advice to be given to retail investors is equally relinquished. Investment advice almost invariably risks bias. In fact, advisers are sellers. There is a fundamental lack of retail access to independent investment services. However, where ELTIFs are concerned, we have difficulty in accepting that to stimulate retail investment, the EU has resorted to lowering investor protection.

Turning to the AIFMD review, here we overall approve the adaptations. Harmonizing the requirements for loan-originating AIFs is the way to go. Especially the way liquidity management-issues concerning loan-originating AIFs are addressed, attracts our scrutiny. AIFMs and UCITS managers may now (temporarily) suspend redemptions. Under the new requirements, such redemptions should strictly be warranted by investors' interests. The connection with the issue of investor confidence is blatantly evident. There are bad experiences stemming from suspension of redemptions, whether they be excused by the corona pandemic or otherwise. Suspending redemption is, *per se*, likely to trigger nervousness.

The matter of the energy transition gains prominence by the day. The IPPC Press Release of 20 March 2023 is broadly taken as stating the evident truth that keeping warming to 1.50C is a mere illusion. With that in mind, financing the transition, and, hence, redirecting and attracting capital to 'sustainable investments', gains urgency by the minute. This brings me to the spate of asset managers having had to 'reclassify' their funds from 'Article 9 funds' to 'Article 8 funds'.

Morningstar estimates that fewer than five per cent of Article 9 funds target sustainable investment exposure between 90 per cent and 100 per cent. The downgradings result from new regulatory guidelines and in no way reflect changes in investors' strategies. If anything, this is a reputational risk for the asset managers involved. But, importantly to European Investors, it is a harsh blow to investor confidence. The kind of blow one could do without. Reliability of Article 9 funds is vital for the impact economy.

To conclude, if the EU-rulebook were to cover the main retail investor needs – ever more so in the actual precarious situation undermining confidence – it must garner confidence, trust investors' preferences, ban inducements and introduce pan-EU collective redress.

SECURITISATION IN THE EU

NATHALIE AUFAUVRE

Secretary General - Autorité de contrôle prudentiel et de résolution (ACPR)

Securitisation: time to turn the bridge into a viaduct

Securitisation is generally described as a bridge between credit institutions and capital markets, allowing the former to free up lending capacity, diversify their funding mix and reduce their financing costs, while allowing the latter to enlarge investment opportunities with a broad variety of risk-returns profiles. Time has come to help make this bridge a viaduct: keeping its foundations solid and trustworthy while acting to grow its size, up to its full potential.

This fine-tuning is all the more needed in the current context of economic challenges, driven both by the end of central banks' accommodative interest rate policies and accrued financing needs arising from the digital and green transitions. Therefore, maybe now more than ever in the post-GFC era, securitisation has a critical role to play, making it our responsibility as regulators, policymakers and stakeholders to allow and incentivize its unharmed and sustainable development, as a key pillar of the Capital Markets Union.

Indeed, the mechanics of securitisation, when soundly structured, make it a unique tool for financial institutions acting in various roles, which furthermore provides additional benefits for a large array of stakeholders, both businesses and individuals.

As a funding tool, securitisation first allows the diversification of funding sources and as such, can be regarded as an integral part of the capital and liquidity management strategy of credit institutions. Beyond the financing component, the singularity of securitisation lies in its capital reallocation power: operations, for which a Significant Risk Transfer is recognized, allow the originating institutions to free up some capital initially set aside to cover the risks embedded in the securitised exposures, therefore turning into a powerful capital management tool.

Both a refinancing lever and a risk reallocation tool, securitisation is also expected to ultimately benefit the economy as a whole. First, by allowing originating banks to enhance their lending capacity. Second, by contributing to distributing risks across the financial sector, therefore also contributing to the overall stability and resilience of the financial system.

Securitisation has a key role to play to foster digital and green transition in Europe.

While the benefits of well-functioning and soundly structured securitisation markets should not be doubted upon, these should be embedded in a safe and robust regulatory framework to ensure both the high quality of assets and the adequacy of the requirements and supervisory schemes. To that extent, the implementation of the new European framework in 2019 was an important and much welcomed step forward, setting both high-level principles and functional requirements needed to revive the market in a sound and prudent manner, despite the stigma inherited from the GFC turmoil. A few years later, we must nevertheless acknowledge that the European market is still delivering below its potential, which might – to some extent – be due to a lack of risk-sensitiveness in the capital treatment framework but also reflect a lack of attractiveness of securitisation in a prolonged low interest rates environment. At the same time, improving the regulatory environment has never ceased to be a policy priority, as evidenced by the various steps already taken.

Indeed, the new rules were enhanced as soon as spring 2021 with the implementation of the Capital Markets Recovery Package, that resulted in the extension of the STS label to synthetic securitisation, the introduction of preferential risk-weights for senior tranches retained by the originator, and the removal of regulatory obstacles to the securitisation of non-performing exposures. No later than a few months afterwards, the Commission opened a targeted consultation on the functioning of the framework and addressed a Call for Advice to the Joint Committee of the ESAs with regard to the prudential treatment. The resulting report on the functioning of the framework was published in October 2022.

As regards the prudential treatment, the ESAs published their advice by the end of 2022, suggesting – in addition to a set of technical quick fixes – to improve risk sensitivity in the capital treatment by acknowledging the merits of a reduction in model and agency risks associated to originators retaining senior securitisation tranches, should adequate safeguards be met. ACPR supports this reasonable and well-balanced orientation.

Although a more holistic approach should certainly be considered by EU policymakers, the risk-sensitiveness of the framework remains constrained by the Basel standards, that is to say the formula-based approaches that – as underlined by the ESAs conclusion – might prove unsatisfactory in achieving the various goals of the regulation.

Turning the bridge into a viaduct will not succeed without reshaping the cornerstone of the prudential regulation: Basel is the right place to do so, whilst ensuring the level-playing field.

PAUL TANG

MEP, Committee on Economic and Monetary Affairs - European Parliament

Towards transparent securitisation

Fifteen years after the start of the Great Financial Crisis, financial markets are getting nervous once again. While the underlying causes are radically different, nervousness has been worsened by a similar factor: a lack of transparency. The risks of rising interest rates are not evenly distributed. "Whenever the Fed hits the brakes, someone goes through the windshield," reminded J.P. Morgan's chief economist the New York Times. But we do not know who.

The securitisation market has of course been long seen as a prime example of opaqueness. This was something the Securitisation Regulation helped to address. By establishing a data repository for securitisation transactions, the market has become more transparent. Not just for investors, but also for regulators and interested external parties. All can become aware easily of what transactions are taking place, and what these transactions look like.

During the negotiations, however, a compromise was needed, leading to a differentiation between public transactions, i.e. those that require the issuance of a prospectus, and private transactions. Private transactions did have to collect all relevant data and share it with the investor, but did not need to make this information on the securitisation repository.

With the review of the securitisation regulation approaching, this differentiation will be revisited. This because an increasing size of the securitisation market is in the private segment. While growth in the public part of the securitisation market has been stagnant, there are some indications that private transactions, including synthetic SRT securitisations, are undergoing rapid growth. The mission of the Securitisation Regulation to provide transparency for the entire market might therefore come in peril. Indeed the Commission stated last year that "the number of private STS securitisations has indeed risen considerably since March 2019." However, given the short timeframe and the lack of data on the number of private non-STS transactions, a comprehensive assessment of the market is difficult, according to the Commission.[1]

And this is precisely the problem. Because, as the European Supervisory Authorities write "it is difficult for supervisory authorities to become aware of the issuance of private securitisations if they are not notified and even when competent authorities are notified, it is difficult to access the information relating to a private securitisation, since it is not made available via a securitisation repository".[2] When even regulators are not able to fully assess the size and details of a market with potential financial stability concerns, it hampers our ability to avoid crises, and can worsen nervousness in the market when a crisis comes.

When even regulators cannot fully assess the market, it hampers our ability to avoid crises.

Luckily the market is moving rapidly towards increased transparency. Recently, this drive has been spurred by rise of sustainable finance. The insatiable need of sustainable investors to increase data flows has led to multiple regulatory initiatives that will also touch the securitisation market.

Firstly, the European Green Bonds Regulation provides a framework for issuers of green securitisation using the "European Green Bond" designation to disclose in detail the sustainability performance, not just of their use of the proceeds of the transaction, but also of the underlying assets. These reporting frameworks can be used, not just by issuers using the EuGB designation, but also by those seeking to showcase the green credentials of their bond without adhering to some of the stricter requirements of the Green Bond Regulation, such as the taxonomy-alignment of the use of proceeds.

Secondly, the European Single Access Point (ESAP) will provide a single database for financial information. This clearly sets the standard that financial data in Europe should be public and easily accessible. Any deviations from this rule will come under pressure and will have to be explained. As such, the European Parliament seek to include also data relating to the securitisation regulation in the database. The exact scope of the database is still under discussion, but even if securitisation is not included in the ESAP immediately, in the revision of the securitisation regulation, the issue will be on the table again.

Financial crises are of course not caused by a lack of transparency, but they can very much be made worse by it. The memory of the Great Financial Crisis has slowly ebbed away, at least in my mind, but has flooded back by recent events. It puts the importance of transparency, for supervisors and the market as a whole, back at the centre of discussion. Inevitably, this will shape also the review of the Securitisation Regulation.

[1] https://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:52022DC0517
[2] https://www.eiopa.europa.eu/system/files/2021-05/jc-2021-31-jc-report-on-the-implementation-and-functioning-of-the-securitisation-regulation.pdf

FRANÇOIS-LOUIS MICHAUD

Executive Director - European Banking Authority (EBA)

Improvements to the securitisation framework

The EBA, EIOPA and ESMA have recently reviewed the state of play of the EU securitisation prudential framework. They reached the conclusion that the capital and liquidity framework per se - albeit demanding - does not constitute a key obstacle to a revival of the EU securitisation market. Other factors beyond the prudential framework should also be considered. This includes a need for increased proportionality of the current transparency and due diligence requirements. The low interest rate environment of recent years also played a role together.

There is however room to improve the prudential rules applying to securitisation. In this spirit the EBA proposes technical adjustments to bring more consistency, clarity, and risk sensitiveness to the banks' capital framework.

A careful reduction of the risk weight floor for originators could be envisaged given that agency and model risks have decreased compared to the early days of securitisation. This would encourage banks to originate resilient securitised instruments to shed and diversify their risks. As there is investor demand for synthetic securitisation (which constitutes the bulk of the Significant Risk Transfer market), this would also help revive the securitisation market, without raising prudential concerns.

On the other hand, a reduction of the capital requirements arising from the "p-factor" was not proposed. Such a change was seen as having the potential of creating cliff effects in the capital requirements and incentives for banks to invest in undercapitalised mezzanine tranches, contrary to revisiting the risk weight formula which would not have such adverse effects.

A better fit of the current shape of the risk weight function to actual distributions of losses and an improved ability to account for non-granular pools could also be envisaged. Changes should in any event preferably be first discussed in the Basel Committee.

Such adjustments matter as securitisation can offer a key risk management tool in the transition to a greener economy.

The EU legislation on the Green Bonds Standard (EU GBS) will create an official standard in the area. As there are not so many taxonomy-aligned assets available yet the EBA recommends aligning with the EU GBS and rely on the use of a securitisation proceeds rather than develop a new approach based on the green credentials of the securitisation's collateral. In the case of securitisation, and generally for any bond issued via a special purpose vehicle, the requirements about use of proceeds should be shifted from the issuer to the originator.

Rules applying to securitisation can be improved - also to support the green transition.

Focusing on the use of the proceeds allows banks and issuers to shed non-green assets and start investing in assets supporting the transition to a greener economy immediately. This would of course need to be monitored and the EBA stands ready to do so. Additional disclosure on the green characteristics of an asset pool and the green credentials of the originator would help.

The need to create a separate label for green securitisation could be re-assessed at a later stage. While supporting the green transition, the development of green securitisation would also foster a more vibrant securitisation market.

FAUSTO PARENTE

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

Investment of insurers and reinsurers in securitisations

Securitisation volumes in Europe have never reached their peak of 2007, before the financial crisis. Overall, the current market is smaller, but of a higher quality and more prudently regulated. The pre-crisis levels of securitisation volumes were unhealthy and unsustainable and should not serve as a benchmark to be targeted. Still, some stakeholders expect that the securitisation market should revive to a higher level than where it currently stands. In particular insurers and reinsurers are seen as a possible source of high demand, yet the appetite of insurers and reinsurers to invest in securitisations remains low.

There have been efforts to remove obstacles to insurers and reinsurers investing in securitisations and indeed the European Insurance and Occupational Pensions Authority (EIOPA) was a pioneer in this regard. As early as 2013, EIOPA proposed a preferential treatment for higher quality securitisations. The European Commission made such a change to Solvency II, and it came into effect in 2019. The amendments introduced a specific treatment for simple, transparent and standardised securitisations (STS securitisations) in the standard formula for the calculation of capital requirements under Solvency II.

According to that specific treatment, the capital requirements for investment in STS securitisations were significantly lowered. For example, the charges for senior STS securitisations are now close to those for corporate bonds of the same credit rating. In contrast, non-STS securitisations have higher risk charges.

The aim of the amendments was to support investments in securitisations by insurers and reinsurers in a prudent way. However, three years after the new treatment has come into effect, investments in securitisation have not materially changed. The volume is overall stable at a level of approximately 12.5 billion euro for the European insurers and reinsurers that apply the standard formula. This is a small fraction of the European securitisation market. It is also small compared to the total investment volume of the insurance sector. At European level, securitisation investments represent 0.33% of total investments of the insurers and reinsurers applying the standard formula. Investments in securitisations are concentrated in a small number of the insurers and reinsurers.

The appetite of insurers and reinsurers to invest in securitisations remains low.

At the end of 2021, 12% of the insurers and reinsurers were invested in securitisations. Among those undertakings, 85% do so for an amount of less than 5% of their total investments. Only a small number of insurers seem to be active players in the securitisation market. Furthermore, we can observe that the majority of securitisation investments of those companies are made in the class of non-STS securitisations which have higher capital charges.

The Solvency II framework does not seem to be a significant driver for the investment decisions of insurers and reinsurers in relation to securitisation. In a survey that EIOPA carried out in 2022, only a few insurers mentioned that the capital charges are one of the reasons that is holding them back from investing in this asset class. The vast majority of companies do not seem to be interested in securitisations because they do not match their investment preferences which are focused on the risk-return profile of the investment and asset-liability management.

Other asset classes seem to show better risk-return profiles. Securitisations do not fit into the asset-liability management of many insurers and reinsurers who are long term investors, in particular life insurers. These companies have long-term insurance liabilities and typically seek to cover them with long-term fixed rate investments in order to reduce the risk that changes in the level of interest rates lead to a deterioration of their capital. The importance of an effective asset liability management became evident during the past years when interest rates varied a lot. Another reason for the lack of demand for securitisation investments from the insurance industry seems to be that investors perceive securitisations as a complex product with extensive due diligence requirements.

Focusing only on the prudential framework makes it difficult to take account of the interlinked and complex nature of the factors in play. That is in line with recent technical advice of the Joint Committee of the European Supervisory Authorities. The Joint Committee does not advise changes to the current framework of Solvency II with regards to the prudential treatment of securitisation.

For the time being, while there is little appetite for investments in securitisations by (re)insurers, this is not a result of the current regulatory framework.

CHRISTOPHE DELAFONTAINE

Global Markets Head of Regulatory and Public Affairs - BNP Paribas

Overmedication risk on a safely predictable EU asset class

Securitisation is a technique aimed at transforming given risks from an originator (e.g. loans from a European bank) into sequenced credit exposures. Hence, a mere tranching of a given risk does not create additional risk per se. Still, blatant case of cumulated agency and model risks erupted when the *originate*-single-recourse-loans-to-distribute model used for US subprime securitisation triggered the infamous global financial crisis (GFC). Originators of subprime mortgages were fees-driven only while the benefit of geographical diversification was overestimated so that the thickness of the senior tranche could be oversized.

The global regulatory answer to the GFC included a securitisation-specific component, which introduced a new non-neutrality parameter known as *p-factor* designed to address agency and model risks. The higher that factor, the more the weighted average risk-weighting of all tranches shall be above the single risk-weighting of the underlying exposure liable to securitisation.

The current paradox is that the EU has transposed international guidance in a most stringent fashion even though EU securitisation has been least exposed[1] to the agency and model risks most targeted by the BCBS framework. In addition to the tight transposition of the BCBS *Framework* and its optional *Standardised Transparent and Comparable* dispositions, EU regulators have added extra requirements along the way applicable to reporting, due diligence, supervisory recognition of Significant Risk Transfer (SRT). Meanwhile, as pointed out by the latest non-paper of Commission, “the US continues to apply a modified version of the Basel II securitisation framework that markedly differs from the EU framework with respect to p factor levels”[2].

The good news is that some voices among co-legislators have joined to the push for lesser non-neutrality *p-factor* while not closing the door to reconsider regulatory HQLA eligibility criteria in a direction more in line with comparable secured funding market instruments such as EU covered bonds or US GSE mortgage-backed securities.

At the time of writing, the Parliament has amendments aiming at temporarily halving the *p-factor* for output floor purposes, along with a mandate to the EBA to report to the Commission on the prudential treatment of securitisation transactions. The industry strongly favours this lifeline granted to EU securitisation in general: a do-or-die amendment for deconsolidating SRT deals in particular.

EU securitisation has been least exposed to structural weaknesses targeted by the BCBS framework.

Furthermore, a recent non-paper from the Commission proposes a reduced *p-factor* under both standardised and internal approaches that would apply to simple transparent and standardised (STS) transactions until future BCBS guidance is available. The industry will welcome this condition for the development of securitisation, especially if not segregating against non-STS deals as there is no mechanical linkage between the STS eligibility of a given transaction and the magnitude of putative agency/model risk (e.g. securitising solar panel loans does not pass STS criteria, all else equal).

Thus, mutually shared objectives should include:

- Implement the CMU while making room for to the substantial financing need for the incoming green and digital transitions;
- Secure a more diversified funding market: financial stability, both systemic and idiosyncratic benefitting from better risk sharing across market participants;
- Preserve retail origination capacity – including SME lending – from the most knowledgeable and risk-aligned lenders, i.e. the banking sector, through both funding and/or risk transferring securitisations.

In line with those objectives and in contradiction with current p-factors calibrations best suited for originate-to-distribute models, structural risk alignment between banking originators and securitisation end-investors derive not only from the legal 5% risk retention rule but also from:

- the full recourse nature of banking loans being securitised that implies shared risks on shared obligors (regardless of specific loans) along with;
- the material interest to protect the franchise of established securitisation repeat-originators that are also repeat-issuers of their own debt.

A revived EU bank-originated-securitisation market does not create additional agency risk: a more commensurate risk-adjusted regulatory treatment is a prerequisite for a larger CMU-friendly primary market, SRT deals included, along with a renewed liquidty of secondary market, senior tranches most concerned[3].

[1] *“From mid-2007 to the end of 2010, only 0.95% of all European structured-finance issues defaulted, compared to 7.7% of all US structured-finance issues, and 6.3% among the universe of global corporate bonds”* (OECD)

[2] *Current EU vs. US p-factors: either 0.5 or 1 (STS or non-STS) vs. 0.5 under SA; 0.3 and 1.5 vs. ≈ 0 under IRBA*

[3] *“prior to the GFC, banks constituted the primary investor base for securitisations in the EU and provided ample liquidity for the tranching of senior tranches”* (Commission)

ALEXANDER BATCHVAROV

Managing Director - Bank of America

Why securitisation slumped in EU, but resurged in the rest of the world?

In recent years, the EU securitisation market averaged about EUR30bn of placed ABS/MBS supply annually and more than triple that for retained issuance. This is a far cry from the roughly five times the placed volume averaged in the years pre-GFC. It is often assumed that this decline is repeated across other securitisation markets, but nothing can be farther from the truth. After a hiatus of a few years, the US ABS issuance bounced back up to the pre-GFC levels (c. $200bn per annum). The US non-agency MBS issuance took a decade to breach the $100bn ceiling, given that Alt-A, Option ARM and subprime loans were left behind and the US agencies stepped up their game.

Australia and Japan new issue volumes also recovered to levels about 20% below those of pre-GFC. Australian RMBS issuance now exceeds EUR RMBS placed issuance five times, despite Australian mortgage market being a fraction of the EU's. US annual CLO volume advanced to the $100bn mark and EUR CLO – to about €30bn; both markets exceeded the pre-GFC issuance levels, while many CDO variations disappeared. CMBS issuance contracted, significantly from the pre-GFC levels, apart from the US, helped by US agencies. New markets developed: China is now the second largest securitisation market in the world; synthetic securitisation took off in the EU in recent years.

In short, the non-agency US securitisation market recovered and flourished despite the scars of the US subprime crisis. Australian and Japanese securitisations were not scarred by the GFC. The EU securitisation market did not recover. While in the rest of the world the investor base for securitisation multiplied, in the EU it shrank. Why?

It is easy to point to excess liquidity that the central banks provided, but that argument stands true for all countries. In Europe, covered bonds (CB) diverted mortgage pools from RMBS; from the Eurozone crisis onwards, mortgage covered bond issuance averaged €500bn p.a. The Netherlands clearly illustrates the cannibalisation of RMBS by mortgage covered bonds post-GFC. The same could have happened in Australia, but the bank regulators prudently imposed asset encumbrance limits on the banks, and provided liquidity support for RMBS during the GFC and the pandemic. In comparison, ECB use of ABSPP was limited. In Australia, unlike in Europe, the view that CBs will be bailed out in times of trouble is not entertained by investors.

The lack of level playing field in the EU regulations bears responsibility for the slump.

We have long pointed to the lack of a level playing field in the EU between securitisation and other investment instruments in every respect: disclosure, due diligence, LCR treatment, capital weights, among others. The capital charge discrepancies are substantial in Solvency 2, but they are not immaterial in CRR either. EU insurers bought large volumes of floating securitisation notes up until 2011, and then withdrew, coincidentally, as the Solvency II drafts were circulated.

While the focus often is on capital and liquidity treatment, the discrepancies are quite large as far as initial and ongoing due diligence and disclosures are concerned. The due diligence requirements for purchasing and holding AAA prime RMBS are burdensome in comparison to those for buying and holding high yield bonds, bank AT1s, mortgage loans and covered bonds. The focus on agency risk in any asset securitisation is overwhelming, but it is not factored in buying the same pool of assets, if not securitised.

In our opinion, agency risk should be addressed in loan underwriting, rather than in loan securitisation. No loan-by-loan disclosure, no stress testing, no regular internal reporting to, no risk retention is required to buy any secured or unsecured investment, but they are all enforced for any EU investor buying any securitisation tranche regardless of its riskiness.

While regulation declared EU securitisation bonds to be of low liquidity, the reality of the crises of the last six months proved otherwise: investors sold ABS over corporate and sovereign bonds, because they furnished them with the best cash price. These crises also highlighted that EU investors could not take advantage of market dislocations because of the codified due diligence requirements for securitisation, which have no parallel in any other investment instrument in Europe and the world. In the rest of the world, the fiduciary duty of the investor stands equal in weight across all investment instruments, not in Europe.

It is well understood now that EU securitisation did not commit the crimes it was accused of in the aftermath of the GFC; it was simply judged guilty by association. That led to a distorted regulatory framework and lack of level playing field across investment instruments. EU securitisation regulations need a radical revamp to level the playing field (or other regulations need realignment with those for securitisation). The sooner the better for the EU economy and for the EU CMU.

6

FINANCIAL STABILITY CHALLENGES AND VULNERABILITIES

- Financial stability risks
- Consequences of rising interest rates
- Risks in the banking and non-bank sectors
- Sustainability risks
- Anti-Money-Laundering proposals

Q&A

ADENA FRIEDMAN

Chair and Chief Executive Officer - Nasdaq

Accelerating the fight against financial crime

The name Nasdaq is often associated with the Nasdaq stock exchange. Yet, Nasdaq's business today far extends beyond the exchange. How would you describe Nasdaq, the company?

Nasdaq today is a highly scaled, global technology provider that serves the world's financial system.

At our core, we deliver leading platforms that improve the liquidity, transparency, and integrity of the world's economy. Those three themes serve as the foundation of our culture, and they drive our focus and our priorities within Nasdaq.

For instance, the technology that we built to underpin Nasdaq's markets, now powers 130 markets worldwide. We also serve the corporate and investment communities with a diverse suite of technology, data and analytics solutions that helps them navigate the complexity of capital markets. And our suite of integrity solutions is used by markets, banks and credit unions to help detect and fight financial crime and market abuse.

You've spoken a lot recently about your focus on Anti-Financial Crime and the strong growth trajectory of that business. What made you expand the Nasdaq platform into this area?

Nasdaq's vision is to become the trusted fabric of the financial system. We see our role across the three foundational pillars I mentioned: maximizing liquidity, increasing transparency, and maintaining the integrity of the global financial system.

Our integrity pillar is focused on detecting nefarious behaviors across markets and trading, as well as rooting out financial crime such as fraud and money laundering. Financial crime is a pervasive and global challenge that causes a major strain on the financial system. It's also intrinsically linked to wider societal harm such as human trafficking, drug and weapons trade, terrorism financing, and other nefarious behaviors that affect communities. As we sought to expand our platform, we wanted to make sure we were using it to tackle the industry's toughest challenges, and we are doing just that with our Anti-Financial Crime division.

How big of an issue is this problem?

Estimates show financial institutions spend over $1.28 trillion a year in the fight against financial crime. Yet, spend alone, has proven insufficient. The United Nations estimates that 2-5% of global GDP – approximately $4.4 trillion – is laundered annually and less than 1 percent of those funds are seized.

It's a problem that requires urgent action, especially because bad actors are innovating every day. We need to outthink them, outwork them, and out-innovate them, which we can only do if we deepen collaboration – both across the industry as well as between industry, regulators and policy-makers.

What are the challenges in combatting financial crime?

They are multifold. With transaction volumes soaring and ever-increasing amounts of data to monitor, banks are struggling to keep up. Surveillance and compliance programs may mark tens of thousands of transactions as potentially suspicious in a single month. Unfortunately, that amount of data can overwhelm the teams of experts within the banks who are investigating potentially criminal activity. The data includes many false signals, what the industry calls "false positives", each of which needs to be investigated and can become a huge drain on the resources within the banks. The best opportunity we have as an industry to combat crime more effectively is to make the alerts more effective in finding real crime and eliminating the noise of the false positives. That can only be done through innovative technologies, data science, and collaboration across the financial ecosystem.

Data silos between financial institutions and regulators, the growth in international sanctions, and the emergence of digital assets and cryptocurrencies add further layers of complexity to the already strained system.

Criminals, on the other hand, are not hampered by similar challenges. They are adopting the newest technologies and leveraging innovation to stay multiple steps ahead of detection. They are exploiting the cracks between financial institutions and among industry and regulators to hide their activities.

And we are all suffering for it: financial crime undermines the integrity and sustainability of our financial systems and money continues to flow into drug and terrorism networks, weapons trade, and human trafficking.

To reverse this trend, we need to not only keep pace, but outpace, the criminals exploiting the global financial system for their own ends.

How can we out-innovate and outpace the criminals?

The impediments to progress are complex but not insurmountable.

The lynchpin will be breaking down the barriers that prevent effective and responsible data sharing across country lines and between financial institutions and regulators. While banks are required to have their own monitoring systems to detect potential fraud and money-laundering activities, in many countries, including within the EU, their insight is limited to their own transaction data. By analyzing data from multiple institutions and locations, patterns can emerge that wouldn't otherwise be visible.

We have been able to implement solutions across 2200 banks that keep the data confidential between the banks, but still allows data pooling within consortium data-lakes that enable much more robust data analytics and significantly better alerting outcomes – fewer false positives and more actual crime detected.

There are signs of progress. There are at least 15 international information-sharing programs under way worldwide that are yielding promising results. But these pilot programs are a mere drop in the bucket when we consider the scale of the crisis.

The US has the most robust data sharing capabilities codified in the law, and as a result, we have delivered unique capabilities for banks to share information with each other and engage in joint investigations into connected criminal activity that spans multiple institutions.

Doesn't this kind of information sharing bring about privacy concerns?

These concerns are real and important, and worthy of debate among all stakeholders. Governments need to balance individuals' privacy rights with the need to enable controlled data sharing. Technology has an important role to play here—not only in using artificial intelligence and machine learning to produce deeper insight from diverse data sources, but also in deploying appropriate controls, including data encryption, to stay in compliance with privacy protection regulation.

Improved data sharing also has the potential to increase collaboration between regulators and industry. Informal dialogues among regulators, law enforcement and the private sector have existed in different forms and across jurisdictions for a long time. However, formalized public-private collaborations have the power to deliver more real-time feedback to financial institutions and to effectively support anti-financial crime efforts.

What is Nasdaq doing to address the issue?

The fight against crime is still largely analog in a digital world. At Nasdaq, we are bringing more modern solutions to the problem by leveraging the cloud, big data approaches, AI and machine learning to increase crime fighting effectiveness and success rates.

By gathering and normalizing data across banks and leveraging AI algorithms powered by our unique big data set, we are better able to detect patterns and identify nefarious actors. We surround the detection capabilities with full-service workflow tools to manage the entire activity chain from detection, to case management, to regulatory reporting. Certainly, we can bring our broad suite of technology solutions to the table to address this issue, but we know it will be more fundamental to foster deep collaboration with law enforcement to combat it.

How can governments here in Europe collaborate with companies like Nasdaq?

The potential of strong collaboration between Nasdaq and our partners in Europe is boundless, and we are already collaborating extensively with governments in Europe, especially on market surveillance.

At Nasdaq, we are deeply committed to Europe and the future of its markets, and if we can combine our collective strengths and expertise, and align on our goals, we can create a more connected, innovative, and equitable financial system. With a careful but full embrace of emerging technology, we have the chance to drive progress and innovation, address complex challenges, and bring about more inclusive growth for Europe and for the world.

FINANCIAL STABILITY RISKS IN EUROPE

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

Staying ahead of the curve: financial policies in Europe

Europe's banks look solid: their aggregate Tier 1 capital ratio exceeds 16 percent, the liquidity regime is robust, and stress tests show resilience even in severe scenarios. Yet, just recently we saw how a failure of a US regional bank, Silicon Valley Bank (SVB), triggered a series of events that threatened Europe's financial stability. How could this happen?

The answer to this question is financial contagion. One channel of contagion is through counterparty exposures. These were minor for Europe in the SVB episode. Another potentially more capricious channel of contagion is market sentiment. In this context, even a small shock can become a "wake-up call", inducing market participants to reassess risks of seemingly unrelated financial institutions or markets.

Such contagion through market sentiment "gets in all the cracks". Markets seek out pockets of vulnerability and respond forcefully. This, arguably, befell Credit Suisse, a G-SIB. The bank had its challenges but was well-capitalized and highly-liquid and in the middle of a complex restructuring. Markets gave Credit Suisse some leeway, until the SVB's failure pushed them to reassess. Clients started to rapidly withdraw funding from Credit Suisse, and counterparty exposures to the bank became risky.

Decisive action quieted down markets. The Swiss authorities stepped in to stop adverse market dynamics, providing public support for an acquisition of Credit Suisse by UBS. Furthermore, all major central banks articulated their commitment to support financial stability without compromising on price stability. In particular, several central banks, including the ECB, announced their willingness to provide liquidity if needed, while continuing to use their main monetary policy tool—short-term policy rates—to control inflation.

But further jitters cannot be ruled out. For this reason, policymakers need to reassure markets that the financial system is resilient. Several measures can help achieve that:

- Supervisors can reduce uncertainty in markets by enhancing the transparency of banks' unrealized losses on hold-to-maturity security exposures. They should also continuously assess banks' liquidity, routinely perform interest-rate risk stress tests, and verify the stability of bank funding structures.
- As the financial cycle turns, banks need be prepared to deal with higher credit risk. Commercial and residential real estate prices may correct in several countries in response to higher interest rates, and corporate insolvencies and non-performing loans (NPLs) will likely rise as economic growth slows. To aid banks in this effort, supervisors should enhance the surveillance of emerging risks and policymakers around Europe should further expand the macroprudential toolkit.
- Policymakers must insist on a faithful implementation of Basel III standards. The IMF, alongside several EU regulators, expressed concerns regarding deviations from the agreed Basel III norms which came to light of recent EU legislative discussions. Indeed, the SVB failure speaks to the dangers of a selective implementation of bank regulation. Deviations from Basel III would make Europe's banks less safe.
- Recent events call for faster progress with completing the Banking Union. We anticipate that the ongoing EU review of the crisis management framework would expand the options for least-cost resolution of banks, covering also the less-significant institutions. The conclusion of the European Stability Mechanism (ESM) treaty ratification process would operationalize a financial backstop to the Single Resolution Fund. An agreement on the European deposit insurance (EDIS) would add credibility to any bank resolution arrangement.
- Capital Markets Union (CMU) initiatives are similarly consequential. The Commission's recent CMU legislative package for the first time includes steps toward harmonizing insolvency processes across member states. Stronger insolvency frameworks would expand firms' access to credit, help banks resolve NPLs, promote entrepreneurship, deepen European debt markets, and foster the green transition and economic convergence in the euro area.

The financial system has withstood the pandemic and the war in Ukraine thanks to forward-looking work by policymakers and regulators. Still, recent events made it clear that the process of building a more resilient financial system is far from over.

This contribution has been co-written by Alfred Kammer, Luis Brandao Marques and Lev Ratnovski, IMF.

MICHAEL WEST
President - Moody's Investors Service

Financial stability does not equal zero risk

The global economy has suffered substantial shocks in recent years. The COVID-19 pandemic saw large swathes of economies shut down for months, while Russia's invasion of Ukraine led to energy price spikes, disruption to the supply of certain commodities, and intensified near-shoring of businesses' supply chains. One industry that fared better than most was the financial sector - but recent events are putting it to the test.

The financial sector's previously strong showing reflects substantial support provided by central banks and fiscal authorities during COVID. The Federal Reserve took decisive action in April 2020; government support with furlough schemes and other measures also limited the deterioration of banks' asset quality. The industry maneuvered through recent turmoil better than in 2007/8, but we must be alert to significant risks and shocks it still faces. Financial stability can never be about removing risk altogether; the essence of market economies is risk taking, which sometimes ends in failure. It is important to distinguish between pockets of risks within specific parts of the financial sector – and risks that threaten the stability of the financial system in its entirety. Crypto is a prime example, where recent disruptions in crypto markets and the collapse of FTX did not morphed into threats for the normal functioning of banks and other financial market participants.

Looking at European banks' earnings for 2022, it would be difficult to discern this was a year when war broke out on the continent. Great strides have been made since the Financial Crisis. Banks around the world typically have more capital and better liquidity than in 2006, and regulatory authorities remain alert. European banking systems saw significant shocks, and some are still working through the legacy of bad debts: ratios for non-performing loans in Greece and Italy are still above average but have fallen substantially since 2016. As ever, the risk landscape is constantly changing. Recent developments in the banking sector globally, show that even banks with good capital ratios can suffer a dramatic loss of confidence when fragile sentiment is combined with doubts over strategy and governance. The consequences of the acquisition of Credit Suisse by UBS, supported by significant government liquidity lines, still need to be played out.

As central banks continue with monetary tightening, the cost of capital is rising and leveraged borrowers and positions will come under more pressure. There is a danger of sudden withdrawals from open-ended funds, possibly triggered by investors becoming more risk-averse following adverse developments elsewhere in the financial system. Such contagion can be hard to stop unless funds have liquidity management tools (LMTs); open-ended funds are particularly exposed.

Sudden withdrawals can lead to forced sales of assets and destabilize markets. This happened during the UK's gilt crisis last autumn, following the Government's mini-budget. In principle, the gradual move towards higher yields are positive for the solvency of pension funds; but funding needed for margin calls relating to derivative positions forced the sale of assets – including gilts – that risked destabilizing the wider financial system.

Similarly, margin calls were at the heart of governments' need to support energy suppliers in summer 2022. Again, the underlying positions of the financial trades were healthy; but the cash needed to support massive margin calls as prices shot up were beyond what firms could afford. It is difficult to discern where the next financial crisis will come from. Market participants and policymakers need to be alert and nimble, like central banks and fiscal authorities in previous crises. But it goes beyond banking. There is need for greater transparency in asset management in particular; we need a clearer sense of where leveraged positions are to assess potential risks and spillovers to the broader financial system. Indeed, revisions to the European Alternative Investment Fund Managers Directive, currently being considered by the EU legislators, include possible rules on LMTs and disclosures.

As ever, the risk landscape is constantly changing.

In bond markets, Moody's sees the next 12 months as challenging, but ultimately not presenting a systemic risk to the financial system. We forecast the global speculative grade default rate will increase from 2.8% to 4.7% over the period, well below the peaks seen in past credit downturns. Even in those instances, the bond market was often a symptom of wider systemic issues, rather than the trigger.

While financial stability does not mean all risk is eliminated, we all must remain vigilant on identifying new risks that could arise.

PETRA HIELKEMA

Chairperson - European Insurance and Occupational Pensions Authority (EIOPA)

Key lessons learnt from recent crises for long term investors

Over the last years the economy, the financial sector and insurance and pension industries have faced several unforeseen exogenous economic shocks such as the pandemic, supply chain disruptions, war in Europe and the energy crisis. Although European insurers and pension funds have successfully navigated the challenges, it is important to distil the key lessons to further improve the sectors' resilience.

At the outbreak of Covid-19, the main concern for the insurance sector was short-term financial market volatility, which has been well absorbed thanks to comfortable capital buffers. While the whole non-life sector with health, business continuity and worker compensation business lines came under scrutiny, it was the high uncertainty surrounding trade credit insurance claims and the risk of insurance coverage withdrawals that prompted a focused government intervention. The broader fiscal response also supported the economy and helped mitigate many potential negative effects.

Russia's invasion of Ukraine ended decades of geopolitical and security assumptions in Europe. While insurers' direct exposures were limited, the subsequent inflationary shock continues to pose serious challenges. For non-life insurers, the unexpected increase in the cost of claims has a negative effect on profitability with limited room for price adjustment due to competition while rising interest rates reduce the value of fixed income investments. Life insurers, which pay guaranteed returns in nominal terms, are less affected by inflation. Nevertheless, lapses may occur as investors seek higher returns elsewhere. Also, potential mid-term implications to the profitability and solvency amid reduction in underwriting and future profits might materialise. Here, supervisors and insurers must closely monitor developments together with potential mid-term implications on profitability and solvency and be ready to take appropriate measures to manage the risks.

Turmoil in the UK gilt market highlighted that if market movements are intense and fast enough, liquidity can be a risk for long-term liability driven investors like pension funds and insurers, where investments are concentrated in shallower markets. The ESRB highlighted liquidity risks in its September 2022 warning on vulnerabilities in the EU's financial system, suggesting that liquidity may be a wider concern. Although such a scenario cannot be ruled out entirely in the EU, the bloc seems less vulnerable to such risks as markets are deeper and derivative-using long-term investors tend to be well diversified in their holdings of fixed income investments so better positioned to cope with potential margin calls.

In March, several regional banks in the United States faced massive withdrawals of deposits, which ultimately led to the collapse of two of them. While triggered by bank-runs, one of the underlying causes relates to the sharp increase of interest rates in 2022 whose impact was not reflected into bank balance sheets due to the enforced book-value based regulatory regime. In the current situation, the risk of contagion through softer channels, such as reputation and fear, seems very high with the less robust banks being the first potentially facing severe consequences. European insurers have significant interlinkages with banks, particularly through investments in bonds. As a result, market corrections would lead to mark-to-market losses for insurers depending on individual exposures. That said, Europe's banking and insurance sectors seem well-capitalized to face current headwinds.

Insurers and pension funds have successfully navigated recent stress events but still headwind ahead.

From the crises shown above, a few valuable lessons can be learnt. First, as shown by the gilt crisis, long-term investors can both be subject to and generate liquidity shocks. Second, due to lack of substitutability, insurance activity can be potentially systemic, as demonstrated by the public interventions on trade credit insurance during the pandemic. Third, inflation is currently a material risk for insurers and assumptions used in the modelling are highly relevant to determine the value of Technical Provisions and capital levels. Fourth, when interest rates rise too quickly this can pose risks. It remains to be seen whether and to what extent the combination of inflation, which reduces consumer purchasing power, and higher interest rates will increase lapses on life policies in search for higher yields, putting insurers' solvency and profitability under pressure.

Bottom line: a robust supervisory framework based on a mark-to-market full balance sheet approach covering the whole risk profile of an industry is not a guarantee against crises, but it is key to containing the impact of adverse economic and market developments.

FRANK VANG-JENSEN

Group Chief Executive Officer - Nordea

European Banking needs a level playing field

The events in the financial sector that unfolded during March 2023 made many ask the question whether we are facing another financial crises comparable to the one that took place in 2007-09. First we saw the failure of Silicon Valley Bank in the US and then just a week later the rescue of Credit Suisse in Switzerland. Both of these situations escalated very quickly, almost out of the blue. By the time this article is published and read there may be additional developments that will have caused further turmoil. However, I feel that there are already important lessons that should be discussed.

In this article I will discuss two perspectives. The first relates to my confidence in the strength of the European banking industry as a whole, much of which is the result of strong prudential supervision and robust rules on capital, liquidity and risk management. The second relates to my concern about the lack of coordination in European macro-prudential measures and related buffers, and as a result, the clear absence of a level playing field and thereby a distortion of competitive factors between banks.

The troubles in the US were enabled by disparity of regulatory treatment. The medium sized banks were not subject to the same safeguards on liquidity as the major US banks following Basel standards. The Credit Suisse rescue shook markets, amongst other reasons, because the Swiss authorities did not follow the European standard approach to the treatment of investors. Our financial system is safe when it is subject to strong, stable and consistent regulation, applied in the same way to all. In contrast, banks that enjoy looser standards can attract business from those that follow stricter rules – and this will in turn create significant vulnerabilities in the financial system.

We have clear and harmonised EU rules and, within the banking union, SSM supervision as far as micro-prudential requirements are concerned, and we have a unified approach to recovery and resolution. All of these provide protection in the EU against similar events that we have seen in US and Switzerland.

However, even with the confidence I have on EU level regulation and supervision, I am deeply concerned about the absence of coordination within EU in relation to macro-prudential requirements, which still remain largely subject to national decision making. Macro-prudential buffers are inconsistently applied in the EU, and there appears to be no consideration of the total capital requirements faced by individual banks. The consequence is that banks can have vastly different capital requirements depending entirely on where they are located. It is the case that even banks that have similar relative size compared to their country of domicile face very different capital requirements What this means is that banks can have capital requirements that do not correlate with their risk profile. Such a deviation is not properly understood by investors. The turmoil of March showed that investor and depositor confidence in banks is paramount. Investor confidence in Credit Suisse was lost, its share price fell, depositors became concerned and withdrew their money. When confidence in banks is lost, no amount of capital will make up for it. At the same time, most of the banking sector is doing quite well, with low loan losses and improved profitability. This is very true for the lower risk Nordic banks that operate in resilient economies with strong social security systems.

Nordic authorities have been frontrunners in applying the macro-prudential tools to a greater extent than in other EU countries. This can be illustrated best with our situation at Nordea – we are subject to the high SSM micro-prudential standards and high Nordic macro-prudential buffers. This combination has driven our overall capital requirements higher than other major European banks. At worst, we see that macro-prudential instruments have been used as substitute for micro-prudential supervision. In addition, due to lack of consideration of their full impact, it is clear that certain requirements overlap and deviate from the ones faced by banks elsewhere with a similar low risk profile.

It is very difficult for investors to understand differences in capital requirements that do not correspond to the bank's risks. In this way, non-harmonised requirements can act against their intended purpose, and will harm banks' ability to compete on a level playing field and attract capital. Our unlevel playing field in capital requirements also interferes with the effective allocation of capital across banks and may inhibit cross-border mergers. As the EU Commission has acknowledged, we need to take action in Europe to harmonise the use of various macro-prudential instruments, covering all counter-cyclical and systemic risk capital buffer requirements. We also need to vest with the home supervisor the task of controlling the overall level of capital required from a single bank in order to manage the interplay and aggregate impact of the full set of different requirements. Recent events have clearly highlighted the need for consistency and level playing field. The common EU regulatory requirements and the accompanying supervisory and resolution regimes in the SSM should be trusted to do the job of delivering a strong financial system without significant country-specific deviations that remain unexplainable.

There is a temptation for regulators and supervisors to see capital as a solution to all problems. Capital did not help the US banks or Credit Suisse facing liquidity outflows. At the same time the economic outlook in Europe is unusual. After the fast recovery from the pandemic, the very long period of expansive monetary policy and then record-high inflation, the Russian assault on Ukraine and tighter financial conditions have all contributed to a challenging macro environment with increased uncertainty and lower consumer confidence. The regulatory response should not be to build capital buffers on buffers, but rather ensure that the rules we have are truly common and well-enforced. This is what is required to maintain the confidence in the safety of banks that can also support healthy growth in the economy. Capital and other prudential requirements need to be predictable and understandable across the board.

SOVEREIGN DEBT CHALLENGES

SYLVIE GOULARD

Bad debt drives out good?

Debt levels increased worldwide as governments and Central Banks intervened massively to support the economy after imposing lockdowns in 2020. To avoid a collapse in the midst of a pandemic certainly justifies exceptional measures. However, a look at figures makes clear that for some euro area countries, the current debt level is not the result of exceptional, time-limited measures but rather a long-term tendency. EU safeguards (and mutual commitments) conceived to keep national debts under control were largely ignored.

When the euro was launched, governments explicitly agreed to keep their debt below 60 % of GDP. Not all did. Most of the euro area current stock of debt existed long before COVID: either since the inception of euro when EC governments closed their eyes on some figures, or from the Great Financial Crisis. Some, like Mario Draghi as he served as Prime Minister in Italy, argue in favour of "good" public debt, "the debt that serves to finance well-targeted public investments; the debt that makes it possible to absorb exogenous shocks such as defense against a war or, precisely, as was the case with the pandemic; the debt used to make counter-cyclical policy"[1].

Well targeted public investments certainly have positive effects on growth, which increases the capacity to reimburse debt, creating a virtuous circle. Green transition, digital transformation and new geopolitical threats actually require investments of an unprecedented magnitude. But the necessary future flows of credit cannot be separated from the existing stock that was neither targeted, nor entirely productive. Statistics show that only a minor part of public expenditures were dedicated to productive investments (below 5 %): net public investment in the euro area between 2011 and 2019 was the lowest of advanced economies, but Japan. The most indebted countries of the euro area had (before Covid) in average less growth, less productivity gains and more unemployment. How can we be sure that governments will do better in the future, in particular when the elasticity of public expenditure is low, as they represent mainly wages of public servants and social allowances?

Time has come to make public opinions aware that our need to invest more in our security and in transition to Net-Zero implies difficult choices.

According to EU treaties, the ECB is strictly prohibited from giving credit to any public entity. Nevertheless, the total amount of monetary support goes above 5000 billion euros (2500 already before COVID). In 2022, 97 % of the exceptional pandemic purchase program (PEPP) consisted in sovereign bonds (states and supranational)[2].

For all these reasons, debt management is not a technical issue to be solved by playing only with maturity and rates. It is becoming a democratic issue.

Firstly, parliaments were born to make sure that representatives of the people consent to taxation and check the good use of public money, in the interest of the whole country. For decades, in some EU countries at least, national Parliaments got more and more used to authorize large deficits and to build piles of sovereign debt though their tax payers don't get what they pay for in debt services. Some political parties openly build their success on making people believe that money is available to live beyond one's means, at the detriment of future generations. Should we be surprised that difficult "structural reforms" (such as the increase of retirement age or competition) are rejected?

Secondly, the most indebted EU countries are not always the ones that have the fairest tax systems. Still sovereign bonds are considered "safe assets" because governments are entitled to raise taxes to reimburse them. Can we continue to envisage mutual monetary support, and more broadly cross border solidarity, without any convergence of tax bases in the Euro area?

Finally, it is striking to see rules that were democratically adopted by the European Parliamentarians and national ministers in 2011, the two branches of legislative power, aiming at reducing debt were not taken seriously. A reform of the Stability and Growth Pact is envisaged but there is no magic stick to deal with debt reduction; we should all begin with respecting more our mutual commitments.

As inflation requires now monetary tightening, which implies increased interest rates, the cost of public debt is increasing, making bad habits unsustainable. Time has come to make public opinions aware that our need to invest more in our security and in transition to Net-Zero implies difficult choices. Markets may no longer accept that, even for the best reasons, we pretend to raise debt according to our "needs", without taking into account our "abilities".

Only God can supply our needs in a sovereign way[3].

1. *Accademia dei Lincei, July 1st 2021.*
2. *Banque de France, Deux ans après son lancement, bilan du PEPP, Bloc-Notes Eco, n°276, juin 2022.*
3. *Philippians 4-19*

PER
CALLESEN
Governor -
Danmarks Nationalbank

Towards healthy public finances

Public finances rely on fiscal policy, cyclical economic developments in the short and medium term as well as longer term structural factors, such as ageing and retirement policies.

The last two years have seen robust economic growth, very strong labour markets, and a surge in inflation. The strong economy has boosted the fiscal balance, and inflation has to some degree reduced debt-to-GDP levels. These factors offer no room for complacency. There are significant risks to the fiscal balance and public debt sustainability going forward.

The inflationary environment, including energy-inflation, is an indication that economic demand, including energy demand, and activity exceeds the potential offered by supply factors, and a correction is therefore needed. To that end, monetary policy has been tightened, following a long period with very low interest rates. Bringing back economic activity to a non-inflationary environment will weaken some of those cyclical factors which are currently improving the public finance balances.

The lift in inflation works in the short term to cut the debt ratio, but only because it was unexpected. Going forward, higher inflation is accompanied with higher debt service due to higher interest rates. A lag between inflation and interest rates may also work the other way round in the coming years as inflation is brought back to target. That will raise the debt ratio. Inflation is no recipe for sustainable public debt ratios.

What can assist public debt sustainability is a low or negative r-g, the difference between interest rates and growth. Fiscal policy has, however, been expansionary for the last three years. First to compensate companies and wage earners for the lock-downs. Second to address a perceived risk of a confidence crisis following the lock-downs. And third by offering fuel subsidies in the context of soaring market prices, despite strict supply constraints at the regional markets for electricity and gas.

Expansionary fiscal policy in the inflationary environment raises the burden on monetary policy to bring inflation back to target, and such a policy mix will increase r-g. The direct budgetary impact from fiscal expansion thus risks to be reinforced by un-favorable debt-dynamics.

What can be done in the context of the Stability and Growth Pact to assist Member States in moving towards stronger public finances, debt sustainability and a better policy mix?

In good times with strong employment fiscal policy should be restrictive.

First, finding a good balance of ownership, flexibility and peer pressure. Sometimes twisting the emphasis and role of national plans can boost attention and incentives for delivery.

Second, stressing the need for tuning fiscal policy to economic conditions. In good times with strong employment fiscal policy should be restrictive, building up buffers for bad times and avoid raising the burden on monetary policy to contain inflation. In difficult economic times with low inflation, where a stimulus may be needed, credibility gains from including budget-improving structural reforms for the medium and longer term, not least retirement reform.

Third, the composition of public expenditures and revenues should continuously be reviewed with a view to improving structural conditions for growth and employment.

AXEL A. WEBER

President - Center for Financial Studies (CFS)

In the long run nothing is more expensive than free money

The European Central Bank (ECB) has just hiked interest rates again at its March 16th meeting and has taken interest rates from -0.5% to 3.5%. Monetary policy still remains expansionary, and the ECB is far from a hawkish policy stance with inflation at 8.6%/8.5% in January/February 2023. The ECB is still counting on the fact that the increase in inflation since 2021 will only be temporary and that inflationary pressure will decrease in the coming months even without a decisive tightening of monetary policy. The trend over the last few months and the ECB's own inflation forecasts indicate that inflation will continue to fall.

However, the ECB is playing a dangerous game by betting everything on this card. Economic forecasts have always been subject to a high degree of uncertainty. The impact of lockdowns, the unprecedented expansion of monetary and fiscal policies during the pandemic and the sweeping economic sanctions against Russia are virtually impossible to model and predict. The fact that inflation forecasts are all pointing downwards does not mean that inflation will actually fall or that uncertainties about future inflation developments have diminished. In fact, the ECB's inflation forecast have turned out to be grossly wrong quarter after quarter after quarter.

Forecast uncertainty today is not lower than before the war in Ukraine, it is greater. It is very easy to imagine an escalation scenario over the summer that could lead to a renewed surge in energy prices. The ECB is therefore counting on a fall in inflation despite forecast uncertainty remaining high.

The long and variable lags of monetary policy transmission combined with the too-late reaction of monetary policy to the rise in inflation poses major challenges for the ECB and its anti-inflation credibility. To be successful, monetary policy must act with foresight and thus be based on forecasts. But the more unreliable these forecasts are, the more important risk management becomes. In an environment of high uncertainty, monetary policy must above all avoid making major mistakes. In principle, two mistakes are now possible: the ECB can be too restrictive or too expansionary.

The long-run costs of a prolonged period of ultra-loose monetary policy and free money would be huge.

In the first case of a too restrictive monetary policy stance, the ECB causes an unnecessarily deep recession, accompanied by stronger disinflation and a possible renewed pockets of weakness and crisis in the financial or real estate markets. This is undoubtedly an unpleasant scenario, but not an existential risk for the monetary union. The tools for fighting deflation, should it emerge, are well known by now and some are still in place. It would also be wrong to change the course of monetary policy now in reaction to the recent financial market turmoil and banking jitters.

There are other policies tools like macro-prudential policy and micro-prudential banking supervision to deal with the problems of individual financial market segments or specific banks. Furthermore, central banks should be mindful in of the long-run consequences of a period of too-low for too-long interest rates. The current too-late tightening has made it necessary to move at an unprecedented speed and with mega-sized steps.

The tailwinds for asset prices and financial markets from ultra-low interest rates combined with ample liquidity from massively expanded central bank balance sheets have now turned into headwinds. The eruption of renewed financial instability is seen by markets not just as a reason for central banks to pause but to reverse the entire monetary policy tightening. This would be a grave policy mistake. The long-run costs of a prolonged period of ultra-loose monetary policy would be huge. 'Mission aborded' instead of 'mission accomplished' would undermine central banks' anti-inflation credibility even further. Central banks should not allow themselves to be held hostage by markets.

In the second case of keeping monetary policy too expansionary, inflation continues to be high and may even rise further. The ECB would then be forced to raise interest rates significantly further, possibly to a level above the rate of inflation. This scenario would pose an existential risk for the euro area, because many highly indebted member countries would face the risk of unsustainable debt dynamics and may be confronted with bond markets again betting against some governments' ability to service their debt.

If central banks act too hesitantly on inflation due to concerns about the impact of interest rate increases on public finances, they could risk being held hostage to fiscal dominance. Such a persistent inflation scenario in my view is undoubtedly today the more dangerous scenario and the best choice currently is to maintain a restrictive monetary policy stance in the face of high uncertainty amidst emerging signs of second round effects in wage-price dynamics.

The ECB pausing now could in the long run be the bigger risk for the cohesion of the euro zone than further removing monetary stimulus. Not doing so is playing with fire.

PROF. MAREK BELKA

MEP, Committee on Economic and Monetary Affairs - European Parliament

The connection between over-indebtedness and the EU's fiscal framework

Debt depends on several factors.

First, one has to look at the growth potential of a country's economy, as the higher the potential rate of growth, the higher relation of debt to GDP that a country can afford.

Second, one has to observe the size of a country's tax base - the bigger the tax base, the more possible it is for an economy to allow itself a higher debt to GDP ratio.

Third, often one mentions that the sustainability of a public debt is dependent on who holds the debt. It is assumed that residents provide for a higher stability of the debt in comparison to non-residents who are said to more easily change their sentiments and preferences and unload their holdings of public debt. Nonetheless, there is a trap in this kind of thinking. The recently observed banking occurrences show that high dependence on domestic financial institutions may create financial stability risks, which many have overlooked or underestimated.

A crucial factor in these deliberations is the level of interest rates. In the last 10 years we have gotten used to the thought that the interest rates will remain on a very low level for many decades to come. For some even a debt of 100% of GDP could have been perceived as sustainable. The recent developments, also connected to the outcomes of the Russian war in Ukraine, have proven that this way of thinking was a ticking bomb and is simply untrue. Central banks have been increasing interest rates in order to fight inflation, which - in most countries - stays way above the target rates. This, on the other hand, has been leading e.g. to banks' problems with solvency.

There is no such thing as a one-size-fits-all public debt to GDP relation that secures public debt sustainability. Still, one can agree that increasing public debt is dangerous.

People might believe that - as the post-WWII experience shows - high inflation rates might be an effective way to reduce public debt. However, high inflation undermines growth and cannot be tolerated by central banks forever.

The current fiscal framework should be replaced with a system that combines flexibility with fiscal discipline.

That being said, how to cope with high levels of indebtedness in the EU, especially in the euro area?

The Stability and Growth Pact does not function the way it should - it is not effective and frequently politically feasible. It is also pro-cyclical. Therefore, virtually everybody is convinced that some kind of reform of the macroeconomic management in the European Union is needed.

The question is: how?

There is an eternal tension concerning any SGP reforms between the North and the South of the EU. The former emphasize the importance of fiscal discipline and adherence to fiscal rules. The latter, on the other hand, emphasize that what one needs is flexibility and a system that can react to shocks, especially asymmetric shocks. What one needs is some effective effort to strengthen the fiscal rules to reconcile both sides.

In the European Parliament the discussion on the possible modification of the fiscal rules has been on the top of the agenda of the Economic and Monetary Committee since the beginning of the mandate. One of the discussion is on a possibility to introduce a certain kind of a "golden rule", which would liberate the budget rules by allowing more spending, especially green investments or military purposes.

In that case, what can be "given" to the frugal countries of the North? They need something to appease their public but also to make the system more coherent.

I believe that a proper way of action is to introduce some kind of expenditure rule, while having in mind that the simpler it is, the better it would function. This rule should define a limit of expenditure over the expected inflation. This measure would be less dependent on unobservable variables and could only function if the countries needing more flexibility would be given some kind of permanent fiscal facility to tap on in case of trouble.

To summarize, the existing way of managing macroeconomic activities, especially within the EU currency union, is impractical and may deepen market segmentation. It should be replaced with a system that combines flexibility with fiscal discipline.

LUDĚK NIEDERMAYER

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

EU's fiscal sustainability challenges amid recent crises

In recent years, the global economy, particularly the EU, was impacted by a series of unprecedented shocks, beginning with the global economic and financial crisis, followed by unprecedented pandemic, and more recently, security and energy crises triggered by the Russian attack on Ukraine. Society and economies have sustained these adverse events relatively well, but a major role was played by unprecedented fiscal policy interventions. Even though some of these measures were temporary, they have substantially increased budget deficits.

After the first of these events, the global crisis of 2008, some years allowed for correction of the situation, but not all states used this option. Good illustrations of this can be seen in the data from the two largest EU economies, Germany[1] and France[2], before the crises, at their peaks, and in 2015 or 2017.

While in general, the "good years" between global financial crisis and the pandemic were used for debt reduction, the stock of debt, especially for some Member States, was a source of concern.

The strong fiscal policy response to the pandemic was fully justified, as were some measures used to address energy crisis. Nevertheless, it should be noted that while in theory, the proper response to such crises should be directed towards those most affected and in need of help, in reality, according to several analyses, only a relatively small part of the measures (less than one-third) were used in such a way.

Again, while in theory, these should be rather one-off measures, the reality can be different, as the data from post-2010 illustrates. If a short period of excess, spending is not followed by a longer period of "normalization" of fiscal policy near a very low level of deficit, fiscal sustainability can be put in danger as the level of debt can steadily grow.

There are at least four factors that can be a concern for fiscal sustainability: lack of growth, lack of rules, the possible end of a low-interest rate environment and lacking adjustment to the new normal. Below I set out the reasons for my line of thinking.

Balancing crisis response and fiscal sustainability is crucial for the EU's economic future.

Lack of growth

It is no secret that at least some EU economies have problems with growth. Starting with growth not supporting demographic outlook and ending up with problems in enforcing necessary reforms. One cannot count on strong nominal GDP growth that supports fiscal sustainability even in the case of relatively high debt.

Lack of rules

EU fiscal rules based on "unobservable variables" (output gap, potential growth) do not provide fiscal guidance in the short run, which is essential for "good" yearly budgets of Member States. Unfortunately, the Commission was too slow to present a well-considered proposal based on the long-term work of the EU fiscal board. Therefore, fiscal rules that will be again fully applicable after the expected lifting of the "general escape clause" will not be adequate and will not play a sufficient role in navigating budgets to a safer path.

Possible end of a low-interest rate environment

A few years ago, when I was involved in assembling the EP view on the new fiscal rules, it was taken for granted that nearly zero percent interest rates would remain forever. As we now see, this was a big mistake, and some countries are paying a high price. It is just a matter of arithmetic to see how substantial the impact of "not low interest rates" on highly indebted countries is.

Lacking adjustment to the new normal

Lastly, we should consider whether the experiences of the last decade and a half of substantial fiscal involvement in dealing with various crises should be reflected in policy setup. The situation where governments are supporting businesses in crises with billions of euros in grants is simply inconsistent with efforts to keep corporate tax rates very low, for example.

In conclusion, the recent crises have presented significant challenges to fiscal sustainability in the EU, particularly due to the strong fiscal responses and the lack of subsequent surpluses or very low deficits. With the current increase in interest rates, these risks are becoming more apparent, and it cannot be assumed that interest rates will remain low in the long term. While the responsibility for ensuring fiscal sustainability primarily lies with individual Member States, the EU should also introduce more straightforward and controlled fiscal rules to reduce macro risks for the EU-wide economy.

By working together, the EU can mitigate the challenges posed by these crises and ensure a sustainable fiscal future.

[1] https://tradingeconomics.com/germany/government-debt-to-gdp
[2] https://tradingeconomics.com/france/government-debt-to-gdp

COLIN ELLIS
Global Credit Strategist - Moody's

Euro area sovereigns face medium-term challenges to debt sustainability

Governments around the world have faced a challenging few years as they responded to large shocks. The public sector balance sheet has played its role as the ultimate backstop to cushion against these negative shocks, and we see this reflected in substantial increases in government debt around the world, including in Europe. Our outlook for euro area sovereign credit this year is negative, reflecting the sizeable fiscal challenges those sovereigns face, as geopolitical, energy and economic trends remain adverse in the near term, while longer term structural shifts pose growing credit risks.

Stepping in to provide support during the COVID-19 pandemic, and more recently to cushion households and businesses from the fallout from Russia's invasion of Ukraine in the form of elevated energy prices, were sensible steps for governments to take. But these fiscal measures over the past three years followed two decades that witnessed several negative shocks that have left public debt burdens at near-time highs in many euro area countries. France, Italy, Spain and Belgium all have debt-GDP burdens in excess of 100% and those burdens are all more than 10 percentage points higher than pre-pandemic levels at a time when interest rates are rising.

At the moment we have negative outlooks on our sovereign ratings for Italy and Slovakia, amongst others, where downside credit risks will grow over the medium term without clear steps to counter them. Importantly, these risks are not simply about the recession many euro area countries may experience this year; euro area sovereigns should be relatively resilient to short-lived downturns in economic activity, although removing energy support measures may prove politically challenging.

Rather than near-term dynamics, it is the list of medium-term challenges facing governments that is more troubling. Demographic effects of aging populations are already lowering trend growth in many places; this is compounded by the rising real cost of healthcare funded by sovereigns; social risks are rising as citizens' living standards stagnate or fall; stuttering globalization is hitting Europe's model of trade-driven growth; and both domestic and geo-political risks threaten policy predictability and effectiveness. With unchanged economic and fiscal strategies, a number of euro area sovereigns face adverse debt dynamics over the long term, with a few of them facing dire prospects.

Investors remember the three sovereign defaults in the euro area.

This is clearly a potent and worrying mix. The good news is that euro area countries have both the opportunity and the time to address these risks, and some have made significant strides. Examples include the former programme countries Greece, Portugal, Cyprus and Ireland – three of these currently have positive outlooks on their ratings. In this context, the Next Generation EU (NGEU) plan is a transformational prospect for European countries, and should bolster growth and employment over coming years as the funding flows and structural reforms are enacted. That said, for most countries we expect the positive impact from NGEU to be more than offset by the slowdown in potential growth from ageing populations by the end of the decade. And the true test of NGEU will be whether it raises sustainable rates of economic growth long after the money is spent.

Euro area countries, like many other advanced economies, have relatively long average debt maturities. This means that recent rises in interest rates and yields will be felt gradually in terms of the public finances. That being said, total debt with a maturity of less than one year exceeds 20% of GDP in Italy, is around 17% in Spain and over 14% in France. So euro area sovereigns would not be immune to market disruption. Prolonged market dislocations for sovereigns would worsen governments' debt-affordability prospects further, increasing interest payments relative to revenues, and could significantly weigh on their credit profiles.

It is now ten years since three sovereign defaults in the euro area shocked financial markets and left investors facing sizeable losses. Investors remember these events. Euro area governments must be alive to the risks that sustained and repeated increases in public indebtedness bring in the context of sluggish medium-term growth prospects.

MANAGING RISKS IN THE BANKING SECTOR

NATHALIE AUFAUVRE

Secretary General - Autorité de contrôle prudentiel et de résolution (ACPR)

EU banks' strengths for a challenging future

The EU banking sector is facing strong headwinds in 2023 with heightened geopolitical risks, high inflation, rising interest rates, high debt levels, the phasing-out of accommodative monetary policy and a deteriorated economic outlook. Against this challenging background, EU banks appear quite resilient, thanks to the strengthening of their financial structure and risk management following the great financial crisis. Nevertheless, some key areas of focus are bank funding and liquidity risks as well as credit risk.

With the failure of several US regional banks and the rescue of Crédit Suisse by UBS, the focus on bank funding and liquidity dramatically increased in March leading to significant stress. Bank funding and liquidity conditions have indeed been changed by the normalisation of the monetary policy that will be achieved, in the euro area, via a combination of a rise of key interest rates, the winding down of asset purchase programmes and the reimbursement of the TLTROs. This will tighten further funding conditions by three levers simultaneously, with potentially overlapping impacts:

i. rising key interest rates could increase the costs of short-term borrowing as well as deposit funding while reducing the valuation of fixed income assets;
ii. winding down asset purchases programmes could raise the cost of longer-term borrowing;
iii. TLTRO repayments could lead to a decline in excess liquidity raising the cost of short-term borrowing (in the interbank market) and long-term borrowing (by necessitating more market issuance by banks).

Yet, the ECB has committed to ensuring that its "balance sheet is normalised in a measured and predictable way"[1] thereby allowing banks time to adapt to this new environment.

Although not yet materialised, credit risk is an increasing area of attention due to the deteriorating economic environment: inflation (that affects consumer goods, energy and wage costs) and rising rates (especially in countries where loans are variable-rate) put pressure on the repayment capacity of borrowers. Banks have already translated this heightened credit risk in their accounts through material transfers of exposures from stage 1 to stage 2, and posted additional provisions accordingly; this comes on top of the reserves built up during the Covid crisis, which most banks have kept unchanged given the persistent uncertain global outlook.

Finally, the current volatile market environment also bears higher market and counterparty credit risks, which could be amplified by the procyclical behaviour of some less regulated non-bank financial institutions (NBFIs). The collapse of Archegos has shown that banks should manage their counterparty credit risk adequately when dealing with less transparent counterparties. Participants with high leverage, including through derivatives, liquidity mismatch or low cash buffers are especially vulnerable to adverse market movements which can lead to large deposit outflows or spikes in margin requirements; and these liquidity strains can contribute to disorderly increases in volatility in certain market segments, as the UK pension funds crisis in late September 2022showed.

When facing these challenges, European banks can however rely on robust levels of profitability along with solid capital and liquidity positions, while some areas of the NBFI ecosystem are now better regulated.

- The increase in interest rates has already started to foster net interest income (NII), which is traditionally the core source of banks' revenues. While higher interest rate may also mean value adjustments of fixed income assets, it is worth reminding that the EU accounting framework requires negative unrealised losses on available for sale securities to be recognised in banks' own funds.
- Thanks to the Basel III reform that apply to all EU institutions, banks now hold more and better capital buffers. In addition, su-pervisors are regularly assessing banks' risk profile, requiring when needed an extra layer of capital to absorb foreseeable shocks. The interest rate risk in the banking book is one of those risks that are monitored on an ongoing basis, through its im-pact on both NII and economic value of equity, with limits that trigger corrective action should they be outpaced.
- Irrespective of their size, EU banks also have to comply with short- and long-term liquidity requirements. These have led them to build comfortable buffers that prevent them from fire-selling held to maturity securities should they face a quick and mas-sive withdrawal of deposits; it has also reduced excessive maturity mismatches that have been at the roots of some US banks' recent troubles.

Finally, derivatives markets are much more resilient, which should greatly reduce contagion risks from NBFIs to banks. However, the recent turmoil shows that there is no room for complacency. In particular, we should now make progress on international regu-lation on the NBFI sector, both from micro and macro prudential perspective.

1. *Monetary policy in a new environment (europa.eu)*

FRANÇOIS-LOUIS MICHAUD

Executive Director - European Banking Authority (EBA)

Risks and vulnerabilities of the EU banking sector

Since the great financial crisis, and driven by changes in the regulatory framework, banks' financial positions have improved significantly. Capital ratios for European banks have increased steadily over the past 10 years and the average CET1 ratio stood above 15% in December 2022, well above regulatory requirements (around 10%). With an average capital headroom of 5%, Europe's banks are in a much better position compared to 2008/2009. Similarly, the liquidity ratios have improved over the past years with the average liquidity coverage ratio (LCR) for the European banking sector at above 160% and the net stable funding ratio (NSFR) at 125% in December 2022.

The exit from the pandemic, geopolitical developments, and the energy crisis have pushed up inflation at levels not seen since the 1980s. Central banks across the world have responded with successive interest rate rises to tame inflation, which will transmit to economic growth, debt and equity valuations and house prices. Market expectations have pointed that this could continue into 2023, albeit at a slower pace than in 2022.

Despite comfortable buffers on the whole, some banks might face challenges going forward amid a potentially worsening economic environment or due to spill over effects from challenges that the global banking sector currently faces.

Asset quality

So far, EU banks' asset quality has remained good overall with a non-performing loan (NPL) ratio remains at historically low levels and only a handful of banks now report NPL ratios of more than 5%. In December 2022, the overall cost of risk in the EU banking sector stood below pre-pandemic levels. First impacts of higher rates are already visible in banks' outstanding loan volumes, which declined in the fourth quarter 2022. This reflected a slowdown in the demand for loans while banks have also been tightening their credit standards. Signs of a slight deterioration of asset quality could also be perceived, with a share of stage 2 loans at a very high level and an increase in provisions for performing loans. Bankruptcies, which were at a low level during the pandemic, have increased in several European countries. The EBA stress test results to be published in July will shed useful light on EU banks' resilience in a baseline as well as in a very severe adverse economic scenario.

> **Recent development reminded of the importance of risk management.**

Profitability

Strong net interest income, driven by increased margins, helped banks to improve their profitability in 2022. European banks reported a return on equity of 8.1%, on average. This is the highest profitability ratio banks have reported for many years. After the lifting of pandemic-related restrictions, banks generally returned to elevated pay-out ratios (around 50%). Lower growth can be expected to result in reduced lending volumes and rising impairments, while higher rates will increase funding costs and higher inflation will increase operating costs.

Funding risks and costs

Banks with sound business models and an ability to keep costs under control during downturn periods will naturally be better placed to navigate challenging market conditions. Indeed, higher rates will also increase funding costs and banks must adjust to a changing environment. This includes possible higher expectations from clients on the remuneration of their deposits. Banks also have to factor in the repayment of the substantial amounts of funds obtained via the ECB's longer-term refinancing operations (TLTRO), either thanks to their large central bank reserves, issuing additional debt or competing to attract more deposits. Some banks also need to keep building up capital buffers or eligible liabilities (MREL).

Risk management and supervision

Maturity transformation is at the heart of banking, and managing interest rate risk is key in banks' risk management. The recent situation of Silicon Valley Bank (SVB), the 16th largest bank in the US, was a clear illustration of the possible challenges for asset-liabilities management in a context of rapidly rising rates, especially for a bank displaying a very concentrated depositors' base. While SVB admittedly had a peculiar business model, it also triggered a series of market developments across the banking sector globally and beyond. This showed -if needed- that confidence remains key and reminded of the importance of adequate risk management and demanding supervision. Market participants should take comfort from the regulatory reforms implemented since the Great Financial Crisis, which have massively increased banks' shock absorption capacity.

TANATE PHUTRAKUL
Chief Financial Officer - ING Group

Bank risks in an environment of rapidly rising rates

After seven years of low rates, since last Summer, central banks on both sides of the Atlantic have been raising rates at a pace not seen in many decades. This has brought new challenges for banks. The recent turmoil is witness to that. This time, the challenges do not relate to capital, not even to liquidity. They relate to interest rate risk.

Managing interest rate risk is one of the core competences of a bank. It is about managing the mismatch in duration of assets vs liabilities, setting a risk appetite for this mismatch, and then managing the mismatch within appetite.

On the asset side of a bank's balance sheet, duration is mostly laid down in contract terms of loans and bonds. Of course there are uncertainties like early repayments and other options and contract triggers. Those have to be modelled and estimated, which works quite well at portfolio level.

Things look different for bank liabilities. Duration here is much more driven by behaviour. When a bank issues bonds, it pretty much has duration management in its own hands. But I want to focus on deposits, which after all are the dominant liability for most banks. With deposits, it's depositor behaviour that drives duration. Many deposits are overnight, or redeemable at notice, giving them a very short duration in theory. But while individual balances fluctuate, the aggregate is remarkably stable. So in practice, current accounts in particular are quite insensitive to interest movements – or in bank parlance, they have longer duration than their overnight label suggests. But what duration exactly? It is up to banks to model depositor behaviour. This may differ per bank, as clients profiles and characteristics may also differ.

Depositor behaviour can be modelled quite effectively at portfolio level, leading to an estimate of the duration of a bank's liabilities on that basis. This is then put next to assets' duration. The mismatch between the two should not grow too large, as that enlarges interest rate risk. The duration of assets (the loan and securities books) can partly be hedged through "natural" offset from the modelled duration of customer deposits. Natural hedging may not reduce the duration mismatch completely to fall within risk appetite: many people still want to be able to take out a 30-year mortgage. Remaining mismatches are thus hedged by interest rate swaps. Next to that, marketable securities are typically hedged by swaps also to reduce capital volatility.

The best defence against a bank run is a strong viable business model combined with customer trust.

For the modelled deposit duration, it matters whether the portfolio consists of many small deposits, or of a few large ones. And it matters whether the depositor base is very diversified, or concentrated in one economic sector, or in other ways might experience correlated shocks. Estimates depend on the assumption that individual depositor shocks and actions roughly cancel out at portfolio level. That ceases to be true when depositors all of a sudden start to behave in synchronous, correlated ways. At such times, the duration of funding could suddenly turn out a lot shorter than estimated, leading to a larger duration mismatch and bigger interest rate risks.

The ultimate unexpected correlated depositor behaviour is a bank run. That outflows can turn into uncontrollable runs, has been known for centuries. But one of the surprising things of the recent turmoil has been the speed and size of deposit outflows. It appears that the availability of digital tools for clients to manage their bank deposits, combined with the speedy propagation of news, rumours and communicated responses brought by online communication platforms (both closed groups and open social media) have made possible even faster run dynamics. it would be good to thoroughly evaluate the run dynamics observed in the recent turmoil, and to review our tools. Yet we also should not be obsessed by bank run risks. In the end, they are mostly the symptom of, or response to, an underlying problem. We'd do better to focus our attention to prevent those problems, and manage them well when they occur. The best defence against a bank run is a strong viable business model combined with customer trust.

Part of such a viable business model is managing interest rate risk, to prevent problems when rates rise fast, as they have been doing in the past year. And the conclusion I draw here is not that we should revisit interest rate risk regulation, or the ways in which European banks hedge them or account for them. Existing regulation gives supervisors ample room to monitor interest rate risks, review the models concerned and require refinements where desired.

It is however important to account for potential concentrated or correlated exposures in e.g. stress testing. That is a lesson that was learnt long ago for bank assets, but is increasingly relevant for liabilities as well. This is especially important given the substantial sums of deposits in the European banking system, partly caused by past monetary policies (quantitative easing).

CHRISTIAN EDELMANN

Managing Partner, Europe - Oliver Wyman

Vulnerabilities in the European banking sector - And how to address them

The past few weeks have shown that rapid rate hikes come with consequences and that, despite the regulatory overhauls after the global financial crisis, banks can still fail. While some of the ingredients of those failures were US- or bank-specific, contagion worries have hit European banks, wiping out almost a quarter of their market cap since the recent peak in 2022.

Rate-increase cycles play out for banks in different ways over multiple horizons.

Phase one, the short-term, is typically beneficial: Deposit betas remain low, net interest margins (NIM) increase, earnings improve, and valuations rise accordingly. That was a main driver of market cap gains for European banks last year.

Phase two, the medium term, is more balanced. Deposit betas go up as customers hunt for better rates—and recent bank failures have accelerated that journey, with some depositors fleeing to safety and banks pricing up. In addition, the active side of the balance sheet starts to feel the impact of higher rates. Corporate defaults increase, particularly among those most exposed to inflationary drivers such as energy-intensive sectors. As incomes lag rising inflation, housing affordability decreases and mortgage volumes come down, offsetting NIM gains. And rate increases impact the banking book, resulting in mark-to-market losses if banks are forced to sell assets.

In phase three, the longer term, NIM volatility increases, because interest rates can go up or down in the future. The recent bank turbulence may have accelerated the journey toward this phase; while the ECB and the Fed went ahead with rate hikes, markets are uncertain on future central bank decisions.

To manage through this crisis, banks should embrace three short-term priorities.

The GFC led to big divergence between banks; that will play out again now.

First, they should reactivate their deposit gathering muscle, through better understanding of deposit behaviour and advanced pricing capabilities supported by models that inform volume and margin trade-offs and liquidity positions aligned with bank targets. This requires targeted, client segment specific commercial actions, revisiting fund transfer pricing and relationship manager incentives supported by marketing campaigns.

Second, banks should ensure their interest rate risk in the banking book (IRRBB) setup is fit for purpose in the new environment to deliver balance sheet and earnings stability. Given the speed of rate hikes, this requires increased management attention and reinforced governance.

Third, banks should examine liquidity reserves, including the ability to monetize securities positions under stress scenarios, and revamp their crisis preparedness, including revisiting resolution and recovery plans and running tabletop exercises that address the potential impact of social media in a bank run.

In terms of strategic agendas, European banks have been returning capital to shareholders through buybacks and dividends to boost valuations; price/book ratios were at approximately 0.6 at the beginning of 2022 and rose to about 0.8 before the crisis unfolded in early March. This can't endure in the long term. Banks need to convince shareholders that some of this capital is better used invested in business model transformation and a move toward more efficient client-centric platforms.

Many banks have failed to deliver on that front and now need to ramp up their performance transformation capabilities to succeed. Some banks could use this capital to expand their footprints through M&A for scale and diversification — both in terms of funding and lending/investment choices.

The ECB's thoughtful application of the Liquidity Coverage Ratio and the Net Stable Funding Ratio has proven critical so far, but there are other areas policymakers and regulators to review. While the ECB has been welcoming of cross-border M&A, more may be needed to help banks pull the trigger. Regulators should consider creating a "European Banking Label" based on providing financing in multiple European economies to incentivize banks to make these moves. This should be done jointly with the banking and capital markets union, which are needed to help banks diversify funding bases and manage exposures more actively via a vibrant securitization market.

If the global financial crisis showed anything, it is that there was a huge divergence between banks that adjusted business models quickly and those that didn't. It is likely this movie will play out again.

FUND LIQUIDITY ISSUES

FRANCESCO MAZZAFERRO
Head of the Secretariat - European Systemic Risk Board (ESRB)

This text does not necessarily represent the views of the ESRB and is uniquely attributable to the author.

Addressing fund liquidity issues: the opportunity of a booming MMF industry

At the last panel discussion on Money Market Funds (MMFs) at Eurofi in Prague (September 2022), it was noted that monetary policy normalisation would have led to large inflows to MMFs, as this historical pattern was confirmed by persistent developments in the last decades. To the contrary, other types of investment funds would have been facing potential issues due to sudden bond repricing. It was also noted that this positive market outlook for MMFs represented an opportunity to fix some structural weaknesses of their regulation at a time when asset managers were strong and had resources to accommodate regulatory changes.

The first part of those conclusions (the increase in MMF assets) has materialised, to the point that one could speak of a MMF industry boom. For instance, after the LDI episode in October, MMFs in the United Kingdom received inflows from pension funds for around £50bn. Since the US regional banks showed important weaknesses, more than USD250bn have moved from bank deposits to MMFs in the United States in one single month. Compared to one year ago, US inflows have summed up to more than USD540bn. Also in Europe, MMFs had around EUR35bn inflows in March. Of course, on both shores of the Atlantic there has been also some reallocation from MMFs exposed to private debt to MMFs exposed to government bonds, possibly reflecting a desire to cut down indirect exposures to the banking sector.

The second part of last panel's conclusions (benefiting from favourable market conditions to achieve better MMF regulation) has unfortunately not materialised yet, despite of work at the FSB and in Europe at ESMA, the ESRB and the ECB. Yet, authorities are worried that an inflated MMF sector – still suffering of systematic first-mover advantages – might experience new tensions with a potential adverse systemic impact on the financial sector and the economy. On 21st March Verena Ross (ESMA) stressed the need of a regulatory review at the ALFI fund industry conference in Luxemburg. The latest Financial Policy Review of the Bank of England reiterated the request on 29th March and announced a forthcoming industry consultation. One day after, Secretary of the Treasury Janet Yellen abundantly referred to MMF systemic vulnerabilities and the need for a regulatory response in a speech at the National Association for Business Economics Conference in Washington.

This happens at a time when market analysts are interrogating themselves on the liquidity impact of MMFs for global liquidity conditions. For instance, they are discussing whether the increased use of the FED reverse repo facility by MMFs in the United States (around USD 70bn only in March) may or may not impact on the liquidity of the US banking sector, in particular for smaller banks. The impact of MMF inflows on global liquidity conditions seems to be less pronounced in Europe.

More generally, several episodes of market illiquidity have materialised during 2022H2 (energy price squeeze in August-September, LDIs in September-October). Recently, questions on liquidity conditions have been compounded by the flightiness of the bank deposit base after the runs at Silicon Valley Bank and Credit Suisse. Much has been written on the impact that FinTech may have on the speed of bank withdrawals. Also, the recent developments related to AT1 bonds are a reminder that market liquidity conditions can deteriorate suddenly. Finally, liquidity has also become an issue in some life insurance markets in Europe.

Turning back to the fund industry, structural liquidity mismatches which need to be addressed are also present in some corporate bond funds. In the European Union, progress has been made in the context of the AIFMD/UCITS review to enhance liquidity management provisions for all UCITS and AIFs with an improved access to liquidity management tools (LMTs) and an enhancement of reporting obligations. This legislation has entered the trialogue phase and should be concluded in this parliamentary term.

Besides liquidity, also credit risk is on the rise. Think, for instance, about Commercial Real Estate exposures of institutional investors, which are receiving more and more attention from a financial stability perspective. The jury is out on whether these CRE risks should be addressed horizontally through a single regulatory action impacting on financial sectors (banks, insurance, asset management, private equity, etc.) or whether it is more appropriate to review existing sectorial regulation through a coordinated reform. However, the perception of the need for action is increasing. For instance, the latest article "The growing role of investment funds in euro area real estate markets: risks and policy considerations" by Pierce Daly, Lennart Dekker, Seán O'Sullivan, Ellen Ryan and Michael Wedow, published in the ECB website on 1st April, includes an analysis of vulnerabilities of Real Estate Investment Funds (REIFS). Their message is aligned with the January 2023 recommendation of the ESRB on "Vulnerabilities in the commercial real estate sector in the European Economic Area."

More generally, the credit quality of bond fund holdings remains a concern, with bond fund holdings below investment grade rating amounting to approximately 40%.

MARTIN MOLONEY

Secretary General - International Organization of Securities Commissions (IOSCO)

The illiquidity premium and financial stability

It is well understood that instruments that are hard to trade or just don't trade benefit from a premium, even if this is never the only influence on returns and pricing. If I am an asset manager trying to maximise returns for my clients, it is very tempting for me to invest in such assets. But if I offer an ability for investors to get their money back at short notice, I have just created a huge problem for myself : to attract customers, I have just added to the risks of my fund not functioning properly.

Normally the threat is manageable. In most investment funds, the amount of shares that are redeemed at any time is low. The outflow is often covered by the inflow of new investments. If it isn't, I will usually keep a small cash or near-cash buffer to deal with those situations. There is a bit of a disadvantage for investors in this, because the bigger the cash buffer the lower the overall return on the fund. If I keep a very large cash buffer, I could easily wipe out the illiquidity premium. If I am invested in equities and that cash buffer proves inadequate, I can easily go to the market. Equity trading is almost never all one way. There is almost always someone willing to invest, if the price is right. Consequently, I may be forced to sell at a time that harms the interests of the continuing investors, but I can sell.
However, there isn't much of an illiquidity premium in equities. I have to go elsewhere for that. So I go to bonds and similar assets. If I am an MMF manager I go from short term treasuries to bank CD and CP. To increase my client's returns I have now created a risk that I might not be able to return them their investment when they want it. And if I can get it back to them, I have created a risk that I will do so only at the cost of significantly damaging the investment of remaining investors.

Moreover, as monetary policy is tightened and interest rates rise, so does the liquidity premium, meaning that issue becomes more acute.
IOSCO and the FSB have been urging asset managers to design funds with this in mind, to develop contingency planning with this in mind and to get better and better at liquidity management with this in mind. Asset managers have responded. Contingency planning is getting better. Liquidity planning is getting better. But what is not getting better is fund design. Asset managers continue to offer daily dealing on funds designed to be invested in highly illiquid assets. It isn't credible. It threatens stability.

There are two things that need to be done: asset managers need to ensure that redeeming investors rather than continuing investors bear the full cost of leaving investment funds. Secondly where asset managers continue to design funds in this way, they should be subject to tighter regulatory regimes. There is more work to be done on this.

Contingency and liquidity planning are getting better, fund design is not.

This year IOSCO will produce guidance on swing pricing and related measures that investment funds can use to ensure that redeeming investors pay the full cost of redemptions in a period of stress. The FSB with IOSCO fully involved in the work will also revise its 2017 Recommendations to encourage a greater focus on those funds which have the least liquid assets. IOSCO will then reflect on additional steps it can take to encourage jurisdictions and asset managers to zone in on those funds which have the least liquid assets and which are most likely to amplify stress if they face a large wave of redemption demands. Of course, none of this is exhaustive in that we have seen recently that even the most liquid securities markets can be problematic in a period of stress. But the emphasis is correct.

There is also a third potential part of this package of measures. We often talk about the 'market' for CD, CP, corporate bonds and other alternative assets. Many of these assets have a secondary market in name only or an under-developed secondary market relying on clunky RFQ procedures and with little transparency. The problem can be hidden by the existence of ETFs invested in those assets which appear to resolve the price discovery process for rarely traded assets. But the truth remains: these asset markets are as far away from equity markets in terms of structure, liquidity and secondary trading as it is possible to be. That is why they 'benefit' from a liquidity premium! And yet we have made little progress on developing well structured secondary markets in these assets.

There are numerous interested parties telling us it can't be done. Perhaps not. But if it cannot be done, then the question we face is how tight the regulatory regime needs to be for daily dealing investment funds that continue to insist on searching out that illiquidity premium.

LEE FOULGER
Director, Financial Stability Strategy and Risk - Bank of England

Money market funds – the need for reform

Since the global financial crisis, when problems in the global financial sector led to a deep recession, policy makers have sought to ensure that the financial system can absorb not amplify shocks, supporting the economy in good times and bad.

Market-based finance (MBF) plays an important role in today's global financial system. Between the start of the global financial crisis and end-2021, MBF more than doubled in size, compared to banking sector growth of around 60%. MBF now accounts for around half the total assets making up the global financial system. It also plays an important role providing finance to the real economy. In 2021, MBF intermediated around half of all lending to UK businesses and since 2007, accounted for nearly all of the growth in lending to UK businesses.

Vulnerabilities in MBF can impact financial stability in a number of ways: directly through reduced provision of credit to households and businesses, through exposures to systemic institutions such as banks, or by amplifying volatility in markets and contributing to core market dysfunction, which can impact financing conditions in the real economy. Vulnerabilities in MBF can take a number of forms, including liquidity mismatches in money market funds (MMFs) and open-ended funds (OEFs) or under-preparedness for liquidity demands from margin calls or leveraged positions. This article is focused on one of these vulnerabilities: liquidity mismatch in MMFs.

The 'dash for cash' in March 2020 demonstrated the importance of ensuring that non-bank financial intermediation is resilient enough to manage liquidity risk in times of stress. MMFs came under severe strain, as investors sought access to cash. Confronted with severe redemption pressure, many MMFs struggled to maintain liquidity levels significantly above the 30% weekly liquid asset requirement and found their ability to generate additional liquidity, for example through asset sales, constrained. This increased the risk of suspension, and in turn the incentives for investors to redeem.

The quick and large-scale responses by central banks including the Fed, Bank of England and ECB, together with fiscal policy measures, restored market functioning. Without those extraordinary measures, the redemption pressure on MMFs may have continued, and some funds may have chosen to suspend redemptions. This could have led to companies failing to make business critical payments – with potentially wide repercussions across the global real economy and financial sector.

MMFs play a crucial role in the financial sector and real economy.

MMFs are subject to liquidity regulation brought in after the 2008 global financial crisis. However, the vulnerabilities exposed in March 2020 demonstrated that, despite this regulation, MMFs may not be sufficiently resilient to severe but plausible market stresses.

MMFs play a crucial role in the financial sector and real economy. During the September 2022 stress, some MMFs used by LDI funds saw outflows that were bigger than during the dash for cash. More recently, MMFs based in the US and Europe that invest in short-term US government debt have seen large inflows following the recent stress in the banking sector. These events highlight the interconnectedness of the financial system, and the important role that MMFs play in this system as a vehicle through which many other corporates and financial companies maintain their own resilience – be it cash management or a source of liquidity for margin payments or leveraged positions. For financial stability, it is therefore necessary that MMFs maintain sufficient resilience.

Robust international policy action has been taken: In 2021, the Financial Stability Board (FSB) published Policy Proposals to Enhance MMF Resilience to address the structural vulnerabilities and 'run risks' associated with MMFs.

FSB members agreed to assess and address the vulnerabilities that MMFs pose in their jurisdiction by utilising the framework and policy toolkit set out in the report, which includes measures to impose on redeeming investors the costs of their redemptions and reduce liquidity transformation. The FSB will review progress by members in adopting reforms to enhance MMF resilience this year, before undertaking a full effectiveness assessment in 2026.

Given the cross-border nature of MMFs, it is important that jurisdictions take steps to implement the agreed reforms. Until this policy work is complete and the policy responses implemented across different jurisdictions – the underlying vulnerabilities remain and could resurface in market stress. In particular, the sharp transition to higher interest rates and currently high volatility increases the likelihood that vulnerabilities crystallise and pose risks to financial stability.

In the UK, the Bank and the Financial Conduct Authority have issued a Discussion Paper seeking views on how to strengthen the resilience of MMFs. Feedback received will inform a Consultation Paper to be published later in 2023.

DALIA OSMAN BLASS

Head of External Affairs and Member of Global Executive Committee - BlackRock

MMFs: a cornerstone of market liquidity in times of stress

Money Market Funds play a fundamental role in underpinning market stability. The movement of cash throughout the financial system on a day or intraday basis has become more important in recent years due to, amongst other things, the heightened importance of margining to safeguard financial stability. At the same time, many corporates and financial entities find it difficult to place non-term deposits with banks due to limited balance sheet capacity and capital constraints. MMFs are now one of the most important tools for many investors to hold liquidity and move cash on an intraday basis.

In recent years, episodes of market stress resulted in notable flows into and from MMFs, underscoring their resilience. There is clear evidence of the critical role MMFs play in continuously providing liquidity to investors who need it during times of market stress. During the recent episodes of bank stress, global MMFs have drawn significant inflows from investors seeking protection through diversification.

Market volatility has provided a real test of the existing EU and US regulatory regimes for MMFs and it is important to reflect upon whether and where improvements may be warranted to further enhance the resilience of MMFs to these types of market dislocations. However, it is equally important to ensure that reforms do not undermine the ability of MMFs to play their cornerstone role in providing liquidity management.

Following the COVID-19 related market disruptions in March 2020, policymakers around the world have been drawing lessons from the market turmoil to improve the resilience of various product and market structures. MMFs were one of the first areas for focus for global, US and European policymakers since March 2020 offered important lessons to improve the resilience of MMFs in times of market stress, many of which are widely agreed upon by policymakers and the market alike. They include: 1) reducing the threshold effect related to breaches of Weekly Liquid Asset (WLA) buffers; 2)ensuring MMFs have a robust and transparent framework for the use of liquidity management tools (LMTs); and 3) improving the frequency and quality of data which is reported by MMFs to supervisors and to the market. In the EU, points 1) and 2) will almost certainly be addressed through the Level 2 work on the UCITS/ AIFMD framework which is set to be agreed soon.

Outflows from MMFs are often a sign of their resilience, not a potential vulnerability.

The more contentious debate is around the future of the Low-Volatility NAV (LVNAV) framework, a key introduction of the EU Money Market Fund Regulation (MMFR) framework, and a means of liquidity management that many European investors find enormously valuable. While some commentators have asserted that LVNAV funds have an inherent 'cliff edge' risk in the so-called 20bps pricing 'collar', we believe evidence for this is lacking. Analysis of individual fund flows and price movements during the market volatility of March 2020, and the UK gilt market turmoil in October 2022, shows that there is no investor redemption pattern correlated with NAV deviations in LVNAV funds.

What these events did show, however, is that it is possible for an LVNAV fund to cross the 20bps threshold. This is not, in and of itself, a cause for concern – it is a deliberate feature of LVNAV MMFs. They also highlighted the lack of clarity as to how funds would handle such an operating event: would they be able to continue providing intraday liquidity, or would they need to shut the fund for a period to build the capability to deal at a variable price? We believe regulators should ask LVNAV managers to clearly articulate to investors how (and how frequently) they would be able to process redemptions if required to deal at a price rounded to 4 decimal places rather than 2.

Finally, the most important point in the broader MMF resilience debate is often lost in focusing solely on funds themselves. MMFs are only one part - albeit an important one - of the overall market liquidity landscape. Alleviating structural pinch points in the financial system generally – for example the potentially procyclical impacts of margin requirements in time of volatility and stress – will be the most effective way to ensure the resilience of MMFs. There are practical ways to reduce redemption pressures on MMFs caused by investors' margin requirements and it is today operationally possible to transfer shares of MMFs directly to facilitate margin payments, although the regulatory framework must be adjusted to allow for this.

MMFs are a critical tool for many investors meeting a variety of cash and liquidity management needs. Targeted MMF reforms can enhance their resilience, and reforms to alleviate ecosystem pinch points can improve the functioning of the short-term funding markets.

It's important that any changes maintain the fundamental attractiveness of MMFs to the range of users who rely on them today, and thus allow them to continue fulfilling the important role they play in the provision of liquidity during both normal and stressed market conditions.

JOSEPH J. BARRY

Senior Vice President and Global Head of Regulatory, Industry and Government Affairs - State Street Corporation

From March 2020 to March 2023: lessons on market liquidity

2023 will be an important year for the future financial regulatory agenda. On the back of rising inflation and as a result rising interest rates, regulators around the world are looking for potential risks in the system, including in the non-banking sector. However, as recent events in the banking sector demonstrate, it is hard to forecast the source of the next instability in the financial system. That is why it is helpful to remind ourselves of what has proved resilient in past stress events and what works well today.

Let's start with Money Market Funds.

The events of March 2020 are a regular subject of debate when it comes to assess the resiliency of MMFs. It was undoubtedly a serious and real-life stress test for the whole financial ecosystem. The trigger was an exceptional and unprecedented demand for liquidity, driven by the shutdown of the economic activity during the COVID pandemic and not by market concerns on the underlying quality of investments in MMFs.

In March 2023, we have witnessed the reverse happening with MMFs inflows recording an all-time high. According to data collected by the Investment Company Institute (ICI), total money market fund assets increased by $117.41 billion to $5.13 trillion for the week ended on March 22, driven almost exclusively by government funds.

These events would seem to suggest that when considering possible reforms, the role and importance of MMFs for the overall financial ecosystem and wider economy need to be taken into account and preserved. Reforms should therefore allow MMFs to make use of their available liquidity during times of market stress, by de-linking MMF minimum liquidity requirements, namely the 30% Weekly Liquid Asset (WLA) threshold, and the potential imposition of liquidity fees and redemption gates.

While fully eliminating market stresses such as March 2020 or March 2023 is impossible, it is possible to enhance the structure of the short-term funding market and of fixed-income markets more broadly. This is another area where regulatory reform can help to mitigate the impact of the next crisis by improving the market structure of CP and CD and by ensuring sufficient secondary market liquidity via discretionary market-making activities. In the EU, the European Commission will in the coming weeks publish an important report taking stock of the MMF Regulation, a good opportunity to re-start the dialogue with the industry on these ideas.

The value of ETFs for end investors should remain at the centre of the legislative agenda to complete the CMU.

Open-ended funds are the second item on the list of regulatory initiatives for this year.

Regulatory concerns in the case of open-ended funds originate from the understandable need of authorities to have comprehensive visibility of the financial system, filling any data gaps on liquidity risks and use of leverage. Moreover, regulators are concerned that these vulnerabilities, through channels of contagion, could amplify shocks to the whole financial system. However, open-ended funds are just one part, and by far the most regulated, of what is commonly referred to as "shadow banking" or Non-bank Financial Intermediation, and despite the stress that stock and bond markets have experienced over the last year, asset managers have, in most cases, managed to deal effectively with redemptions.

More generally, as the recent events in the banking sector demonstrate, liquidity mismatches are not limited to open-ended funds. Perhaps regulators should also be looking more carefully at the supply of liquidity in corporate and government bond markets. There are currently limited alternative sources of liquidity, as well as challenges to improving market-making especially by banks, and as a consequence these markets when under intense stress may be unable to absorb sudden increases in selling. Some ideas for reform to domestic government and corporate bond markets are included in the latest FSB report in enhancing the resilience of non-bank financial intermediation and should not be lost in the policy discussion.

Encouragingly, in the EU an important regulatory reform is already underway with the review of the AIFMD. The proposal, which is close to a final agreement, will reinforce reporting for UCITS funds and ensure the development of a strong EU framework for the design and use of LMTs, whose activation should nonetheless remain with investment managers and fund boards.

Finally, a positive actor that is easily forgotten is ETFs. ETFs have long offered investors value as liquidity and price discovery tools during crises. This latest banking crisis serves as another reminder of the additive liquidity created by ETFs and of the reasons why investors gravitate toward ETFs in times of market stress. Whilst the EU progresses in the completion of its Capital Markets Union, the value of ETFs for retail and professional investors should remain at the centre of the legislative agenda.

SIMON JANIN
Head of Group Public Affairs - Amundi

Open-ended funds need both well-functioning markets and well-adapted regulations

While the Silicon Valley Bank and Credit Suisse collapses are negative market shocks and add to an already uncertain backdrop, they seem to pertain more to different idiosyncratic events than constituting – by themselves- a threat to financial stability. However, these recent events observed in the banking sector are a reminder that financial shocks can appear under multiple shapes. They also underline the need to closely monitor non-systemically important banks along with some other non-banking financial institutions.

It is then legitimate for national, EU and international financial authorities to explore the different options to enhance the regulatory and supervisory framework built to ensure financial stability and limit any spillover effect when crisis happen.

And indeed, since the great financial crisis, the banking regulation has been considerably reformed, while the fund management sector has been also substantially reinforced. As an example, the European MMFR (Money market fund regulation), adopted in 2017, enabled MMFs to enter the Covid19 crisis in a resilient and reliable condition. Indeed, back in March 2020, both real economy and financial system were facing the effects of the lockdowns imposed in a number of countries, MMFs recorded large outflows without any incident.

Moreover, not only could MMFs pay the redemption demands but very soon their users massively came back. This could happen because MMFs were not the cause of this major market liquidity crisis but rather revealed it. In this respect, we can only subscribe to the Financial Stability Board (FSB) assertion that "MMF reforms by themselves will not likely solve the structural fragilities of STFMs [short-term funding markets]"[1].

More generally, open ended funds (OEFs) have been put under high scrutiny for some years, as some regulators point out the need to address "liquidity mismatch" issues, where a discrepancy is supposed to lie between the timeframe of a fund's liability (mostly daily) and the time needed to liquidate its assets, sometimes much longer than days, especially during market stress. Such an assessment should be challenged, by reminding that OEFs, including MMFs, act as intermediaries between risk and performance takers, investors, and risk and performance providers, financial markets. Contrary to banks, that systematically perform transformation, OEFs balance sheets involve investors who bear the economic risks of the assets.

LMTs are fit for purpose for a fund to comply with the fair treatment it owes to its shareholders.

In this context, though most of the time their status of collective schemes allows for a pooling of the liquidity risk, OEFs may need to activate tools like swing-pricing or gates where a market liquidity deterioration, combined with unbalanced flows, require to do so. Such liquidity management tools (LMTs) are perfectly fit for purpose in order, for a fund, to comply with the fiduciary duties and fair treatment it owes to its shareholders. By limiting, or raising the cost to access liquidity, LMTs allow fund managers to reflect fairly to investors the market conditions under which inflows and outflows are dealt with.

In this perspective, we commend the recent developments of the EU Capital Markets Union action plan where both AIFM and UCITS Directives are about to be amended to include measures such as the mandatory availability of LMTs for OEFs. Such a change in the funds' regulation framework will undoubtedly enhance the resilience of both AIFs and UCITS funds during market stress, thus providing more financial stability.

Moreover, the probable introduction of a consolidated tape under the currently discussed MiFIR review will help enhance markets liquidity and transparency. As investment funds are products that require well-adapted regulation and well-functioning markets, such positive achievements are more than welcome.

Conversely, some of the measures currently contemplated could not only miss their goals but also undermine investment funds' attractiveness. These measures, meant to tackle the "liquidity mismatch", vary from requiring minimum liquid asset holdings to imposing longer notice periods or less frequent dealing for funds investing in "less liquid assets". Such policy options, some of them being clearly inspired by banking regulations, are not fit for purposes and would raise a series of structural and operational issues if adopted in investment funds' regulations: unworkability, cliff effects, non-adapted definitions and other unexpected side effects.

Regulation should rather focus on reinforcing the process by which end investors will be better informed about the liquidity risks they take when investing in a fund while the funds themselves will be better equipped to effectively cope with market liquidity shocks. Giving time for these changes to be implemented - and their impact to be assessed - is key to enhance financial stability while preserving EU-domiciled funds competitiveness.

[1] FSB, Policy Proposals to Enhance Money Market Fund Resilience, June 2021

DENNIS GEPP

Senior Vice President, Managing Director and Head of European Government Affairs - Federated Hermes (UK) LLP

Policymakers rightly consider measures to improve short term funding markets

Short Term Funding Markets (STFMs) comprise mainly of certificates of deposit (CD) and commercial paper (CP) issued by financial and corporate entities to finance the real economy. In the EU, STFMs are the CMU's entry point. Market participants typically buy primary issuance and hold securities until maturity. This does not mean that STFMs are intrinsically illiquid. It is only in stressed times that participants may need a vibrant secondary market. In March 2020, as global investors sought liquidity as governments around the world shuttered their economies, STFMs froze when they were most needed.

Increasing liquidity and transparency must be addressed as part of any STFM improvement, as no one type of market participant was responsible for the structural failures of the STFM. The question to answer is: how do we organise STFMs so that their secondary markets remain fully functional in times of stress? Current workstreams undertaken by the Financial Stability Board and IOSCO, rooted in a factual analysis of why STFMs froze in March 2020, must be completed and we urge the FSB and IOSCO to recommend policy changes focused on transparency, depth and liquidity.

Large parts of the European CP and CD markets lack transparency. National regulators can only track issuance in their own markets: e.g., the Banque de France provide data on the French NEU CP market; the ECB on Short-term European Paper, and the Bank of England on the sterling CP market. While there are some commercial data providers, overall market participants lack an overview and struggle to ascertain STFM size and composition. Increased and central information on primary issuance for both investors and regulators is needed. More transparency on trades in both primary and secondary markets would also lead to more accurate pricing.

Policymakers express concern that STFMs have few market participants. Deeper STFMS, with many more and diversified participants, would be less vulnerable to shocks. Instead of looking only at those few market participants that need secondary trading in time of stress, policymakers should develop measures that will make STFMs more attractive in all circumstances. An urgent fix is needed to make STFMs fit for the 21st century.

We urge the FSB and IOSCO to recommend policy changes focused on transparency, depth and liquidity.

Ironically, it is more difficult for a professional investor to buy a CD or CP issued by a fully regulated EU bank than for a private citizen to buy a fraction of Bitcoin on an unregulated platform. Moving away from OTC trading, where buyers are normally limited to the issuer and selling broker and fostering the use of electronic all-to-all platforms, would make STFMs more attractive and competitive. Market participants and industry bodies must work with global policy makers in forming workable and practical suggestions for improving the functioning of global STFMs.

Deeper, more automated, less fragmented, more transparent STFMs will be more liquid. Central banks should play a key role in making STFMs more liquid, especially in time of stress. A standing repo facility whereby banks – i.e., entities that are fully regulated and supervised by the central bank - could obtain short term loans to fund their short-term holdings is key and should be established. Such facility could be limited to high-quality short-term ("HQST") assets as defined in bank prudential regulation. If participating banks could repo the HQST assets, even in stressed periods, banks would be more willing to buy them in times of stress, alleviating pressure in STFMs.

This would quickly improve liquidity in the underlying short term markets during periods of stress and be a market-based solution under the full supervision of the central banks. This would not be a bail-out. This would be a market mechanism by which central banks organise the liquidity through short-term, and consequently longer-term, financial markets. Ensuring liquidity of the financial system is surely the function of central banks in charge of financial stability. Better functioning STFMs would complement central banks' monetary policy. More liquid STFMs would be a win (sell side) - win (buy side) - win (central banks and policymakers) game.

In conclusion, central banks and global securities markets regulators should first address a root cause of financial contagion in times of crisis – a widespread and sharp drop in liquidity across markets, particularly in the STFMs that are vital to the functioning of the capital markets. We cannot emphasise enough the importance of improving STFMs and urge the FSB and IOSCO to continue to consider the actions necessary to improve STFMs.

SUSTAINABILITY RISKS IN THE BANKING SECTOR

MERCEDES OLANO

Director General, Banking Supervision - Banco de España

C&E risk management: work in progress

Since the Paris Agreement in 2015 the concern for climate change has reach another dimension. The agreement covers climate change mitigation, adaptation, and finance, and stablished a new goal, "to keep the rise of global temperature well below 2º Centigrade, and preferably limit the increase to 1.5º C.

As all we know, climate change has a global dimension and therefore should be addressed globally and in a coordinated manner. Europe is leading this process from the beginning. In this vein, from one hand the European Commission has reach the agreement of climate neutrality by 2050, meaning net zero greenhouse gas emissions for EU countries as a whole. On the other hand, European Central Banks, Supervisors and other international institutions, as BIS or FSB, as part of the Network for Greening the Financial System (NGFS), are working together to build common criteria regarding this issue.

The EU Taxonomy is a clear example, since some countries are taken this as inspiration in order to develop their own taxonomy.

Early supervisory assessments in Banks' management of C&E risks, before 2020, suggested that these risks were not considered relevant for a large number of institutions. Trying to address this situation, in late 2020, both, EBC published a Guide on climate-related and environmental risks.

The ECB guide sets out 13 supervisory expectations for how banks should integrate these risks into their business strategy, governance and risk management as well as disclosure expectations. At the same time, the BoS published 8 supervisory expectations for LSIs.

After publishing its supervisory expectations, the ECB has conducted several supervisory exercises on banks' approaches to managing and control these risks. First, in 2021, a bank self-assessment was conducted and analyzed, and in 2022 a climate stress test, a thematic review on C&E risks and some on-site inspections were carried out directly by the supervisors.

Even if we have seen relevant progress, institutions still need to work hard.

In late 2022, as a result of the thematic review and the stress test, the ECB published a compendium of good practices observed in some banks, regardless its size or business model.

The thematic review concluded that, even if 85% of banks already have in place at least basic practices in most areas, they are still lacking more sophisticated methodologies and granular information on C&E risks. Additionally, a supervisory concern related to execution capabilities of most banks was shown. As a result, the ECB has established institution-specific and progressive deadlines for achieving full alignment with its expectations by the end of 2024.

Additionally, the ECB is including bank-specific climate qualitative requirements on more than 30 banks in its annual supervisory assessment (SREP). Furthermore, a review of banks' disclosures is performed every year.

In 2023, and in the upcoming years, the treatment of C&E risk will remain as one of the main supervisory priorities. As a consequence, the supervisor will continue working hard to make sure that C&E risks are fully integrated with a holistic approach in the regular institutions' risks management processes and business decisions, with targeted deep dives and on-site inspections. Compliance with upcoming disclosure requirements will be also closely assessed.

In line with the ECB roadmap, National Authorities will continue working in the same direction, in order to assure the same treatment for LSI.

As regards to the prudential regulatory framework both, BIS and EBA, are working to find the proper way to integrate C&E risks under Pillar 1 requirements bearing in mind the risk-based approach. In this regard, the main challenges are the lack of historical data in terms of risk differential between exposures (i.e. "green" vs "brown") and proper methodologies to quantify these risks, closely linked with the distinctive characteristics of C&E risks such as its materialization in longer time horizons and so on. Therefore, regulators have started by incorporating these risks into Pillar 3 (i.e. ESG disclosure requirements in the EU recently entered into force) and Pillar 2 (supervisory process).

It is also worth mentioning the recent (2021) formation of the International Sustainability Standards Board. The ISSB is developing standards that will result in a global baseline of sustainability disclosures focused on the needs of investors and the financial markets. In this regard, I would highlight the Corporate Sustainability Reporting Directive, published in December 2022, according to which institutions will disclose very detailed information on sustainability risks following the standards currently being developed by EFRAG.

KERSTIN
AF JOCHNICK
Member of the
Supervisory Board -
European Central Bank (ECB)

Fostering banks' preparedness for the green transition

In a previous contribution for this magazine, I outlined the many efforts made by the ECB in recent years to include climate-related and environmental (C&E) risks as part of its ongoing supervision[1]. I would now like to take stock of the work that we have done in recent months to foster banks' preparedness for the green transition, and to outline the main deliverables we expect on this front going forward.

The conclusion of our thematic review on C&E risks has been a key milestone in this regard, because it has allowed our supervisors to assess the extent to which banks adequately identify and manage climate risks as well as environmental risks such as biodiversity loss. The review, the results of which were published in November 2022[2], also looked into banks' risk strategies and their governance and risk management processes in the C&E domain.

Overall, the results have been mixed. On the plus side, banks have made meaningful progress in accounting for and addressing C&E risks, acknowledging the materiality of such risks in their portfolios and making progress in building up their risk management frameworks and processes. However, the results also showed that, although the bulk of our supervised banks have in place at least basic practices in most areas, they still lack more sophisticated methodologies and granular information on C&E risks. This aspect is critical if banks are to get a firm grip on the C&E risks they actually face. The review concluded that banks therefore continue to significantly underestimate the breadth and magnitude of C&E risks and noted that almost all banks have blind spots in identifying these risks, including in physical risks related to climate change and the management of broader environmental risks beyond climate. Moreover, we also found that banks have yet to address C&E risks in a sufficiently strategic manner, with management boards rarely initiating actions that result in changes to either the strategic direction or to meaningful risk limits.

In its role as prudential supervisor, the ECB has made it clear that it is not in the business of telling banks how green their lending policies ought to be[3]. However, it has also underlined that failing to take into account the transition towards a more sustainable economy would be incompatible with sound risk management. This is why we are insisting that the banks under our supervision manage C&E risks in the future in the same way as they would now manage any other material risk.

Failing to take into account the transition towards a more sustainable economy would be incompatible with sound risk management by banks.

With this goal in mind, the ECB has now set bank-specific deadlines for achieving full alignment with its supervisory expectations in the C&E domain, as laid out in the Guide it published in 2020[4]. We are mindful that, important as it may be, this process can also be challenging for banks, which is why we have set staggered deadlines. We expect banks to already have in place an adequate categorisation of C&E risks and to have conducted a full assessment of their impact on their activities, in line with our deadline for the end of March 2023. Looking ahead, we expect banks to include C&E risks in their governance, strategy and risk management by the end of 2023, and to meet all remaining supervisory expectations on C&E risks by the end of 2024, respectively.

Moreover, in order to facilitate the supervisory convergence process, we have published a compendium of good practices among banks derived from our thematic review[5], for example as regards the integration of C&E risks into the work of the management body or the use of planning tools aimed at managing the risks of the transition, respectively. This compendium should not be seen as a "one-size-fits-all" path towards meeting of our supervisory expectations in the management of C&E risks, but rather as a demonstration of the practical way in which some banks have tackled implementation challenges in order to achieve rapid progress in certain areas.

[1] See "Climate risks for banks – the supervisory perspective", article by Kerstin af Jochnick, Member of the Supervisory Board of the ECB, for Eurofi Magazine, 7 September 2022.
[2] See "Walking the talk: Banks gearing up to manage risks from climate change and environmental degradation. Results of the 2022 thematic review on climate-related and environmental risks", ECB, November 2022.
[3] See "Urgent and vitally important: 2023 as a key milestone in stepping up the management of climate and environmental risks", speech by Frank Elderson, Member of the Executive Board of the ECB and Vice-Chair of the Supervisory Board of the ECB, at the Foreign Bankers' Association (FBA) 30th anniversary, 27 March 2023.
[4] See "Guide on climate-related and environmental risks: supervisory expectations relating to risk management and disclosure", ECB, November 2020.
[5] See "Good practices for climate related and environmental risk management: observations from the 2022 thematic review", ECB, November 2022.

MARTIN PERSSON

Head of Large Corporates & Institutions, Branch Manager Sweden, Group Leadership Team - Nordea Bank Abp

Enabling banks to finance the real transition

At Nordea, we aim to embed sustainability at our core. We are committed to reaching net-zero carbon emissions by 2050 and are well on our way towards an ambitious target to reduce absolute emissions from our lending and investment portfolios by 40-50% as soon as 2030. We have also set several sector-specific climate targets as well as sustainable financing and investing goals.

As a bank, we have a unique opportunity to facilitate our clients' transition towards a more sustainable and net-zero future. In order to drive meaningful change, we must be able to finance companies that are working to change their business models, including in carbon-intensive industries, and there must be a recognition that this takes time and effort.

Regulation that is too rigid or short-sighted risks being counterproductive, as it could limit banks' ability to help clients transition to a more sustainable future. Such a client selection approach would be counter to the European Banking Authority's guidance and would achieve very little beyond moving financing to other financial services providers that may not be as committed to instituting real change.

Nordea's commitment to facilitate real change is thus based on partnering with our clients according to their transition needs, while at the same time taking proactive steps to mitigate ESG-related risks. Achieving that objective requires a policy environment that reflects the complexity involved.

Policymakers and supervisors have set an agenda that will introduce a number of changes quite quickly. In our view, it will be key to ensure that the policy measures help us achieve our stated aim – to support a meaningful transition. These measures must factor in flexibility and time, while ensuring a consistent pathway, as we and our clients navigate towards achieving common sustainability goals.

Banks are taking a proactive approach in laying out their own transition plans, including targets across various time periods and limits on the most harmful impacts that will ultimately steer their portfolios. How the portfolio looks today will be very different from to how it will look going forward. The very economies we support are undergoing a seismic shift, and we all have to understand and manage new risks in a way that we have not consistently done in the past.

By facilitating real transition for our clients, we are also mitigating and managing ESG risks.

To that end, we are working closely with our clients to understand their transition plans. We complement that engagement with a range of other initiatives, including deep-dive assessments of key sectors and our transition financing approach. By facilitating real transition for our clients, we are also mitigating and managing ESG risks.

One notable challenge is our major dependency on reliable data, not just on the status quo but more importantly forward-looking data. Nordea continues to invest and engage with clients to overcome this challenge, but it is a dependency that must be recognised. Having thoroughly vetted, structured ESG data is a prerequisite for developing models that can adequately quantify how ESG risks materialise, which also limits the speed at which banks and supervisors can move ahead.

Furthermore, it is important for supervisors to understand the markets and sectors in which individual EU banks operate. Even within Europe, physical and transition risks differ from one region to another. For example, the physical risk of water scarcity differs between southern and northern Europe. Transition risks are also lower in the Nordic energy sector, with much of its energy production already based on renewable sources, compared to other parts of Europe and beyond.

Consequently, individual banks will have different focus areas when it comes to steering portfolios, client engagement and allocating capital in a way that is most relevant to the sectors and segments in need of transition. Regulation and supervision must take that variation into account. While we support having harmonised rules, it is not always possible to apply a one-size-fits-all supervisory approach to ESG for all banks in the EU.

As the EU continues to manifest its leadership in climate transition, it is important to focus on the carrot as well as the stick. If policymakers can incentivize the investments needed in the sustainable transition, then we will be there to finance it, to the extent the risks are acceptable. We must avoid a situation where it becomes more advantageous for non-EU banks and non-banking entities to provide the financing and investment needed in the EU. It is the challenge of the century and the opportunity of a lifetime.

To achieve real progress on the sustainability agenda, we need banks that are committed to supporting their clients' transition and a regulatory framework and supervisory practices that support banks in this task. The content, pace and sequence of the regulatory and supervisory agenda must be carefully considered and include a degree of flexibility and predictability to avoid hindering those segments most in need of transition financing.

KAY SWINBURNE

Vice Chair Financial Services - KPMG LLP

Tensions between risk management and real world outcomes

ESG is substantially different from most regulatory action seen over the last 50 years. Typically, regulators and banks take much longer to develop, debate and apply regulatory policy. With ESG, given the urgency to act, this simply wasn't an option. We have seen methodologies and data requirements for reporting, stress testing and broader risk management activities develop in parallel with implementation. It was the only approach available, but it has taken many banks into unfamiliar and potentially challenging territory.

Generally, the regulatory push should be seen as a push towards better risk management, reflecting regulators' market stability mandate in action. The policy driver though is net zero outcomes in the real economy. And there is an inherent conflict that risk management might, but doesn't necessarily always, achieve real outcomes. It may encourage short term investment in the 'worst' areas (from a sustainability perspective) where the returns are sufficient, then divestment in the longer term. Real world outcomes require a greater understanding of and investment in the transition. Risk management identifies flooding and wildfire risks but struggles to meaningfully quantify second and third order effects like significant migration flows or large pools of stranded assets. Real world outcomes require a much deeper dive into the complete transformation of sectors.

Banks are struggling with the breadth of 'sustainability risk' and we've only scratched the surface. At opposite ends of the spectrum are areas such as climate risk - where there is more data and attempts can be made to apply traditional financial risk modelling - and then reputational impacts and broader risks around ESG strategy, execution and greenwashing that are distinctly non-financial. In these areas firms have only ever really done 'scenario-based' modelling. The challenge is to bring these aspects together.

Climate risk is being incorporated into traditional market, credit and liquidity risks. Banks already have some of the tools they need, but there is more to do on data and modelling approaches. The ECB has pushed for ESG factors to be included in the consideration of loan origination and monitoring, driving banks to try to incorporate them into credit risk techniques. For now, this is being done in a range of ways with both qualitative and quantitative overlays. In the longer term, we could expect to see it becoming part of underlying core model development. For the broader reputational, social, and governance elements of sustainability, scenario analysis and approaches more traditionally taken for operational or non-financial risk are more likely to persist.

There is an inherent conflict that risk management might, but doesn't always, achieve real outcomes.

There are already different approaches from supervisors to non-financial risks – for example, the use of models for quantifying operational risk in Pillar 1 capital (the AMA) is removed in Basel 4 because of the widespread difficulties in achieving consistency and good quality outcomes. Operational risk moves to Pillar 2 which is more likely to be more scenario-based and is open to variability in outcomes from banks and supervisory regimes.

Returning to the theme of achieving real world outcomes, banks should be encouraged to weight sustainability factors as heavily as profit. Not just to drive shareholder value, but to do the right thing by the planet and people and demonstrate their role in the transition to net zero. Recent focus on the sustainability of banks' business models is key to ensure clarity around what they are doing to support sustainable business.

A sustainability lens should be applied end-to-end across the organisation, to avoid silos – in deals and transactions, new product development and the onboarding of new clients, and in performance scorecards and remuneration. And banks should be encouraged to look across to the second and third order risks - and consider the interactions between them - to find clusters or linkages and identify the unintended consequences.

Climate has been at the vanguard, driven by the recommendations of the TCFD, but nature is no less relevant. Equally, any risk mitigation actions will need to consider social impacts via 'just transition'. Treating any or all of these risks in isolation runs the risk of double or even triple-counting impacts and failing to net off opportunities created.

The breadth of reporting required under CSRD will help to effectively create a checklist of ESG Risks (or related impact areas) that need to be considered - across climate, the environment, nature, social and governance objectives. It will bring clear structure and should compel banks to do meaningful things. Interoperability with the ISSB and SEC standards is to be supported as this will help drive consistency and comparability at a global level, to the benefit of EU banks.

TAKANORI SAZAKI
Regional Chief Executive Officer for EMEA - MUFG Bank, Ltd.

Transition Finance as a credible risk mitigation strategy to achieve net zero

In order to understand the progress banks and other financial institutions are making with respect to the management of climate and environmental risk, it is not sufficient only to assess the outcomes of scenario analysis, risk assessments and heat maps that demonstrate the most pressing environmental risks. Our supervisors also expect us to embed climate risk in our governance, risk management framework and, perhaps most importantly, our business strategy.

Financial institutions have an important role mitigating financial risk. Mitigating climate risk through transition finance will drive global progress in achieving our collective net zero ambitions.

We have made good progress on governance and risk management. Environmental and social elements are a top priority for bank management teams, and we have the governance structure to support it. We are also starting to better understand where we are most exposed to climate risk across our portfolios, but more work is needed from all of us in this respect.

Creating or adapting business strategy for climate risk will be interpreted in different ways. Our view is that business strategy for climate risk may also be defined as creating a 'plan to mitigate the risk of climate change', in other words, a transition plan.

In creating these strategies, we need to remind ourselves of two very important roles we have as banking institutions; we fulfil a role as risk managers ensuring financial risk is managed and mitigated, but we also have a role as financiers of the real economy, assisting economic progress in the markets where we operate. As a globally significant bank, we play a major role in financing the economies in which we operate, as well as their net zero pathways.

Our government's and clients' net zero commitments form the basis of our transition plan as these guides where we want to be in the lead up to 2050. The sector specific intermediate emissions reduction targets we set ourselves as part of the NZBA commitments guide our capital allocations to finance the transition. In this context, Japan and Asia's transition story is different to Europe's, given Asia's reliance on hard-to-abate sectors for its energy security. As we have outlined in our Transition Whitepaper, these sectors need continuous financing to help them to decarbonise. We view it part of our responsibility to help our clients in hard-to-abate sectors to decarbonise by means transition finance, which ultimately reduces climate risk.

Mitigating climate risk through transition finance will drive progress on net zero ambitions.

Decarbonisation pathways are written through engagement, commitment, and persistence. Net zero cannot be achieved in a niche; we all need to become more focussed on considering net zero as a shared problem, which we need to resolve together, as opposed to just by ourselves.

Divesting from carbon intensive assets means we are kicking the can further down the road to those stakeholders we did not commit to the same decarbonisation pathway. Divestment is not a solution as there is no assurance that actual emissions will decrease, even though divestment does reduce our financed emissions very swiftly. We need to engage with hard to abate sectors and feel we have the responsibility to engage with our clients in all sectors and regions and finance their transition journey. This is the only credible way to deliver a 'just and orderly' transition, without unnecessary shocks to the financial system and the economy. Together, with various collaborators from both the public and private sectors, we intend to consider how the society can mobilize financing for the necessary technological innovations.

Last month, the Japanese Ministry of Economy, Trade and Industry (METI), the Financial Services Agency (FSA), and the Ministry of the Environment (MOE), together with ten global private financial institutions including MUFG and other organizations, launched the Japan Public and Private Working Group (WG) on Financed Emissions to scale-up transition finance through developing complementary metrics in addition to financed emissions. We view this private-public partnership as an important model, which we see as widely beneficial and applicable to other jurisdictions.

To conclude, by moving from risk management to risk mitigation, important strategic decisions that need to be taken to ensure we can continue to manage the risk as well as continue to finance the transition to net zero. The UK Transition Planning Taskforce's Guide is an important framework that helps to guide institutions like ourselves to write a credible transition plan. However, to avoid undue complexity and duplication, we do need to ensure that we continue to drive international consistency in standards.

The overall priority should remain the creation of a properly embedded climate and environmental risk framework, consisting of governance, risk management, metrics and most importantly ensuring integration with the overall business strategy.

HANNES MÖSENBACHER
Chief Risk Officer - Raiffeisen Bank International AG

Building trust via data: why sustainability reporting standards must be unified

Progressively, European supervisors appear highly concerned about banks' exposure to physical and transition risks related to climate and environmental risks. In due course they are increasing pressure on institutions to enhance their management of such risks. A primary challenge currently faced by the European banking sector is to measure, address, and report sustainability risks in a suitable manner. While European banks have a good understanding of ESG risks and their implications for classic risk categories like credit and market risks, they are still facing challenges in integrating and measuring climate and environmental risks due to the complexity stemming from this integration.

The European Central Bank (ECB) on the other hand has implemented multiple sustainable risk initiatives for banks, including the upcoming 2023 climate risk stress test. From these supervisory efforts, it has been observed that banks are advancing in their management of climate-related and environmental risks, however, the ECB maintains that progress is not consistent across the industry, and some banks are still lagging. At the EUROFI financial forum in September 2022 the ECB stated unequivocally that supervisors will continue to push banks to improve their systems and management of environmental, social, and governance (ESG) risks.

While regulations concerning sustainability risks are constantly evolving and accompanied by ever increasing supervisory expectations, the European banking sector is rapidly improving in terms of measuring, managing and disclosing ESG risks. European banks are constantly under pressure to implement new requirements, adjust their systems, processes and KPIs, whilst considering the potential interlinkages of various regulations. However, it is no secret that there is still high degree of uncertainty and legal insecurity in the financial market when it comes to practical implementation. Alas: The disclosure requirements for ESG risks are yet to be finalized and are for their better part far from being fully synchronized.

The quality of measurement and reporting finally depends considerably on the availability and quality of relevant ESG data. For example, evaluating the sustainability level of a counterparty requires that the customer possesses the necessary data and provides it to the bank in a manageable format. Gathering this information is challenging and leads to extra expenses for both customers and banks. Additionally, the diverse and comprehensive data requests from various banks could overwhelm customers and discourage them from providing data. As a result, it is vital for banks to educate and inform customers in time about the new data demands.

As global problems require global solutions, we need a global baseline for sustainability reporting.

As things stand, the banking industry is experiencing a shortage of ESG data due to the novelty of ESG risk measurement. To address this, banks must engage with their customers and alert them to ESG requirements. In the past months, Raiffeisen Bank International has made great progress in this area by creating a customer questionnaire that facilitates the customer journey and generates crucial data for disclosure and internal management. Additionally, collaboration and sharing of methodologies among market participants can promote a customer-centric approach.

The adoption of the Corporate Sustainability Reporting Directive (CSRD) in December 2022 can be seen as an important step to address this issue, as it is expected to mitigate the issue of customers receiving varying requests for information and in fact should work to improve the comparability of sustainability risks within balance sheets of financial institutions. These new reporting requirements come with detailed standards applicable to all reporting institutions and companies, which may – to a certain degree – be helpful in unifying the relevant ESG data points and thus improving data availability.

Nonetheless, there remain evident discrepancies in the approaches and rating methodologies of financial institutions regarding ESG risks as well as sustainability risk reporting, leading to a lack of consistency in the market. Additionally, many financial institutions' portfolios are not in line with their net-zero commitments, highlighting a larger gap between the net-zero goal and the real economy, globally. As a result, markets, investors and individuals have become increasingly mistrustful, undermining the EU sustainable finance strategy.

It is essential to recognize that climate crises and distrust of markets participants are not solely a European issue, but a global one. High-quality, consistent, and comparable climate-related data and metrics are critical to providing reliable and resilient information to market participants. Therefore, implementing a global baseline for sustainability reporting is a priority, with local initiatives keeping compatible and coherent with globally agreed approaches to avoid fragmentation. Global problems require global solutions.

SUSTAINABILITY RISKS IN THE INSURANCE SECTOR

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

Supervisory approach in the light of sustainability risks

Sustainability related events and risks of a disorderly green transition produce potential adverse impacts on both liabilities and assets of insurers. At the same time, the transition to a more sustainable world calls for the insurance industry to be a catalyst in its dual role as risk taker and institutional investor.

From the point of view of supervisors, it is increasingly difficult to separate these two perspectives. A failure to provide a visible and reliable contribution to sustainable factors could affect the value of the company, given its reputational consequences. Strategic risks are more and more affected by the way the company characterizes its sustainability objectives and operations. Also, the correct implementation of the increasingly complex sustainability regulation implies compliance risks that cannot be disregarded.

In this context, the supervisors' traditional objective of consumer protection assumes a broader and more evolved scope. Today, consumer protection must also be seen from the point of view of satisfaction of the protection needs of individuals and of the achievement of sustainability objectives.

How can these goals be pursued in the practical supervisory approach?

First, it is certainly important for supervisors to have deep knowledge of the relevant phenomena and be able to appreciate their risks and opportunities. A prerequisite for any regulatory or supervisory action must be qualitative and quantitative evidence of the phenomena. Today, this appears to be the main challenge.

In 2022 Ivass carried out a survey among the supervised entities, aimed at collecting granular data on the sustainability of the companies' investments and on their underwriting activity in covering natural perils. The companies have given the supervisor highly granular data on a variety of topics, such as the degree of alignment of their investments to the European Taxonomy, the carbon footprint of their portfolio, the premiums collected and the claims paid in the business of providing coverage for natural perils, the role adaptation or preventative measures in the underwriting and pricing of this lines of business.

The path towards sustainability is long and difficult for supervisors too.

This data collection effort has been very challenging for insurers and has even obliged them to use proxies and estimates. This means that there is still a lot to improve for companies in collecting and using data to measure risks, but also for regulators in clarifying the legal framework, introducing widely recognized metrics and facilitating data collection.

But that is not enough. We need that knowledge of these phenomena, and of the potential transmission of the resulting risks and benefits, becomes part of the store of knowledge of those operating at all levels of the Authority. As was the case with the introduction of Solvency II, the new scenario requires an evolution of the supervisory culture. This is often forgotten, yet it is essential but difficult to achieve in practice.

Supervisors, then, must foster awareness of the phenomena by those to whom the insurance service is directed. Insurance education is a fundamental part of supervisory activity, and it is especially so in the current context.

But aside from knowing and ensuring others have knowledge, what are the approaches required from supervisors in the current scenario?

The on-going EU and national regulatory work is intense. New tools and requirements are being developed in the whole regulatory framework: financial requirements, risk management disclosure and market conduct.

In the presence of such new and complex phenomena, supervisors can first of all play an essential role in collecting data and contributing to defining risk metrics and indicators. National authorities and international fora should contribute to the quantitative definition of phenomena and to the identification of ways to measure their risks, even before suggesting how to mitigate them. A lot of work is being done at both EIOPA and IAIS in this area, for example in the development and application of scenarios for climate change stress tests.

Just as for businesses, which are working to integrate ESG measurements into decision-making processes, metrics and indicators related to sustainability risks and opportunities will then need to be incorporated into supervisory processes in order to calibrate their intensity and determine when to intervene on the basis of risk considerations.

The need for a simpler relationship between the Authorities and supervised entities should also be recognised. A simplification of supervisory processes, which are often the unintended result of jumbled and complex regulatory interventions at both the national and European level, would help supervisors and companies to face new challenges without unnecessary burdens.

Overall, the path towards sustainability is long and difficult for supervisors too. It needs to be approached with commitment and perseverance but also with common sense and balance.

ÅSA LARSON
Executive Director Insurance - Swedish Financial Supervisory Authority (Finansinspektionen)

Sustainability risks in the Swedish insurance sector

Sustainability risks for the insurance sector, and the financial system, stems from both an unsustainable development and the transition to a sustainable economy. These risks clearly threaten financial stability and are thus integrated into the Swedish FSA's (FI) overarching risk identification and our ongoing supervision of insurers and pension providers.

FI is, for example, following how insurers manage sustainability-related risks in their own risk and solvency assessments. In 2022 we conducted an in-depth analysis with a specific focus on physical risks for non-life insurers. We have also initiated a thematic review to get a better understanding of how undertakings integrate sustainability into their corporate governance. For example, we collect data on risks they identify as material and how they measure those risks. The results form a basis for supervisory dialogue and qualitative assessment of the companies' sustainability risk. In 2022 we and four Swedish IORPs participated in Eiopas climate stress test for the occupational pensions sector.

While climate change risk is often said to be an emerging risk and an untraditional risk, this was in many ways a traditional stress test. The participating IORPs from Sweden were more affected in terms of how the funding ratio decreased post-shock than those from any other participating country. However, the decreases in funding ratio were not due to Swedish IORPs having a particularly large exposure to carbon intensive economic sectors, but rather due to their unusually risky asset allocation – they overall had a much larger portion of their assets invested in equity than IORPs from other participating countries. In this sense, the results of the stress test reflected overall asset management strategy more than sensitivity to transition risk.

It should also be noted that the IORPs were not put under any particularly heavy pressure in terms of solvency. In fact, the funding ratios of Swedish IORPs were on average higher post-shock than they were pre-shock in any other country. In this sense too, the results of the stress test were not as informative as we might have hoped: the scenario was not sufficiently severe to actually stress the Swedish IORPs.

Last year we also did an analysis of how the floods in Gävleborg, largest flooding for many years, in 2021 impacted general insurers, costing. insurers two billion SEK.

Access to relevant, comparable and reliable data and resilience in the financial system are crucial.

In our analysis we used the floods as a real-life stress test of the resilience of Swedish general insurers to physical climate change risk. From a solvency perspective none of the companies were seriously threatened. All of them could have handled significantly larger disasters. For the large general insurers, with their extensive geographic diversification – no problem! For smaller local insurers gross claims were in some cases huge in relation to written premiums and theyheavily depended on reinsurance to meet their obligations.

While reinsurance is and will remain a crucial risk management tool for general insurers, the reliance on reinsurance is also a risk in a forward-looking analysis. Climate change is affecting and will continue to affect the reinsurance market on a global scale. If reinsurance prices increase or capacity diminishes it would have implications for direct insurers.

Such dependencies, and also the management actions insurers and other actors might undertake to respond to climate change, ranging from exclusion to adaptation, are also difficult to understand within the confines of traditional micro-prudential stress testing.

Methodologically, Eiopa's IORP stress test was certainly a step forward. The forward-looking methods and models used by Eiopa, ESRB and ECB to derive stresses from the scenario were sophisticated. Here Eiopa's role as leaders in developing stress test methodology is crucial. We appreciate that EIOPA have signaled that future climate stress tests will focus more on systemic aspects and less on micro-prudential requirements.

FI's roadmap for sustainable finance contains three goals –

1. good access to relevant, comparable and reliable sustainability related information,
2. high levels of trust in sustainable finance,
3. resilience to sustainability risks in the financial system – and will thus guide our priorities. In my last Eurofi panel I spoke about the importance of data, in order to measure, compare and understand the risks related to sustainability and climate changes.

My contribution to this panel, will be more about the latter and how we supervisors need to increase the understanding for and knowledge of sustainability-related risks faced by the insurance and pensions sector, in order to assess the resilience and whether those risks are properly managed.

FAUSTO PARENTE

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

Sustainable insurance to protect society in the long term

Economic and insured losses, caused by weather related events, have been on an upward trajectory in the last decades. Looking at the consequences of a number of major European natural catastrophes, historically, insurers have been well placed, handling the resulting claims. Looking ahead, insurance capacity is of concern to the European Insurance and Occupational Pensions Authority (EIOPA). The insurance industry's capacity relies to a great extent on reinsurance. An increase in extreme weather events, but also a change in accumulations, is leading to greater demand for reinsurance and higher reinsurance prices, changes in reinsurance conditions and affordability and availability issues. This reduces risk mitigation possibilities for insurers in the near future.

Furthermore, only around a quarter of the total economic losses caused by extreme weather and climate related events across Europe are insured today. If unmitigated, the further widening of this insurance protection gap will have potentially broader macroeconomic implications and expose insurers to reputational and wider operational risks.

In this context, insurers and supervisors play an important role to ensure sustainable insurance activity protects society for the long term.

The insurance sector's ability to continue to offer financial protection against the consequences of climate-related events relies on its ability to understand the likely impact of climate change and adapt their business strategies. EIOPA's analysis on ORSA showed that climate change risk, if assessed at all, was often treated in qualitative manner, as a reputational risk mainly. EIOPAs physical risk analysis shows that many undertakings are not undertaking climate change analyses yet. The integration of longer-term scenarios in enterprise risk management remains a challenge. EIOPA's pilot exercise on impact underwriting concludes that the European insurance market is at an early stage in terms of standardising the implementation of climate-related adaptation measures in insurance contracts.

EIOPA expects the insurance business to evolve to better adapt to climate change risks and opportunities. Insurers will need to explore innovative product design to keep insurance available and affordable. By including and promoting adaptation measures in insurance products (e.g. investments in property-level resilience to perils such as windstorm or flood), insurers could reduce their exposure to physical risk and potential future insured losses, while policyholders would pay a reduced premium thanks to the reduced risk. Through information sharing, both on risk assessment (modelling, pricing) and possible adaption measures (e.g. construction standards), insurers could also play a role in raising public awareness to risks posed by climate change and possible ways to address them.

Sustainable insurance protects society in the long term.

EIOPA supports these efforts through its sustainable finance strategy. EIOPA will continue its analytical work on physical risks as well as transition risks with an overall aim of supporting further forward-looking views and analysis of risks in light of climate change. Jointly with EBA, ESMA, the ECB and the ESRB, EIOPA will conduct a one-off scenario analysis to assess the resilience of the financial sector in line with the European Commission's Fit-for-55 package.

At micro-level, EIOPA is conducting supervisory oversight of sustainability risks, including through discussions on the inclusion of climate change in colleges of supervisors. EIOPA supports the transparency, and open access to data and development of scenarios and modelling to allow forward-looking risk assessment of nature-related risks. Efforts to improve the usability of taxonomy and sustainability reporting will play an important role, too.

EIOPA will continue identifying underlying causes of the protection gaps, as well as assessing the macro-economic consequences of a lack of insurance. At the nexus of public and private initiatives, EIOPA is engaging in the EU Commission's Climate Resilience Dialogue and the IAIS Protection Gap Task Force to ascertain the role of supervisors and assess measures to improve insurability of climate risks.

Finally, looking ahead, EIOPA will also seek to engage further on nature-related as well as on social risks, in an effort to improve awareness on the risks and impacts and to allow addressing these risks in a convergent and proportionate manner.

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HIDEHIKO SOGANO

Managing Executive Officer, Chief Sustainability Officer - Dai-ichi Life Holdings, Inc.

The necessary framework of sustainability risk management

Japanese life insurance companies are strengthening their ESG investment and stewardship activities by signing the PRI and accepting the Stewardship Code. Since fiscal 2017, the Life Insurance Association of Japan has been working on "collaborative engagement," in which multiple life insurance companies cooperate to send letters and engage in dialogue with investee companies. According to Association's survey, regarding the appropriateness of corporates' ESG-related activities, there is still a big gap between the self-complacency of corporates and the expectation of investors, which leads us to beef up our engagement. From fiscal 2020, we will expand the scope of target companies, targeting all top 50 greenhouse gas emitting companies in Japan. Such engagement consists of the formulation and disclosure of a roadmap for reducing greenhouse gas emissions toward net zero.

Dai-ichi Life is a member of the Net Zero Asset Owners Alliance and is committed to achieving net zero greenhouse gas emissions in its asset management portfolio. In particular, in September 2022, we established the "Policy on Transition Finance" and stated that it will select investment activities that prioritize the realization of long-term carbon neutrality for society as a whole. When making investment decisions, in addition to complying with major domestic and international guidelines regarding transition finance, we will independently examine the appropriateness and feasibility of a company's transition strategy from the perspective of securing investment income.

In addition, we will continuously review the judgment criteria used in the scrutiny, taking into account the external environment surrounding the transition and the state of technological innovation. We would like to encourage companies to improve their transition strategies and improve the effectiveness of their initiatives through engagement, based on the knowledge we have gained through these specific considerations.

While the above describes our efforts as an institutional investor, and as a life insurance provider, it is important to understand the "long-term" risks and opportunities posed by climate change. Dai-ichi Life estimated the relationship between the maximum temperature nationwide and the occurrence of deaths using its own death insurance payment record. According to the RCP8.5 scenario (4°C rise at the end of the 21st century), the incidence of death will increase by 1.0%, which is equivalent to an increase of about 4 billion yen.

Select investment activities for the long-term carbon neutrality for society as a whole.

The Dai-ichi Group recognizes that responding to climate change is an important management issue that can have a significant impact on the lives and health of customers, corporate activities, and the sustainability of society. We must steadily strengthen our risk management and governance systems.

Specifically, the "Group ERM Committee" discusses how to assess and respond to physical risks and transition risks. We formulate policies and strategies related to sustainability in the newly established "Group Sustainability Promotion Committee" and monitor the implementation status of initiatives. These details are disclosed in our annual integrated report to increase the transparency of information.

In addition, in fiscal 2022, we will introduce multiple sustainability indicators, including an indicator related to progress in reducing CO_2 emissions, as part of our executive remuneration evaluation indicators. As one of the results of strengthening our efforts and expanding our information disclosure, we were selected as an "A-List," company, the highest-rated company in a survey on climate change by the CDP (international environmental NGO). The Group will continue to strive for further sophistication of sustainability governance.

In Japan, three ministries (Ministry of Economy, Trade and Industry, Ministry of the Environment, and Financial Services Agency) are working together on transition finance. With the involvement of the METI, we are able to build a system to tackle sustainability risk not only for the financial industry but also for the Japanese business community as a whole.

Regarding an attempt to incorporate climate elements into solvency frameworks such as capital regulations to ensure the soundness of financial institutions, we have a view that it may not always result in a desirable outcome since the original objectives are different and it is too premature to do so in the midst of too much uncertainty. Rather, the government is expected to play a role in supporting the movement of private insurance companies which provide funds for transition to the corporate sector, to advance engagement rather than divestment. In this regard, Japan's FSA has been actively working on various measures to promote the private sector's activities such as the establishment of the Sustainable Finance Expert Panel in 2020 which has emphasized sustainable finance as "the infrastructure that supports a sustainable economic and social system."

MIREILLE AUBRY

Director of Prudential Regulation Standards & Foresight - Covéa

Sustainability issues and risks in need of sustainable governance and oversight

In its February 2022 report on Climate change risk governance in the insurance sector, ACPR identified 5 areas of scrutiny.

The very first is Strategy. Here, identification of components of climate change risk is viewed an essential prerequisite for the development of an appropriate strategy including the long-term dimension. The second area is Risk Management where the various dimensions of climate risks are to be integrated into risk mapping with their interactions with other risks. The third area concerns Internal Organization with actions aiming at mobilizing and informing management bodies. A clear definition of internal responsibilities is key for implementing the measures related to the risk of climate change with the involvement of the business lines. The fourth area is looking at the role of insurers as experts in helping raising awareness among stakeholders. Actions aimed at involving employees have multiplied and raising awareness among stakeholders have stepped up.

The fifth and last area is Communication. Organizations emphasize the importance of clear communication on their strategy and commitments in terms of climate change. Reporting obligations and the development of appropriate communication require the development of associated skills.

In its 2020 climate pilot exercise ACPR has subjected the French Market to a first assessment of the financial risks due to climate change. The exercise was totally new and comprehensive, with a 30-year horizon including 3 transition scenarios and 1 physical risk scenario. Results have demonstrated a moderate exposure to transition risk while natural disasters would lead to a 2 to 5 fold increase in the number of natural disaster losses in the most affected departments.

ACPR is preparing for the next climate exercise and has consulted the industry to gather return on experience and identify way forward to refine the exercise. The schedule is still indicative with provisional assumptions delivered in April 2023 and a launch of the exercise in July 2023. Participants' submissions would be expected by end of year 2023 and results would be published end of April/beginning of May 2024. The new exercise will bring the opportunity to include new risks such as hail and granularity could be refined. A short term scenario will be added to the exercise (5-10 years) that could include combining several perils and specifying geo-localisation to enable a quantification of the cost of insured goods as well as possible effects on property prices. A unique feature of the ACPR exercise is the inclusion of health risks in the scenarios also with the progressive availability of Covid 19 experience data.

It may very well be that prices are not helpful in assessing transition risks.

The modelling allows factoring the possible link between life and non-life contracts via the use of individual address. With regards asset value shocks assumptions are made according to geographical breakdown (FR/EU/US/RoW), sectors (55), bonds spreads per bond category (0.5% of bonds in the most exposed sectors) and EIOPA risk free rate curve. ACPR adopts the hypothesis of marked sectoral shocks ("stranded assets") with contagion mechanisms. In terms of granularity transition risk sensitive sectors (e.g. energy, transport, etc.) would be analysed in greater detail and real estate shocks could possibly be included. The calibration of the shocks will be based on short-term and long-term scenarios with input from NGFS and Banque de France/ACPR. In the latest generation of NGFS scenarios, published in July 2022 macroeconomic variables (inflation, growth) take into account chronic and acute physical risk.

Taking a broad look at sustainability risks we find physical and transition risks in a much different maturity stage. On the climate side, we note that physical risks are a topic of science and experience where insurers and regulators can build on the insurance strong expertise and therefore be particularly well prepared to identify, measure, manage, monitor and report the risks arising. On transition risks the situation is different. Transition risks are not directly connected with climate but rather with energy volumes fuelling the economy and the result of human actions and choices. Transition is occurring everyday irrelevant of the actual understanding of the underlying drivers. It may very well be that prices are not helpful in assessing transition risks. Transition risks very much rely on the paths towards transformation and on the understanding of the interconnections between sectors and technologies.

Today the unique criteria for transition risk evaluation seems to be the volume of GHG emissions and yet data may not be reliable and still underestimate the emissions on the entire value chain of the transition choices pushed forward. Other key risks involved in transition choices such as metal rarefaction and soil and/or water pollution as well as social issues linked to mining are overlooked (eg. for renewable energy & electric cars).

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AML: KEY SUCCESS FACTORS

MARCUS PLEYER
Deputy Director General - Federal Ministry of Finance, Germany

AMLA: an AML gamechanger that will dovetail with national supervisors

We are taking a major step forward with the European legislative package to comprehensively combat money laundering and terrorist financing. At its heart is the establishment of the first European Anti-Money Laundering Authority (AMLA). AMLA will provide a European anchor point for the Member States' supervisory regimes and will itself play a role in the direct supervision of individual, particularly high-risk and cross-border financial institutions. In this way, we will not only set uniform substantive standards for anti-money laundering (AML) throughout the EU but will also establish a body to oversee compliance with these standards.

However, merely providing the legal basis for AMLA's establishment will not make the authority fully functional. AMLA needs state-of-the-art IT infrastructure and highly specialised professionals, as well as expertise and support from the Member States, to bring it to life and infuse it with substance. Specifically, AMLA's General Board, which is comprised of members of the national supervisory authorities, must jumpstart the substantive regulatory regime.

The AML Regulation and the AML Directive contain a large number of provisions regarding regulatory and implementing technical standards that will be developed by AMLA. Without such standards, the unified European AML package will not be applicable in practice due to a lack of specifics. The development of such regulations requires lead time and effort. Thus, in order for the EU AML package to function effectively, it is of utmost importance that we now move on to the final steps in co-legislation and swiftly create an environment for AMLA to take up its work. Only in this way will we be able to give AMLA and national supervisory authorities the opportunity to start developing the in-depth regulatory details.

What is also still pending is where AMLA will be located. In this regard, it is important to respect the European Court of Justice's ruling that future decisions on the location of EU agencies must be made using the regular legislative procedure with the involvement of the European Parliament.

Before the AML package is applicable in practice, AMLA needs to start developing technical standards.

In order to ensure AMLA's optimal development, it needs to be established as quickly as possible in a location that combines first-rate connectivity with an international environment. In addition, it is essential for AMLA to be located in a city where it can engage effectively in exchanges with prudential supervisors, first and foremost the ECB, because anti-money laundering supervision and prudential supervision are closely interlinked. This is a strong argument for Frankfurt, in close proximity to the ECB. This would also help ensuring that AMLA develops a deep understanding of the financial sector and is well equipped to perform its essential tasks.

Germany is doing more than just bidding to serve as AMLA's future home. We in Germany are keenly aware of the importance of contributing to the fight against money laundering and terrorist financing. We are currently in the process of setting up a new national Anti-Financial Crime Authority (Bundesoberbehörde zur Bekämpfung der Finanzkriminalität, or "BBF" for short) that will have a separate department specifically dedicated to AMLA.

As a Member State with a large number of obliged entities (especially in the non-financial sector), it is crucial for Germany to pool its expertise and offer AMLA and other Member State's supervisory authorities a central point of contact. We are taking up this challenge in order to drive the joint European project forward. The BBF's core task will be to pool under one roof the most important functions for combating financial crime: financial intelligence and analysis, investigations and supervision.

This includes a pillar that will be responsible for criminal police investigations of complex international money-laundering cases and for the effective enforcement of sanctions. In a second pillar, it will provide financial intelligence serving as home for the FIU. And in the third pillar, it will coordinate supervisory authorities particularly in the non-financial sector and serve as a point of contact for AMLA. The new authority will fully integrate the use of state-of the art digital technology into its work, strategic orientation and specialised training programs.

We must take all necessary steps to get the new anti-money laundering regime up and running quickly. This is essential in order to stop money laundering and protect the integrity of our internal market, fair competition, social peace and trust into the rule of law.

ANTE ŽIGMAN
President of the Board - Croatian Financial Services Supervisory Agency (HANFA)

AMLA - A new partner in the common EU supervisory agenda

As we know, AMLA's integrated system of AML/CFT supervision across the EU will be based on common supervisory methods and convergence of high supervisory standards. The new Authority will also have the power to create guidelines, technical standards, and opinions to further harmonize national-level supervisors' work. AMLA will have the power to adopt binding decisions and to impose pecuniary administrative sanctions. As a partner of national competent authorities, AMLA should provide expertise, knowledge, data, and coordination. It should be an AML hub for the exchange of information, best practices, and training on advanced AML/CFT supervisory methods, taking full advantage of digital and technological innovations.

The list of AMLA`s tasks and responsibilities seems a mile long and includes the supervision of AML risks in crypto assets, as well as the direct supervision of high-risk and cross-border financial entities. New technology and new risks will place increased demands on AMLA (and national authorities) regarding specialist skills and available infrastructure.

New technologies are shaping our future and our expertise and knowledge must follow this progression. Supervisors' efforts to tackle problems have been hampered at times by gaps in data quality and by difficulties in scaling up our analytical infrastructure to quickly perform a 'deep dive' analysis on a particular area of concern. In some respects, technology and data governance processes have not kept pace with the growth and increased complexity of the AML landscape. AMLA will likely have to tackle the same problem. It will be essential for AMLA to have both specialized AML experts, data analysis experts, as well as experienced AML hierarchy-trained liaison officers for direct and efficient cooperation with national authorities.

Do we expect too much of AMLA?

It is hard to tell at this point. AMLA is still a long way off from being operational. The plan (as it stands now) is to reach full staffing in 2025 and to start carrying out direct supervision in 2026.

We are opening a new chapter in our AML/CFT common agenda.

While there is no doubt that the intent is there, we should not be surprised if there are delays, and there should be contingencies in place to anticipate and address them. It will be crucial for national authorities to understand AMLA`s role and integrate it into their processes, to avoid both redundancies and supervisory gaps. As with any new system, uncertainty can lead to miscommunication, and that can cause problems that should have been flagged to be overlooked. To be effective, the transition into the "AMLA age" should be made with a thorough understanding of timelines, individual responsibilities, common obligations, tasks, and available collaboration tools. From the level of AMLA's General Board to the experts in joint supervisory teams, national supervisory authorities should be proactive and driven to enhance AML results at the EU and national levels.

While AMLA is not the SSM, there are similarities and experiences that we can draw on. Adapting to the direct supervision approach may provide some challenges at first, but this model will provide a much-needed horizontal perspective when supervising cross-border financial sector entities exposed to the highest risk of money laundering.

Direct supervision aside, AMLA will mainly function as the central authority coordinator and a facilitator for national authorities, and it will provide support for national-level supervision while having a holistic overview of the EU landscape and the risk emerging in the system. Joint supervisory teams are not a new concept and they work well for the banking system. They can and should be used by AMLA and national authorities as a tool to enhance supervisory efficiency and to provide net enhancements through collaboration.

Like in banking, AMLA can benefit from the expertise and experience of national competent authorities to avoid the pitfalls of a 'one-size-fits-all' mindset, which can be damaging for both the supervised and the supervisor. The expectation is that the new joint approach will be supported by robust empirical research on the real effects of supervision, leading to an outcome-based, forward-looking system. The experience and practice gained through cooperation and resource-sharing should be seen as additional capital for both sides.

Human resources and shared knowledge make only one side of this equation. A realistic budget and a functional infrastructure are the other. If we empower AMLA with a systemically important role, we must make sure that the role is properly funded. Otherwise, we are creating a single point of failure in the system.

All those pillars are equally important. We are opening a new chapter in our AML/CFT common agenda, and it is up to us to provide a solid framework for the future and imbue it with added value. If we do that, pooling expertise, high-quality data, and collaboration under the same umbrella should provide a recipe for better AML/CFT results.

TOBIAS THYGESEN

Director, Fintech, Payment Services and Governance - Danish Financial Supervisory Authority (Finanstilsynet)

How can the AMLA take us to the next level?

The fight against ML and TF has been significantly strengthened in recent years. In Denmark, following two wake-up calls (the 2017 FATF MER and the Danske Bank Estonia case), lawmakers, supervisors, obliged entities, and law enforcement authorities have all devoted considerable extra resources to this important effort. At the DFSA, we have increased inspections manifold, developed and refined supervisory techniques, risk assessments and guidance to obliged entities.

The recent settlement in the Danske Bank Estonia case, with combined fines of more than 2bn USD, furthermore indicates that we have gotten incentives right in the sector, at least for now.

This should not lead us to rest on our laurels, however. It is difficult to measure the efficiency of current efforts. Although the number of suspicious activity reports have more than quadrupled over the last eight years, it seems obvious that we need to take the fight to the next level to succeed. The current debate and negotiations on the future AML regulatory framework in the EU is a window of opportunity to do just that.

We have a momentous job in establishing the supervisory set-up and getting it right, including setting up the AMLA. The creation of the AMLA will raise a number of co-ordination challenges. AML/CFT supervision occurs within the context of national legal regimes and in close co-operation with national authorities, mainly the FIU, the police, other relevant authorities (e.g. tax authorities) and the courts, as well as in coordination with prudential supervisors.

This requires a strong understanding of domestic legal practices and government infrastructure (e.g. the domestic tax system, the domestic ID system etc.) and daily co-operation with domestic law enforcement and other relevant domestic entities. This will not be the core competence of the AMLA, and we need to ensure an effective cooperation between these authorities and the AMLA.

We think the AMLA should focus its attention where it has the greatest potential to add value: on the key value chain (obliged entities – FIU – law enforcement) rather than only on the indirect route through strengthened supervision.

To truly add value, the AMLA should push the use of technology to combat financial crime.

We need to harness the power of technology to succeed here and not focus on doing "more of the same" by applying blood, sweat and tears – and more paper work. Increased use of technology is even a win-win-win. It is more effective, it is more efficient and it is in some areas less intrusive for customers – and all three aspects are important. In 2021, we published a report setting out seven initiatives[1] where technology could help increase either effectiveness or efficiency (or both) – but subsequent discussions with interested parties have shown that there are likely many more avenues for improvement.

Underlying this are very difficult trade-offs – the fight against financial crime, which we all believe is crucial for society, on the one hand – and unassailable basic rights of privacy and, in the final instance, human rights on the other. These are difficult questions – but we need to pose them. Luckily, there are answers too.

In close cooperation with Germany and The Netherlands, Denmark has pushed for increased room for cooperation and data sharing in the future European AML rules. Current rules restrict obliged entities to arrange their preventive efforts in silos. The consequence is that we cannot follow money trails when criminals launder their proceeds through networks of accounts across financial institutions. At the same time, obliged entities are highly restricted in their ability to share insights on suspicious customers and transactions with each other. Costs of compliance, risk of negative supervisory actions and negative public backlash can push financial institutions to derisk instead of taking a true risk-based approach. The rules incentivise a "better safe than sorry" approach.

Our proposal aims for a framework which creates room for new and innovative approaches without specifying the recipe, based on the possibility for national discretion to develop initiatives on data sharing and cooperation, with all due safeguards. We are happy to see that the Council agreed on a way forward.

Thus, we believe that in order to add value, the AMLA should focus on driving increased efficiency and effectiveness through pushing this important agenda forward at a European level. There is a need for an authority with muscles to do this – and with the ability to answer difficult pan-European questions on the trade-offs involved.

However, huge shifts towards the future and technological openness in Europe cannot stand alone. The possibilities of technology should be an integral part of the FATF standards, which we should upgrade to actively encourage and even require increased use of technology and, in a wider sense, more co-operation and information sharing. But this is a debate for another day.

[1] https://www.dfsa.dk/News/Press-releases/2021/Consultation_project_aml_tek

ANDREAS SCHIRK

Head of Division - Austrian Financial Market Authority

Structural challenges for AML/CFT in the EU and key measures to address them

The EU is facing three main structural challenges when it comes to AML/CFT. They concern regulation, supervision and coordination including exchange of information.

First, in terms of regulation the lack of clarity and limited nature of some of the rules adopted at EU level, combined with different approaches in gold-plating, have resulted in diverging implementation of the EU legal framework across Member States (MS) and across obliged entities (OE). While in some cases national specificities might justify divergences, very often entities that share comparable risks across the EU do however not follow comparable approaches to tackle them because of divergent AML/CFT rules. Such inconsistent transposition and application of the EU AML/CFT framework creates blind spots and provides opportunities for regulatory arbitrage thereby undermining the combat against ML/TF across borders, as the recent AML scandals have shown.

Second, AML/CFT supervision within the EU is currently MS-based; its quality and effectiveness are uneven, due to significant variations in resources and practices across MS. The methods to identify risks and to apply the risk-based approach to supervision diverge among the more than 60 authorities covering the financial sector – not speaking of the many more authorities covering the non-financial sector. While some risks remain national in nature, others may impact the entire Union financial system. Fragmentation of supervision leads to information and supervisory gaps that in turn may lead to failure. AML/CFT supervision is as strong as the weakest link.

Third, there is still insufficient coordination and exchange of information. All recent major ML cases reported in the EU had a cross-border dimension. The detection of these financial movements is however left to the single OE and their national authorities and to cooperation among them. While this reflects their autonomy and protects data secrecy, this also leads to situations where relevant data are not shared and joint analyses are not performed for lack of common tools or resources or – more generally speaking – a common structure to underpin cooperation, coordination and innovation in the combat against ML/TF.

The EU's AML package aims at addressing those very weaknesses and supervisory gaps. The creation of a single EU rulebook for AML/CFT will reduce current loopholes and contribute to levelling the playing field. It should also provide clear rules on data sharing that allow for sufficient room for innovation and cooperation while imposing adequate safeguards.

Whether AMLA will deliver on its objectives will depend on how it is implemented in practice.

The establishment of AMLA will tackle the issue of institutional fragmentation of AML/CFT supervision and poor coordination at the EU level concerning actions to prevent ML/TF. Whether AMLA will deliver on its objectives will depend on how it is implemented in practice, in particular in terms of governance structures, framework for cooperation and investment in human resources and technology.

Starting with governance, AMLA will seek to ensure independent decision-making and operational independence, which are essential to avoid regulatory capture and promote fair and strong supervision. AMLA will institutionally link all supervisory authorities in the EU and establish binding cooperation mechanisms to prevent a deja-vu of past failures resulting from supervisory gaps and loose collaboration.

To succeed with its tasks AMLA will need strong leadership and sufficient highly qualified staff. To develop the required qualifications quickly while forming a common supervisory culture, mobility between national authorities and AMLA will be crucial. Rotation in both ways – from the national to the supra-national level and vice-versa – should be(come) the role model for career progress. Also, AMLA could become the hub for joint training initiatives.

AMLA could also make a significant difference in terms of AML/CFT supervision in the EU when it comes to data management and supervisory technology. One of its tasks is to develop an EU platform for data gathering and access to relevant information. A common platform is expected to ease exchange of information and provide a basis for data-driven AML/CFT supervision including with analytical tools, which could be used by both AMLA and national supervisors for risk-based supervision. This in turn should facilitate the convergence of supervisory practices.

AMLA will have the tools to identify best practices and foster supervisory convergence. Using them in an inclusive yet determined manner will strengthen supervision and contribute to ever more mutual understanding and trust among supervisors. The SSM and SRM have shown how important broad inclusion of other authorities is when setting up a new supervisory model.

Early buy-in of national supervisors will be key for building up the necessary capacities and setting the scene for effective and sustainable cooperation – AMLA should seek to learn from the experience including lessons learned of the ESAs and the SSM in this regard.

PAOLO COSTANZO

Manager, Financial Intelligence Unit (UIF) - Banca d'Italia

AMLA: perspectives for an effective action and support to FIUs

The European AML/CFT framework is complex: it is multi-disciplinary and multi-agencies and applies across a wide range of obliged entities The AML Package brings about important innovations that will strengthen the system: notably, a significantly higher level of harmonization through an AML rulebook and AMLA as an entirely new supranational agency. Still, a significant variance will remain across and within Member States in the nature of competent authorities, their powers, the distribution of competences. This variance is higher in the non-financial sector, less regulated and less known. Competent authorities, especially FIUs, will remain regulated in a directive, with ample room for national implementation that, while ensuring flexibility, may be less conducive for convergence.

It is a challenging context for AMLA to work in effectively and produce tangible results on common approaches and risk detection and mitigation. Expectations should be set correctly to avoid overreliance and complacency at national level; moreover, AMLA will have to "test" its governance processes, contain possible weaknesses, maximize the effects of its operational toolkit.

AMLA's General Board comes in multiple configurations. Firstly, it is split in a supervisory and an "FIU" composition; secondly, the former branches out in multiple settings, depending on sectors involved and national competences. Owing to divergent national solutions, different authorities may seat in the same configurations of the Board.

Different from its supervisory role, AMLA as the FIUs' Mechanism will play a coordination and facilitation role, more than taking binding decisions. National FIUs' remain in charge of reciprocal cooperation and information sharing, similar to the status quo, and the system will thus retain essentially its multilateral nature. This shows particularly in the crucial area of joint analyses: AMLA would manage a process where FIUs decide on whether to launch or participate in joint exercises and on whether, and on what extent, information can be shared. Incentives may not be there to effectively tackle significant cross-border financial criminality, as the experience shows.

The defence of national prerogatives has weighed heavily in Council's negotiations. While the matter may be further discussed with the European Parliament in the upcoming trilogues, it is important to reflect on key factors that can be leveraged to support AMLA's effective action for FIUs to step up their capabilities and converge toward common methods and activities.

Right expectations, realistic objectives, communication on results are key for AMLA's credible role.

The expectations on AMLA's role and capacity to deliver should be set correctly. In the FIUs' domain especially major responsibilities remain at national level; AMLA is certainly not a panacea for the ML/TF exposure troubling the EU; the new system will not be failure-proof mostly due to national inadequacies and discrepancies. AMLA should not become a scapegoat in case things go wrong (again) somewhere in the EU because of overreliance and complacency.

AMLA should deploy all its powers and functions, as limited as they may be, to foster a cooperative framework where FIUs have an interest and incentives in investing and participating. This common and cohesive playground should be underpinned by clear objectives, priorities and commitments.

AMLA will also have to rapidly set out and make available to FIUs working tools and methods that offer simple and convenient options for engaging in analyses and cooperation: flexible templates for information reporting and sharing, straightforward procedures to engage in joint analyses, guidance on analytical methods.

AMLA should develop IT tools and procedures for FIUs' operations and information sharing, building trust based on confidentiality and security, together with cost-effectiveness and convergence.

Effective communication is another key factor: to reconcile expectations with results; to keep the FIUs engaged. Objectives should be set out ex ante; what has been achieved and what hasn't, and why, should be transparently explained; difficulties and obstacles encountered should be identified, together with their causes and possible remedies; what AMLA can and cannot do, and the role of national authorities should also be clearly communicated, highlighting the level of commitment by the latter.

To sum up, AMLA's tasks will be challenging; for an effective role as the FIUs' "Mechanism" it is important to: set the expectations right, avoiding overreliance by national authorities; define clear objectives and priorities with realistic deliverables; provide for flexible guidance on FIUs' working methods; promote cost-effective IT tools; communicate transparently the results achieved, the obstacles encountered, what cannot be done.

DR. CHRISTOPHER P. BUTTIGIEG
Chief Officer Supervision – Malta Financial Services Authority (MFSA)

Reflections on effective AMLCFT supervision: a prudential regulator's perspective

The effectiveness of supervision with anti-money laundering and counter terrorism financing (AMLCFT) compliance is a topic that continues to be high on the political agenda. While efforts toward EU harmonisation in AML have been many, cross-border AML issues continue to come to light, and the powers of the proposed EU AML Authority (AMLA) remains the subject of debate at the level of the EU institutions. It is opportune to reflect on the elements that make an AML supervisory framework effective. This article focuses on the importance of cooperation between the prudential and AML supervisors for effective supervision.

An AML supervisory framework must have a clear legislative basis with well-structured laws and guidelines. It must be informed by comprehensive risk assessment and a sound understanding of the threats and vulnerabilities faced by the financial sector. This must be complemented by a supervisory regime that responds to identified risks, guides obliged persons towards compliance, and has the necessary tools to take remedial action and impose proportionate and dissuasive sanctioning measures.

Inter-authority and public-private information sharing arrangements, domestic and international supervisory cooperation, supported by a sophisticated technological infrastructure, have become fundamental for effective supervision. Supervisory cooperation is key to address the inherent weaknesses of a fragmented institutional architecture, where information gaps may result in supervisory failure. In an interconnected financial system, any supervisory mechanism, is only as effective as the level of cooperation that supports it, even more so from a cross-border perspective.

For jurisdictions operating with an institutional architecture, with different authorities with distinct AMLCFT, prudential and investigative remits, building cooperative relationships and conduits of information exchange are paramount for enabling effective supervision of financial entities and financial crime prevention. In the absence of these efforts financial supervision is likely to fail with authorities scrambling to act on incomplete information.

More is yet to be done at European level through the implementation of the new AML package to continue to develop supervisory cooperation.

Extensive cooperation between AML and prudential supervisors is essential. Indeed, experience suggests that effective financial supervision that identifies, understands, and mitigates the risks to the stability and integrity of the financial system cannot be achieved through a siloed approach. Effective prudential supervision requires access to AML supervisory information as deficiencies in an obliged entity's AML compliance framework may be a symptom of general failures in the governance and internal controls of the said entity.

Similarly, AML supervision requires access to prudential supervisory information, such as concerns related to the integrity of individuals or aggressive business models, that presents a holistic outlook on obliged persons. This supervisory cooperation serves to further enhance authorities' risk assessments and understanding through a complete information set.

While important, Regulators' cooperation should not simply revolve around the practical part of exchanging information, but also through the sharing of expertise, in this case between specialists focused on AML and those focused on regulatory compliance, to guarantee that information shared is information understood. It would be frivolous for regulators to flood each other with supervisory information haphazardly simply to show that it is diffused. Regulators must consider the quality of the information they are exchanging and how such information is considered within their operations, translating into more informed and effective tangible results.

At national level, the process for cooperation between prudential supervision and AML supervision in jurisdictions like Malta has been strengthened through enhanced cooperation and constant communication between the MFSA, which is responsible for prudential supervision, and the FIAU, Malta's AML supervisor. This has made both AML and financial supervision in Malta more effective.

At EU level, a lot has been achieved in the field of cooperation through the EBA's AML mandate which enabled it to foster and deepen cooperation between prudential and AML supervisors. However, more is yet to be done at European level through the implementation of the new AML package to continue to develop supervisory cooperation.

MARKUS RONNER

Group Chief Compliance and Governance Officer - UBS

Europe in unison can deliver a world-class AML framework

The EU has an opportunity to deliver a holistic and comprehensive reform of its anti-money laundering (AML) and combating the financing of terrorism (CFT) framework through the legislative package being considered by the European Parliament and EU member states. The aspiration should be to create a cutting-edge framework that is both effective and efficient, with consistent supervision across the European Union.

In implementing these reforms, the EU should streamline the AML-CFT framework by reviewing existing rules and harmonising their implementation as far as possible. EU legislators should limit national exemptions and avoid leaving room for parallel interpretation at EU member state level.

The primary focus needs to shift from simply maintaining technical compliance to a more outcomes-oriented approach. The Wolfsberg Group statement on demonstrating effectiveness provides a good benchmark: we need to establish clear priorities in terms of the money laundering and terrorist financing risks to which firms are exposed. Regulators should enable firms to operate a more risk-focused financial crime programme that takes into account the inherent risks of their own business model and services. For example, a payments provider faces a different set of risks to a wealth manager.

The new framework also needs to recognise that one of the key tools to fight financial crime is fostering public-private partnerships. Formalised cross-sectoral cooperation has an established track record in delivering more effective regulatory outcomes and prompt insight into emerging risks. Such partnerships should be at the centre of the set-up of the new EU-wide AML authority, AMLA, buttressed by extensive data-sharing arrangements.

Where at all possible, we must avoid additional layers of complexity, such as divergent or duplicative requirements from supervisors or in national rules. AMLA, the centrepiece of this integrated AML supervisory system, must have a clearly delineated supervisory scope, especially the boundary with prudential supervisors. Proactive alignment between supervisors will be key, to avoid conflicting communication or overlapping requirements. The set of criteria used to determine which entities will be supervised directly by AMLA should be transparent and easy to implement, so that the selection process operates smoothly. Equally important will be to ensure that firms that are not directly supervised by AMLA follow the same rule-set.

The aspiration should be to create a cutting-edge framework that is both effective and efficient.

In this regard, AMLA will have the opportunity to build a less fragmented, clearer and more consistent framework through its forthcoming mandate to draft regulatory technical standards and interpretative guidance. Legislators should also use the current reforms to ensure rigorous alignment with international FATF standards, in tandem with appropriate enforcement capabilities within AMLA.

New technologies could also play a key role in making the AML-CFT framework more effective. They will be crucial in supporting institutionalised solutions, for example to enable negative news-sharing across the industry. Likewise, innovative industry collaboration could help to build a more future-oriented framework through artificial intelligence-based solutions, for example to detect atypical behaviours. Increased use of shared utilities by banks and other parts of the financial system, including the shadow banking sector, could increase the effectiveness of money laundering prevention efforts, helping to safeguard the EU financial system. Subject to data protection requirements, such tools could potentially be extended across jurisdictions beyond the EU.

Legislators thus now have the chance to design a world-class framework that truly embeds more effective, risk-based and harmonised AML/CTF measures across the EU. Consistent enforcement, ensured via streamlined supervision, alongside encouragement of innovative solutions to reduce operational complexity, will be crucial in achieving this goal.

SYLVIE MATHERAT
Global Senior Advisor - Mazars

Fighting AML risks: what should be expected of the new setup?

It is relatively easy to draw a list of expectations for the new framework; it should cover everything we did not managed to have in the recent years, in a nutshell: harmonization, consistency, information sharing and efficiency.

It should foster in particular:

- more harmonization of rules,
- more harmonization in terms of rules implementation,
- more clarity in terms of what is expected from banks,
- more information and data sharing,
- more efficiency in terms of means used and outcomes,
- more cooperation between banks and authorities.

All this seems reasonable, still there is a lot to do to get there and the proposed new authority AMLA has an essential role to play. AMLA will be tasked first to implement a coordinated approach of what should be common rules out of the new EU regulation, it will then hopefully simplify data sharing and finally lead by example in terms of outcomes required as it will have direct supervisory powers although the number of banks under its direct supervision is not yet decided. Importantly, clarity about the level of scrutiny and coverage of AML risks is needed.

More harmonization and consistency in rules implementation

There is first a strong need for more harmonization. One critical characteristic is that AML rules are still based on national laws. This should be modified in order to fight efficiently money laundering that do not stop at borders.

In this respect the fact that new rules will come out of a regulation and not a directive is in itself an improvement. By being directly implementable in national jurisdictions, the new rules should be, by definition, harmonized across all EU countries. Then it is important to make sure that the implementation of rules will be also harmonized and that the different FIUs practices will be consistent across EU. AMLA has an important role to play there through its direct supervisory powers. In that respect the ECB recommendation that AMLA should have, at least, a bank directly supervised in each country is very important as it should deliver common supervisory practice in all EU countries.

To be efficient, AMLA should clearly state expectations in terms of coverage of AML risks.

Appropriate information sharing

There are two elements there: the first one is that the new authority should have access to the data it needs and then that this data should be of good quality. As recently mentioned in an ECB blog, AMLA needs to have access to all the information already existing in the different national AML/CFT authorities, it should also have access to the regular accounting and prudential data bases of the other EU authorities in order to gain sufficient knowledge of the situation of banks it will have to directly supervise.

Moreover, going forward it should enrich its own data base and the ECB proposal that it should create a new central hub to which all national authorities could have access is welcomed. It is a precondition for the new system to be efficient and all roadblocks linked to data protection need to be lifted for this very specific purpose.

More efficiency / which coverage of AML risks should be expected?

There is a lot of expectations there from public authorities, but also from banks. The public perception of the supervisory oversight of AML /CFT issues is quite negative as each scandals highlights loopholes in the supervisory framework hence the necessity for more harmonization and consistency as mentioned above. On the banks side there are a lot of frustration as well about the lack of cost efficiency of controls put in place in the last years.

Most banks have spent a huge amount of money to reinforce their internal controls without managing to fulfill nor the regulatory expectations nor those of the public at large. How can it be improved? First information sharing of some public data across banks (like clients ID for example) should be possible, then tools improvement like more use of Artificial Intelligence (AI) should also help to reduce cost while providing more efficient controls. But, more importantly, clarity about what is expected from banks and enhancement of the dialogue between banks and authorities is also needed. Unlike traditional credit risks where a margin of error is tolerated, there is an expectation that 100% of AML risks should be covered. This focus on exhaustive controls is not only expensive but also not efficient as all risks are treated the same way whereas FIUs are overwhelmed by huge number of suspicious activity report that they cannot prioritize. It also triggers stringent banks reactions towards certain activities like correspondent banking for example or banking coverage in certain countries or certain activities.

Common and public understanding of the required outcomes need further discussions in order to accept that banks focus on the most important issues.

AMLA should also clearly explain what is expected in terms of coverage of AML risks. Only this will increase the efficiency of the current system.

BRYANT GOFSTEIN

Deputy Chief Compliance Officer and Global Head of Financial Crimes Compliance - Western Union

Equipping Europe to deliver on global AML challenges

The last few years have made it abundantly clear that global problems know no borders. Financial Services Stability, pandemics or even supply chain problems do not stop at national borders. Increasingly, we are coming to realize that our common challenges demand joint solutions and approaches.

In what is an increasingly volatile world, where transnational dangers seem to ever increase, the response to ML/TF are immediate priorities of paramount importance for the stability of our economies and our societies at large. This is not an easy task for an interconnected world that is crisscrossed by a myriad of networks, that connect but also disintermediated by countries, regions, and economic sectors.

ML/TF are one of these global phenomena that are transnational and trans-sectoral by nature and demand thoughtful coordinated solutions. The EU is taking a leading role in developing a transnational AML/CFT response. This is not an easy task for what is essentially a federation of 27 States with, quite often, different domestic and foreign agendas, priorities, and capabilities. But it is essential, and it will also provide more clarity to financial services providers that operate in the EU's single market, benefiting companies and consumers alike.

Recognizing this, the European Commission ambitious Package to reinforce the European AML/CFT Framework. This push for further harmonization can, we believe, serve as a cornerstone for a more resilient framework. For financial services providers, operating within the EU Single Market, this evolution to a Regulation means that crucial functions, such as the templates for the reporting of suspicious activities, will be harmonized across Member States. The consolidation of supervisory activities through the AMLA can also increase efficiencies for providers operating in multiple Member States. For example, presently, obliged entities can be subject to multiple independent inspections in individual Member States. With AMLA, this scenario will be improved for obliged entities under direct supervision which will now be expected to be subject to one coordinated inspection action by AMLA and consolidated feedback that is aligned with all regulatory expectations.

ML/TF challenges demand joint solutions and approaches.

Apart from the new regulatory framework, another important point is developing a risk-based approach in the EU . While requirements for harmonization at EU-level through the Regulation is important, there is also a need to let obliged entities have enough flexibility to innovate and adapt to evolving ML/TF risks. To that effect, at Western Union we believe that a risk-based approach when it comes to ML/TF prevention and detection is key. This is something that the EU framework should embrace, enabling companies to develop and implement appropriate risk mitigation techniques.

There are additional areas where the AML Regulations can close some of the existing gaps.

The first one is information and intelligence sharing which is one of the main tools to address ML/TF risks; AMLA's centralized position enables it to act as a facilitator. Western Union also believes that AMLA's work in this area can be supported by developing a European one-stop-shop platform to further facilitate information flows between relevant bodies and entities, as well as enable information sharing on a need-to-know basis.

Associated with information sharing, there is of course a need to ensure adequate data protection. Data sharing practices need to be built on the principles of necessity, proportionality and protection of fundamental rights. AMLA, alongside the European Data Protection Board, are in a good position to support the interplay between data privacy and data sharing requirements for AML/CTF-purposes.

Finally, AMLA can also play a significant role is ensuring closer collaboration between all relevant parties. Western Union sees particular great benefits in enhancing public-private partnerships (PPPs). For a well-functioning system, it is important to ensure that the feedback from this assessment reaches back obliged entities and their respective regulators.

The below referred challenges are by no means exclusive to the EU. At Western Union we believe that the above principles are also key to addressing global ML/TF challenges. The FATF has been playing a fundamental role in both these areas and has been contributing to a culture of collaboration amongst different jurisdictions with the sharing of best practices and reinforcing the importance of cooperation.

The way forward is increased international consistency and harmonization, which still remain a challenge, globally, in spite of several initiatives and efforts. We are pleased the EU has recognized this need and is tackling today's ML/TF challenges in consistent, robust way.

NEXT EUROFI EVENTS

THE EUROFI FINANCIAL FORUM 2023

13, 14 & 15 September 2023

SANTIAGO DE COMPOSTELA - SPAIN

THE EUROFI HIGH LEVEL SEMINAR 2024

21, 22 & 23 February 2024

GENT - BELGIUM

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INDUSTRY REPRESENTATIVES

EUROFI PRESIDENT // David Wright
SECRETARY GENERAL & PUBLISHER // Didier Cahen
ASSOCIATE PUBLISHERS // Jean-Marie Andrès and Marc Truchet

EDITORIAL COORDINATORS // Virginie Denis and Daniela Craciun
GRAPHIC STUDIO // Initial Production - www.initialproduction.be //
Canana Studio - www.canana.studio

ABOUT EUROFI

The European think tank dedicated to financial services

- **A platform for exchanges between the financial services industry and the public authorities**
- **Topics addressed include the latest developments in financial policy and the macroeconomic and industry trends affecting the financial sector**
- **A 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 policy work in the financial sector 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 70 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 policy developments impacting the financial sector 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, China...) 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 (digitalisation, 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 post-Covid recovery, vulnerabilities in the financial sector, enhancements to the EU financial policy framework, sustainable finance, digitalisation trends and policies.... These documents are widely distributed in the market and to the public authorities and are also publicly available on our website www.eurofi.net :

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

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