www.eurofi.net

EUROFI

HIGH LEVEL SEMINAR
STOCKHOLM - APRIL 2023

Organised in association with the Swedish EU Council Presidency

Summary

Inside

- ECONOMIC CHALLENGES AND IMPLICATIONS FOR FINANCE
- BANKING AND INSURANCE REGULATION PRIORITIES
- DIGITALISATION AND PAYMENTS
- THE EU AND GLOBAL SUSTAINABILITY AGENDA FOR FINANCE
- CMU NEXT STEPS AND CHALLENGES
- FINANCIAL STABILITY CHALLENGES AND VULNERABILITIES

eurofi

Foreword

The Eurofi High Level Seminar took place in Stockholm on the eve of the informal Ecofin meeting and was organised in association with the Swedish EU Council Presidency. More than 1000 participants from the public and private sectors followed the 41 sessions of this Seminar and the interventions of key representatives from the public and private sectors and the civil society.

The macro-economic challenges facing Europe and the main regulatory and supervisory developments in the financial sector at the European and global levels were discussed during this Seminar, as well as the main vulnerabilities in the financial sector and the EU policy initiatives aiming to support the digitalisation of financial services and the development of sustainable finance.

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

This report, as well as the different publications published on the occasion of this Seminar (Regulatory Update, Monetary and Macroeconomic Scoreboards and the April 2023 edition of the Eurofi Views Magazine) are available on our website www.eurofi.net.

Marc Truchet
Senior Fellow

Didier Cahen
Secretary General

Jean-Marie Andrès
Senior Fellow

I. ECONOMIC CHALLENGES AND IMPLICATIONS FOR FINANCE

Stagflation in Europe: challenges and way forward
Implications of inflation, indebtedness and de-globalisation for finance
Inflation and monetary policy: way forward.
Fostering investment in the green transition
Key trends in the Nordic-Baltic financial sector

II. BANKING AND INSURANCE REGULATION PRIORITIES

Basel III implementation : global consistency challenges
Competitiveness of the EU banking sector
Enhancing the EU bank crisis management framework
Taking advantage of bank diversity in Europe

III. DIGITALISATION AND PAYMENTS

Digitalisation trends and policy approach
Cryptoasset and stablecoin regulation
Crypto and DeFi technology applications in finance
AI and ML applications in finance
Digital operational and cyber-resilience
Open finance: ambition and policy approach
Digital Euro: use cases and design
PSD2 review priorities
Cross-border payments and global infrastructures
Instant payment attractiveness for EU citizens

IV. THE EU AND GLOBAL SUSTAINABILITY AGENDA FOR FINANCE

Avoiding greenwashing in the financial sector
Transition of financial activities towards net zero
ESG issues in the asset management area
Global convergence of sustainability reporting standards
Climate change insurance needs

V. CMU NEXT STEPS AND CHALLENGES

CMU: short and longer term priorities
EU capital market competitiveness and integration
Retail Investment Strategy: key issues
MIFIR review: pending questions
Strengthening EU clearing
Impacts of digitalisation on trading and post-trading
SME equity funding: Listing Act and ESAP proposals
Investment product frameworks: trends and further issues
Securitisation in the EU : future prospects

VI. FINANCIAL STABILITY CHALLENGES AND VULNERABILITIES

Financial stability risks in Europe
Sovereign debt challenges in the EU
Managing risks in the banking sector
Fund liquidity issues
Sustainability risk in the banking sector
Sustainability risks in the insurance sector
AML: key success factors

Sessions

I

ECONOMIC CHALLENGES AND IMPLICATIONS FOR FINANCE

Stagflation in Europe: challenges and way forward

Europe is facing is facing a triple challenge of too high inflation, rapidly cooling growth, and financial market jitters

The Chair stated that Europe is experiencing a stagflationary period following the double shock of the pandemic and the Russia's war in Ukraine and the subsequent energy crisis. The European Union has not experienced this structure and combination of shocks in modern economic history. At the same time, Europe is in a global monetary policy tightening cycle after an extended period of declining and very low interest rates.

Europe has shown a great deal of resilience so far, but it is also experiencing financial fragilities. It avoided an all-out recession this winter but is facing a triple challenge of too high inflation, rapidly cooling growth and financial market jitters. Many find this setting worrying. Although some find reassurance, but others also find it potentially explosive. Stagflationary periods always pose difficult policy challenges, but this is a particularly severe setting in which to ask for the appropriate monetary and fiscal policy response. That will be done in this opening panel and later in the conference, and it is very appropriate to put so much emphasis on the macroeconomic environment because it is such an interesting setting.

1. Monetary policy should remain tight until core inflation is unambiguously on a path back to central bank targets

An official explained that there were great concerns about a deep recession in Europe over the winter because of a Russian gas shut off and that did not happen because of very strong policy action, helped by a mild winter. There was a strong recovery from the pandemic in the first half of the year and then the Russian invasion of Ukraine set up this year of slow growth and high inflation. It increased the costs for businesses, resulted in inflation, cut people's purchasing power and required tighter monetary policy.

This year, aside from the slow growth that is expected to recover into 2024, it is necessary to tackle high inflation. Headline inflation will come down because of lower energy prices, but food inflation is still going up and underlying core inflation rate remains more persistent. This reflects energy costs working themselves through, but as core inflation affects a very broad base it also reflects the very tight labour market and the fact that the euro area is working at capacity.

Monetary policy needs to take this into account. Defeating inflation is the number one priority. Monetary policy needs to stay tighter for longer to bring inflation down. In failed episodes of monetary tightening, there was a premature loosening or failure to react decisively enough when inflation risks were recognised. Therefore, the European Central Bank (ECB) should tighten further. That requires a hike in policy rates and higher rates need to remain for longer to bring Europe back to the inflation target of 2% during 2025.

1.1 Taming inflation requires positive real interest rates and fiscal consolidation

The resurgence of inflation started before the war in Ukraine and monetary conditions have not been tightened in real terms in the euro area

A market expert explained that the facts need to be accurately determined to assess the situation and work out a solution. It is a mistake to say that the Ukrainian war triggered inflation because inflation was already more than 5% when the war started. Despite nominal rate increases, between January 2021 and April 2023, real rates remain very negative. Monetary policy has been loosened, not tightened, and the key question is the level of real interest rates that would be consistent with taming inflation. The answer is not known, but it is imperative to fight against inflation and accept a modicum of economic slowdown.

The Chair recalled the German Bundesbank President Joachim Nagel's statement that, if inflation is stubborn, it is necessary to be more stubborn, though monetary tightening comes at a cost.

A public representative commented that the inflation problem necessitates policies that impact the economy overall. That is basic knowledge, but getting control of inflation is an absolute priority. Paul Volcker, the man who killed inflation in the 1970s, always repeated the same mantra. Once there is an inflation problem, two things are necessary: first, positive real interest rates for a sustained period of time and, secondly and unfortunately, a recession to get inflation under control. This basic truth remains accurate.

It is undeniable that central banks increasing interest rates to a level of positive real interest rates will have an impact on economic growth. However, one must take into account the substantial worldwide budget stimulus. In the US, the Inflation Reduction Act is stimulating inflation. In Europe, only around €130 billion of the €700 billion Recovery and Resilience Facility has been spent. China is also reopening. To speak of budgetary restraints at a time when there are still important national deficits is not realistic.

This expansionary budgetary policy sits alongside increasingly restrictive monetary policy. To get control of inflation, which is very destructive notably for poorer people, monetary policy will have to go further. There must also be a process of reducing national budget deficits because of the huge stimulus at the European level with the Recovery and Resilience Facility, REPowerEU and the European Sovereignty Fund.

1.2 The shocks of the Covid 19 pandemic, the war in Ukraine and heightened geopolitical tensions have created a great deal of uncertainty for monetary policy, which should not be overtightened

Another speaker stated that the present situation is strikingly unprecedented. There have been exceptional price shocks but also forced savings during the pandemic, meaning that the reopening occurred amidst very large household savings. That unusual buffer is beginning to fade, as are the exceptional corporate profits, although they remain strong. Bankruptcies also remained exceptionally low during Covid because of government support for companies, though corporate defaults are now beginning to tick up. Their absence during the pandemic meant the job losses associated with them did not materialise, explaining the exceptionally tight labour market. These buffers are exceptional but, as the price shocks work their way through, they are beginning to fade. This creates tremendous uncertainty for monetary policy, raising the question of whether the fading buffers should be minded to avoid over tightening.

Several indicators point to a pause in the rise of interest rates

A speaker explained that corporate defaults are a lagging indicator of the cycle. The leading indicator is credit conditions and bank lending surveys show a substantial tightening in the pipeline, both in the US and in the euro area. The European Commission's survey of selling price expectations is also a good leading indicator of core inflation and these are falling.

The other issue, tied to financial stability, is that this exceptional period of unusual buffers and rapid tightening comes after a long period of exceptionally low interest rates. That argues for a little caution. Although policymakers should not cut rates, they should take some time given the uncertainty and the lags with which monetary policy feeds through. 3.75% is a good place for the ECB to get to and take a pause. Real rates on longer maturities have moved back into positive territory. There is a very delicate balancing act at play.

On fiscal policy, it was right to provide support during Covid and Europe did a much better job than the US. However, the response to the energy crisis should have been more targeted and it is right that these measures are rolled back.

1.3 Fighting inflation should be the policy priority which requires further tightening monetary policy

A public representative stated that, as there is a great deal of fiscal stimulus in Europe and the US China is reopening, there should be more restraint at the national level. The policy mix of budgetary policy and monetary policy should always be considered. A huge sector of 'zombie companies' that cannot survive without low interest rates and fiscal support has been created by recent monetary and fiscal policy. It is necessary to deal with this.

With respect to credit tightening, Joachim Nagel recently stated that there is more than €4 trillion of excess liquidity in the euro area. It is not possible to bring inflation under control without tightening credit to reduce that amount. Otherwise, that excess liquidity will continue in perpetuity and prevent policymakers from controlling inflation. European policymakers must focus on inflation because a return to the stop go policies of the 1970s will produce the worst of all worlds: inflation that remains out of control, recessions followed by weak recoveries and the constant threat of financial instability. It is simply necessary to bite the bullet.

The Chair commented that the low productivity companies suffering at present are small and medium sized enterprises (SMEs) without access to capital markets, as they are dependent on banks, whose credit standards are tightening. Getting rid of 'zombie companies' would imply wiping out parts of the SME sector, which would represent quite a structural change for some countries. The question is how dramatic this action should be and whether progress must first be made on Capital Markets Union (CMU) to offer them alternative sources of finance. That is not yet in place yet and will only become effective in several years into the future, but monetary policy is already tightening. It is unclear which companies would replace these parts of the economy if they went out of business.

1.4 Whatever the uncertainties of the moment, the fight against inflation must be the priority

An official stated that monetary policy needs to focus on bringing inflation down because if this is not achieved, there needs to be a second attempt and the duration of financial stress is going to increase.

A market expert explained that pursuing an aggressively stimulative fiscal policy alongside an accommodative monetary policy in recent years was bound to create inflation. Inflation was already present in financial and real estate assets, but it was not recognised and eventually inflation caught the whole system. Monetary and fiscal stimulation together is creating inflation. Now, the fight against inflation must be the main priority, because having some inflation with some growth does not work. The stagflation in the 1970s and in the early 1980s was a disaster. There was no growth and there was a great deal of inflation, with all its attendant negative social consequences. Uncertainty has always been a feature, but it is necessary to reduce inflation.

Real interest rates are still negative. This is a call to operators to borrow more, but this will not solve the problem of inflation. It is necessary to accept that monetary policy is being restrained after a very accommodative period. Credit is becoming less easy, but it is not possible to have it both ways. Credit restrictions and higher unemployment are necessary to combat inflation. Larry Summers has calculated that unemployment must increase from 3.5% to 5% in the US to tame inflation. This is realistic. Summers acknowledges that there is a price for reducing inflation, but it will be impossible to benefit from eliminating inflation if this price is not paid. A degree of realism is necessary.

If the banking system is characterised by large portfolios of bonds with fixed and low returns on the balance sheet, as in some regional banks in the US, there is an additional problem, as seen in recent cases. But if the banking system is well regulated, as in Europe, banks can benefit from higher interest rates and their portfolios are less affected by the reduction in value that comes from higher interest rates.

1.5 Price stability can be achieved without jeopardising financial stability

1.5.1 There is no trade-off between price stability and financial stability

A speaker commented that, ex post, there is no trade-off between price stability and financial stability, given that financial crises are deflationary. However, it must be acknowledged that, although liquidity support can be provided, it is harder to counteract falling collateral values and no one argues that central banks should provide this support. Caution is necessary because it will take time for the cost of credit to roll over due to increased durations and liquidity support cannot address the substantial underlying tightening that the signals indicate is coming through to financial markets.

A market expert expressed a view that price stability can be achieved without jeopardising financial stability. Restrictive monetary policy is compatible with necessary, limited liquidity provision to banks caught in the trap of higher nominal rates reducing the value of their bond portfolio. In the US, the consequences of crumbling bond portfolios have been acute in some deeply mismanaged cases that have been aggravated by poor supervision and even tinkering with accounting rules.

1.5.2 In principle, financial risks should be contained through financial sector policy action, strong supervision and, where appropriate, liquidity provision through the central bank's 'lender of last resort' role

An official observed that the financial stability risk is different from 2008. The banking system is well capitalised and has high liquidity. In Europe, it is well supervised and well regulated. It has some resilience going into this period of financial stress. More can be done on the supervisory front. There needs to be stress tests for interest rate risks and liquidity and funding issues need to be examined.

It is normal for there to be financial stress during a period of tightening. European policymakers need to be prepared for issues in commercial real estate side and for an increase in non-performing loans (NPLs), but the system should be able to cope. If there are problem spots, the central bank and supervisors can intervene, but there is no reason to subsume monetary policy to financial stability. They should go in tandem, with a focus on bringing down inflation.

2. Decisive fiscal consolidation is needed starting this year to support monetary policy and build buffers

An official stated that more ambitious fiscal consolidation will help central banks meet their objectives at lower rates, with positive spillovers for public debt service costs and financial stability. Tighter fiscal policy will also enable governments to restore depleted fiscal space to cope with large future shocks and long-term spending pressures.

Expansionary fiscal policy during the pandemic was appropriate to avoid the collapse of the economy. The focus on cost of living in 2022 was correct, but could have been targeted more efficiently to save money. In 2023, the energy and cost of living packages should be phased out because energy costs are coming down. At a minimum, they need to be made more targeted because that contributes to aggregate demand, which is contrary to fighting inflation. Fiscal policy must be aligned with central bank policy to fight inflation.

Consolidation is necessary in the medium term because the next crisis is just around the corner and there must be fiscal buffers to be able to intervene. Structural reform is going to be key both for this and for inflation, because active labour market policies can reduce the impact of labour market issues on inflation.

2.1 Expansionary fiscal policies have enabled European economies to cushion the blows caused by Covid 19 and Russia's war against Ukraine. Europe has also entered 2023 on a stronger footing than previously projected

A policymaker observed that the European Commission might be a touch more positive than the panellists in its growth expectations for 2023 and 2024 because of more positive recent data and the significant reverse terms of trade impact of falling energy prices, but the narrative is very much the same.

Fiscal policy in recent years helped increase the resilience of Europe's economy in the face of two large shocks. Fiscal policy supported demand during Covid when large sectors were shut down. During the energy crisis, it played a critical role in supporting corporates and vulnerable households cope with the pace of the energy price increase. Finally, it has helped to reverse the declining levels of public investment and bring these back to levels seen before the global financial crisis. A great deal of that is due to additional spending at EU level and this is essential to support European economies and help with the critical structural changes in the climate and digital transitions.

2.2 Very high levels of public debt need to be addressed and fiscal policy should ensure medium term debt sustainability

A policymaker commented that fiscal support has left the European Union with a legacy of higher deficits and debt levels from already elevated levels before Covid. Highly indebted Member States must now move towards some process of consolidation, and it is a question or getting the pace of that right.

The recent fiscal outcomes are better than expected, due to two reasons. The impact of the energy support measures has turned out to be lower than expected because energy prices have declined and inflation has had a very positive impact on public finances in terms of higher revenues, particularly from indirect taxes. Nominal GDP has gone up, which has had a positive impact on public debt levels, but this could turn over the longer term because there are additional expenditures associated with the energy support measures and interest rates will push up the cost of servicing debt.

The budget positions of Member States are probably overly expansionary for 2023 in the context of higher inflation. For 2024, the fiscal plans shown to the European Commission are contractionary, but that contractionary stance is contingent upon the energy support measures actually being phased out. That is currently the case on paper, but it remains to be seen if it will transpire. One issue to watch is that some of the short term positive windfall effect on fiscal outcomes that inflation is having is being spent in some of the budgetary plans. This is leading to additional current expenditure, and it is going to be a critical priority to make sure that this fiscal illusion is not inadvertently spent.

2.3 The most important challenge is that European populations have now understood that it is easy to do fiscal policy when something goes wrong. This is going to be very difficult to walk back from

A speaker suggested that existing fiscal support measures could result in pressure for more fiscal spending to counteract food price inflation or for support in response to a new shock somewhere else. This is going to be very dangerous, and the worst situation would be to end up with fiscal policy overburdening monetary policy in the other direction, with too much fiscal impulse and too much monetary policy tightening. It is necessary to be cautious of this situation because it would result in the private sector being crowded out. Limiting stagflation risks at the cyclical level requires that monetary policy and fiscal policies work together. Christine Lagarde, President of the ECB, warned that fiscal measures to mitigate the energy price shock should be temporary, targeted and tailored to preserve the incentives to consume less energy. Individual Member States have very divergent fiscal policy responses and several fail this test, adding to inflationary pressures. Effective fiscal policy co ordination between Member States in the euro area is therefore necessary.

Euro area governments must be careful not to overburden the ECB

A speaker warned that while it is important to be careful on inflation, it is also important to be careful on the stability of the real economy. Following the recent successes on the fiscal policy side, fiscal policy will be tightening and there is room to take things a little more slowly.

2.4 Structural reforms are of the essence to promote growth

Another policymaker stated that fiscal policy has done a good job in recent years, but it is now more expansionary than it needs to be. It needs to be a bit more contractionary to support the efforts to reduce inflation, and the two key objectives for this year are severely restricting the energy support measures given the reduction in prices and avoiding spending the short term inflation bonus.

Some other elements are key. First, important fiscal and structural reforms that can be growth friendly and improve fiscal sustainability need to be pursued. The significant tax reforms being discussed in Italy, Spain and Lithuania need to proceed and be ambitious. Belgium also needs to progress on pension reform. European countries need to look at the way they design their social benefit systems, because the inability to provide sufficiently targeted support to those most vulnerable has led to overly generous or expansionary support measures.

2.4.1 Structural reforms should prioritise lifting crisis damaged potential output and easing the growth inflation trade offs

An official commented that increasing productivity in the long term will require reskilling the labour force for digitalisation and supporting the green transition. Growth is what matters in the long term and long term growth is driven by productivity growth. The focus must now be on medium term growth and structural reform, which is important in the short term but essential in the medium term. The NextGenerationEU Fund is a fantastic vehicle to incentivise structural reform and lift productive capacity. It is an appropriate vehicle to provide investments in key drivers of the transition and needs to be spent well.

Another speaker observed that structural reforms are key at both the national and European level to boost growth and strengthen the resilience of the euro area economy. Good visibility is a priority, as this is critical for the private sector to have certainty and understand what is happening. There also needs to be the right type of financing given the significant financing needs of the green and digital transitions. Europe is still highly dependent on bank lending as a source of financing for its economies, but while bank lending is very important, it cannot finance the new technologies that are needed in Europe today. Capital Markets Union is critical.

2.4.2 NextGenerationEU is an essential tool to support public and private investment

A policymaker noted that while inflation in recent years is partly driven by demand, much of it has been due to supply side shocks. Looking forward, with the fragmentation of the global economy being noted in recent discussions in Washington, global supply may be less responsive to fluctuations in demand. That could be an important challenge for policymakers. European policymakers can help by supporting both public and private investment, and this is where implementing the Recovery and Resilience plans is important. Approximately €160 billion has been disbursed to date, but that still leaves close to €500 billion still to be disbursed in the coming years. That implementation should be progressed.

2.4.3 Credible fiscal rules with the right tools for enforcement are essential to ensure sound public finances across the EU

A policymaker commented that it was essential for the Economic Governance Review to be agreed quickly. The legislation must be adopted within the current European Parliament cycle and, ideally, by the end of the year, because it is necessary to benefit from a credible medium term framework for fiscal policy to get the right policy mix.

2.4.4 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 loose, it damages aggregate supply

A market expert stated that, for four decades, the belief was that the main problem was a lack of demand and there have been attempts to correct this so called lack of demand by providing money to the system. This was a mistake. In reality, economies were suffering from a lack of supply. The supply system is very inelastic, notably in Europe, and it is not possible to revive it by throwing money at it. Only by investing more and making the right structural changes is it possible to enlarge the potential growth of a country, but more money has obstinately been put in to create more demand, which was not the problem.

Another speaker concurred that the problem was on the supply side and observed that, if central banks misdiagnose what is really a negative supply side shock as a negative demand shock, the real neutral rate is pushed down and unproductive investments are created. This has a very negative effect, so it is critical that those reforms are delivered.

Implications of inflation, indebtedness and de-globalisation for finance

Introduction

The Chair noted four broad questions about this vast topic: dealing with the recent banking sector developments, the macro financial implications of high debt rates, the opportunities and challenges facing the financial sector in the current environment, and the relevance of economic security/strategic autonomy in the new geopolitical context.

Lessons can be drawn from the collapse of US regional banks and the takeover of Credit Suisse by UBS for the regulation and supervision of the EU and global banking systems.

1. Lessons drawn from the collapse of regional banks and the takeover of Credit Suisse by UBS

1.1 The US banking turmoil reveals a triple failure of management, regulation and supervision

An official stated there is a paradox because bankers one year ago were happy to see interest rates increase, but now there is the risk of rate increase.

The US regional bank crisis shows a triple failure. It is a failure of management not to deal with interest rate risk, duration and diversification, which were forgotten by the management of Silicon Valley Bank (SVB). It is a failure of regulation, as it was the 16th US bank not covered by Basel III since the Crapo regulation. It was a failure of supervision because many people knew what was happening but there was no remediation action by the supervisor.

An IFI representative argued that what happened in the US revealed primarily an issue of supervision. Following the tightening of the financial regulations after the Global Financial Crisis, focus needs to turn to implementation, and the quality and scope of the supervision. Lessons will have to be learnt by regulators on new developments in the market, such as increased fluidity of deposits, and the role of social media in this acceleration.

An industry representative stated that the first issue was on both sides of banks' balance sheets. For many years there were no interest rates as they were very low or event negative during the past decade and suddenly, they appeared with a vengeance. Many institutions were not prepared or forgot how to handle interest rate risks. On the supervisory side, not enough attention was put on how some institutions were handling interest rate risk.

1.2 European banks have weathered the recent banking turmoil in the US and Switzerland

1.2.1 A widespread banking crisis did not happen

An industry representative observed that a few lessons can be drawn from what is going wrong with the US banks. These are banks in crisis, but this is not a widespread banking crisis. There were three things affecting these banks. First, there were weaknesses in their business models. Second, there was weakness from a liquidity perspective. Lastly was the treatment of the interest rate risks affecting their bond portfolios.

An industry representative stated that the European system was very resilient. The response from the authorities and the political circle was effective. The old world and Europe have been hit in the last few years by incredible shocks. The response has been appropriate, both at the macro level and the market level.

1.2.2 The EU banking industry is resilient so far

An IFI representative added that the same contagion effects as 2008 are not seen looking at emerging markets in Eastern Europe and the European neighbourhood. There has been a great deal of work done since 2008 to strengthen the financial system and the banking system, including the Vienna Initiative.

1.2.3 Contrary to the US, all EU banks are subject to the Basel requirements

An official stated that the situation in Europe is very different. Unlike the US, all banks are under Basel III in Europe. There is high level of capital, a high level of liquidity, which is sometimes criticised, but there is also centralised supervision with the Single Supervisory Mechanism (SSM). There are old patterns like bank runs and new patterns like digitalisation, the use of social media and the velocity of the bank run. It is not time now to change the regulation. Basel III and the framework need to be implemented. There is a consensus text of the Council now in Parliament. Europe needs to be ready for 2025.

Secondly, there is a need to implement what has been decided. The Single Resolution Fund (SRF) should not be increased at this juncture. But the ESM backstop o this SRF should be implemented. The certification of the European Stability Mechanism (ESM) has been missed.

Finally, the question is whether the resolution of SVB should be copied. It was peculiar to see that the US administration decided to guarantee all the deposits. Cases have been seen where deposits were not guaranteed and were built in, in the US, Denmark and other jurisdictions. If the route is followed to guarantee all the deposits, there could be many good things, but there might not be an economic rationale. Moral hazards could be created for big corporates, so that they will deposit and not care about the situation of the banks they deposit into.

An industry representative noted that there are interesting statistics regarding the metrics that EU banks publish versus underreporting in the US market. For example, SVB did not have to report their Net Stable Funding Ratios (NSFRs). The US regional banks are significantly weaker on Liquidity Coverage Ratio (LCR) and other metrics reported than EU banks.

1.2.4 The EU responded quickly and appropriately to the fall of Credit Suisse

An industry representative advised that when risks present themselves it is important for authorities to come out with clear and rapid communication to calm markets. That happened in Europe in the wake of the additional tier 1 bond (AT1) issues in the Swiss market. It was important to re-establish the hierarchy of claims in the EU. Market risk remediated after that as a result.

1.3 The crisis should lead to reflections on the consequences of the speed of deposit flight in age of social media

1.3.1 Regulatory and supervisory tools need to adjust to social medial and digital banking

An IFI representative stated that the risk of black swans cannot be excluded in the current context. It is necessary to remain vigilant, taking into account the new phenomena of social media and the speed to withdraw deposits, which adds to the risks of sudden stops, compared to the GFC. Work is needed to adjust the regulatory tools to react better to this new reality.

An industry representative mentioned that the role of social media can be very devastating. In the middle of a panic, it can be a dangerous accelerator. Policies and companies have to be aware of this and prepare for how to respond. Things are not only going to change during a panic. Mobility of deposits is going to increase substantially because the technology is there, the financial literacy of the new generation will change, and the nature of deposits in a certain institution are more commercial than retail and will generate a need for banks and the banking institutions to look at deposits in a different way. This has implications on the business models and profitability of banks, and the way in which supervisors will look at the business model from the risk point of view.

1.3.2 Diversification of banks' funding sources is of the essence

An industry representative highlighted that one of the most important points is the need for diversification in funding sources. 88% of SVB's deposits were unsecured corporate deposits, compared to 16% in the banking sector in Europe. They had huge concentration risk, in addition to the tech sector. Diversification of funding sources is going to be a critical component to the way the banking sector takes forward risk and evaluates portfolios. In the wake of SVB and First Republic, there was huge utilisation of the Fed window. In the United States during the financial crisis in 2009, about $115 billion was used. In the week after SVB, it was $165 billion. The European Central Bank (ECB) and the UK have active windows, which remains critical for the banking sector to regain its footing after something happens. Banks will have to think a lot harder about digitalisation. Credit Suisse ended the year with about $56 billion of cash on its balance sheet. It lost $50 billion in a matter of five days. That was at the core of the bank being married with UBS.

1.3.3 Confidence and systemicity at the digital age

An official stated that the combination of social media and mobile banking presents a challenge for institutions, which manifested in the $42 billion run for SVB in a few hours. Speed is of the essence but there is need to be realistic on what can be achieved, as well as what needs to be done and how to bridge that gap. It is also known that dragging moments happen, and there is need to act decisively, quickly and to be flexible when action is required. One of the lessons is that both US and Swiss authorities reacted within hours, in a swift and coordinated manner. Many think that the AT1 markets left a few strings loose, such as the specific definition of what systemic is. Linking that to the social media argument, everything is informationally systemic.

1.3.4 The nature of sovereign bonds as "risk free assets" raises questions

An industry representative noted that a great deal of interest risk was coming from sovereign bonds. Years ago, a bank finding itself in trouble because of holding too much sovereign bonds was strange. From the supervisory point of view, the system has as an important 'risk-free asset' in sovereign government debt. The fact that during a crisis this can be a problem instead of a solution means there needs to be a rethink of what it means for the prudential framework. On the liability side, something new has happened in that deposits are legally in demand and so are short, but in practice have been considered sticky, except during a panic.

1.3.5 Anticipating crises remains challenging

An official stated that economists are not good at anticipating crises but may be good at explaining them ex-post. The question is why because economists are always trying to identify risks everywhere. It might be a matter of not putting the exact likelihood of the risks. There may be a component avoiding a self-fulfilment in the identification of risks.

2. EU priorities for the financial industry in the current challenging macro environment

2.1 Opportunities and challenges for the financial sector in the current macro-economic environment

2.1.1 Inflation is not a good deal for banking and finance

The Chair wondered whether the main threat from over indebtedness comes from higher financing costs. This is just one element of a much broader macro-financial context of high and persistent inflation combined with sluggish growth. Notably, real interest rates remain negative.

A public representative commented that there have been opportunities with the increase of interest rates for the financial and banking sector. There have also been threats and effects on balance sheets. There is need to be wary about inflation. Interest rates are the result of trying to cope with the high inflation. The problem is how to deal with that and the impact on the financial industry. In the medium and long term, inflation affects expectations and investment plans, because it creates uncertainty. One potential risk is that investors look more at the medium and short term, because they do not know the dynamics. This could affect investments in the medium and long term, affecting potential growth. In the past year, there has been the impression of too much reliance on the ECB and monetary policy. The same has been done more recently on inflation. The ECB has a key role, but it is a very complex phenomena and there are certain things that ECB and monetary policy alone cannot do.

2.1.2 The challenges and impacts for the financial sector

An industry representative highlighted that things are doing well in Europe in this environment. The question is how to manage assets in liabilities and interest rate risk. Loan deposit repricing is outpacing the increase in the deposit pricing. That is called beta, which is the reason banks in Europe are doing well. Their deposit rates are not reverting as fast as their ability to reprice their loan. The losers are Capital Markets businesses and mergers and acquisitions (M&A) businesses. 2022 saw wallets decline about 50%, and 20% in the first three months of 2023. Clients are waiting for a moderate business environment and ability to take decisive action to commence deals. The execution enclosure of transactions has softened. In some bank results, if they are heavily oriented towards markets or the investment banking businesses, they have had a harder year. It is still a benign credit environment. The one thing that could surprise is credit deterioration, partially because of the higher interest rate environment. It is important to keep eyes on managing assets and liability frameworks to make money.

One risk that cannot be quantified is quantitative easing being pulled back. The impact that is going to have on the banking system is not known, with liquidity effectively being withdrawn from the market. However, there could be pockets of liquidity weakness because of the monetary policy being unwound. On a positive note, the outlook for economics in the EU has been upgraded. Southern Europe was one of the reasons that Europe recovered better last year and had a better economic outcome. Europe is not in crisis, but Switzerland and the United States have been. There is still a lot of work to do on banking unions and capital markets unions (CMUs), not waiting for the crisis.

2.2 More equity financing and less debt financing is the right way forward

The Chair commented that US and Swiss banking sector developments are an example of how the financial sector has been caught out by the abrupt paradigm shift, which is not only relevant for banks. Much of the international economy has drifted into a financialisation trap, where over indebtedness has become a constraint on the investment needed to boost productivity and deliver long-term growth.

A Central Bank official noted when inflation and interest rates go up, typically the financing conditions tighten. Deglobalisation is also playing a role. For the financing in general and financing of enterprises, this will have an impact. For emerging economies with higher inflation and higher interest rates, this might constitute a much higher impediment. With regard to Europe, this will not be a decisive factor, but this challenge should be used as an opportunity to put more emphasis in the future on equity financing instead of debt financing. The analysis of CMU's specific issues and the study of the supply of and demand for equity funding, as well as the governance structure would allow the CMU question to be put to rest.

With regards to central banks and from an economic point of view, it is important to think more about equity in an economy. The first part is to look how enterprises and corporates are financed in the US and Europe. In the US, the corporate financing happens to roughly 25% with debt and 75% with equity via capital markets. In Europe, there is roughly 25% of equity and 75% debt financing for the corporate sector; and this creates a challenge for central bank policy. With a deep capital market, from a central banker's point of view, this implies less reliance on government public finance in order to deal with asymmetric shock in a currency union, such as the Euro area. US estimates suggest that more than 50% of the shocks can be absorbed by capital market flows.

Also looking at the most recent estimates, there is a role of equity financing instead of debt financing to deal with green transition. Equity financing is much more effective with regards to getting green measures across compared to the banking system and monitoring it.

Equity financing is also much better in bringing to life the so-called creative destruction by Schumpeter to boost productivity. One of the main reasons why productivity is so low in Europe compared to the US has to do with the lack of risk capital in the form of equity financing. In Europe R-star, the equilibrium real interest rate, is negative territory. In the US, it is still in the positive territory. If R-star cannot get back into positive territory, once inflation is back at the 2% target, it might be necessary to go back to unconventional monetary policy in the course of a monetary policy cycle.

In order to have an effective, efficient and deep capital market, there is need of capitalists (e.g. in the form of pension funds that cover much of the population). A capital market cannot be created simply by government regulation.

2.3 Coordination among central banks at the international level, coordination between fiscal and monetary policy and coordination within the Union are essential to address the challenging economic outlook

A public representative stated that coordination needs to improve. A coordinated effort has to be made to keep inflation down. Different types of coordination need to be considered. First is coordination among central banks in different jurisdictions. When all the major central banks raise the internal rates simultaneously, it could have a more negative impact on the GDP and the growth potential. The effect on inflation can also be weaker because the foreign exchange channel is less effective.

The second type is coordination between fiscal and monetary policies. Not enough has been done, especially in Europe. This is very challenging, because there is one monetary policy but 27 different fiscal and economic policies. All the countries tried to be coordinated, in not giving room for a wage spiral and coping with the high inflation for lower income, by providing some support at the national level so salaries did not have to be renegotiated. However, inflation was not temporary. A more coordinated effort needs to be found. It is also a double issue, with the profit spiral. This is not so much a monetary problem as a distributional issue.

The European Union needs to be credible and intervene in a way that does not slow the economy too much. More coordination would be needed among central banks and the fiscal policies across jurisdictions, Waiting for the ECB to solve the inflation will end up creating more problems. Finally, coordination is important on a broader international level, in particular with regard to the Inflation Reduction Act (IRA) adopted in the US and other measures that might have the effect of trade barriers or incentives to delocalise Europe's renewable energy industry.

2.4 Improving the EU crisis management framework

An official raised that officials have to try to learn from others' experiences and crises, and to reinforce the ambition on the regulatory agenda, not only pushing with the crisis management and deposit insurance framework (CMDI). Working from the legislative proposal provided by the Commission and a clean implementation of Basel III are needed. Public decision makers have to go further and take pieces of these new lessons. Liquidity before, during and after resolution. We need to rethink how to act and take into account the figures of the liquidity needed for Credit Suisse in comparison with what is within the SRF. This is linked to confidence as well, which is particularly important in a world where liquidity is more liquid than ever. There are also further steps that are pending beyond CMDI. Keeping the work on addressing the vulnerabilities of non-banking financial institutions is also important. The last lesson is to explore whether other regulatory improvements are still necessary. There might be even less time to react.

An IFI representative noted that each constituency has its own regulatory regime, but all decisions are interpreted by investors at a global level. What happened in Switzerland on the treatment of Credit Suisse's AT1s was specific to the situation but had a global impact on the AT1 market and the assessment and the pricing of its risks. The decision taken on the crisis management deposit guarantee scheme had also repercussions. This should call for increased cooperation at the global level, for example to give a common definition of what a systemic bank is.

There was a great deal of work put in on how to deal with systemic banks and the resolution. In the US, there are eight banking groups, which have the total loss-absorbing capacity (TLAC), when in Europe there are 115 groups subject to the direct supervision of the ECB. They are very different approaches with the same tools. One of the big questions moving forward is what the resolution framework is, how to preserve its credibility, and in particular the assessment of what a systemic institution is.

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

An official stated that geopolitics is leading to fragmentation. We should also look at the figures because trade is still growing. Trade between the US and China is growing. Trade between Europe and China is growing. Europe has done a good job in this environment: dealing with the energy crisis by rebalancing the energy supply in a very short time, increasing different spending, showing solidarity with Ukraine and taking action to deal with the global challenges of green transition. To increase strategic autonomy, there is need to deal with human capital and put more people to work. That is the reason for the pension reform in France. There is a need to look at capital, and more equity is needed and less debt. In the CMU there is an alphabet soup of EMEA, Markets in Financial Instruments Regulation (MiFIR), European Long Term Investment Fund (ELTIF) and risk, but the European Commission are pushing this with a great deal of resolve and determination. A deeper capital market will be created in Europe.

There is progress on digital euro and investing in sectors to be more resilient, with green tech and sectors in which Europe wants to be more independent. The European Union will continue to trade, but in sectors such as batteries, chips, hydrogen, solar panels and electric vehicles (EVs), more independence is needed.

2.5.1 Autonomy means building resilience in the EU financial markets

A public representative stated that strategic autonomy is not the same as protection. The two things sometimes get confused: that to be strategically autonomous Europe needs to close. This is the wrong way of achieving autonomy.

Autonomy should also not be an objective in itself. The objective is the resilience. In physical supply chains, autonomy when there are physical disruptions could be good for resilience. There could be sectors where autonomy is not the best way to achieve resilience. Openness, scale or regulation might be the best way. If there is a threat to resilience, it could be a physical or it could be a non-material like cyber-attacks. This has to affect the response and how resilience is built more than autonomy. One thing is regulation and international standards, because it is a highly interconnected market and infrastructure. It is very difficult to stop that from being international. It is a strength, not a weakness, but needs to be regulated. The only thing that Europeans can do is to have the CMU to build resilience in the financial market.

2.5.2 The security and the diversification of supply needs to be taken into account in the financial area

An IFI representative stated that Covid and the energy crisis triggered by the war on Ukraine have revived the issue of security of supply. With globalisation, the world had largely lost sight of the importance of ensuring security of supply and a proper diversification of supply-chains, which now more than ever prove to be key for stability in trade and in economic development. For the financial sector, this issue relates particularly to clearing services and the understanding that overdependence of EU financial institutions to a single foreign financial centre can pose acute security and stability problems. It does not mean that we should move from globalisation to fragmentation. But diversification of supply needs to be taken into account.

2.5.3 Applying the strategic autonomy objectives in the financial sector should be handled with care

The Chair noted that the system seems to be moving towards a partial de-globalisation. The policy actions of the United States, China and the EU are resulting in a fragmentation of the system.

An industry representative agreed there is a link between de-globalisation and inflation. Central banks are trying to curb inflation, which is resilient and will have to be dealt with for months, if not years. Part of the job that interest rates was done in the past by the structural deflationary input of international trade through globalisation. That deflationary element will disappear if movement remains in the opposite direction.

When talking about countries about strategic autonomy, the problem is what is meant by strategic autonomy. There are certain sectors that are too important not to be able to rely on in any circumstance. For some industries, it is right to have policy that ensures that international trade does not need to be relied on under any circumstances. There are times where, if international trade does not work, there needs to be access to certain products and services. The right way of approaching it is sector-by-sector. Then the big question is where financial market fits within this definition of strategic autonomy.

There needs to be care with financial markets because it is a network. Each institution cannot operate by itself. All institutions need to be fully integrated through the proper supervision. There are the authorities which are essential cornerstones. The strength and the ability to provide service efficiently does not depend on an institution itself. It depends how the market works, how deep they are and how well regulated they are. A financial market needs to be open and well regulated, with common standards, but with more institutions well connected with each other across Europe and across the world. That point has not been reached because not everyone has the same objective.

When talking about strategic autonomy, the best interests of financial markets Europe and in the US are to be well-connected and well-regulated together. There is always suspicion that all non-EU banks retreat to its own constituency when tough times. However, recent experiences like Covid say the opposite. JPMorgan, for instance, increased lending in Europe by 20%. Rathan than retreating, the participation of global firms in the EU system brings added competition and market depth. The reliance is not on the institutions but on institutions and the market network.

2.6 Closing the financial files by the end of the EU legislature

An official liked that the starting point is a positive and optimistic one. The good health of the financial sector is a good sign. The worst scenarios are not materialising as expected. Everyone is aware of the challenges being faced. Central bankers coordinate better than policymakers or fiscal authorities. At the same time, everyone is in recovery mode but has to start generating fiscal buffers and making good on investment commitments. This poses challenges and a holistic approach is needed, but there are tools to do it. Europe has many important files coming to maturity over the next few months and needs to engage in closing those files with this holistic approach. Not all of them have to be financial. The energy market reform and structural reforms related to the energy market are key to ease the trade-off between the monetary and fiscal policy in terms of taming inflation. On the financial side, there are investment needs going forward. This is what will ensure resilience. All potential sources of funding need to be unlocked and made good on.

The opportunity coming from Next Generation EU funds and associates has to be seized and made a success. There is need to ensure that investment is not a victim of consolidation processes. Quality spending is important. Then public decision makers have to push further with the CMU. Integration of financial markets is of the essence because it leads to more competition. There can be a discussion on whether the betas for the deposits are optimal or not. Then there is reinforcing of payment systems for increasing autonomy, including the work on the digital euro and the anti-money laundering package, which includes elements like financial intelligence and cooperation around financial intelligence.

The Chair stated that this is a very challenging and dangerous macro-financial context, as it has shifted from the paradigm of "low-for-long' interest rates to much higher interest rates. Evidence suggests that the EU is not seriously affected. However, the big question is to decide is whether SVB and Credit Suisse were idiosyncratic cases, or "canaries in the coal mine". The CMU must happen., There is now a geopolitical overlay on what was a very globalised economic system, and it does not fit so well. While there is a risk of de-globalisation, the more likely outcome is a re-globalisation, reflecting this geopolitical overlay. Economic security now has renewed importance, but it is difficult to manage in the financial sector without significant fragmentation costs because of network effects. Open strategic autonomy is the way to go.

Inflation and monetary policy: way forward

The Chair introduced the discussion by describing inflation as the "elephant in the room"—specifically, an inflation rate in the euro area that still stands at more than three times the European Central Bank (ECB) target. Headline inflation is drifting down, but core inflation is stubborn, and no one would be shocked to find it higher than headline inflation in some months.

The panel discussed whether central banks are still behind the curve despite increases of nominal interest rates, agreeing that further tightening of monetary policy is necessary to combat persistently high inflation. Moving cautiously and adjusting gradually, central banks should also get out of directly shaping the yield curve.

1. Central banks have more work to do despite increases of nominal interest rates

1.1 Inflation remains high in the euro area and the monetary policy stance needs to become restrictive

A market expert reflected that inflation remains persistently well above the 2% target with no evidence that it is coming back under control. Although central banks have raised policy rates since spring 2022, the real interest rates are still negative. While it is often suggested that positive interest rates in real terms would be a nightmare, the argument can be turned around. Positive rates would force over-indebted states to reduce deficits and debts, savings would receive remuneration. Low interest rates misprice risks and encourage the survival of non-productive and unworkable enterprises and push households to favour illiquid savings rather than long-term productive investments, which are poorly rewarded.

A central bank official mostly agreed with the comments. Although the ECB Governing Council has differing views, it has raised rates significantly since the previous Eurofi meeting and there is a clear understanding that inflation remains too high, and rates need to go up further. If the outlook for medium-term and longer-term real rates already is positive, then short-term rates will soon become positive. The importance of bringing inflation down to the 2% target and the determination to do so should not be doubted. The current forecast expects inflation to reach 2% by the end of 2025 yet bringing it down sooner (say by end 2024) will be beneficial to reduce the negative impacts of high inflation.

1.2 The ultra-loose monetary policies over the last 10 years have inflated asset prices

A market expert highlighted that central banks have pursued a policy of monetary accommodation, manufacturing financial vulnerabilities for more than 20 years. The long lasting very low interest rates have favoured the growth of debt which has reached unprecedented levels, increased financial leverage and undermined financial stability. A normal monetary policy will monitor credit growth, but over the past 15 to 20 years credit growth has exploded without control by central banks. This is creating conditions for financial and real estate asset inflation and subsequent demand side inflation, as well as discouraging productive investment. The addiction to permanently zero interest rates has weakened the financial system over the past 20 years. A McKinsey report shows that the 75% of the trebling of net wealth came from higher market valuations and only 25% from real investments and wages. In conditions where fiscal dominance has been superseded by financial dominance, it is imperative to fight against inflation and accept some economic slowdown if necessary.

1.3 The ECB was too late in starting to respond to inflation

A public representative stated that the ECB has done a good job during the past months and the only problem is that they started too late, recalling that he wrote in early 2022 that the inflation problem was not transitory. The Fed started in March 2022, when the situation was worse in the US than in Europe; the ECB lost four months, so now that situation is reversed. Dutch and Belgian members of the Governing Council are warning that there are clear wage pressures on the horizon, which will disadvantage the euro area and give consistent extra pressure to the inflation problem. Additionally, two further invisible but very real elements are the rescheduling of supply chains and the de-risking of China, and the cost of decarbonisation, which will exert ongoing pressure on prices in the system.

1.4 The transmission of monetary policy to bank lending rates is working so far

In relation to the 350 basis points of rate hikes so far, a central bank official could not offer any further indication about interest rates but highlighted the difference between monetary policy and fiscal policy. Fiscal policy is restrictive or expansionary depending on whether government increases expenditure or whether it increases taxes. The monetary policy stance depends on many issues besides the level of the key rates, including past inflation and even more inflation expectations. Inflation expectations are still anchored in the range of 2-2.5%, so the stance has probably moved into the restrictive territory. However, market expectations that the ECB will reverse scores sooner than suggested by another central bank representative could make monetary policy looser than intended.

Transmission is working and interest rate hikes have transmitted quicky into lending rates. Loan momentum has sharply decelerated, in part also due to the decline of energy prices. The energy sector in particular has repaid some of loans needed to finance the working capital when energy prices were very high. The transmission to lending rates has been very quick and strong, but money market rates have not responded fully. The floor is «leaky» because banks and other market participants have forgotten how to operate in the money market, while in Europe non-banks cannot place deposits with the central bank like in the US. The problem of «leaky» floor is overly exaggerated and has not affected the transmission of monetary policy, but there have been stronger increases in bank interest rates in some countries and lesser increases in others.

In Croatia it has been necessary to slash reserve requirements before the accession to the euro-area, so excess liquidity has increased hugely, and this has muted the transmission of tighter policy. Croatia is one of the countries with the lowest lending rates for corporates or housing purchases, but it probably has more to do with Croatia's adjustment of monetary instruments than the way that monetary policy works.

There are three important issues going forward: first, the inflation outlook needs to be assessed in more nuanced way and consider not just the headline but also underlying inflation and detailed price indicators. There will be many groups of goods and services where prices are moving in different directions. Wages and the prices of products and services with a high wage component will increase faster this year and those that are energy intensive will decline. Second, the economy has been stronger than initially expected and it has avoided recession so far, which supports further policy hikes. The instability in the financial markets may not yet be over, so central banks have to look at this carefully. Finally, after this period of very loose monetary policy it is necessary to check the strength of monetary policy transmission month-by-month.

2. Inflation and monetary policy: the way forward

2.1 Monetary policy in the euro area needs to tighten further

2.1.1 The cost of not doing enough to tackle inflation is higher than doing too much

A central bank official highlighted the lessons from the '70s and '80s that one better deals with inflation in one attempt, cautioning against stopping too early which will require a second attempt and result in higher policy rates and a higher employment rate. The risks of doing too much by raising rates remains smaller than not doing enough, so the only way is up. The modus operandi for monetary policy is very clear: look at the data and do it step-by-step. There is little forward guidance provided because the situation is too uncertain. It is important to monitor underlying inflation, which is a major concern and yet to come down in the euro area.

If we experience a situation when the headline inflation is below core inflation and core remains well above the target, it will be necessary to continue monetary tightening. The labour market remains tight and there are wage pressures, so corporate profit margins should come down to reduce the possibility of inflationary wage increases. The transmission of monetary policy, financing conditions and lending conditions are variables that will be monitored. It is encouraging news that financial conditions are tightening and lending is slowing, which is necessary to break the backbone of inflation persistence.

It is only once inflation is at risk of sustainably undershooting the 2% target when one should think of rate cuts. The current market expectation of a rate cut in early 2024 is not consistent with the baseline scenario and economic outlook. The financial market volatility is worrying from the perspective of monetary policy transmission rather than in terms of financial dominance. There is the separation principle and there are instruments to deal both with inflation and with financial market instability.

2.1.2 If the fight against inflation stops too early, inflation could get out of control

A public representative warned that if action stops too early inflation will end up out of control, there will be recession, weak expansions, and constant financial instability. Rates will need to stay up for at least another 18 months to combat negative real interest rates and fight inflation. Considerations of financial instability should not be mixed up with the considerations of inflation, because regulators can intervene in a way that does not hamper the anti-inflation interest rate policy. There is no logic saying that raising interest rates will increase financial instability. There should be policy room built in to allow a response to upcoming market shocks. Interest rates should increase until negative real interest rates are gone. Policy action is needed to ensure that European interest rates return to 2% instead of relying on models to predict this.

2.1.3 All the monetary tools should be used to tame inflation

A central bank official highlighted that it is necessary to align all the instruments of monetary policy, including the balance sheet. There is no limit for increasing interest rates, which are the key element to deal with inflation. Quantitative tightening (QT) is not a substitute for interest rates increases. With QT, the balance sheet is like playing an accordion: to make sound it needs to be moved; the balance sheet has to be squeezed so that it can expand again in the future, if necessary. The recent IMF report about the estimates of real neutral rate (R star) predicts that after this episode R-star will be back to around zero. Then there will be effective lower bound problems where monetary policy is not that effective.

Without a common fiscal facility, a situation of effective lower bound and insufficient room to expand the balance sheet will lead to trouble. It is necessary to be cautious in reducing the balance sheet because central banks do not want to harm the transmission of monetary policy, but QT is an important and integral part of monetary policy going forward.

A central bank official stated that the interest rate policy is definitely the main inflation-fighting tool, but that there needs to be some normalisation of the balance sheet. There has already been the removal of the targeted longer-term refinancing operation (TLTRO) benefits and the repayment of €0.9 trillion TLTROs since October, which is also good for the profitability of the Central Bank, although increases in policy rates will induce substantial losses for central banks. It may be time to consider reserve requirements and reverse tiering, this time of positive interest rates, which could further support the monetary policy stance. There are pros and cons, but there is definitely some merit in discussing such proposals.

2.2 Moving cautiously and adjusting gradually

2.2.1 The problem of inflation seems more acute in Europe, but the pace of tightening should slow to avoid potential accidents

An industry representative agreed that inflation remains a problem, and that policy needs to tighten both on the rates side and the balance sheet side. A year and a half ago, the US had a worse inflation problem than Europe and now that is reversed. Negative real interest rates can be reduced by moving rates higher or lowering the inflation rate. In the US, the inflation rate has come down about 2% from the peak, but the combination of the Fed's tightening with that minor reduction in inflation means that the real interest rate is now almost zero. There are probably going to be positive real interest rates sometime over the course of the next quarter. Europe is roughly four to six months behind, because the inflation began a little later. The ECB should be open to the possibility that the pattern will be the same. As the peak of the cycle emerges the pace of tightening should slow to avoid potential accidents, as has been seen in the US and Switzerland. If there has been enough movement Europe ought to be aware of possible signals that enough has been done or will be done not too far ahead.

2.2.2 Gradually reducing the ECB's balance sheet, but without rushing

A public representative counselled caution in terms of reducing the balance sheet too abruptly to avoid causing the kind of financial shocks that central banks want to avoid in the first place. Letting bonds that mature fall out of the balance sheet and ensuring there is enough economic growth will result in a spontaneous reduction of the balance sheet over time. An extra push might need to be given, but officials should be careful not to go too quickly.

The Chair noted that the €4 trillion of excess liquidity could be soaked up either by shrinking the balance sheet or immobilizing some portion via higher reserve requirements. Reserve requirements played an important role when the Federal Reserve broke the back of the post-World War II inflation in 1948. The ECB's operational framework review will look at issues including excess liquidity, whether the floor is a leaky floor and the link between excess liquidity and the fact that bank deposit rates are not moving much. A central bank official highlighted that there are pros and cons to a floor with this much excess liquidity, although demand is difficult to predict. The excess liquidity will shrink but will not end soon. The floor system has benefits and will remain for some time. This matter will be discussed at length in the Governing Council and it is important not to comment pre-emptively.

2.3 Central banks must get out of the business of directly shaping the yield curve

The Chair quoted Stefan Ingves: 'When it comes to running a Central Bank, it is not about talk. It is all about the balance sheet and using the balance sheet and having the guts to use the balance sheet'. A market expert noted that he wants faster QT. In the transition towards a more normal interest rate situation, it will be necessary to change the quantitative easing into a form of tightening, otherwise normal market-oriented rates will be limited by maintaining the enormous amount of assets that have been bought by central banks. With a €15 billion reduction per month, it would take 27 years for Europe to reach normality. One of the inevitable aspects of this transformation towards normality is to have a reasonably convincing monetary policy of tightening.

Central banks cannot continue to shape the yield curve through the bureaucracy of central banks, because in a free-market environment it is the supply and the demand of capital which shapes interest rates on the market. If a central bank continues to believe it can determine the exact interest rate of a bond of 15 or 20 years, the transformation will be missed. Over the past decades, Europe has been living in an environment where it is normal for a central bank to determine the exact amount of interest rates all along the yield curve, but it is not normal and it should be abandoned.

2.4 Learning from the 'US Accord' after the Second World War

A public representative noted that the President of the Bundesbank has recently said that there is more than €4 trillion excess liquidity in the euro area. While this number is contestable, there is a huge amount of excess liquidity which is the origin of financial instability. There is no other way to get liquidity out of the system than balance sheet reduction in conjunction with credit tightening. Immediately after the Second World War the Federal Reserve let bonds mature and did not replace them, so there was an automatic reduction of the balance sheet. The post-war inflation provided a lot of help to bring down the balance sheet as a percentage of GDP and something can be learned from that experience.

2.5 The best institutions know what they know and know what they do not know

An expert highlighted that a responsible institution should know what it does not know and central banks should accept a degree of modesty with regard to the future. If an insufficient degree of modesty in action is not taken, one believes one can forge destiny through bureaucracy, which is not possible.

The Chair asked what the panel thought of moving to zero reinvestment or even outright sales. An industry representative stated that they will not be doing outright sales. The Fed is doing the right thing in letting the balance sheet run off by letting securities mature. The central banks are not only tightening interest rates, but shrinking balance sheets, which they have never done before. It is not known exactly what effect this will have on markets, but it is important to be modest and cautious and monitor indicators. The balance sheet shrinkage should be done predictably, and the pace should be changed only for good reason. A public representative suggested that humility will probably translate into caution.

The abandonment of forward guidance is a mark of humility

A central bank official stated that stepping away from forward guidance is a recognition on the part of the ECB of the need to be humble and cautious using models. Uncertainty is high, there are structural shifts, and it is not possible to know everything that is going on in the world. The models are mean reverting ultimately, because the economics' world is built on equilibrium, so one has to be cautious.

An investor representative asked the panel what should be done to address the risk that Italian bonds would be declared non-investment grade. A central bank official stated that monetary policy cannot be the solution to structural problems. An industry representative noted that the central bank official would likely not comment on how the ECB would treat Italian collateral in their operations. The speakers agreed that staying in the investment grade was something for the Italian authorities to ensure.

Fostering investment in the green transition

Introduction: Delivering on the net zero transition requires substantial investment

The Chair observed that there is no dispute over the need for massive new investments in the order of €350 billion per year in this decade to meet EU targets for the transition to a net zero economy. This requires a multi pronged approach, including cutting emissions and a Schumpeterian creative destruction process producing investment. Projects such as the NextGenerationEU package are in place, but changing Europe's capital stock, production processes, consumer habits and technologies requires more investment and coordination between public and private sectors.

1. The uncertainties and drawbacks that need to be resolved or lifted are clearly identified

The Chair questioned what is inhibiting this investment if the need is clear. It could be any number of reasons: incorrect relative price incentives; a lack of financing; insufficient incentives from public authorities; a lack of international coordination with other initiatives; an absence of clearly defined regulatory frameworks enabling investors to be sure that their investments will have a good risk return profile; or a lack of skills among those implementing new investments.

1.1 The absorptive capacity, supply constraints, lack of skills in implementing projects and a failure to use the size of the Single Market are concrete obstacles

An IFI representative commented that 70% of municipalities believed they do not have access to climate related skills, either in the municipality or via consultants. That raises problems around designing interventions and implementation, which are the most binding public sector constraints. For the private sector, tightening financial conditions and uncertainty are key impediments for investment. In the last year, energy efficient investment survived the uncertainty effect, but uncertainty is weighing negatively on the whole package of climate mitigations and adaptations. The EU made a major step in reconfirming its climate ambition at the time of the energy crisis. The fragmentation of the EU market also works against investment and prevents European companies maximising the potential of the Single Market. Bureaucracy is also a constraint, with permits and authorisation often slowing down investment. While the Commission's proposals on permitting are excellent, implementation should be quick.

An official agreed that absorption capacity is very important for public investment. There is a great deal of EU level instruments dedicated to advance the green and digital transitions, including structural funds the EU budget, NextGenerationEU and REPowerEU. However, absorbing these funds institutionally seems to be quite challenging, especially for small countries' administrations. It was noted that the quality of public spending is key. The ultimate objective is not to spend the money but to achieve the transition which is not an easy task, especially in a market that is marked by supply constraints and strong demand.

The real binding constraint is access to skills

An IFI representative commented that 70% of municipalities believed they do not have access to climate related skills, either in the municipality or via consultants. That raises problems around designing interventions and implementation, which are the most binding public sector constraints. For the private sector, tightening financial conditions and uncertainty are key. In the last year, energy efficient investment survived the uncertainty effect, but uncertainty is weighing negatively on the whole package of climate mitigations and adaptations. The fragmentation of the EU market also works against investment and prevents European policymakers maximising the potential of the Single Market, in contrast to the US Inflation Reduction Act. Limiting this fragmentation is important. While the Commission's proposals on permitting are excellent, implementation cannot proceed if local authorities are not aware of them.

1.2 The lack of robust and transparent ESG data and investable projects

An industry representative stated that her organisation provides market data to a global customer base and takes its contributions to the green transition seriously. The fundamental problem is that the world needs significant capital investment in the order of $100 trillion to achieve net zero by 2050. A fundamental blocker to this is the lack of robust, transparent ESG data. Having robust data is essential to the investment process because it creates transparency in decision making and enables investors to make sensible decisions around risk and return.

There is also a lack of investable projects. Energy infrastructure is a key factor in emissions reduction targets but there are few investment grade projects available to help achieve this, and this is exacerbated by the lack of data. Having access to widely disclosed and standardised data is an essential part of the investment process. 42% of publicly listed companies globally do not disclose scope 1 and 2 emissions, which are part of a core dataset. Only 16% of globally listed companies disclose transition plans. Policymakers have a real opportunity here to support the growth of the green economy by mandating corporate disclosures and focusing on transition plans.

A policy maker commented that while Europe is ahead in disclosures, the landscape is complicated and a sophisticated, holistic approach is needed to deal with different situations. Few issuers will be taxonomy compliant at the outset, but it is not clear that they should not be eligible for sustainable finance investment and transition companies need to be supported. The approach taken must correspond to this complex reality. Asset managers are the ones using these disclosures and they must make the difference here. Joining these elements up is crucial, and Europe is moving in the right direction and creating solutions.

An official observed that while significant progress has been made to establish EU-wide regulatory framework in the field of green finance, the accessibility and availability of reliable data remain a major problem. Closing the data gap will be key to minimising greenwashing and mobilising private funds.

1.3 The absence of a credible transition path to stabilise expectations

1.3.1 A map of the investable projects that are central to delivery of this agenda and the capacity to implement

A policy maker stated that there is ample public and private capital to shift investment in a greener direction. Finance is a critical enabler, but it needs to be part of a cross government, economy wide strategy. This cannot be broken down into a single problem. Providing a map of investable projects is a core part of the strategy to deliver this agenda. The difficulties are easy to see in the timeframes involved in building a wind park. These realities need to be built into expectations around the transition.

1.3.2 The lack of a clear and fixed transition scenario

An official observed that coordination is a structural reason for the problem of absorption. During the pandemic, governments turned for solutions to doctors, resulting in overly expensive measures because costs did not figure highly in their thinking. Similarly, environmental experts have settled on an adaptation path without considering potential bottlenecks because of an overriding environmental objective. The adaptation path may not be optimal if all the costs and benefits are not assessed. While environmental experts have not made this calculation, investors will, because whether a project pays off is crucial to them. Investments in fossil fuel technologies will only represent stranded costs if sustainable technologies can produce enough energy to satisfy demand, and investors would not be wise to rely on this assumption.

The Chair asked if there should be a continuous supply of brown energy to avoid disruptions. The official replied that, even if it is unpleasant to keep using brown technologies longer than anticipated, it would be less pleasant for the lights to go out.

1.4 An effective carbon pricing system to create the right market based incentives for changing behaviour

The issue is not the availability of finance. A policy maker stated that effective carbon pricing is needed to create market based incentives for changing behaviour. Europe is moving in the right direction with an emissions trading system (ETS) covering 40% of industrial emissions. If carbon pricing is to be changed, there must be support for the sectors and households affected by the adjustment. The Social Climate Fund makes €65 billion available for this agenda, partly funded by the ETS Innovation Fund.

An official observed much carbon taxation policy is implemented at Member State level and more could be done to promote harmonisation at the European level.

1.5 The lack of a business case logic in sustainability planning

A public representative stated that private money is more important than public money. The goal is to deliver the transition, not spend money. The Russian invasion of Ukraine and high energy prices triggered many investments in the transition and this momentum must be maintained.

Europe has a clear direction, with a climate law in place committing to reduce emissions by 55% in 2030 and heading to climate neutrality. There is also a strategy breaking down this goal into different categories. Money in the form of the NextGenerationEU project, the Modernisation Fund, the Social Fund and the EIB is also in place. Such a systematic approach has not been taken in many other countries. What Europe is missing is a consideration of business logic. It is necessary to consider why the financial industry funds some investments and not others. While the US's Inflation Reduction Act creates a single market by using federal policies, there are 27 different policies across the EU. Excessive bureaucracy and fragmented sustainability policies could impede the success of the transformation.

Offering consumers and businesses incentives to buy green is effective. If Europeans are offered €5,000 to buy an electric car rather than a petrol car, it will stimulate the production of electric cars very strongly and a lot of people will opt for electric cars. If businesses are offered a certain tax incentive to produce one kilogram of hydrogen, there will be a focus on generating green hydrogen. But the fragmented national approaches with complicated policies overlooks the business case logic, meaning more money is used to deliver less. This business case consideration needs to be added to provide an understanding of where the strategy does not work and how to promote it. The lack of investment occurs when public authorities fail to recognize that certain desired investments are too risky.

2. Solutions are well known but their implementation remains challenging

2.1 Addressing the challenging macro economic environment for fostering investment in the green transition

An industry representative observed that there is no single cause and therefore no single remedy. It is both a macroeconomic problem and a microeconomic problem. The green transition was presented as a way to find a new growth strategy and welfare environment for Europe before the Covid crisis. This has become more challenging.

The European macroeconomic response to Covid has translated into the NextGenerationEU project, which seeks to provide public investment, structural reforms to improve markets and private investment to return to growth and deliver the green transition. Public money alone will not do the job, so it is necessary to convince private money to invest. There needs to be a suitable macroeconomic environment, which is now very different to that before Covid because Europe is in a multiplicity of crises. This uncertainty makes it impossible to be sure that the macroeconomic environment will remain constant long enough for investments to be activated. International Monetary Fund highlights new shocks hitting the global economy, such as secular stagnation, geopolitical concerns and fragmentation, all of which affect private investment.

It is also necessary to understand the microeconomic incentives, as uncertainty makes it difficult to prioritise between projects. Skills shortages affect both green and non green activities, so investment and education has to be pursued over a period of time, despite the risks.

2.2 Regulators should intervene to close the data gap

An industry representative commented that it is realistic to view private capital as the key to the transition, but access to high quality principles based data is necessary for this. This data must be independent and transparent. This independence and innovative data collection methodologies must be protected.

An industry representative agreed that the lack of data made it difficult to assess risk and decide where to invest, and building up data will take time. The BIS produces much useful data for investment, and this should support the transition. It is however necessary to understand the extent to which microeconomic data can transform itself into predictive behaviour and can enable the creation of the necessary financial instruments for the transition.

A policy maker observed that is no shortage of data, and disclosures are in place. Structuring that data, ensuring responsible actors use that data and having a responsible intermediation ecosystem is required to put the data to good use. The social, economic and technological rewiring of a continent was never going to be fast or easy. The strategy is on the right track, but patience is needed.

An official stated that national level initiatives must fill regulatory gaps at European level, especially regarding data. Lithuania has prepared the national green finance action plan. The key pillar of the Plan is to establish a centralized and publicly available sustainability database with granular data on firms, including SMEs, and households all in one place to facilitate connection with investors. The Green Finance Institute will be set up to drive the green finance agenda and help the exchange ideas and best practices between the public and private sector.

2.3 We need to fully exploit the potential of the EU single market and NextGenerationEU to reap the competitive benefits of market scale

An IFI representative explained that the EIB is active in supporting the green transition and provides technical assistance as well as financing. The EIB supports the scaling up of firms and technologies and it is necessary for any solutions to overcome the fragmentation of support and take advantage of the size of the Single Market.

2.3.1 Removing barriers to investment that are preventing capital from reaching significant projects

An industry representative commented that sustainability should be viewed as a growth opportunity. The green economy is the fourth biggest industry sector, accounting for 7% of market capitalisation. That growth opportunity is going to attract private capital to the market, but this requires a supportive global regulatory framework to reduce complexity while retaining flexibility to support innovation across different sectors.

2.3.2 The Recovery and Resilience Fund should be fully exploited

A policy maker observed that €187 billion of expenditure under the Recovery and Resilience plans is destined for climate transition policies. REPowerEU will increase these amounts with a strong focus on energy diversification and support for renewable energy. If the right projects are identified, it will be possible to deliver a decisive impetus and definitively change the carbon-profile of public funded investment. ETS has already changed incentives and behaviours and the EU will accompany this with socioeconomic support (the new ETS financed Climate Social Fund with an envisaged budget of EUR 65bn for 28-34). There are also budgetary guarantees to de risk investments and mobilise private capital.

2.3.3 Favouring a European approach rather than fragmented, national ones

A public representative stated that the European budget should finance a European approach, rather than subsidise Member States' budgets. Private money will do the trick and public policies should focus on creating the case for private investments.

2.3.4 Being more methodical

An industry representative emphasised taking a methodical approach. More substance must be given to the notion of circular economy. Multidisciplinary cooperation is needed to mobilise viable resources.

2.3.5 The energy price level in Europe must be competitive at the global level

An official commented that, where shortages cannot be avoided, the adaptation plan should be amended to become more realistic. The energy price level in Europe must be competitive with the US, requiring the cooperation of other partners is needed. Being a pioneer can be positive, but it can also result in taking the wrong decisions.

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

An industry representative noted that the mobilisation of finance for the green transition remains lower than private and public finance flows into fossil fuels. The obstacles to green investment are tied to the need for this investment to be long term and risk tolerant. Infrastructure projects are a vital component of the green transition, but high upfront costs and regulatory and technological uncertainty hinder private capital mobilisation. Also, investments need to cover projects of all sizes and complexities. Quantifying results is also complex, so a taxonomy is needed to provide a common language for effective financing of the green transition.

The Chair asked if there are appropriate vehicles for green investment. The industry representative replied that there are standout vehicles such as blending instruments and promotional banks can help with project engineering. These promotional banks are crucial for the transition because their long term management horizon lets them finance projects that would not be otherwise viable. Public financing through the InvestEU mechanism is important for developing financial instruments with promotional banks.

Key trends in the Nordic-Baltic financial sector

The Chair introduced the session by emphasising that although there are differences in terms of size of the economies and currency, Nordic-Baltic countries share a number of key strong points in both economic and financial areas, including a relatively robust fiscal situation up till now, a high level of digital maturity, and an integrated and healthy financial sector. Although the region's economy has been performing relatively well over the last few years, it may be more challenged than some other parts of Europe in the current crisis due to its proximity to Russia and the exposure to rising interest rates, which are affecting the commercial real estate sector in particular.

1. Main strengths of the Nordic-Baltic financial services sector

The panellists identified three main areas of strength of the Nordic-Baltic financial services sector: the level of digitalisation, the strength of the capital markets activity and sustainable finance.

1.1 Digitalisation of financial services

An official stated that the main strength of the region's financial sector is digitalisation. Banks in the Baltic and Nordic regions are ahead of other banking industries in the EU, notably those in the Eurozone, when it comes to digitalisation. Two factors can explain this. First, the overall acceptance of digital solutions by clients which has been high early on possibly due to the cold climate. And secondly the fact that companies and banks anticipated well the opportunities from digitalisation in terms of business development and profitability. The Nordic and Baltic countries were already forerunners in the telecommunications sector and continued this trend with the implementation of internet-based solutions. Information and Communications Technology (ICT) investments of Estonian financial institutions are twice as high as in the Eurozone on average, but overall administrative costs are much lower, showing the impact of digitalisation on the business.

An industry representative agreed that the level of digitalisation is one of the fundamental strengths of the region. There has been great progress over the last 20 years in moving towards a cashless society and digitalising financial services in particular. That would not have been possible without strong fundamentals in the region, including innovative fintech companies, an efficient financial ecosystem, active capital markets and a high quality educational system.

An official noted that the pandemic had accelerated the move towards more digital channels even further. Industries and the financial sector in the region responded to the challenges of the pandemic by the adoption of new business models and new digital services, notably a modernisation of payment systems.

A second industry representative emphasized that financial market infrastructures such as CSDs, which are essential for connecting efficiently all the stakeholders in the financial market and safeguarding the data that is transported and shared in that market are also in the process of digitising their activities. The issues that are being addressed, along with finding long-term financing commitments, in this respect are how to implement modern technology, such as cloud with sufficient capacity, choosing encryption technology to use and how to control it, what bandwidth is needed to transport the data, are appropriate digital IDs available, are the cyber security components needed available, etc... Achieving further digitalisation is the result of a multitude of small technical advances for which the Nordic-Baltic region is well positioned since issues such as mobile bandwidth investments have been anticipated.

1.2 Strength and integration of capital markets

The Chair stressed that while efficient and profitable banks operate in the region, a key characteristic of the region is that it is punching above its weight in terms of stock market capitalisation and the number of IPOs.

An official agreed. Sweden and Denmark represent 6% of EU GDP but 15% of EU stock market capitalisation. The Swedish market funding ratio for non-financial companies (i.e. the share of corporate bonds and listed shares in the sum of those two plus bank loans) was 59% in 2021, compared to 46% for the Euro area. Although bank financing remains dominant in the region, capital markets are also very active, notably when it comes to equity. This is seen across a range of indicators such as the number of listed companies in Sweden, which is comparable to that in France, and the market capitalisations of the Swedish and Danish markets which are higher than those in many significantly larger European economies, but also in the relative size of corporate bond markets.

The official stated that while the exact reasons for this success are difficult to isolate, three main aspects stand out, in particular for the Swedish market. The first is the engagement of pension funds in equity markets. The allocation to equities is about twice as high in Sweden as in the euro area. The risks associated with this of course need to be appropriately managed, as recently shown by the risky bet that was taken by one of Sweden's occupational pension funds on Silicon Valley Bank, for which it was the fourth largest shareholder. The second aspect is the extent of retail engagement in Swedish capital markets, driven by policies such as the retail investment account implemented in 2012 with attractive fiscal incentives. This has supported the development of SME growth markets such as the Swedish First North market of Nasdaq. There are almost 700 listed companies on Swedish MTFs, the highest number in the EU. This benefits the broader capital market ecosystem, since a significant proportion of companies listed on the growth markets eventually graduate to the regulated markets. Since 2013, an average of 41% of all the new listings on Nasdaq Stockholm have come from a growth market. The third aspect is that the private equity (PE) and venture capital (VC) environment is also very strong in Sweden. PE eventually needs an exit route provided by the public markets, so there is a virtuous cycle between the private and the public markets.

An industry representative observed that the listing momentum in the Nordics over the last five to seven years has been outstanding and Nasdaq has the ambition to be a European leader in this area. In 2022 more than 200 companies were listed in the Nordics. Many of those companies were SMEs that got access to capital through Nasdaq's First North Growth Market. Statistics show that companies listed on First North create around two to three times more jobs than similar companies that remain private, because the capital obtained supports investment in growth strategies and facilitates access to additional capital. The retail momentum and interest in equity markets is also significant in the Nordics, particularly in Sweden, and supports the development of the equity market. More than 50% of trading on the First North SME market comes from retail. Retail trading in Sweden has dropped recently, but it is still is still around 30% of the total market, which is higher than before Covid. and much higher than the proportion of retail investment in Germany and some other EU countries.

The industry representative added that beyond the success of the Swedish market there is a strong integration of capital markets in the Nordic region on the trading side. Progress is less significant in the clearing and settlement area, which is more challenging to integrate. 15 years ago Nasdaq acquired the OMX exchanges and started a process where it looked at how it could improve liquidity in the Nordic region both for large and small cap stocks and make it easier for institutional and retail investors to invest in equities. The implementation of a common trading system across the Nordic and Baltic exchanges led to a reduction of spreads that were pretty large between countries previously, and facilitated the access to Nordic company shares for global banks. Now, an investor connecting to the Swedish stock exchange through an online broker can also easily get access to best bids and offers for the other Nordic and Baltic shares. Improvements have also been made in the areas of data, market monitoring and listing with consistent processes across the Nordic and Baltic regions. There is nevertheless also the objective to take the specificities of each market into account e.g. with different bond market data across countries and a recognition of the higher sophistication of the Swedish retail investor community.

1.3 Sustainable finance

An industry representative observed that the Nordic and Baltic countries have a head start in sustainable finance and can sustain it. The Nordic region is a global leader in ESG matters and particularly in terms of sustainability in three main areas: clean energy transition, the circular economy, and protecting biodiversity. The current main strength is on clean energy transition with a strong development of wind energy, biofuels and hydrogen. Nordic companies are also leading the way in decarbonization in sectors such as electric cars, green steel and new battery technology.

The industry representative added that the region's financial sector is also front leading on ESG related financing. Improving sustainability means helping companies to transition to net zero, not taking a very hard line from the start. $125 trillion of climate investment is needed by 2050 to meet net zero, according to the UN. This amount of capital is not available in any single market, which means that private capital is needed as well as public sector investment in various forms to incentivise investment, potentially through government guarantees. A well-functioning and deep capital market is needed in Europe to support this evolution, which is why the Capital Markets Union (CMU) is so important for the EU and also for the region to be able to capitalise on its leading position in terms of sustainable finance.

2. Main challenges facing the Nordic-Baltic region

2.1 Economic and geopolitical challenges

The Chair observed that the Nordic-Baltic region's economic forecasts are not very positive compared to other European countries. The geographical position of the region in Europe and the Russia-Ukraine war are a challenge in this regard.

An official stated that in addition to the global pandemic and the energy crisis, the hybrid security threats posed by Russia and Belarus have imposed additional challenges in the region despite the Baltic countries being part of the EU and NATO. This might worsen the low investment activity in some countries of the region, in particular Latvia, hindering future growth. Given the geographical position of the Baltic region there was maybe too much complacency in the past about being a transit corridor with a few high-added value industries and a high yield financial sector. There have been dramatic reforms in the financial sector however to curb illicit finance. This can be seen as a good investment for the region's economy but also for the region's security, as it made the Baltic region much more prepared for the tectonic changes that have been faced since the Russian invasion of Ukraine, allowing the region to implement the sanctions adopted against Russia and Belarus without major disruptions to its financial system or economy.

2.2 Cyber-risks and operational resilience issues

The Chair stressed that operational and cyber-resilience issues are key for financial stability. An official noted that the ongoing trend of digitalisation indeed raises questions about the related vulnerabilities in terms of cybersecurity.

Given its geographical location, the region has the experience of being under the threat of an aggressive neighbour and its cyber professionals have been developing hypersensitive technologies over the last few years to be able to tackle those issues.

An official observed that Estonia was the world's first victim of a state-sponsored cyberattack 16 years ago, when Russia attacked its state agencies and banking system. Private - public cooperation and partnership are key to fight such threats. The financial industry is a vital infrastructure for states and their economy, so the state security agencies, military agencies, banking supervisors, and the banking industry should all work together to guarantee its resiliency to cyber-risks.

2.3 Procyclicality and ownership structure issues in the bond market

The Chair noted that corporate bond markets are another area of vulnerability in the region. The supervisory authorities have been concerned for some time about the procyclicality and stability of those markets in turbulent economic conditions.

An official agreed that such issues are a challenge, as market-based financing is meant to provide a stabilizing effect. The Nordic economies are heavily bank-based, and although the outstanding amounts in Swedish corporate bond markets have doubled in real terms since the 2008 banking crisis, bank credit remains five times larger than bond financing for non-financial companies. The diversification of credit origination is positive, but comes with some risks. First, corporate bonds have been issued by smaller companies, which is beneficial from the perspective of capital market access, but which also creates new liquidity challenges. Secondly, an excessive concentration of bond issuance has been observed in the Swedish market. The real estate sector has grown from essentially nothing pre-2008 to about 40% of outstanding amounts at present. Real estate financing is very rate sensitive, which is challenging in the current macroeconomic context and poses specific challenges in terms of refinancing costs, underlying asset fluctuations and foreign exchange exposures when bonds are issued in foreign currencies. A third issue is the ownership structure of the Swedish bond market, as it is currently heavily dominated by investment funds, which have grown from 5% of total domestic ownership in 2010 to around 40% today. This may increase liquidity risks and the risk of fire sales, particularly with smaller issuers in the market, although authorities have done work on liquidity management tools such as swing pricing and redemption gates to address this. Foreign ownership, which is about 60% of the total, is also likely to include a large share of investment funds.

2.4 Vulnerabilities in the banking sector

Answering a question from the Chair about the possible implications for the region's financial stability of the recent events seen in the US and Swiss banking sectors, an industry representative noted that risks are subsiding, but the guidance is still to watch and see how events pan out. Risks to the financial sector need to be looked at in two ways, 'acute' risks related to e.g. the risk of a bank run and the 'chronic' stress that the sector is under. Policymakers and regulators were very quick to react at the outset of the US and Swiss bank crises in 2023, whether in the US or Europe, so acute risks have probably been avoided. There are however more chronic risks coming from the current macroeconomic conditions, with high interest rates, high inflation and unrealised losses on securities. Banks' margins will be under pressure if clients are looking for higher yields elsewhere and move their deposits. Another factor is the commercial real estate exposure.

The industry representative added that the economic forecast for the global economy has been revised up for 2023 because of an improved situation in China, and US and EU performance so far, but it has been brought down for 2024, due to the risk of a recession starting later in 2023 in the US and potentially in Europe. If that scenario materialises, there will be an increased risk of credit loss. A major crisis of the banking sector is not expected because Nordic banks are well capitalised, but this will probably lead to reduced lending.

3. Policy priorities for developing capital markets in the Nordic Baltic region

Answering a question from the Chair about the relevance of the EU Capital Markets Union (CMU) agenda for the Nordic-Baltic region, an industry representative considered that too much time is spent on the wrong issues. The priority should be to help SMEs to get access to capital and to support them on their journey to grow from small cap to large cap companies and also to foster more retail participation in the capital markets, but too much time has been spent on discussing technical projects such as the consolidated tape proposal. A consolidated tape can contribute to improving the functioning of the market, but will not help SMEs to access capital or attract retail investors. The Listing Act proposal is much more important for the growth of capital markets in this regard. Implementing dual share classes for example will help to ensure that the founder can list a company while retaining the majority of voting rights.

Another measure that is essential, the industry representative suggested is banning payment for order flow (PFOF) in order to ensure that order flows go directly to exchanges in a transparent way and ensure appropriate price formation and equal access. This is the way retail orders are currently handled most of the time in the Nordic region. Orders are sent directly onto the exchange and customers can see their orders in the order book in a transparent way, which creates trust. The risk with PFOF, which is quite widespread in some other member states, is that some of the global high-frequency firms start buying order flow from online banks and brokers in the Nordics then the flow will never be seen on the exchange and the retail investor will not see where their orders are executed. More than 50% of the trading in the SME shares listed on the First North growth market is done by retail. If that flow is not seen on the exchange, but instead matched internally by brokers, that will harm liquidity and threaten the development of SME markets.

An official stated that achieving the CMU is a significant challenge as there are major differences between EU member states in the size and depth of their capital markets. There are also significant differences within the Nordic-Baltic region. Since 2017 Latvia has started to work with its Baltic colleagues on the development of a pan-Baltic capital market. This initiative showed that some elements that would be relevant for the Baltic region are lacking in the EU level discussion. For example, developing index labelling from the whole Baltic region would need to be addressed, because the markets of the individual Baltic countries will always remain too small for international or institutional investors. A second idea would be working towards the implementation of a common regulator for the region in order to foster more market integration, but this proposal is more politically challenging. Another initiative that needs to be mentioned is the creation of a Capital Market Development Accelerator Fund (CMDAF) with the support of EBRD to provide finance for pre-IPO SMEs and also small and mid-cap companies in the Baltic countries, where SMEs tend to be penalized by their small size. The objective is to help Baltic SMEs to attract more interest from the larger investors with improved growth prospects.

A second industry representative suggested that the role and functioning of market infrastructures will also need redefining to support the growth of capital markets and the funding of companies in the region. In the future, order execution will need to be instantaneous and no longer sequential. A challenge is however to finance these developments which have relatively long term paybacks. A further challenge is ensuring the security and resiliency of market infrastructures in an increasingly digitalised environment e.g. making sure that data is well stored, reliable and cannot be tampered with. In order to achieve this, a first issue for the region and the rest of Europe is securing sufficient resources with digital and financial knowledge, in a context where there is a shortage of such competences. Europe needs to think hard about how to attract such talent into finance. The second issue is ensuring sufficient technical resiliency and information security, which requires a collective effort from the financial market to design and build the overall infrastructure needed to support an effective functioning of the region's capital markets in the future, rather than improving each individual component in an incremental way.

Sessions

II

BANKING AND INSURANCE REGULATION PRIORITIES

Basel III implementation: global consistency challenges

1. Basel III implementation process

1.1 Important stakes behind the implementation of the latest Basel III package

An industry representative stated that Basel III has been discussed extensively, and the journey has started to ensure that banks are adequately capitalised for the risks that they take. Where banks are overcapitalised relative to their risk, the pricing ends up being uneconomic. The non-bank financial sector then steps in, and banking activity moves outside the regulatory perimeter. When banks are inadequately capitalised for the risks through the credit cycle and macroeconomic cycles, there are bank failures and financial stability concerns. Therefore, stakes are high. The Basel Committee on Banking Supervision (BCBS) sought to devise a solution that took local specificities into account but addressed the same risk with the same regulations.

A regulator explained that the EBA strongly believes in and works very hard on the standards negotiated, and the Basel standards already incorporated many of the national idiosyncrasies brought by various jurisdictions, including the EU. Basel III, being more recent, is more appropriate to ongoing idiosyncrasies of the European Union. The level of need to have specificity is decreasing.

1.2 In the EU the outcome of the trialogue is expected at the end of September 2023, though various issues are still being negotiated

A public representative stated that the objective of the negotiation team is to finalise the negotiations during the current semester. There have been two political trialogues, but not much advancement and the political problems remain. The Swedish presidency and the negotiation team from the European Parliament has not moved from its initial position in the negotiations, nor has the Council.

The European Parliament wants a clear end date to the transitional arrangement in the regulation but there has not been much advancement in this area. There has been no advance on other issues such as third-country branches, fit and proper chapter, ESG, and crypto.

There will be another trialogue in May and two in June. Aside from the political issues, the teams from the Parliament and Council have been working well at a technical level. Hopefully negotiations can be finalised in the next three political trialogues. A regulator hoped that the negotiations will be finalised by the end of September in line with timely global implementation.

1.3 In the UK, the aim is to have the rules effective from 1 January 2025. The consultation for implementing the last Basel 3.1 standards received significant feedback from industry

A Central Bank official stated that the set of objectives provided by the UK government included safety and soundness, and also competition, and UK competitiveness and alignment with international standards. The package is in line with the overall Basel approach, where the aims were to make the standardised approach more risk-sensitive, and to put a cap on the degree to which risk weights can be driven down using models by creating a new the output floor. The Bank of England had looked to align with international standards for safety and soundness reasons, with some targeted adjustment taking into account UK evidence.

The name 'Basel 3.1' might suggest that the package is small, however this is not the case. The Bank of England wanted firms to engage with the package and released a large consultation package so that firms can understand the thinking and provide feedback. The firms sent thousands of pages of feedback, which is positive, but will take time to review, triage and catalogue. With regards to timing, the aim is to have the rules effective from 1 January 2025, in line with the EU. Alignment across the major financial centres would be an advantage. The Bank of England will keep a close eye on the other jurisdictions, including the EU.

It was not necessarily the case that the Basel 3.1 package needed to change in response to recent events. This was not because there weren't lessons to learn on Basel 3.1, but because the areas covered by the package were not the main ones affected during the events. Recent events are a reminder that strong global rules that are consistently implemented are advantageous to everyone.

2. Main issues raised by the last Basel III package

A Central Bank official stated that the big issues in the UK are similar to those in the European Union such as the level and scope of the application of the output floor, small and medium-sized enterprise (SME) lending, infrastructure lending, unrated corporates, several issues around housing, credit conversion factors (CCFs) and securitisation.

2.1 Though the EU adjusted the package, EU banks still consider that it should eventually have a significant impact on the level of bank Tier 1 capital and would reduce the risk sensitiveness of the framework, which works to low-risk banks' disadvantage

An industry representative explained that one concern is that the banking package will significantly increase capital requirements in the EU. The latest monitoring report issued by the Basel Committee in February 2023 highlighted that the reform 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 is nearly neutral, and the rest of the world will have a 4.8% decrease. The banking package being discussed would not dramatically change the impact because, according to the EBA Basel III monitoring report published in September 2022, the fully loaded impact is a 10.7% increase for all banks, a 12% increase for Group 1 banks, and a 20% increase for global systemically important banks (G-SIBS), which provide about 50% of EU financing.

The second concern is that the proposal would reduce risk-sensitiveness and ignore national specificities. Since the US inspired the Basel framework in many aspects, many of its features have been designed to address the specific conditions of the US economy. However, the situation is different in the EU, with a much smaller capital market and an economy based on a majority of unrated corporates, for example. Additionally, the output floor significantly reduces the risk sensitivity on mortgage loans in internal models. After such a reform, large retail banks would be able to double their risk on mortgage loans without any impact on capital requirements. This penalises European banks, which have lower risks, due to the double recourse to debtors and real estate assets, while US banks have recourse only to assets. Solvency ratios may be identical, but they conceal different realities, notably the higher risk density in the balance sheets of US banks, while medium-sized banks, such as Silicon Valley Bank (SVB), generate a $20 billion loss.

The banking package incorporates some adjustments to cope with the specificities. The most significant adjustments are temporary and European adaptations would give only a five percentage-point relief on the increase in capital requirements. This is a limited, temporary adaptation to the EU risk profile.

A regulator stated that there has been a long debate about the quantitative impact and the overall assessment of the impact has been decreasing over time as a result of the enhancing of banks' capital positions. This does not mean that overall capital requirements would not increase as there could be adjustments. It also does not require increases in the capitalisation needs of banks, because the number of shortfalls has significantly declined.

2.2 Smaller banks require simpler rules, not lowered ones.

The Bank of England is developing a regime which is more proportionate and simpler for smaller firms, called Strong and Simple. The idea was that the rulebook could, in certain cases, be too complex for smaller banks. The aim of Strong and Simple is to reduce unnecessary complexity that adds little prudential value for smaller banks, not to lower standards.

An industry representative stated that with regards to proportionality, the key principle is same risk, same rules. The failure of a medium bank in the US recently, 30 years after the bankruptcy of 1,000 savings and loans associations in the 1980s, shows that small size does not equate to small risks. The US example has shown that international standards have limited interests if they apply only to a limited number of banks and without proper enforcement. This also shows that the standard model can conceal the real risks and constitute a weak reference. International comparability will therefore not improve.

2.3 Banks active globally need consistent implementation across regions throughout the globe. However, one already observes an uneven implementation or features within existing standards

An industry representative was fully supportive of timely and compliant Basel III implementation globally and of phase-in periods being as brief as necessary to have an orderly transition to the new capital standards. Banks should be adequately capitalised relative to the risks that they are taking. BCBS will look at all jurisdictions globally, and the implementation will either be largely compliant, materially non-compliant, or non-compliant. There is hope that all jurisdictions globally will be compliant or largely compliant. Recent events such as the US middle-sized bank crisis have been a reminder that consistency of standards is a strength and that confidence in the financial sector is a global matter.

An industry representative commented that this would not be a problem for American banks, because it has no impact. For US banks, it will be easy to implement the reform. There is poor implementation of Basel III in the US because it applies to only 13 banks, with major carve-outs. There is no credit valuation adjustment (CVA) or operational risks in the American standard, so it is a 30% discount. There is also the fact that most banks do not apply these rules, and there is a poor supervision on them.

An industry representative stated that their firm is concerned because banks need adequate capital relative to the risks taken, especially given the macroeconomic challenges. It contributed over $500 million to the Single Resolution Fund levy. The money should not be spent, and the strong capitalisation of the banking sector would be the best thing to inspire confidence, which would be an absolute necessity for financial stability.

2.4 One unsettled issue for banks is that the actual impact of the latest bank regulatory package should be strongly uneven among banks and regions globally, which should trigger significant credit provision policy adaptations and raises level competition issues

An industry representative stated that the finalisation of Basel III, or Basel 3.1, was different from other regulatory reforms seen in the recent past. Basel III was originally focused on the capital itself, whereas it is now focused on RWA, and risk is different in every institution.

There have been many impact analyses with many different banks over the last months and years and the outcome of these impact analyses has been diverse. The average impact was around a 10% and 15% increase in the RWA. The average number is unimportant. More important is that there are institutions that will benefit significantly from the rules. The record is a decrease in RWA of 15%, while the highest increase is 40%. This depends on the business model of the bank and the market in which it is operating. Banking markets in Europe differ from country to country. The impact is very different between small and medium-sized banks that use standardised approaches, versus large banks that use mostly internal models, especially due to the output floor. Even looking only at small and medium-sized banks, for example, which use the standardised approach, the impact can vary significantly depending on the business model and the type of clients. This is what makes the finalisation of Basel III so different, as banks will react differently to the new rules and will adjust accordingly.

When these impact analyses are presented to the boards of directors of the banks they might indicate, for example, that the total impact is an increase of 8%. The reaction from the boards of directors is that they can 'live with that', but then they are shown a decrease of 15% in one portfolio and an increase of 20% another, which is when they wake up and react. It must be done in a precise and strategic manner.

An industry representative stated that banks' business models would be heavily affected because banks in other jurisdictions would get a competitive advantage. The impact study on banks and the economy published by Oliver Wyman in January shows that on average EU banks face higher capital requirements than their US peers, with 10.6% of Common Equity Tier 1 (CET1) in the EU versus 9.9% in the US. The Basel III framework widens this gap further. In addition, only 13 banks apply the Basel standards, leaving others with weak requirements.

Apart from unfair competition, banks have the means to adapt to this situation by reducing their financing or increasing their margins and fees to cope with the extra cost of capital. The problem would mostly be for European borrowers. Copenhagen Economics published a study on the EU implementation of the final Basel III standard estimating that its finalisation could reduce banks' financing capacity by approximately €3 trillion. Copenhagen Economics also calculated that the annual cost of borrowing in Europe would significantly increase by €25-30 billion overall, and corporate customers are expected to be the most impacted, with an estimated 25-basis-point increase in borrowing costs on average in the EU.

As the regulation of the banking sector is tightening the market is moving. The share of shadow banking increases year on year and the banking sector is increasingly becoming an empty fortress. It is not clear that the overall financial stability would improve.

An industry representative stated that the Copenhagen study sponsored by the European Banking Federation (EBF) noted some methodological limitations. The risk-weighted asset (RWA) density variation between Europe and the US was not considered in the study.

The amount of RWA for the same risk in the US is higher than what it is on average in Europe, and so a lower percentage of capital in the US results in more absolute dollars of capital for many given risks. The US is already subject to an output floor, the Collins floor, which is why US banks have a smaller gap overall in terms of the capital raised. The US has increased its capital adequacy more from the point of the financial crisis than Europe. This has all led to a complex multifactor equation to ensure that the correct financial constraints are priced and considered, including things such as leverage constraints. Marginal economic pricing, rather than regulatory pricing, should be considered.

A public representative stated that there is an easy way to reduce the complexity of the Basel regulation. The capital ratio could be established at 25% and most of the regulation reduced but this would not be a good proposal. On proportionality and the difference between American and European banks, a lobbyist from the European banking sector would not, for example, focus so much on the different impacts between the US and Europe, because markets can understand that the European banks are not well capitalised. Europe will implement the latest Basel recommendations on time and negotiations should be finalised in the next few weeks.

2.5 The actual effect of bank regulation on day-to-day banking business and decisions raises questions

An industry representative commented that the finalisation of Basel III is extremely complex, and it will be important to widen the scope to include Capital Requirements Regulation II (CRR II), because there have been recent changes with a focus on RWA. One example is to look to the derivative transactions between banks. The risk weight changes for a bank using a standardised approach, for example. The CVA risk capital charge would also change. The standard approach for counterparty credit risk (SA-CCR) changed significantly one and a half years ago. There have been many changes in one product, and, for banks, this is an extremely complex tool to handle.

The output floor was a huge complexity. Many banks, including larger ones, focused on their internal ratings-based (IRB) or internal market risk models, but because they never had to calculate the standardised approach, they never paid attention to it. They now must calculate it with the same quality as an IRB approach because it will determine the RWA for the capital ratio. The standardised approach will become the even more important approach. These banks do not have much experience and may still use the old, standardised approach in their impact calculations. An impact analysis was performed and when the new standardised approach was calculated for the first time, it caused a 10% increase in RWA.

One of the biggest challenges for banks is that the output floor introduced non-linearity to the capital ratio, because the output floor was calculated on the highest level. All the RWA would be added up for market risk, credit risk and operational risk, and then the floor would be applied. In the future, changes in trading strategy used in an internal model would influence the RWA of the credit business, because it would have to be somehow redistributed. This becomes more complicated when considering the output floor, in that the RWA could be calculated for one single exposure and result in 100, but when calculating contribution to the total RWA, it will be 80 or maybe 110, causing pricing trouble. The finalisation of Basel III is one of the most complex changes in the framework so far.

A regulator noted that regulation always starts simple with complexity later added. The output floor is a backstop and there is a consensus between the trade-off about the use of internal models calculated entirely by banks and perceived to be being used initially, with the assumption that they would be risk-modelling, and then it is more about optimising capital. In the end, banks usually operate with an amount of capital above the capital requirements.

The opportunity cost of managing that capital is their economic capital, not their regulatory capital, and the pricing should be done on that opportunity cost, not on the regulatory aspect. It is difficult to understand how the regulatory aspect would be the binding part of the pricing rather than the effective economic capital that needs to be used for each product, given that the overall level of capital is above the minimum requirements, including the output floor.

3. Though they do not impact the content of the last Basel III package, important lessons should be drawn from the recent bank crisis

A Central Bank official stated that there are a few lessons, including one on resolution. The speed with which uninsured deposits can run in this digital world means resolution framework needs to be looked at. The need to think about liquidity regulations is driven by the same thing, which is that uninsured deposits can run quite quickly. It was possible that there would not be a wholesale need for big changes in these areas, but it would be important to make sure that these frameworks were working as intended. The resolution and liquidity issues are twinned because they are driven by the same thing. The final point is on interest rate risk in the banking book. Basel has a framework for interest rates in the banking book. What is needed is to check the way everyone has implemented is consistent across jurisdictions.

4. Current negotiations

4.1 The currently discussed transitional arrangements deal with various national/regional specificities, i.e., application of a complex package to banks beyond internationally active ones, local financing specific arrangements and perceived riskiness, role of national and EU level supervision authorities, activities' separation in the UK, crypto assets risk specificities...

A public representative stated that the most problematic European specificity is the decision made by regulators some years ago around implementing the Basel recommendations to every bank. The need to adapt recommendations and guidelines to the different business models constrains the ability of co-legislators to adapt or freely implement, or with more room for manoeuvre for the Basel recommendations. Banks may need time to implement the output floor for the first time, but the real estate exposures cannot be excluded from the implementation of the output floor. Europe would not implement the output floor at all in this case, so Parliament wants to establish a clear end date for the transitional arrangements. A regulator added that there is an additional specificity within the decision to apply Basel to every bank, which is to apply it to every level of application within a banking group rather than only at consolidated levels. This is also part of the agreement on the issue of the output floor between the Council and the Parliament.

A public representative stated that the Council's position is strong on the matter, and they have been unable to take any step in that direction. In Parliament, the argument has been to apply the output floor to both levels. There are fears and a lack of trust in some jurisdictions. The European Deposit Insurance Scheme (EDIS) is not there. The banking union does not work as well as expected in that context. The latest proposal to review crisis management is welcome, but there are not enough elements to incentivise the evolution of the banking union in general.

There are concerns in some host countries on the implementation of the output floor at consolidated levels only, but the position of Parliament is clear. A link between the evolution of the banking union and the implementation of EDIS has been introduced in the proposal. Parliament recognises that there are many elements around the banking union table but could not wait for everyone. There is a way to advance in other elements of the banking union regarding the implementation of Basel.

A Central Bank official explained that on the level of application, the UK has proposed that it applies at the consolidated level, with the addition of ringfenced banks. Ringfenced banks are philosophically viewed as being like a whole bank. The logic of the output floor has been taken to be calibrated and applied at a diversified level, and therefore the highest level of aggregation has been applied. It was also important to take account of level playing field considerations across different types of banks such as large building societies that have internal models.

In the UK, the Bank of England can only make certain rules where the Treasury has transferred the legislation on shored from the EU to the Bank of England. On the prudential treatment of crypto, some of the legislation needed to make the relevant changes hadn't yet been transferred to the Bank of England.

A public representative stated that this transfer is on the table. The European Parliament knew about the Basel recommendations on crypto in December and negotiations were closed in January, so there has been opportunity to introduce some elements. The proposal has not completely closed. Parliament wants to invite the Council to negotiate these articles to implement the Basel recommendations on the matter. The Council is open to debate with Parliament so that there will be at least a partial implementation of the Basel recommendations on crypto.

An industry representative stated that the different risk intensity in the balance sheet of EU banks and American banks is not in the Copenhagen Economics study; supervisors are aware that there is a significant difference in risk intensity. On crypto assets, there are two main issues. The first is to protect the regime set in Europe for the development of crypto. The pilot regime is important, and the Council and Parliament should take that into account. The second aspect is about a level playing field, as European banks do not currently deal with crypto assets. In the future, with proper regulation and supervision, the market will become increasingly safe. There should be no more constraints for the European banking system than other jurisdictions, as this regulation will apply in Europe in five years' time, which is when European banks should be able to compete on the same footing.

4.2 Expected timeframe for striking an agreement in the EU on the package

An industry representative stated that if there is no agreement during the Swedish presidency, there will be a problem in terms of the implementation of the package, as significant time will be needed for this.

A regulator stated that over 100 mandates are directed to the EBA in the implementation of the Basle package. Hopefully this will not be the subject of the discussion at the next panel. An industry representative shared the same view. A Central Bank official did not think that the topic at the next panel would be either Basel III or Basel IV.

A public representative stated that they hope the negotiations are finalised in the next few weeks and there will be agreement during the current presidency. There is more concern about non-banking activities in the financial markets, and the new players and stakeholders entering into financial activities. More needs to be done for a legislative point of view on the matter.

An industry representative believed that Basel III would be finalised on time, and that there would be a Basel IV, Basel V, and Basel VI, as the financial world is developing, and regulators will have to follow. A regulator agreed that this sounds like Basel V. Hopefully progress will be made in making systems more robust and continuing to finance the economy.

Competitiveness of the EU banking sector

Introduction: The European banking sector is lagging behind the United States banking sector in terms of competitiveness

The chair introduced the session by reminded the audience that the European banking sector is lacking behind the United States banking sector in terms of competitiveness. More interestingly, we could consider questions such as why this competitiveness gap exists. Are there historical reasons? Are there geographical reasons related to the fragmentation of the general landscape? Are they regulatory? To what extent is it a problem beyond the shareholders of the banks? What are the broader ramifications to the society of this competitiveness gap, and whether the ongoing trends, and perhaps the recent turmoil, brings anything new into the picture. Finally, what should we do about it? Are there any low-hanging fruits that we have not identified, or should we go all in and do something drastic to address the issue?

This session highlighted the reasons for this competitive gap and outlined several avenues of progress to bridge it.

1. There are several reasons explaining this gap in competitiveness

1.1 The state of play

A supervisor noted that Single Supervisory Mechanism (SSM) banks suffer from structurally lower profitability in comparison with the US banks. SSM banks' return on equity in the third quarter 2022 stood at 7.6%[1], compared to 13.1% in the US. This weaker performance has been reflected in their valuations, with price-to-book ratios and market capitalisation of SSM banks well behind US peers.

A regulator stated that the word 'competitiveness' acts as a reminder of a debate and a famous article by Paul Krugman, in which it was said, 'Countries do not compete; companies compete.' The real key issue to think about is whether Europe has a banking and financial system that can provide the adequate allocations and roles that is supposed to be provided to the European citizens. That is basically to provide adequate financing and to allocate savings and investments in an effective way across the Union, and then beyond that hopefully also able to export that model and provide those services to other countries.

Competitiveness is a combination of two things that sometimes get mixed. One is the obvious loss of market share of large European banks in the global financial markets. The global European banks have been losing market share relative to American banks in global financial markets. That is not a good sign, but that is not as relevant.

The real concern or the real difficult parameter is the valuation and the fact that banks might not be able to get an adequate return on capital to compensate investors. Operating in a sector in which investors are now satisfied is a necessary condition for sustainability over the medium and long term. That is the key issue. That not only affects large banks, but it affects the banking sector in Europe. It affects the smaller banks, medium banks and large banks. Average profitability is probably too low, or has been low, and the question is why that is the case and how it can be answered. It is banks that need to be able to put this forward. There are always references to the macro environment in which Europe operates not being prone to profitability. In fact, profitability has risen over the last year. The effectiveness of the European market has been the ability to develop a single market. That is an area in which Europe needs to work for the policymakers to put that forward.

It has also been said the complexity of the regulation, or the perception of the regulation within the European Union, is more burdensome than others. Differences in implementing the global standards are putting differential pressure on the banks. The single market can be effective and bring economies of scale there. Those are the issues. As part of ensuring a banking sector that is sustainable over time, there needs to be an adequate return on capital.

A third argument is whether the cost of equity is too high after all the reforms put forward. That is for the markets to provide us input on this issue.

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

A supervisor highlighted five cyclical and structural differences between EU and American banks that explain this competitiveness gap:

- Euro area growth has been slower than the US over the past decade. 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.

  A leader of the industry (F. Vicario) agreed that cyclical factors, such as weak economic growth and a

1. Banks' return on equity increased to 7.68% in 2022 from 6.70% in 2021. It reached the highest reported value since 2015 as net interest income rose to €298 billion from €260.7 billion in 2021. The net interest margin stood at 1.36% in 2022, up from 1.21% one year earlier.

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.

- The prevailing bank business model in Europe implies, in principle, the retention of loans on the balance sheet until full repayment, given also 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.
- The 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 pressures than its US peers, with an additional impact on pricing. Despite efforts towards establishing a 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.
- SSM banks show larger management buffers above capital requirements than US peers. In particular, European banks are typically concerned with market stigma. Therefore, they usually decide to hold significant management buffers, which are expensive.
- Regulatory pressures and supervisory intrusiveness are perceived to be very high for SSM banks. Despite the application of the proportionality principle, actual differences between large and small banks are not perceived very material from the regulatory and supervisory standpoints.

A supervisor stated that, when looking at recent events, there is a need to look at how risks are governed, controlled and how the regulations and supervision can help tackle this issue. Europe has a different scope of application or regulation supervision. A great deal of work has already been done at Basel and at the European level regarding the interest rate risk in the banking book. This is already part of the Pillar II. Looking at different jurisdictions, some supervisors have already used it to a significant extent in order to tackle the expected increase in this risk.

One issue that has not been tackled on both sides of the Atlantic is opacity in the CDS market. After 15 years, it is still not understood where the interconnection in that market lies. The other topic that has not been tackled is crisis management.

1.2.1 Banking remains a fragmented industry in Europe

A supervisor agreed that Europe still has an issue about fragmentation and overcapacity. 5% of the top EU banking groups hold 20% of total assets, while 5% of the top US banking groups hold 40% of assets. There is a significant gap between the two sides of the Atlantic, and one of the reasons for this is fragmentation and overcapacity there still is in Europe. Another reason is that Europe still has domestic markets and not a fully unified market. That makes it more difficult for banks to expand properly to design products that could be sold all across the EU. That is despite of the banking union, but it is also because the banking union is not yet completed.

Securitisation is something which is missing at this stage in Europe. On top of that, there are several cyclical factors linked to the level of interest rate, the slope of the yield curve, and the level of growth, but the main structural factors are to be found in the first one I mentioned.

A leader of the industry agreed that 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 non-European 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.

1.2.2 EU appears more like a conglomerate of 27 different markets and is not prepared for a new banking crisis

An expert stated that banking is all about size. UBS just got a lot bigger, due to a well-rehearsed takeover. A Swiss bank could easily complain about the size of the home market because it is a small market. With a small home market, it is necessary to be a lot more international, and being very international means banking all the markets in the world.

There will be more financial stress. European regulators and banks have a complete sense of complacency about where Europe stands in the credit and business cycle and what the risks are ahead. It is the same complacency and finger pointing witnessed 15 years ago. Europe points at the US, saying US banks are in trouble. This time, it is not the big US banks. It is the second league of US banks. But I would be more cautious and recommend humbleness rather than complacency. The crisis might well return and then be haunting European banks.

The title of this session is about competitiveness of European banking. But Europe did not want competitive banks. The whole regulation has been about making banking a commodity and bringing down the cost of financial services, rather than having globally competitive banks. With new financial stress, Europe is again standing at a crossroads.

If stress emerges, acting quickly is key. The UBS takeover of Credit Suisse was well-rehearsed. The banks and the regulators were ready to act on a weekend. If an EU bank were to run into trouble, the other European bank would not be ready for a major acquisition of a competitor. Boards and managements of these banks would be quite reluctant to adopt such risky takeover on a weekend without a proper due diligence process, since without it they could end up in court down the road. Europe is not prepared for a new financial crisis. Prudent risk management is not about hoping that risk will not materialise. It is about being prepared when risks materialise, being ready to manage these risks. In 1860, the US created with the Federal Banking Act a US federally chartered league of banks that could offer banking services across the US. They are supervised by the Office of the Comptroller of the Currency (OCC), and deposits are insured by the Federal Deposit Insurance Corporation (FDIC).

A federal European insurance deposit agency with similar powers does not exist. A similar size balance sheet, and the ability to tap markets and raise funds and have the other banks pay into the federal deposit insurance scheme, is not there at a similar scale in Europe. Europe afforded he luxury of waiting 10 years to discuss this, but 10 years of action to implement this would have been preferable because during this time Europe could have built a European deposit insurance scheme that is worthwhile having.

Europe must create a federal European crisis management mechanism in order to deal with pan-European banking problems. The current system consists of 27 national regulators, and to make things even more complicated, a European 28th regulator on top. Complexity in managing financial stress in Europe multiplies by 28. Even smaller banks in Europe operate cross border instead of only nationally, but there is no truly European league of pan-European banks.

1.2.3 Insufficient scale or synergies across markets

An industry representative stated that there is now competition among countries and regions. Without a scale, it is very difficult as a company to compete with other companies that are global and have that scale, and it is very difficult to compete among countries.

With the current fragmentation, SMEs cannot grow in Europe. SMEs benefit when they can export and when they can get global. It is difficult to attract foreign investment. It is very difficult for big companies to get global and to have efficiencies there. Europe's strengths are related to sectors. The finance sector is at the front and centre of Europe's strengths, but Europe have other sectors on which it can lead and be an example, such as the energy sector and the outer sector.

A weakness of Europe is that it is not one single country. We have seen in the past, and are seeing now, how regulation has the capacity to really scale and grow sectors very fast and very efficiently. Fintech is a good example of growing a successful sector. We are seeing, and have seen, how regulation is able to destroy sectors, to really kill innovation and not allow companies to grow. The European finance sector should be front and centre of growth and competitiveness.

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

An industry representative stated that the root causes of the competitiveness gap between EU and Is banks are well known as to why European banks are less profitable than US and Asian banks. The starting point here is SSM banks have a good capital base and are very illiquid.

In 2012, the stress test focused also on sovereign risks included in the balance sheets of these SSM banks across Europe. Europe has a problem of scalability and national barriers, but there are early steps to go into a banking union and capital markets union which just require accelerated implementation. It is also difficult to compare American banks with European banks, as European banks tend to have more internal models with a lower risk-weighted asset density.

Europe distributes more in the US, and less in Europe. There is a wealth of securitisation activity happening in the US that is not quite happening yet in Europe. There are a few important steps that could get the European SSM banks to accelerate some degree of consolidation. That does not mean it will be at the cost of a weaker client service, but better profitability with a lower cost base.

2. Some priorities to bridge the gap

2.1 Some nonperforming banks should exit the market

A regulator stated that the European Union consists of 27 member states and has to consider a 28th country. In the area of supervisory and bank supervision, the relative wait between the one and the 27 has shifted the most, and the most progress has been attained. There are problems moving liquidity and capital across the European Union and this has to be worked on.

The parameter by which large banks in Europe are less different from large banks around the world is on their balance sheet. The question is how to explain the benefits of size. That has much to do with synergies for a rotation of assets. We have to question the benefit of having in Europe an even larger bank just purely in terms of balance sheet without a different business model that makes it more profitable, that is capable of providing an adequate return on equity. The question is why Europe has such large banks that seem to be so unable to be profitable, or to be adequately profitable. It could be because there are many small banks that do not have a goal to be profitable and Europe has a domestic market that is not capable of being really competitive and constructive. It is also important to clean up some of the non-performing banks. Europe needs to address how big the market is for corporate governance in the banking sector and how many poorly run banks can be taken over, run and changed.

2.2 Facilitating the consolidation of the market

A supervisor stated that the issue is not that Europe should avoid failing banks exiting the market, but banks should exit the market in a proper and smooth way without creating additional tension in the market.

It is true that scale and size has always been the proxy for sustainability of a business model, but it is also fair to say now that digitalization helps even second-tier banks to survive because they can also be part of a bigger platform. Banks sometimes are a by-product of platforms, and these non-banking and non-financial firms can survive because they have the possibility to crunch, manage and aggregate massive amounts of data. One additional key driver for success might be data aggregation and data management. One of the priorities for the EU could also be to go deeper into the regulation of digitalization of the governance of DeFi. This might be an additional field where competitiveness can increase at the global level.

2.3 Europe needs more funding through capital markets to improve competitiveness

An industry representative explained that Europe faces the need for a great deal of investment (digital and green transition, defence...). For facilitating these investments, debt and equity capital markets and hedging activities for foreign exchange or interest rates are activities that need to be developed in a deeper way in Europe[2]. The first defence is to have a strong franchise with customers and recognised resiliency. The reason the scalability that was mentioned was, when you have a deeper market like the US, they are able to expand and start from a strong base. The strong base for European banks should be in Europe.

Perhaps short-term measures, like securitisation, is a way diversify funding sources and to make progress in the CMU. In the short term, we need to be careful in the EU clearing framework not to penalise global EU banks that need to have some of their non-EU clients to access clearing houses that sit outside of Europe, even though we should support more clearing on the Continent Certain protective measures, such as an inducements ban in the retail investment strategy, would hurt our franchise for our retail customers and would away them from capital markets as well as not giving the ability for European asset managers perhaps to get some of these assets.

Regarding long-term changes, regulation has been effective, but Europe really needs to reflect on the business model, and sustainability of business models. The Prudential Regulation Authority of the Bank of England and the Monetary Authority of Singapore have a prudential mode at first, but they definitely have a mandate to also make sure that banks thrive.

Lastly is consolidation of market infrastructures. In Europe there is a great deal of fragmentation across central clearing counterparties and exchanges across 27 national markets. EU equity capital markets are only 25% the size of the US. Moreover, 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 would create 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 a better climate and long-term growth.

2.4 Further harmonising local tax, insolvency and anti-money laundering frameworks and addressing ring fencing issued would help increase commercial synergies

An industry representative stated that a great deal of money could be saved if insolvency and anti money laundering frameworks were equal across Europe. 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.

The other aspect that matters is intra-group capital and liquidity ringfencing by country within cross-border banking groups. This makes life very inefficient. Good intentions are being discussed in Brussels. 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.

Once a better place has been reached it frees up capacity to continue to invest in technology. Banks are technology departments with an attached banking service provision that makes banks safe.

2.5 Thinking European rather than national

An industry representative suggested that countries will think of themselves first before thinking about Europe. Unless that is changed, this debate about the finance sector, and any other sector, will happen again and again.

An industry representative stated that there are certain jurisdictions, in the US in particular, where there are some requirements for having an independent holding company or a different setup. It is quite efficient for fungibility of capital and liquidity operating through branches.

2.6 European Banking Union needs a regulatory big bang for a fully-fledged EU banking framework for cross border banking groups

An expert highlighted the need for a European league for EU-based international banking groups in order to

2. 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.

compete with U.S. banks at the level and degree of sophistication that the US banks display. Some European banks can compete, but Europe simply does not have an integrated home-market of the size and depth that would foster such a pan-European set of sophisticated financial services. Should there be banking problems not just in the US or Switzerland, but in the eurozone, there is a question whether Europe would be prepared and able to manage these risks.

15 years ago, financial crisis management in Germany was largely improvised. Looking at, in particular, the Benelux countries, preserving national banking systems mattered a lot in how rescue operations and how crisis-related mergers and acquisitions were done. A crisis will never come from where the last one was.

There is not much time. Europe should not discuss Basel IV and Basel V ad infinitum. Europe should basically implement a pan-European banking union. It needs to happen fast, not just at the spend of the lowest common denominator. There has to be some tough decisions at this point in order to create such forward momentum. If the hope is the next crisis will create that momentum and that acceptance, it is likely there will be another crisis before moving to the next level.

The chair noted that it was said that Europe needs a lot more European agencies, operators. But when you look at these heroic banking mergers, or banking interventions, be that Credit Suisse or the actions in United States, in the great financial crisis, what is common there is that, behind all these different private banks and regulatory agencies, there is a unified political will that is directing things.

An expert answered that it is necessary for Europe to allow banking mergers, or banking takeovers, without there being a completed banking union or a politically legitimated European to supervisor or regulators. If the aim is to get to European banking union by taking everyone along and creating something that has organically grown, it will take a long time because there are 27 members, and it will happen ot the speed of the slowest members. The takeover of Credit Suisse by UBS shows that even if resolution works, it is likely to be more risky and can be much more painful than a takeover by a competitor. If you look at that example, Swiss banking consolidation has come at a lower cost, less financial distress and was a much smarter solution as opposed to letting the distressed bank drive into the wall, picking up the pieces and then selling the pieces. Pieces of a bank are not worth a lot. The bank as a whole can be worth a lot.

Europe needs to have a single European banking licence. UBS, as a Swiss bank, needed 27 national licences in Europe, 27 platforms, and 27 management teams. If UBS could be run its entire European business out of Frankfurt centrally with a single banking licence, supervised by a single supervisor, subject to a single resolution regime, subject to a single deposit insurance scheme, it would have been a profitable market. It could have achieved a level of profitability of French clients, German clients or Italian clients that was unachievable based on a fragmented business, and it would have increased competition pressures in the home markets French, German, Italian and any other European banks. More competition based on lower cost would have reduced the cost of financial services for clients, and based on lower cost, an increasing number of clients could have benefited.

Secondly, there is a big misperception when talking about scalability. In banking, it is often argued that the number of branches and the number of clients matter. That is what Europeans call scale. However, branches have moved from being an asset to being a liability for banks. Scalability is not about banking more clients. It is about banking the same clients multiple times with different products. Scalability in Europe is not about becoming bigger. It is about becoming more universal financial service providers.

It is hard to understand the creation of a European banking union was designed as a journey that would take all banks onboard and therefore required national savings banks and corporate banks to move along. They are only purely national financial service providers. They are the second tier of European banks. Why not let them do their job and let them bank their clients nationally? Why do they need a European licence and all the complexity of European supervision and regulation if they run only local banking businesses? Europe needs global banks and pan-European banks to be regulated at the European level, because that is where competition will be the most intensive and benefit clients most.

Europe has chosen to travel at the speed of the lowest common denominator to European banking union. At the moment that speed is strongly influenced by German savings and corporate banks. They do not want European regulation; they have German business and regulating them nationally would absolutely suffice. None of them operate beyond the borders of Germany. The concern of European Banking supervisors should be about the top 15 international and pan European banks, because if they have a problem, it will require cross-border collaboration to rescue them. Supervising the top 50% of each member-countries banking institutions was how the Single Supervisory Mechanism was set-up. Supervising the top 50% of the Euro area banks would have been a smarter way to start it. The real challenge now is not to worry about the smallest 50% of Euro area banks, the puerly domestic local banks. It is not a key risk for Germany, nor for any other country. Could Germany afford to rescue its saving banks and its corporate banking sector? Of course, it could, but they will organize the rescue within the groups because they allow competition to take over and consolidate the system within the group. But can Germany afford to rescue its big banks? I'm sure it can, but it would have to happen within a European framework, which has key elements still under construction to date.

In the other 26 countries Europe, ask yourself the same question. The risk is that if financial stress continues, the market may test whether the regulators and a country 's government can afford to save their banking system. This is where contagion risks become very dangerous for Europe. Whether a bank has a fundamental problem is then largely irrelevant. If speculative market pressure and short selling increases for a bank by enough to cause deposits to flow out, if the stock price falls enough to add to the perception of instability, that will organize be the moment where the regulator and the home-country may have to step in and save that bank. It is not about whether European banks are safe or not safe. It is a question of whether a European bank in trouble can receive sufficient support and access a backstop, a deposit insurance and other recovery mechanisms to stabilise the bank, as the U.S. did.

The U.S. supervisory authorities have far-reaching emergency authorities. Europe needs 27 authorities with little power each around the table to agree to move on European supervisory issues. The European public would not forgive the supervisors and regulators if there were another round of banking problems in Europe and they are not dealt better and much quicker than last time around. Europe needs to be prepared for this. There is a sense of complacency that is not addressing the fundamental issues.

The Chair concluded the session by noting that the banking sector in Europe has a competitiveness issue. To fix that, we need to do a bunch of things. We need to create scalability in whatever definition of that word. We need to create standards and efficient technologies. We need a European banking licence. We need European deposit insurance, European agencies, and European spirit. We need a big bang, and we need time. That is the plan. Thank you for your attention.

Enhancing the EU bank crisis management framework

1. Introduction

The Chair noted that significant events took place in March in the US and Switzerland in the banking sector. The failure of US regional banks and the merger of Credit Suisse and UBS demonstrated the significance of the availability of liquidity in resolution, effective supervisory frameworks as well as the growing influence of digitalisation (mobile apps) and social media in triggering sudden financial outflows. We have seen bank runs that were unprecedented in volumes and speed. EU authorities need to take this into account. Funding can disappear rapidly. Crisis management needs to be flexible enough to tackle all sources of risks.

This banking turmoil is a powerful reminder of the need for effective and agile crisis management frameworks. The European Commission has recently published the crisis management and deposit insurance (CMDI) review proposal.

This session allowed, first of all, to draw lessons from the collapse of the US regional banks and the takeover of Credit Suisse by UBS for the EU crisis management framework. Then the panel focused on how to address the funding gap in resolution notably for small and medium sized banks whether or not they are under the remit of the Single Supervisory Mechanism and the Single Resolution Board. Allowing Deposit Guarantee Schemes (DGS) to address the funding gap in resolution for mid-sized banks remains a controversial issue.

2. Lessons learned from the recent banking turmoil that could improve the CMDI

2.1 Unlike in the US, all European banks apply Basel requirements, notably for the treatment of interest rate risk

An industry representative stated that after years of low interest rates, tighter monetary policy is challenging banks 'effective risk management in securities portfolios and loans exposures. This massive shift in the macro-financial regime after more than a decade of ample liquidity is magnifying the consequences of any mistakes. In the US incidents, mistakes were made in the management of liquidity risks and interest rate risks by banks, but the consequences of those mistakes were magnified. The prudential framework in Europe already prevents most of the consequences of those types of mistakes because of the strength of the regulation and the quality of the supervision. The US example also demonstrates that the consequences of a failure of a so-called medium-sized bank may not be benign. This will likely lead to a sharper assessment of the public interest of many institutions. Indeed, some small, medium sized or regional banks can have a significant public interest.

The takeover of Credit Suisse by UBS marked the first failure of global systemically important bank since the global financial crisis. This crisis management shows that disregarding the hierarchy of creditors and favouring shareholders over bondholders, as was the case in the rescue of Credit Suisse, leads to a lot of turbulence in the markets. In Europe, on the contrary, the hierarchy of claims is clearly defined in the EU crisis management framework, and CET1 capital would always be first to absorb losses and would be fully written down before Additional tier 1 instruments could be written down.

A Central Bank official noted that effective supervision is the first line of defence which reduces the probability of a banking crisis occurring. More uniform implementation of Basel regulation (liquidity, stress testing, and other requirements) provides more effective and equal supervision (both micro and macro) for banking institutions across Europe. This approach can serve as an example to other jurisdictions, such as the US, where a two-tier based supervisory system is applicable, but was proven to be less effective by the recent events.

2.2 The speed of depositor flight in the time of digital banking and social media have highlighted the need to review liquidity ratios

A Central Bank official commented that social media, which can quickly spread financial news and rumours, and digitalisation of finance were important contributors to the speed of recent events. Liquidity buffers were calibrated in a world less influenced by social media and digitalisation and, accordingly, should be rethought.

A policy-maker stated that the question around speed of deposits is not about resolution per se but is instead about whether a failing or likely to fail bank can get to the weekend, at which point the toolbox can be used.

2.3 The key points of the Commission CMDI review proposal

2.3.1 Lessons learned from the recent events in the banking sectors of the United States and Switzerland

A policy-maker stated that the crisis management and deposit insurance (CMDI) revision proposal should be regarded as a continuation of the process that started 10 years ago when banking union began. The CMDI reform is not an urgent response to what happened in the US and Swiss cases. However, there are two lessons learned already from those cases that are relevant for the CMDI negotiations. The first is that it is possible to have an excellent, robust theoretical framework that does not work at all in practice over the "resolution weekend". There must be enough flexibility in the framework to allow it to work in very uncertain and time-constrained circumstances. Excessive rigidity should be avoided. The second lesson is that, although it has been argued that bail-in is more efficient and fairer than bail-out because it prices risk and creates the right incentives, it is not necessarily economically or politically easier than bail-out.

2.3.2 The CMDI extends the existing framework to another set of banks

A policy-maker explained that the CDMI proposal will enhance the existing framework, extending the existing crisis management toolbox to mid-sized banks and the ensure the availability of funding so that these tools can be applied to any bank irrespective of its size and location in the EU. A continuum of responses to bank failures will be created. The proposal aims to replicate options similar to those available to the Federal Deposit Insurance Corporation (FDIC) in the United States.

2.3.3 Removing the super preference of DGS for allowing them to step in, in lieu of deposits to manage the failures of medium-sized banks

A policy-maker commented that the incentives to use resolution tools have become distorted, mainly around the treatment of depositors. In the EU context, we are speaking of deposits of small and medium-sized enterprises(SMES) and not the much larger deposits which characterised the balance sheet of SVB in the United States. Experience suggests that EU policymakers have chosen to bail out SME depositors using public funds rather than bail them in. That is because bailing in these SME depositors was seen as creating a financial stability risk through possible contagion or as inflicting excessive economic damage on the local economy.

The CMDI proposal addresses the question of whether the taxpayer or the banking-sector safety net should bear the cost of a bank failure in circumstances where the bail-in of SME depositors is excluded for reasons of financial stability/economic damage. In line with the fundamental principles of the EU resolution framework, the proposal provides for an extended use of the safety net so as to protect the taxpayer. The CMDI reform will start by extending resolution tools to medium sized banks but, to do that, funding possibilities must be improved, Banks' shareholders and creditors must always be the first to bear losses. However, external funding possibilities must also be expanded, which means using the deposit guarantee schemes (DGSs) more proactively. To accommodate that more proactive use, the creditor hierarchy must be changed, creating a single tier preference for deposits and the super preference of DGS must be removed. The proactive use of DGS, as opposed to the standard paybox function, will be governed by a harmonised least-cost test. All the elements in the CMDI proposal are interdependent. It is not possible to pick and choose between them. If the creditor hierarchy and super-preference of DGS cannot be changed, the DGS cannot be used proactively either. Only when you have the funding in place does it make sense to extend the use of resolution tools.

2.3.4 EDIS is still missing

A policy-maker noted that a European deposit insurance scheme (EDIS) would further enhance a reformed crisis management framework, by supporting the national DGS in a situation where it was not sufficient to meet the funding needs of a failing bank. In such circumstances today, the national DGS would turn to the state. As a basic principle under the Bank Recovery and Resolution Directive (BRRD) is that the state should only be involved as the absolute last resort, EDIS would therefore strengthen the crisis management framework.

An industry representative noted that EDIS is no longer being pursued.

2.3.5 When an IPS functions as a DGS, it must observe the rules of DGS

A policy-maker stated that the Commission must find an appropriate balance between the level playing field with recognising the specificities of national banking sectors including a functioning framework for the IPS. This balance was reflected in the Eurogroup statement of June 2022. The Commission believes that it has found that balance in the CMDI proposal, whereby an IPS must observe EU DGS rules, when it is recognised as a DGS and functions as a DGS. Otherwise, the IPS is still able to perform other non-DGS-related functions.

2.3.6 A more proportionate approach to Minimum Requirement for own funds and Eligible Liabilities (MREL) for medium sized banks

A policy-maker stated that it may not be possible to have equal treatment for MREL between very large and smaller/mid-sized banks. More proportionate MREL treatment for medium sized banks is proposed in the CMDI proposal. Unlike two years ago where interest rates were persistently low, the issuance of subordinated debt has become more costly, and some banks may struggle with this in their existing business model. MREL treatment should be equivalent between banks, although he accepted that equivalent treatment is more difficult to measure. The proposal is for a proportionate approach to MREL for medium sized banks. If the 8% bail-in threshold for accessing the Single Resolution Fund (SRF) cannot be met, it would be possible – in very specific circumstances – to use the DGS as a bridge to achieve access to the SRF so long as all shareholders and eligible creditors have already been bailed in. However, the quid pro co for this is that entities will be liquidated, i.e. exit the market fully, thus addressing the risk of moral hazard. All banks contribute to the SRF, so there is no philosophical reason why the SRF cannot be applied to all banks, but MREL will be the first line of defence. And all banks should pay for stability of the banking system as a whole.

An official commented that the European banking sector is indeed very diverse. This may hinder finding a solution over the weekend in a crisis. Instead of finding second best solutions to this problem, banks should compete for funding and allow the investors to assess the risk of different business models. The best tool for this is to require all banks to have the 8% MREL.

2.3.7 Resolution starts with MREL

The Chair commented that resolvability does not stop with MREL. It starts with MREL. Entities must be ready to withstand a resolution decision. If CMDI is adopted, the first thing that the Single Resolution Board (SRB) will do as a resolution authority is to request that these banks targeted for resolution respect not only MREL but also resolvability. The proposal is not a 'free lunch for dying quietly'.

In other words, the banks' funds (MREL) should and will remain the first to shoulder losses in resolution, but it is key to have -after MREL- credible access to the safety nets built by the industry (DGS and SRF), without gaps. This will enhance the ability of the resolution toolkit to meet its objectives, including the minimisation of use of public funds.

3. Should DGSs be allowed to address the funding gap in resolution for mid-sized banks?

The debate on this subject is controversial. The main arguments for and against this legislative proposal have been expressed.

3.1 On resolution, there is much for Europeans to learn from the US

A Central Bank official noted that the US has more powerful and flexible instruments in place to resolve a failing bank. In case of Europe, capacity and flexibility will increase once DGS systems are in place and ready to participate in resolution more actively. This could enable the controlled market exit of banks while minimising market panic and preserving the value of the bank under resolution. However, to have equally powerful and flexible resolution tools in Europe as in the US, the banking union would have to be fully finalised, including an agreement on EDIS.

To enable better resolution functioning from the practical perspective, 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.

3.2 Constrained flexibility is needed to secure financial stability in banking crises

An official stated that the regulatory and supervisory reforms enacted in Europe in the last 10 or 15 years mean that Europe is in a safe place. The recent events in the US and Switzerland demonstrate that trust can be endangered by a medium-sized bank. Resolution is about preserving trust while curbing moral hazard. In order to do that, a large toolkit and constrained flexibility is needed, meaning a clear framework is required, with legal rules and a safety valve. As happened with the systemic risk exemption in the US, unknown unknowns must be taken into account. The Commission proposal goes in the right direction but is unsatisfactory in parts. For example, on the precautionary capitalisation, it adds constraints that are not fully justified. So far, the precautionary capitalisation has been used in a way that wiped out shareholders and subordinated instruments, so moral hazard was addressed.

Regarding uncovered deposits, recent events vindicated what was stated in Europe after enactment of the BRRD in 2011 and 2012. The Italian authorities argued that depositors should not be bailed in due to the risk of contagion effects. In the case of SVB, 90% were uncovered depositors, but the US authorities stepped in very quickly to protect them in order to preserve trust. This should encourage consideration of what is in the European crisis management framework. The 8% rule was applied with certain technicalities about whether the impairment should be factored in. Recent events have proved that flexibility is needed.

3.3 Increasing the possibility of using DGS and the Single Resolution Fund to manage bank failures

An official stated that the banking ecosystem in Europe is made up of very different banks and should be preserved. MREL is a crucial part of ensuring resolvability. However, some business models cannot issue MREL instruments or cannot issue up to the point that would be required if the rules were applied in the same way to all different business models. Level playing field does not mean applying the same rules in different situations. Around €35 billion is sitting idle in DGS. There is €80 billion in the SRF. As stated by the European Central Bank (ECB), this should be used when it is the least-cost solution. An element of the proposal that needs fine-tuning is the governance of when to use these mutualised funds as the preventative measures. When measuring least cost, not only direct but also indirect cost should be considered.

A Central Bank official commented that the role of resolution is to help banks with failing business models to orderly exit the market. An effective system is needed to ensure that the banking sector is vibrant, viable and moving forward. As a country with many fintech companies, Lithuania has a positive attitude toward the proposal because if the e-money institution is keeping funds in the bank, the DGS could treat funds on a granular (person) level. This provides more favourable environment for banking as a service business model.

3.4 Moving to the FDIC model remains challenging. Too much focus on the deposit transfer tool may prevent consideration of the big picture. The DGS super preference should be maintained

An official commented that the same rules apply across small, medium and large banks on liquidity and capital purpose. This is correct and appropriate.

Crises come in waves and complacency must be avoided. The quickness of the digital deposit run was shocking and has interesting implications for the growth companies and founders. The FDIC tool relied on the transfer of deposits, which was not possible to achieve within a weekend. Speed is very important here, not only in how quickly the market reacts but also in how quickly officials react. Whether the proposed changes in the CMDI would achieve the necessary speed should be considered. The EU crisis management framework should be formulated ex ante. Before the crisis, as complete a toolkit as possible should be built. The ex-ante toolkit will signal that there is a level playing field between the different sized banks.

Different levels of subordination and seniority protect themselves. A bank that only had deposits, corporate deposits and retail deposits, would run very easily. From the financial stability point of view, a full spectrum is needed. That is achieved by designing the right incentives for the banks and investors through regulation. There is currently too much focus on the deposit transfer tool. The wider implications of focusing only on this should be carefully considered. The shareholders and creditors should pay first. The hierarchy should be in place. Diversity is valuable, but it is not the only thing that should be optimised. The banking sector's role is to be extremely efficient at pricing risk correctly, so that the system works as smoothly as possible. From that perspective, the present model is very effective.

The general depositor preference is a concern. If the deposit transfer is indicated to be the preferred tool through the design of the least cost test and DGSs end up being used in all various crisis events, there is a danger that the money will run out. This is a clear risk in Europe with the very diverse banking sector with various business models. If it is indeed the case that banks cannot access markets to reach the 8% requirement of MREL then it is likely that over the weekend solution in a crisis would mean a huge haircut on bank assets in a transfer situation. Replenishing DGSs ex ante could be too expensive from the industry point of view. If everything is covered, it is unlikely that the private sector could pay and still be competitive. Then there is a risk that it would fall to the taxpayer again. There are also moral hazard consequences. If it is stated ex ante that there is a possibility of transferring all of the deposits i.e. none of them are used in bail-in, it is a huge investor protection scheme.

A policy-maker acknowledged that the CMDI proposal focuses primarily on the transfer of deposits, but the use of the transfer tool, other tools or the use of DGS in a paybox function only would be at the discretion of the national resolution authority. These would be no obligations to use any specific tool. Also, under the CMDI proposal, the existing crisis management framework is being extended. More fundamental changes in the approach to EU crisis management would have to be in the context of the overall framework including for "too-big-to-fail" banks.

3.5 Not respecting the creditor hierarchy and eliminating the DGS super priority would lead to a great deal of turmoil in the markets

An industry representative commented that the CMDI framework must respect the fact that a level playing field across Europe is essential. No public or mutualised money should be used to maintain so-called zombie banks on the market. The least-cost test and public aid rules must be more widely applied and harmonised across Europe. That means that all the European authorities in charge of overseeing this scheme must address a larger number of institutions than was initially envisaged.

The question of whether the taxpayer or the industry should pay was raised previously. In the first place, shareholders and creditors should pay. No bank should be entitled to escape from the common rules, in terms of having sufficient buffers of different categories of liabilities and protecting the deposits. There should be technicalities that allow all sizes of banks to access these types of liabilities and to issue different types of securities in order to build up those stacks. DGSs should not be used to address funding gaps in resolution and facilitate the access to the SRF for medium sized banks. Access to the SRF must be reserved for banks that have built the level of (MREL) and remain subject to prior bail-in of at least 8% of total liabilities and own funds (TLOF). Reviewing the deposits or the DGS positioning in creditor hierarchies would present bank liquidity issues, increase volatility of bank deposit financing and introduce moral hazard.

The Chair noted that all banks contribute to the SRF, although not in the same amounts.

3.6 The CMDI review puts thousands of small and medium-sized banks at risk

An industry representative stated that the CMDI review puts thousands of small and medium-sized banks at risk for two main reasons. First, resolution for all means a combination of the authorities stepping in very early, a least-cost test and preferences for resolution. That would replace the decision-making process within an IPS and make an IPS obsolete. Secondly, the proposed Deposit Guarantee Schemes Directive (DGSD) changes would make IPS measures close to impossible for the DGS IPS[1]. Flexibility, trust and speed are very important. The EU IPS released a joint declaration on 26 April. There are wo calls for action. First, IPS measures must come before resolution actions. Second, the new DGSD should distinguish between the paybook schemes and schemes that are also legally recognised as IPS.

Conclusions drawn from the US are not necessarily the right conclusions for EU banks. The European Banking Authority (EBA), the SSM and the SRB are doing an excellent job so far. Policy-makers should actively embrace the diversity of the financial sector. The German banking sector is a good example of the benefits of diversity. Diversity of a banking sector can be considered in the context of future risks. The existing banking union already provides a solid foundation for banking stability.

The Chair commented that a new source of funding must be identified to address the funding gap in resolution for medium-sized banks. This raises a number of questions around DGS super preference, least-cost test and articulation between least-cost test and no creditor worse off. The role of the DGS is one of the most important changes in the CMDI proposals.

1. DGS-IPS refers to all IPSs that are recognized as DGS.

Taking advantage of bank diversity in Europe

1. What is at stake

1.1 The variety of banks' business models contributes to the EU system's overall resilience

The Chair detailed that while there was consensus that bank diversity in the business model is an asset, past Eurofi discussions have resulted in disagreement about whether the Single Supervisory Mechanism (SSM) and European Supervision were applying a one-size-fits all approach to different business model.

1.2 The scope of the EU very detailed regulation must be reviewed

A regulator suggested that the aim of harmonising supervision across the EU has inferred that we produce very detailed regulation and guidelines. But there should really be a discussion about whether the scope of regulation and supervision is correct. The definition of a credit institution is something that has not been harmonised, lending to the public is at the core of this discussion. The concept appears clear, but when considering the details, it is not actually clear.

If the aim of European regulation is simply to prevent bank failures, there might already be the right scope to protect depositors in deposit-taking institutions. However, in the last 20 years there has been an increasing focus on the stability of the credit supply. If the aim of supervision is the stability of credit supply, it does not makes sense to only have macro tools and supervision for credit institutions. It must be asked whether to also include other entities in the scope.

1.3 A stable, predictable, trustworthy regulatory environment is beneficial for all kinds of business models

A regulator suggested that financial innovators and fintechs are needed as they can challenge the old and large banks. Despite what they claim, their business models and risks are not fundamentally different. All banks, be they old, small, traditional savings banks, large, systemically important banks, the new, fast-growing fintechs, are fundamentally the same. A stable, predictable, trustworthy regulatory environment is beneficial for all kinds of business models.

An industry representative raised the importance that politicians and regulators do not fall for populism and consider effects on investment climate when assessing the profit levels and not rush implementation of for example windfall taxes.

1.4 A sustainable bank is a profitable bank with diverse funding

An industry representative remarked that entities with strong buffers are much safer in the current environment. The best buffer is profitability, and the key is long-term profitability. There is also a need for diverse funding. Entities need deposits and market funding. Other buffers include capital, liquidity and credit provisions.

Banks that are built on one thing alone will suffer in the current environment. Predatory lending will also not work. In a world with 0% interest rates, entities can lend to everybody, but in this time they need to be more prudent.

An industry representative noted, from German cooperative banking sector and institutional protection schemes (IPS) perspective, and with regards to an exit door and an instrument for reacting very quickly, action is taken through early preventive measures.

The chair summarised that there should be a full-scope type of supervision, incorporating all of the information and data. There are two legs. There is regulation and supervision to try to reduce the probability of banks defaulting, but there is no regulation nor supervision that can completely avoid the potential default of a bank, which is why all of the legs related to the how to manage crises are needed, which includes an exit door.

1.5 Combining the diversity of business models and consistency

A Central Bank official suggested that the cornerstone of the system is an adequate risk assessment. Recurring profitability is linked to the governance and the business model, as well as the economic environment.

The fundamental objective of supervisors, and of the SSM as a supervisory authority, is to analyse the risks that institutions take, and whether the institutions are properly managed. The joint supervisory teams (JST) are responsible for that assessment. And for them, it is important to be able to identify and understand the reasons behind each figure, structure, ratio or score.

The banks under the supervision of the SSM are quite diverse. So, when dealing with more than 100 institutions there is a need to apply a minimal level of consistency. And that is not definitely a one-size-fits-all approach.

There is also a need for flexible application of supervisory methodologies. It is reasonable to assess similar risks in a similar way, but there are many other factors that can explain differences, such as the business model.

Combining the diversity of business models and this level of consistency is essential. The SSM approach applies this second layer of consistency and benchmarks, but it also strives to apply the right balance between risk-based supervision and consistency. There is an evolutionary process in that respect.

2. Contributions and suggestions on adjustments the SSM could consider

2.1 Going beyond proportionality for sound supervision

2.1.1 When business model supervision is accurate

A regulator pointed out that when it comes to diversity it is very difficult to identify a common trend, as diversity is, by definition, not common. The banking sector across EU member states is a very diverse one. Additionally, defining what exactly constitutes a business model is far from trivial. The viability of individual banks is one of the most important issues. Profitability is also important, but focusing solely on it gives the wrong signal. Very profitable banks can, at the end of the credit cycle, be the most dangerous banks, because they are over-leveraged and the profit is coming from that area.

A comprehensive view on the bank and the viability of its business model is very important, so the SSM is undertaking horizontal comparisons with benchmarking. Business models are already supervised on the basis of proportionality and at individual levels. This is an important exercise, but it is not sufficient – detailed assessments remain essential for individual banks.

In assessing business models, supervisors have to be smart and bold. Supervising banks in line with the standards is easy; but it is much more difficult to argue why a special situation applies for a specific bank.

A diverse banking system in Europe is not, per se, more stable. It can be more stable in that a single event does not affect all players in the same way, but a set route for market exit is essential for greater stability. There is a need for the instruments to take effect very quickly

2.1.2 What proportionality means

An industry representative noted that business models develop on the market. The European regulatory framework should be neutral. It should be more flexible to allow new businesses to reflect existing businesses and support future growth.

The primary concern is for the business models of those, mainly locally operating, banks, which are owned by roughly 18 million members, to be adequately supported in the framework. The rules on institutional protection schemes, the knowledge, and the financial stability granted by the support and monitoring systems have ensured that taxpayers have never had to step in to cover any of losses for more than nine decades. This should also be reflected in the current discussion on crisis management and deposit insurance (CMDI).

The diverse business models contribute to the structural resilience of the European banking market. In some jurisdictions 'proportionate' is used as a synonym for exemptions from regulation. Instead, there should be more flexible regulation. Proportional regulation means appropriate regulation that reflects the size and business model of an institution and does not mean weaker regulation. It means simpler but not weaker regulation.

2.1.3 Supervisors and regulators should be neutral with regard to the business model

The Chair suggested that supervisors and regulators should be neutral with respect to the business model organisation. That has been a longstanding principle of European regulation and supervision. 'Proportionality' can have different meanings. From one perspective, people tend to see the size, even though recent events show that interconnectedness might also matter significantly. There is also proportionality in supervision, which is based on risk, and sometimes supervisors spend a great deal of time on small intermediaries because they might be riskier.

2.2 Benchmarks for banks

2.2.1 Acknowledging banking diversity in Europe through tailored indicators or benchmarks

An industry representative remarked that the industry's concern is about the indicators taken by the supervisor. For instance, Profitability is a ratio that compares results on equity. For some firms a better indicator could be the residual income after distribution: what should be assessed is a bank's capacity to put earnings into reserves. The capacity to serve customers and small companies should also be an indicator for supervisors, and benchmarking should be adapted to the specificity of each banking model.

Regarding governance, the fit and proper procedure has to be adapted to the relevant particularities, such as elective processes. Regarding the different recommendations made on the SREP process, the integrity of the business model should be questioned.

Day-to-day supervision runs contrary to the general recognition of the diversity of business models being an asset for stability. The supervisory procedure should encapsulate a bank diversity suitability test so that recommendations from a joint supervisory team do not question the integrity of a bank's business model.

Regulation itself can lead to numerous unintended consequences on the different business models when the big picture is ignored. The leverage ratio, if applied individually and not globally, tends to favour risky activities, while the net stable funding ratio (NSFR) favours long-term activities. Those indicators would incentivise banks to favour a non-diversified, risky long-term business model. There is a need for more tailored supervision from the SSM.

2.2.2 How the governance framework functions

A Central Bank official noted that the question of the risks should be stressed. No one governance structure is better than another. It is how the governance framework really works what matters. There is a need to distinguish the substance from the form. People do not assess in exactly the same way, because it is human nature to make some differentiations on soft elements that sometimes are not particularly soft.

2.2.3 A greater reliance on information quality

An industry representative highlighted that having more dialogue and communication is a key factor for everyone.

Every business model is unique and has a right to grow. Putting all of these business models in a corset is not the right approach. The mandate of supervisors is to assess the viability of such business, and to assess and monitor the risk. Entities have to organise excellent risk management.

However, it is not only important to look at numbers. It can be asked whether there is a desire to understand the business model behind the numbers. A schematic approach with only statistical data and models could be the only way to handle certain business models.

The approach needs to be further developed and refined, and the indicators used should sufficiently reflect the relevant strengths. There should be stronger dialogue with stakeholders on the approach taken. That could also minimise the administrative burden with respect to unnecessary information being requested.

The Chair agreed that there should be greater reliance on the quality of the information. A bottom-up approach that helps to complement quantitative data is the true value-add of prudential provision.

2.2.4 Proper risk management backed by sound supervision

A Central Bank official remarked that the question is how to incorporate the nuances of the different business models, and whether that should be included in regulation or in supervision. Beyond the refinement of methodologies with different elements, scores, etc., there is a need to assess vulnerabilities and the riskier areas independently of the business model. There is also a need to properly apply supervisory intensity through a multi-year approach meaning to reinforce the supervisory risk-based approach.

Considering the latest financial instability episodes, there was doubtless a significant component of risk management in addition to the weaknesses of regulation and supervision. Therefore, It has to be ensured that risk management and governance are in control, and that strategic decisions are taken based on data.

There is a bidirectional relationship between regulation and supervision. The more proportionality is applied the tougher the supervision should be for the riskier parts. Some business models are less risky than others, and in those cases less supervision should be applied. That process is underway. However, in other situations, there should not be great deal of proportionality where entities are competing in a very complex market with the rest of the institutions. It also has to be ensured that the risks are properly assessed.

2.3 Focuses for regulation and supervision

An industry representative noted that, ultimately, both supervision and regulation are derived from the will of the people through democratic elections and politicians. What is on the regulatory and supervisory agendas is usually what is on politicians' minds. One risk is that the regulatory and supervisory bandwagon is looking in the rear-view mirror when what is needed is to look forward.

There are four issues to highlight. The first is climate change, which is a huge issue. The second is fraud. The new kind of theft involves phishing. The third issue is new technological developments. Innovation is good, but it also creating new risks. The same activity and same risk should have the same regulation. Finally, it is all ultimately about governance. In the end it is about getting the governance right; that is what drives the risks.

A regulator added that there is significant technological transformation currently occurring, with digitalisation, data issues and artificial intelligence. In addition, there should also be a discussion about BigTechs entering the value creation chain of the financial sector. They are not in plain sight currently, but huge issues about who creates the value and who gets the value are apparent in the back end.

A more stable, diverse banking industry requires a great deal of change, including in supervision. However, for example Governance is always needed and cannot be fully digitalised or automated. While it is very easy to say that smart supervisors have to carry out the necessary checks; it is nonetheless a very difficult task, because intervening in the governance process of a bank is a complicated issue and the most severe measure a supervisor can impose, as then it is about management's interactions.

An industry representative remarked that the SSM is made up of many procedures, so dialogue is key, but all of what has been said should be encapsulated in the procedure. There is a SREP review in 2024, which should encapsulate more respect of the diversity of business models.

Closing Remarks

The Chair summarised that there should be respect of the market developments. These might create some tensions on the scope, because there are new players, but what cannot be avoided is respecting market developments in terms of business models or organisations.

Both the public and private sides agree that the risks should be followed. There should be focus on traditional risks and emerging risks. There also needs to be consideration of the safeguards, and there is a hierarchy of profitability buffers.

There is a perception that the SSM does not consider bank specificity properly, which is not true. Many details are considered. However, there should be more dialogue and communication, given also the forthcoming review of the SSM methodologies. There should also be explanation of what is derived from and dependent on the horizontal analysis and what is bank specific, because there is still some miscommunication there. There is an interaction cycle with the banks. First, banks say they are different and so should be treated differently. Once they receive reassurance, they then say that others should be treated like them. That is why the horizontal analysis is needed. It is the usual ongoing interaction between being reassured that the specificities are properly considered and there not being any competitive distortion.

Despite having different cultures, different backgrounds and different experiences, the SSM tries to apply the same methodology, which is the strength of the system. Its strength comes from collective and extensive discussion.

Sessions

III

DIGITALISATION AND PAYMENTS

Digitalisation trends and policy approach

1. Digitalisation trends and drivers

The Chair stated that digitalisation impacts all financial activities, steps in the financial value chain and players involved. In some cases it disrupts existing market structures and value chains, in others it is absorbed by the existing players. For regulators and supervisors, the challenge is striking the right balance between openness to innovation and mitigating the potential risks from digitalisation for customers and the overall financial system.

A regulator suggested that technological disruption supports three different developments. First is the emergence of new products associated with new business models such as decentralised finance (DeFi) and cryptoassets. Second is the emergence of new digital distribution channels and production processes for the delivery of traditional financial services. Third is the emergence of new players in the financial market, such as fintechs and bigtechs.

An industry representative remarked that customer needs and expectations are the main driver of digitalisation. Customer demands are evolving and digitalisation can help to better meet these expectations. Customers expect a wide range of channels to access financial services including digital channels, services that are easy to use, convenient and accessible anywhere at any time, as well as maximum security and safety. Regulation is a second important driver of digitalisation, as an enabler of data sharing. The upcoming open finance framework notably should facilitate data sharing with the implementation of new data sharing and API standards. Care must be taken however that regulatory requirements do not hamper innovation.

A second industry representative agreed that customer expectations are a key driver. Digital innovation is continuous within financial institutions because customer expectations are evolving and they need to respond to these evolutions. Technologies will also continue to evolve, providing financial institutions with new opportunities to respond to customer expectations. Quantum computing in particular should be a major driver of innovation in the near future.

A third industry representative stated that digitalisation has also helped market infrastructures such as CSDs (Central Securities Depositories) to innovate and seize new opportunities, while preserving operational resilience. For example the French securities market has been dematerialised for many years, which has improved efficiency. New technologies can also be used for addressing new challenges related to data. The collection of ESG-related data for example is going to be a significant challenge for the industry that can be supported by digital tools.

2. Benefits and challenges from digitalisation

2.1 Main benefits from digitalisation

An industry representative noted that technology, and cloud computing in particular, enables financial firms to enhance customer experience and customer interaction. The result is that now very few customers still regularly go to bank branches. Technology also allows financial firms to improve risk management, especially against fast-evolving cyber-threats such as distributed denial-of-service (DDoS), ransomware and state-sponsored attacks. Cloud computing also provides a higher level of cyber-resilience due to the level of security put in place by cloud service providers (CSPs). A third benefit of digitalisation, which partly relates to the second is a higher level of operational resilience and business continuity, as seen during the Covid crisis where technology supported remote processes.

A second industry representative emphasized that digitalisation helps financial services firms to achieve better outcomes for individual consumers and also SMEs and larger enterprises. Technology can for example support more effective and sustainable credit processes with new payment options and tools to allow customers to manage their finances responsibly, which contributes to driving down costs and better allocating capital across the economy. In this respect, two technologies – open banking and artificial intelligence (AI) – have the potential to bring significant customer value. Open banking allows for accounts to be verified and fraud to be tackled more effectively and supports more dynamic underwriting. Open banking also facilitates access to financial services for example with financial services embedded in e-commerce platforms, which saves customers' time and money. Artificial Intelligence (AI) should also be a key driver of innovation and improvement in the financial sector in the future, for example allowing financial institutions to proactively inform their customers of a reduction of interest rate or to better tailor products to customer needs.

2.2 Challenges and risks from digitalisation

A regulator noted that digitalisation will be beneficial to customers and the financial industry, as far as the related risks are appropriately managed. Four main types of risks from digitalisation can be identified. First is the risk of exclusion. Enhanced data-driven risk assessments e.g. for insurance or credit attribution might lead some riskier customer categories to be systematically excluded or charged excessive prices. While charging higher prices for higher risks is normal, this raises questions about the nature of insurance activities going forward, whether risk pooling will still exist and what the consequences of such evolutions could be. Another type of exclusion is digital exclusion for customers who are not capable of using digital tools appropriately or who do not want to share data because of privacy concerns. Different access channels need to be maintained because the financial system needs to be inclusive.

A second risk is price optimisation and abusive sales practices. Price optimisation involves using AI technology for pricing on the basis of elements that are not relevant from a risk perspective. Data analytics can for example allow financial firms to assess the price sensitivity of different customer segments and raise prices for those who are less likely to leave if there is an increase. This can lead to significant price discrimination for similar services, which should be avoided. In addition, there can be quite aggressive sales practices in online environments with the role of social media and influencers in particular, which may lead to mis-selling.

A third risk is financial stability risk due to the possibility offered by technology to quickly scale-up a business, which can lead to concentrations of risk or to possible spill-over risks within diversified tech companies or multi-activity groups providing a range of different services. It is uncertain whether current regulation is sufficient to deal with such risks. This is currently being assessed by the European Supervisory Authorities (ESAs).

A final risk concerns supervision. The current approach which is technology-neutral and applies 'same activities, same risk, same regulation' principles is well suited for addressing digital evolutions in the financial sector. However digitalisation also leads to an increasing number of companies selling products and services remotely with no local branch on the basis of the freedom to provide services provisions. If there is a problem of mis-selling for example it is up to the home supervisor to act but if this is not done effectively or fast enough, there should be the possibility for a European supervisor to step in. The importance of this issue is due to increase as digitalisation develops.

An industry representative noted that some technologies such as distributed ledger technology (DLT) are also bringing new challenges. Their potential impact needs to be appropriately evaluated as well as the possible implications in terms of regulatory framework. The DLT pilot regime should allow to do this and to test in production what the technology can bring to the market.

3. Update on the European policy approach to digitalisation

A policy-maker stated that digitalisation is profoundly transforming the way the financial sector works and also the way consumers approach financial services. There are different opportunities, and also challenges and risks associated with these evolutions. Digitalisation may accelerate the fragmentation of the single market in certain areas. There are issues around how to foster digital innovation and deal with data sharing at the European level. The challenge is providing a regulatory framework that will support these evolutions adequately. A Digital Finance Strategy was adopted in 2020 and was completed by horizontal measures concerning data and AML. Several additional legislative texts have been adopted since 2020 covering different areas of digital finance. The DLT pilot regime has been in application since March 2023 and provides a sandbox approach that allows securities firms to use DLT for trading and post-trading activities following specific rules. With MiCA (the Markets in Crypto-Assets regulation) a comprehensive framework has been provided for cryptoassets, stablecoins and the related service providers. The Digital Operational Resilience Act (DORA) will enter into application shortly. Proposals are also being prepared for the revision of Payment Services Directive 2 (PSD2) and open finance. Work is also being conducted on the digital euro. The legal framework for the digital euro will be proposed by the Commission, but the decision on whether to issue it will be taken by the ECB.

Three additional aspects are being closely considered by the Commission in the digital finance space, the policy-maker stated. The first is supervision, both at the domestic and at the cross-border levels, since many digital operators are active cross-border. The second is digital inclusion. Financial education will help, but there is a need to be mindful of citizens who are less digitally adept. Moreover, there is also the international dimension. There is supervisory and regulatory work taking place at the international level on many topics of digital finance such as cyber-resilience and crypto for which consistency is needed at the international level.

4. Issues to consider in further steps of the regulatory approach to digital finance

4.1 Conditions for a successful regulation of digital finance

The panellists highlighted a certain number of conditions that are important to meet for a successful regulation of digital finance notably in terms of focus on data, proportionality, collaboration between regulators and the financial industry.

An industry representative suggested that it is critical for digital finance regulation to be centred on data usage and data sharing. From that perspective, two important legislative proposals are expected in the coming months: the upcoming open finance framework and the review of the PSD2. The aim should be to enhance competition within the EU financial services sector while maintaining a level playing field among the different players concerned. The AI Act is also very important in this respect. The industry speaker moreover called for proportionality in the regulation applying to digital finance, as well as the promotion of mobility and choice among financial services and products.

A second industry representative emphasised the importance of collaboration between the authorities and the financial industry in the development of regulatory frameworks and technical standards, with the objective of ensuring that the learnings of earlier regulation and the conditions for a successful implementation of the regulation are taken into account in the drafting of legislation. A second issue is the overlap of regulations, although this is not specific to digital finance measures. Matching DORA, AML and GDPR requirements at the same time is quite challenging for banks, which may need the support of supervisory activities to ensure the implementation of these different rules in an efficient way. The harmonisation of regulatory frameworks is a further aspect to consider the industry speaker suggested. A harmonised regulatory framework is needed for building an effective digital finance ecosystem, but the differences between different markets and countries in terms of digitalisation of financial activities or usage of cash also have to be factored in. Combining harmonisation and an understanding of the differences across markets is very important. Another important element for the success of future digital initiatives is the EU e-ID which needs to be appropriately developed.

The Chair observed that customer protection is another important dimension to consider. For example in the digital world, the reverse solicitation of retail customers should be banned because it is too risky.

4.2 Speed of digital innovation

The Chair remarked that the speed of innovation is a challenge for the regulation of digital finance, because by the time the legislative process is finished, the world has already changed to a certain extent. A policy-maker noted that that is not unique to Europe or to digital finance. Regulators are always slightly regulating in retrospect, and that is inevitable because democratic legislative processes and Level 2 standard setting take time. What can be done is trying to have frameworks that are as flexible as possible, and anticipate the fact that there will be further evolutions in the market that may require a review of the legislation. For example, in MiCA there is a need to further consider decentralised finance (DeFi).

A public representative suggested that while there is a temptation to change the regulatory and supervisory approach with digitalisation, this should not be done in haste. The correct approach with continuous evolution is to keep a steady pace in the legislative making process. A regulatory framework that stays in place for some time provides predictability and stability for the industry and also for the public authorities who have to supervise the implementation. For example, many events happened in the crypto market over the last months, when MiCA was being finalised, including the failure of certain major cryptoassets and crypto service providers. Some were calling for these issues to be taken into account in the negotiations, but that is not the way to proceed. There should be a longer term view about the objectives of the regulation, its potential benefits for different stakeholders and how it can be effectively implemented. However if there are some systemic problems or threats of the scale of those that emerged during the 2008 financial crisis, then the regulatory framework has to be rearranged.

The public representative added that while it is unlikely that the European legislative process can be significantly accelerated, what could be considered is moving towards a more principle-based approach to regulation. That could help legislation to adapt more easily to changes in the market than the current prescriptive approach with rules addressing issues that happened in the past. Much more could be achieved that way with a more future-proof perspective.

An industry representative suggested that an outcome-based regulation can indeed be more effective because businesses then have the opportunity to find different ways to achieve the outcomes defined by regulation while focusing on common objectives.

4.3 Adapting regulation to industry evolutions triggered by digitalisation

An official emphasized that many stakeholders convey a complacent view to regulatory changes, considering that issues raised by new products, players and production processes supported by digitalisation can be addressed with a slight adaptation of the current framework. That is a first step, but is not sufficient in all cases. For example, regarding new products, the AML/CFT standards were successfully adapted to incorporate the new crypto-related service providers. However, that is not enough for tackling these risks in a decentralised finance (DeFi) environment, in which accountability is difficult to determine. A new regulatory approach is needed in this case, that allows the identification of the people or entities in charge of those platforms or the focusing of certain regulatory actions on the actual users of those platforms.

When it comes to new production processes, there is an increasing challenge posed by the reliance of traditional financial institutions on the services provided by certain new entities, especially CSPs that operate on a global scale. The current rules for outsourcing and operational resilience are not fit for purpose to tackle the risks posed by those third party providers which have become critical to the financial sector. The concentration of this market and the dependencies created require that rules focus not only on the financial institutions outsourcing those services but also on the providers of those services. From that perspective, the DORA approach is relevant, but it does not provide a global response. The services provided by CSPs to European financial institutions are typically provided from outside of the European Union. That means there is a limit to what the EU DORA legislation can achieve by just regulating activities in the EU jurisdiction.

When it comes to new entities, the idea that activity-based regulation is not sufficient to address the risks posed by multi-activity groups such as big techs has been expressed at previous Eurofi events. Big techs provide regulated financial services and need to obtain a licence to do that. The issue is when they provide a mix of services including regulated financial services, non-regulated financial services and non-financial services. This combination of activities generates specific risks such as spill-over risks that require a specific regulatory response, which cannot be activity by activity. It has to incorporate an entity-based dimension.

Taking these issues together, an ambitious regulatory revamp is required, the official believed. It is not enough to just enlarge or adjust the existing regulatory framework to take these new evolutions into account. There is a need for new approaches in some areas. The European Union has been at the forefront of this so far and a similar approach is needed at the global level. Technological disruption also requires a rethink of supervisory approaches. There are two main channels through which technological disruption can eventually affect the safety and proper functioning of financial institutions. One is operational resilience, because financial institutions increasingly rely on ICT third party service providers and the second is business model sustainability, as traditional financial institutions have to face the competition of new players, threatening the viability of certain business models. Those two risks, which could eventually affect the solvency of financial institutions are recognised in the current prudential framework, but those risks cannot be addressed solely by increasing capital requirements. There is indeed no reasonable level of capital that could compensate for a bank failing to provide sensitive services to its clients on a continuous basis, or for a unsustainable business model. These risks posed by digitalisation require novel approaches. The official concluded that the supervisory approach has to pay more attention to fostering risk-preventing management actions. Quantitative capital and liquidity requirements should remain at the core of the prudential regime of banks, but in the future the supervisory regime should probably become more forward-looking and less capital-centric.

4.4 Next steps of the DLT pilot regime

An industry representative highlighted the importance of the DLT pilot regime that was launched earlier in 2023, which will allow to assess the value that this technology can bring to the securities ecosystem. A certain number of successful experiments have already been conducted for the issuance of government bonds on DLT. One challenge with the pilot regime is that it is outside of the current regulatory framework. It is not known what the future regulatory framework will be, but this can influence the uptake of DLT-based solutions.

Following a remark by the chair that the DLT pilot regime is a regulatory experiment in itself, the industry representative acknowledged that the regime shows the willingness of European regulators to authorise a wider use of DLT in the securities market. It will be important to test the implementation of DLT using both the current regulatory environment and the pilot regime to identify the pros and cons of both regulatory environments and to have the right insights for drafting the future regulation.

5. Supervisory implications of digitalisation

A public representative emphasised the importance of the proper enforcement and application of regulations such as MiCA. Supervision can contribute to this but there is also the need for effective cooperation between the industry and the regulatory and supervisory authorities to achieve an effective enforcement of regulations and to anticipate the need for future evolutions of the framework. In the new landscape of digital financial services, mutual learning and cooperation to improve the regulatory framework are essential. Improvements can be made thanks to supervision and an effective collection and use of data, but there are still a number of shortcomings in this regard, both at a national level and at the European level.

Answering a question from the Chair about whether digitalisation challenges the very idea of national supervision in the EU, the public representative suggested that with digitalisation, much more effort is required in terms of a harmonised and cooperative approach to supervision. That does not mean abandoning national-level supervision but adapting it to digital services that can more easily be provided on a cross-border basis. Technology can also help supervisors to overcome some of the issues. The public sector side also needs to embrace digitalisation in its own processes.

An industry representative added that for efficient supervision what matters is approaching issues and compliance with a 'same activities, same risk, same rules' perspective. It is not just about protecting customers or financial stability but about protecting trust in the financial industry. Trust is essential for banking activities in particular and effective supervision can help in this regard. There is also a need for supervisors to have the right digital skills, which means hiring new competences and training and retaining existing people.

Another industry speaker stressed that supervisors need to adapt their approach to the digital world. The objectives of supervisors have not changed with digitalisation, but they need to adapt their tools and practices to the new digital environment. One example concerns CSPs that operate multi-tenant environments, which means providing similar services to clients across industries such as financial services, healthcare providers, governments etc. The possible implications of supervisory requests for the rights to security and privacy of other customers need to be considered. In addition, CSPs operate on a global scale, which raises questions, from a supervisory perspective, with regards to the evolution of different frameworks impacting cloud services across jurisdictions. The shared responsibility model that is used for cloud services is a further issue that customers face in supervisory discussions. These two aspects – the multi-tenant environment of cloud and the shared responsibility model – will require an adaptation of supervisory approaches and tools, particularly when DORA comes into force in 2025..

Cryptoasset and stablecoin regulation

Introduction

The Chair introduced the session by mentioning that while some people had thought that crypto was a fad and would not last very long because it does not serve any useful economic function, it is not gone, still attracts investors and is probably due to last. There are however some concerning aspects to crypto that need considering such as a high degree of anonymity that has led crypto to be used for illegal activities and a recent downturn in the market, as well as the failure of several cryptoassets and service providers in 2022. Ensuring sufficient resilience of crypto is a starting point for further development of the market. The panellists were invited to discuss the added value of crypto and its future prospects, the lessons that can be learned from the recent market turmoil and whether the issues facing crypto can be handled with the policy initiatives that are being led in various jurisdictions including the EU.

1. Added value of crypto and future prospects

An industry representative stated that the value proposition of crypto is quite simple to understand. Crypto is the ability to transmit value electronically. The internet has evolved from a medium where people could simply read information into a medium where people can also participate and contribute to providing information online for others to read or use, such as social media. Crypto is part of the third generation of the internet (Web 3), which adds the ability to transmit value via tokens, which can be used to store that value or as a payment mechanism. Tokens can also be used to safeguard personal information or affinity, which has enormous value, since it can facilitate online participation without handing over the data for others to monetise.

A second industry representative believed that the future for digital assets and blockchain technology is bright. There are significant value drivers that will support their development. Blockchain and cryptocurrencies were indeed invented to solve a problem, which was a lack of trust in the existing financial system and traditional currencies. Those who dismissed Bitcoin initially were sceptical about the value of such assets and about the benefit of self-custody, with the common belief that banks could be trusted with holding assets. Then some banks in the US started failing, which reinforced the value of self-custody, which ensures that an asset cannot be taken away from its owner and that an intermediary such as a bank cannot use it inappropriately. Self-custody is an ongoing value driver for digital assets and there has been repeated proof of that over the last few months. A similar effect is taking place with decentralised finance (DeFi), which is proving to be a powerful force of growth in the market. Over the last year, there have been many weeks in which the volume of DeFi has exceeded the volume of transactions on centralised exchanges. A key value driver of digital assets and crypto going forward is their capacity to solve real-world problems of value transmission in the financial sector and also everyday questions such as functional non-fungible tokens NFTs that can be used by their holders to e.g. prove club membership.

A regulator emphasised the need when speaking of crypto to distinguish between the underlying technology, and the products and assets that are issued and used with the technology. The difficulty is understanding the value of each component of the crypto ecosystem and addressing it in an appropriate way. Some regulators are concerned about consumers and banks buying or storing cryptoassets because of the difficulty of understanding the precise nature and value of these assets. There is no doubt about the value of Distributed Ledger Technology (DLT) which is being used in many processes within financial institutions in a profitable way and there are many further opportunities to exploit. NFTs are easy to understand, they are a product, not a financial asset, but their value is difficult to evaluate. Stablecoins are more challenging to categorise. They look like a financial product but can also be considered as a payment device, in which case they need to be regulated as such.

2. Lessons learned from the recent market turmoil

An industry representative stated that the recent downturn was the fourth in crypto. As with many early stage asset classes or early technologies, there is an up and a down cycle until greater maturity is reached. The fact that there has been so much public coverage of the latest downturn is a credit to or a product of the increasing adoption of crypto over the last couple of years and also of the rising interest of policymakers in the implications of this. What has been learned over the last few weeks is that crypto is like many other asset classes. People brought the asset into their portfolios when the value was going up and then, when de-risking occurred in the wider financial market because of macro conditions in particular, people de-risked and sold crypto as part of this.

The core elements of crypto have nevertheless remained strong over the recent period, the industry speaker stressed. The technology has proven to be hugely resilient under enormous stress. The networks and the tokens have worked efficiently and with no interruption. DeFi protocols such as borrowing and lending protocols have continued to be able to provide credit through smart contracts. Stablecoins backed by short-dated assets have done very well also. What have not done well are the more fragile or badly managed components of the ecosystem: either highly experimental models like algorithmic stablecoins, or activities that were poorly risk managed or did not operate a viable business model. In terms of adoption, retail trading activity has been down but holding steady. What has picked up and stayed high throughout the market downturn is institutional interest, which is expected to continue to develop with an increasing number of hedge funds or pension funds accessing the crypto markets.

A regulator stated that the root causes of the recent turmoil and failures in the crypto system are a combination of five main factors. First, the high inherent volatility of crypto markets. Second, IT security and hacking issues experienced by some platforms. Third, issues related to the design of certain protocols, for instance algorithmic stablecoins. Fourth, governance problems, including conflicts of interest and the lack of segregation of client assets and also the difficulty for domestic regulators of monitoring risks in large and complex international crypto groups with a wide range of activities. Finally, there have been domino effects within the crypto sector due to a high level of interconnectedness among crypto players. No major spill-over effects have been observed at this stage between crypto activities and the traditional finance world however. For all these reasons, there needs to be a regulation of crypto activities in place at the EU level and possibly at the international level.

A second regulator observed that the recent market turmoil revealed the truths about unregulated stablecoins and exposed the illusion of some unsustainable crypto business models. For example, algorithmic stablecoins are not unlike Ponzi schemes, sustainable only with continuous inflow of new money. The various risks and vulnerabilities to which the crypto ecosystem is exposed are similar to those facing traditional financial systems, but the problem is that they are not regulated adequately in most jurisdictions. For example, stablecoins backed by assets may suffer liquidity and maturity mismatch, and run risks. Cryptoasset lending and derivative transactions involve the risk of excessive leverage. When entities manage clients' assets, there are risks of misuse of these assets and of conflicts of interest.

An official summarized that the crypto market has been exposed both to the same adverse macroeconomic conditions as the rest of the financial sector and also to more specific issues of poor risk management and governance failures, which led to a stream of crypto companies filing for bankruptcy protection in the second half of 2022. Many of the measures that were put in place to increase the resilience of the traditional financial system post-financial crisis, including a reinforcement of risk management and corporate governance requirements, industry-driven best practices and a strengthening of supervisory oversight, are missing in the crypto market. There are some instances of crypto entities, however, where a regulatory framework does apply - for example, LedgerX, a derivatives exchange and clearing organization purchased by FTX in 2021, which is registered with and regulated and supervised by the U.S. Commodity Futures Trading Commission (CFTC)[1]. As a result of that regulation and supervision, LedgerX remained solvent following FTX's bankruptcy, and was successfully sold in April 2023 and remains a going concern.

The official emphasized that individual investors are particularly exposed to the risks of crypto markets. Regulators should ensure that the right guardrails are in place to ensure that markets are fair and transparent, with appropriate customer protections and that regulators have sufficient visibility on how the different activities of firms are handled. During summer 2022, when prices were at their highest, retail investors were still buying in cryptoassets, while sophisticated investors were exiting the market, engaging in a sell-off as the melt-down began. That left regulators deeply concerned. A study by a Bank of International Settlements (BIS) economist recently noted that not only did retail investors pay the highest price, but they likely lost the most in comparison with other larger and more sophisticated investors.

3. Progress made with the regulatory framework of crypto

3.1 Main objectives and scope of crypto regulation

A regulator noted that in order to correct the shortcomings exposed by the recent turmoil in the crypto market in terms of operational resilience, corporate governance, segregation of funds, etc., an authorisation process is needed, as well as regulatory requirements addressing governance and conflict of interest and potentially also liquidity and leverage issues. The interactions with the traditional financial sector and with the investor world also need considering, e.g. whether investors are appropriately protected when investing in crypto products, whether the role played by banks in the crypto value chain is creating new vulnerabilities, spill-over or interconnectedness risks. Finally, it is important to understand whether crypto technology is being used for providing a financial product or asset. If this is the case, particularly if there are interactions with the banking sector, these activities need to be regulated and supervised e.g. as payment activities.

1. On the day of FTX's bankruptcy, LedgerX was solvent, could account for customer funds and was able to present financial resources to ensure that the firm could participate in an orderly wind down. Pursuant to the CFTC's regulatory framework, there was a segregation of customer accounts and customer funds. There were conflict of interest policies, cybersecurity policies and direct oversight of management in place to ensure that a qualified, capable board of directors was engaged in ensuring the risk management of the firm.

An industry representative stated that the regulatory momentum around crypto in the EU and in many other jurisdictions including the UK, Brazil, APAC region, UAE and more recently the US is a healthy development and shows that crypto is becoming a more mainstream activity that should be subject to appropriate regulation. It is essential that these initiatives do not regulate crypto as a technology, but consider the underlying activities that are performed with the technology (e.g. providing a payment mechanism, a financial asset, an affinity coin) and that the need for regulatory oversight is determined depending on the significance of activities for the wider public and the potential risks posed.

The industry speaker suggested that the primary area where regulation and oversight are needed is for activities led by cryptoasset service providers (CASPs) serving as centralised intermediaries, taking client funds and safekeeping client assets. The regulators should ensure that these activities are performed in a safe way and that funds and assets can be returned to the customer if needed. The second category of players that should be regulated are stablecoin issuers. Regulators should ensure that stablecoins are appropriately backed by a particular fiat currency, that the assets are stored safely, that there is transparency in audits with regard to the reserves, that the rules around redemption are clear, and that customers understand what their rights are and the terms under which they can get their money back.

3.2 The EU Market in Cryptoassets (MiCA) regulation

A regulator explained that MiCA will provide significant improvement but will not solve all the issues posed by crypto. MiCA will come into application between 2024 and 2026, so will take up to three years to be completely applied. It will complete existing requirements and registration processes put in place in certain member states e.g. France and contribute to investor protection. In terms of legal clarity there are still problems of definitions and of consistency between jurisdictions for instance between the US and Europe on what is a financial instrument and what is a virtual asset. MiCA provides many new and welcome requirements concerning segregation of assets, governance, management of conflicts of interest, internal controls, IT security requirements, better disclosure requirements towards clients and anti-money laundering (AML). The question is whether this is enough to tackle the main risks from crypto and what may be missing.

The lessons from the failure of FTX should also be taken into account, the regulator suggested. Even in a more regulated world, large frauds are difficult to avoid. Therefore, supervisors need to remain very vigilant. One of the possible difficulties with MiCA is having a fully consolidated view on large diversified crypto groups. The European Supervisory Authorities (ESAs) and the National Competent Authorities (NCAs) have to find a way to cooperate in a forum where they are able to discuss real cases, with colleagues from other sectors. Another possible issue regarding MiCA is the way market abuse is handled, because existing surveillance tools used in the traditional financial market are not adapted to crypto markets. The thinking on this topic is still at an early stage and will need to be pursued.

An industry representative considered that MiCA is a ground-breaking initiative and a model for ensuring that assets are being held safely, that CASPs have appropriate prudential controls in place, and that there is sufficient surveillance of potential market manipulation. An important step will be the production of the Level 2 rules, which should be an opportunity to clarify a certain number of aspects of the regulation. The policy intentions of MiCA with regard to stablecoins need clarifying in particular. Reserve capital requirements and hard caps on the number of stablecoins issued seem excessive in the present rules. That may reduce the opportunities for the euro to be tokenised and to be widely used in digital environments that are due to develop. Europe should be part of those evolutions, which is why the euro stablecoin needs to be widely accessible.

A regulator stated that significant progress is being made with MiCA. The regulation will enter into force in two years' time and regulators and supervisors are preparing for this. In this perspective, supervisors need to enhance their capabilities and regulators need to provide more clarity in terms of definitions, distinguishing technology, products and financial assets.

3.3 Policy initiatives in other jurisdictions

A regulator stated that in Japan the JFSA introduced a regulatory framework for cryptoassets in 2016, followed by a revision three years later, which has been working successfully. For example, CASPs are required to use highly reliable methods to manage and protect customers' cryptoassets. They have to undergo external audits over the status of their segregation management. CASPs are also required to have their financial statements audited and disclosed publicly. Even after the bankruptcy of FTX, FTX Japan was able to protect client assets and the clients have had access to their funds since February 2023. The Japanese regulation and supervision of cryptoassets address issues like conflicts of interest, onboarding procedures and fairness. As a result, complex and opaque trading platforms have not developed in Japan in the same way as in some other jurisdictions. The Japanese framework is effective but not yet perfect. While the existing regulation of virtual asset providers has been effective, some cryptoasset activities are not yet regulated. For example, crypto lending activities which were one of the causes of recent problems are not regulated.

An industry representative suggested that although there are still some hard questions about conflicts of interest and transparency, the path to a sensible regulatory framework for cryptoassets and stablecoins is quite straight forward. Jurisdictions around the world are making significant progress and are generally adopting the same type of framework. The UK, which is in the midst of its own consultation process, is expected to adopt something similar to MiCA. Brazil and Australia will start consultations by Q2 or Q3 2023. Dubai has a regime in place. Hong Kong is in the midst of consultations. The US is however still an outlier on crypto regulation, because the US regulatory system is fragmented across several different regulators at federal and state level. There is in particular a jurisdictional issue around whether cryptoassets can be considered as securities.

An official suggested that one benefit of the US regulatory framework is that it is flexible and there is hope that a solution will be found to address the divisions in Congress about the way to address cryptoassets.

3.4 International coordination

The panellists were generally in favour of consistency and coordination among jurisdictions in the policy approach to crypto assets and activities at the international level.

A regulator stated that, given the cross-border nature of cryptoassets, there is a need to strongly promote consistent and effective regulation and supervision across jurisdictions. The FSB's high level recommendations on cryptoassets and stablecoins are being finalised. IOSCO is working on these issues as well. International cooperation among supervisors is also necessary, even though there may be some differences across frameworks.

An industry representative concurred that global consistency is critical. In the US, the legislative process is chaotic, so there is a risk of inconsistency in regulation across jurisdictions. The real risk is that innovators and entrepreneurs start building for the US markets and that the products distributed in Europe end up being inferior because of this. If regulation is not sufficiently consistent, siloing will occur.

The Chair wrapped up the discussion mentioning that IOSCO will produce its own proposals for global standards for the regulation of crypto before summer 2023, which should contribute to achieving a consistent framework for cryptoassets at the international level.

Crypto and DeFi technology applications in finance

1. Main use cases of crypto and DeFi technology in finance and related benefits

The Chair stated that crypto and decentralised finance (DeFi) have emerged as potential disruptors of traditional finance. Distributed Ledger Technology (DLT), which supports these activities, allows for innovative features such as the tokenisation of securities, which could make traditional assets, such as real estate or private equity, more accessible to a wide range of investors. DeFi introduces new features such as smart contracts and decentralised execution that could automate financial agreements, reduce the need for intermediaries and improve the speed and cost of financial transactions.

An official noted that a poll conducted during the recent BIS Innovation Summit showed that half of the respondents were expecting DLT or blockchain to become widely and significantly adopted in the financial sector three years from now.

An industry representative emphasised that the use of crypto technology and of DeFi technology, which may open financial services to the potentialities of Web3[1], is still at a very early stage of development but these technologies have strong potential. The level of adoption of crypto technology is only at about 4% to 5% of the population. This corresponds to the state of development of the internet in 1999. In addition, crypto and blockchain technology do not exist in a vacuum but were developed to solve problems and have potential applications in many different areas of finance. Most major financial firms have had a significant blockchain and crypto agenda over the last few years working on the development of blockchain use cases for financial services.

One of the highest usage of blockchain is for financial infrastructures at present, with the objective of improving the efficiency and costs of middle and back office processes for security and commodity transactions in particular. Settlement periods for these transactions are still pretty long, between T+3 and T+1, because they go through quite archaic infrastructure and technology and several intermediaries. Blockchain provides instantaneous settlement leading to faster order execution and significant cost savings, which benefit financial institutions, but can also be potentially passed on to end-users. However, development is still at an early stage for the use of blockchain for the trading, clearing and settlement of securities.

Many use cases are also being developed in the payments area, the industry speaker observed. With a blockchain-based platform, money can be remitted very cheaply and almost instantaneously both at the domestic and cross-border levels, without having to go through intermediaries such as correspondent banks. The use of crypto technology also facilitates financial inclusion, which is a major challenge in many parts of the world. Crypto is being used for payments and also to send money back home by people who may not have access to a bank account. The cost of that is very low. Many multinationals are also experimenting with blockchain and Web3 today to improve customer service and engage more closely with clients and also to achieve cost savings.

A second industry representative explained that, four and a half years ago, the Swiss stock exchange, which has been operating a regulated electronic stock exchange for over 25 years, set up a digital exchange based on blockchain technology to support asset exchanges and safekeeping. The objective was to implement this new technology and test new use cases in a safe and reliable way in the context of a regulated platform with a trading and post-trading licence. This digital exchange is also established on the principles of strong governance, risk management, security standards and compliance processes, with AML at the forefront of its objectives, in line with the principles governing traditional financial market infrastructures.

A third industry representative stated that asset managers are evaluating the potential of digital securities and tokenisation supported by blockchain technology. While cryptoassets such as Bitcoin do not seem to add any proven value in the investment world notably in terms of correlation with traditional securities, digital securities and of the tokenisation of certain assets such as real estate, may have a strong transformative potential. Digital securities do not change the nature of the product itself, but facilitate their distribution and help to optimize the value chain with potential benefit for issuers and investors. Buying a fund today requires going through multiple intermediaries. If that distribution is directly handled by the asset manager, that will have a significant impact on costs. In Germany, there is an example of direct distribution of securities with Siemens, which issues bonds directly without going through any intermediaries. According to the ECB, there is an outstanding €20,000 billion in euro denominated securities, and about 6% of this amount is issued every year. If only a portion of that volume was issued digitally, that would amount to a

1. Web3 is considered to be the future of the internet, a decentralized form of the internet, where users become owners. Rather than using centralised platforms and apps to connect to the internet, browse, interact, and make transactions online, as with the current internet (Web2), users in the future.

significant number of securities in absolute terms that could reap the benefits of tokenisation.

The industry representative added that many traditional banks are considering the development of new services to cater for the needs of their retail and institutional clients holding digital and crypto assets. These adaptations to the digital world will be a key focus of financial institutions in the coming years.

A fourth industry representative agreed that blockchain technology has strong potential and may bring attractive new features in the market such as eliminating the need for reconciliations and confirmations between the counterparties to a trade. Their bank has started very thorough experiments using real test cases and setting up their own digital assets platform, which is integrated into the bank's systems and business processes in order to offer digital asset solutions. This platform that covers all the steps of tokenisation, including legal and compliance aspects, technology and business processes, has been used to issue tokenised bonds for a few institutional and corporate issuers. Their bank is also developing custody solutions for digital assets and is already a custodian for a small number of digital assets. This however remains a small market at present.

An official explained that the BIS Innovation Hub was set up three years ago by the BIS in collaboration with several central banks across the world to explore and experiment with new technologies such as blockchain from two perspectives. One is to assess how these technologies can potentially change the financial systems as they exist today in order to anticipate possible evolutions. Another objective is to evaluate how central banks and supervisory authorities can use these technologies for improving the way they conduct their own activities. The aim is to test the use of new technologies, learn from these experiments and report back to the central banking community and the whole public sector. The implementation of these new technologies will depend to a certain extent on regulations, but ultimately on the potential benefits for users e.g. in terms of cost savings and the impact on competitive positioning in the market

The official described the main areas of application of blockchain technology currently explored by the BIS Innovation hub. A first area is cross-border payments which are still slow, opaque and expensive in many places. Several projects are being run, using central bank digital currencies (CBDCs) in order to explore how the use of DLT can improve the payment infrastructure needed for executing cross-border payments and execute cross-border payments more efficiently by reducing notably the dependence on the correspondent banking system. A second area investigated in the context of a project called Mariana is the use of technology underlying DeFi platforms, such as automated market making (AMM), to improve liquidity and settlement efficiency in the foreign exchange trading and settlement area. AMM solutions are based on smart contracts that use liquidity pools to transfer digital assets automatically, without the traditional process of matching buyers and sellers. The aim is to assess how new technologies can be used to alleviate some of the frictions that are typically a problem in the financial system. Finally, experiments are led in the area of green capital markets. DLT and smart contracts are being used to track and transfer digitised carbon forwards, which is a way for capital markets to contribute to the green transition.

2. Conditions for a successful implementation of crypto and DeFi technologies

An industry representative mentioned that an issue for their bank in implementing blockchain-based solutions is that they want to stay away from the cryptocurrency world. Their perception is that cryptocurrencies such as Bitcoin, have no real economic value and have major negative environmental impacts. In addition, the pseudonymous aspect of crypto wallets has attracted many fraudsters, which means that there is the risk for banks of being exposed to stolen assets and of indirectly facilitating criminal transactions, which is a strong reputational risk for regulated entities.

Developing the use of these new technologies, while avoiding the cryptocurrency business, is however quite challenging, the industry speaker acknowledged, because, in practice, cryptocurrencies represent 90% of the applications of the new blockchain technology. There is a need for a reliable digital currency on the blockchain for facilitating digital securities transactions in a safe way. This is necessary to be able to benefit from the instantaneous features of the blockchain and to avoid reconciliations. If payments are executed outside the blockchain, much of the potential benefits will be lost. Banks are currently assessing how this can be done in a safe and efficient way. One option is developing their own stablecoin, but using this stablecoin on a public blockchain will expose them to the same cyber and AML risks as with other stablecoins, since they will be using the same infrastructure and filtering transactions seems difficult. Conversely, using a private blockchain will make it difficult to reach a wide enough market. Even if wholesale markets focus on certain counterparties, they still require being connected to quite a wide number of stakeholders.

A regulator shared the view that there is potential for improvement in the efficiency of different processes such as securities issuance and transaction settlement and cross-border payments, with the use of DLT technology, but for such developments to be successful there needs to be sufficient trust in the market in order to achieve mass adoption. Building trust is not only about the proper functioning of the technology, but requires adequate regulation and an adequate risk mitigation approach in a context where hacking cases and frauds are widespread.

In order to build sufficient trust, all the risks posed by crypto technology need to be taken into consideration in a sufficiently comprehensive way, the regulator stressed. This includes traditional operational, cyber and ICT risks as well as risks that are more specific to the crypto ecosystem. These specific risks include oracle or mining risks, governance risks and legal risks and also market risks posed by unbacked cryptocurrencies and counterparty risks related to crypto custodians. Finally, the AML risk needs close consideration. The anonymity and the instant nature of transactions on the blockchain is very attractive for criminals, hackers and people trying to circumvent sanctions.

An official agreed that there is scope for this technology to improve the way financial markets operate, including in the way that financial instruments are distributed and transactions executed. It is for the private sector to innovate and to come up with propositions that deliver on the potential of this technology, but that new ecosystem has to operate in a context where risks are appropriately managed and that does not pose significant consumer protection and market integrity issues. Evolutions in the way transactions involving traditional asset classes are executed and the plumbing of those markets should be encouraged, as long as we protect against financial stability risks and the possible implications of these changes for the overall financial system.

3. Policy approach to the use of crypto and DeFi technologies in different jurisdictions

A regulator stated that, in order to build trust in these new crypto technologies, the policy measures need to cover all the risks from their use in a sufficiently comprehensive and granular way, while avoiding a one size-fits-all approach and allowing sufficient flexibility. Many specificities need to be considered such as the differences between operating a securities settlement system on a private blockchain and providing this service on a public blockchain. And when the service is provided on a public blockchain, it is important to consider whether the access to the application is permissionless, which poses higher risks, or restricted through e.g. a whitelisting function in the smart contract. There are different bespoke DLT regulations, such as the EU Markets in Crypto-Assets (MiCA) regulation and the DLT Act that was implemented in Switzerland in 2021. These are very helpful to bring legal clarity in the use of blockchain solutions on different aspects related to financial regulation, but also on questions such as the treatment of bankruptcy with regard to crypto assets. However, this field is very dynamic with continuous new market developments. Since updating the framework takes time, supervisors need to be able to intervene in a timely manner to address emerging risks. This is the reason why the approach «same business, same risks, same rules» remains key.

Taking the example of DeFi, which aims to replicate traditional financial services, like trading or lending, in a peer-to-peer way, the 'same activity, same risk, same rule' approach states that DeFi activities should be regulated in the same way as traditional financial activities, the regulator noted. The challenge however is that, in most cases, the developers of DeFi applications argue that these activities are supported by smart contracts which are self-executing and open access and that no one is really accountable for the delivery of these services. In practice, it has been observed that at the current stage of development of DeFi platforms, there is very often a core group of people having a material influence on these applications. Different criteria have therefore been developed by FINMA, the Swiss regulator, to determine accountability for DeFi applications. A first criterion is whether some people are controlling further developments of the application through an admin key or a majority of governance tokens. A second criterion is whether the application depends on specific input provided through an oracle. A third criterion is whether people are having business relations with the end users or getting revenues from the application. Those are all criteria that help to determine who may be held accountable for the services delivered by a DeFi application, and that may facilitate the enforcement of the applicable regulation, solving some of the key challenges posed by DeFi.

An official concurred that while the 'same activity, same risk, same rule' approach is the usual way forward, these structures based on new technologies such as crypto and DeFi technologies bring new models and new complex risks that regulators have not had to think about before. When talking about DeFi for example, there are very different models of decentralisation that may have different exposures to risks such as cyber risks. The authorities are in a learning phase on these issues with significant focus on understanding the different propositions from the private sector, their transformative potential in markets and the risks they may pose. The UK authorities have also been thinking about the best model for allowing these kinds of systems to develop in an appropriate way. The UK's Financial Market Infrastructure sandbox[2], the first iteration of which will be implemented this year, is an example of how the UK approaches this challenge.

The FMI sandbox structure will allow public authorities and regulators to evaluate with firms that want to launch innovative propositions based on DLT technology, the degree of flexibility that may be needed in terms of regulation to allow that proposal to be implemented in the context of the sandbox. The value of a sandbox is to allow technically expert supervisors to sit with the firm through the lifecycle of a new proposition and assess how it operates before it can be moved to scale. Part of the reason for setting up this sandbox and adopting a different

2. Participating platforms in the 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 can make permanent changes to UK legislation, and participating platforms will have the opportunity 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, without compromising regulatory standards.

policy approach to these new developments is that they tend to cut across existing provisions in regulation.

An adequate regulatory response is necessary, but not sufficient, the official added. A whole range of other elements need to be in place for these new structures to operate in an adequate way, such as appropriate legal and fiscal rules. The UK Jurisdiction Taskforce recently conducted an extensive assessment that established that digital instruments can work under English law, which is an important aspect, since English law is widely used for securities markets.

Answering a question from the Chair about whether EU digital finance regulations can adequately support the uptake of crypto and DeFi based platforms, an industry representative stated that, when thinking about DeFi, blockchain or digital assets, regulators must remember that financial services providers are providing a service based on technology but are not themselves technology service providers. In addition, all financial activities cannot be conducted with a smart contract. For example granting a loan or market making should continue to require the intervention of traditional financial institutions.

The industry speaker agreed with previous comments that a safe environment is needed to encourage investors and issuers to use DLT-based solutions and to foster the development of a market of sufficient size. Regulators are currently approaching these issues in an appropriate way with the EU DLT pilot regime. It should allow the identification of requirements in EU legislations such as MiFID that may not be compatible with digital assets. The DLT pilot regime will also allow to better evaluate how transactions can be executed in a DLT environment e.g. to what extent order execution and settlement can be combined. A challenge with the implementation of the DLT pilot regime however is to obtain sufficient participation from the industry. A further issue to consider is that securities laws still differ to a certain extent across the EU, which will not change in a digital environment.

4. Expected impacts of MiCA and pending issues

An industry representative stated that a further element to consider for the use of crypto and DeFi technologies is the implementation of MiCA in the EU by the end of 2024. Under MiCA, cryptoasset service providers (CASPs) will have to be authorised and will be subject to a range of rules in terms of governance, risk management, segregation of funds, and transparent communication. It however has to be borne in mind that none of these very basic safeguards will exist in the crypto market until MiCA is implemented and also that MiCA will not apply to DeFi, which will remain unregulated for the time being, while banks that serve the same clients with the same activities are already subject to strict rules.

An industry representative stressed that cryptoassets account for a small fraction of financial assets. Furthermore, the amount of illicit money that goes through crypto channels only represents 0.05% of what goes through the banking system. At present, between $800 billion and $2 trillion is being laundered via traditional banking channels and fiat currencies on a yearly basis. In addition, very few people have self-custody crypto wallets at present, because this requires being comfortable with technology. However, crypto adoption is fast among the younger population, and this will support the development of crypto technology over time. The risks posed by crypto need to be properly addressed while promoting innovation. MiCA is an attempt to strike that balance.

An official agreed that traditional financial players should look at developments in the crypto industry as a wake-up call to improve the current financial system. The crypto world has pointed out several areas that need to be improved in terms of efficiency or financial inclusion. Cross-border payments in the EU are still too inefficient, and a fast payment system is still awaited. There are already 60 or so fast payment systems around the world. More should be done on this front in the EU.

AI and ML applications in finance

1. AI and ML market trends and use cases

1.1 AI use in financial services

An industry representative stated that artificial intelligence (AI) is now widely used by banks with many live use cases that add value in different ways. There has been a great deal of positive impact of AI use for banking activities in areas such as market making, the identification of fraud and financial crime, risk and pricing calculations and the management of banks' balance sheets. AI also enhances banks' ability to service clients with an improved understanding and even prediction of their interests and needs. Natural language processing (NLP) also helps to communicate with clients more quickly and more effectively in many areas. There have moreover been huge benefits to the bottom line of banks from the use of AI that supports intelligent automation, enhancements in reconciliation processes and more generally the ability to digitise at scale. A condition however for realising these benefits is a thoughtful implementation of AI and an embedding of ethical principles.

A regulator stated that surveys conducted by the UK FCA together with the Bank of England show that the use of ML is expected to triple over the next three years in the banking and insurance sectors. AI can help to solve many issues in the consumer area. As citizens need to take more responsibility for their future financial wellbeing, healthcare and pensions, AI-based robo-advice and financial planning solutions can be very helpful in providing advice in a cost-effective way.

1.2 AI use to support financial regulation and supervision

An industry representative stated that AI and ML (machine learning) can also support regulatory and supervisory activities in a very effective way. Regtech companies have been using NLP for some time for translating regulation into code and ML for automating regulatory reporting processes as far as possible.

A regulator agreed that there are many applications of AI and NLP in the supervisory space and further investment is needed in that respect. The UK FCA is using AI to scan 100,000 websites every day and identify the main potential problems in terms of consumer harm. AI is also used to accelerate investigations in the context of the most complex enforcement cases that often require a massive amount of digital data to be interrogated. In the area of financial crime, AI also helps to track criminals more efficiently. At the same time, criminals are also avid users of AI technology, which requires supervisors to stay ahead of the curve.

An official stated that suptech is a very interesting area of application of AI that is also being experimented in the US. US financial regulators are all in the process of deploying suptech solutions to enhance oversight capabilities and that trend is due to accelerate. Suptech is a new word, but not a new concept however. The CFTC in particular has been using data analytics and ML for a long time to support its mission, e.g. to detect market manipulation and to support surveillance and enforcement efforts. The CFTC is currently also developing an analytics toolkit leveraging AI and deploying a new cloud-based architecture, which combined with advancements in AI and ML tools, aims to achieve more accurate, efficient and consistent data reporting. The CFTC is also looking at using NLP to convert regulatory reports that come in many different formats into structured data that will support better oversight of markets..

1.3 Future prospects of AI and issues to further consider

An official observed that while there are some very promising use cases of AI for improving customer service, it is the more internal facing uses of AI that are probably going to see the most continued deployment in the coming years in the financial sector, as they can provide the most immediate value – e.g. using AI to automate risk management processes, regulatory compliance processes, and different operational and back office processes .There are concerns that with AI, machines may eventually overtake humans, but whilst AI may automate and replace some jobs, it cannot wholly replace human judgment and remains an additional tool that humans can use to expand their capabilities. There is however a need to use AI appropriately and responsibly. Regulators will need to ensure that adequate supervision is applied to AI, including generative AI, just as it is for financial services activities. This may go beyond the supervision of risk management processes and guidelines and also include aspects such as the supervision of the personnel in charge of supervising AI systems. A public representative agreed that the aim with AI and ML should not be to totally replace human labour, but to supplement human activity.

An industry representative explained that 20 or 30 years ago it was possible for supervisors to understand what was happening at financial institutions with some fairly basic calculations of liquidity and capital ratios based on available financial data and some qualitative assessments of activities and risks. Nowadays financial activities have become much more complex and the amount of data produced has exploded and has become unmanageable, making the supervision of most activities in a traditional 'back-of-the-envelope' way practically impossible. AI and ML can really add value in this perspective, supporting efficient data collection and data analytics and helping with the identification of potential outliers and risks. There is however the need to still have critical judgement about the data produced and the operational management of the firm supervised in a more traditional way. In the case of SVB (Silicon Bank Valley), which recently failed, much of the data that could have surfaced out the problems was already publicly available and had been communicated to supervisors. What was lacking was the critical thinking and assessment of the supervisors around the data produced. The industry speaker also emphasized the importance for supervisors of understanding the potential impact of AI on bank customer behaviour, as the technology and use cases evolve. In the future, AI based alerts about the health of a bank may trigger a bank run much faster than at present. Those issues need to be considered from a supervisory perspective, with the ability for supervisors to intervene immediately when that kind of behaviour is observed.

Concerning generative AI, the industry speaker considered that this new generation of AI offers very interesting opportunities, particularly when it comes to customer support chat boxes, and can be helpful to customers in this regard, but it does not provide significant added value for all activities. For example, financial regulation turns out to be still too complex to use ChatGPT effectively for regtech or suptech applications.

A regulator observed that some of the challenges related to AI implementation, such as the legacy systems of financial institutions are traditional ones, but others are more specific. AI poses important ethical challenges in relation to customers. Financial institutions are also faced with a shortage of skills and possible dependency issues when working with third party providers. Some of which are very advanced tech firms, investing tens of billions of dollars in order to keep an edge on data analytics and the most advanced AI applications.

2. Regulatory approach to AI

2.1 Issues and principles that need considering in AI legislation

The chair questioned the panellists about how to strike a right balance with AI legislation between enabling innovation and dealing with risk and protecting consumers.

An official stated that there is no guarantee that new technologies such as AI will follow Isaac Asimov's 1942 Three Laws of Robotics by default[1], especially the Zeroth Law: A robot may not harm humanity, or, by inaction, allow humanity to come to harm. To uphold those laws, it will take careful observation, foresight, and nimbleness from policymakers and regulators.

A regulator emphasised the importance of ensuring that humans continue to take responsibility when AI-based systems are being used. Transparency is also needed around the way in which algorithms are being utilised and whether it is fair and respects privacy. Although AI algorithms such as those used in the context of robo-advice may be broadly right 99% of the time, there are times when they get it wrong. A new type of framework will be needed to allow such cases to be dealt with. In addition, AI is an area where challenges are growing for the financial regulatory community, because, particularly with generative AI, far deeper cooperation with other regulators will be needed. The FCA has set up a forum in the UK to really deepen the work conducted in this area.

An industry representative observed that AI, including generative AI has much potential, but is a complex area. There is a need to use AI in an ethical way based on adequate principles and product reviews in all sectors, but more particularly in regulated industries. Sundar Pichai, the CEO of Google, recently stated that AI is too important not to regulate and not to regulate well. Many jurisdictions are considering AI regulation and the EU has been at the forefront of this effort with the AI Act. In terms of process, there is the need for a collective approach to the legislation in this area including a wide range of stakeholders such as governments, academia, and companies. In terms of content, the objective is calibrating the way in which AI is used in order to maximise its advantages for society, while avoiding adverse effects for humanity.

The industry speaker suggested that there are three main issues to consider to help address these challenges in terms of legislation. The first is to ensure that there is parity between AI and non-AI systems in the way they are considered. Considering specific use cases and the risks they pose is the right way to think about this, because not all AI applications are highly risky. Secondly, there is a need to leverage existing rules to the fullest extent possible. When assessing the standards needed for AI, there are very few cases where new specific rules are needed, except possibly for high risk applications, for which there need to be proportionate safeguards in place. Thirdly, an international perspective must be taken. Many different countries around the world are looking to Europe to see how a regulatory framework for AI can work so Europe should set a great example in this area. Care needs to be taken in particular to avoid adopting a one-size-fits-all approach to AI, which may lead to accidentally regulating aspects that relate to research for example. The source code needs to be protected and it is important to refrain from unnecessary restrictions.

A second industry representative explained that, in 2020, HSBC had released principles for the ethical use of AI, with a focus on detecting and mitigating bias, respecting the privacy of customers and staff, being transparent with customers, employees and shareholders, and also ensuring appropriate levels of explainability, transparency and accountability. With

1. The Three Laws of Robotics are a set of rules devised by science fiction author Isaac Asimov. (i) A robot may not injure a human being or, through inaction, allow a human being to come to harm; (ii) A robot must obey the orders given it by human beings except where such orders would conflict with the First Law; (iii) A robot must protect its own existence as long as such protection does not conflict with the First or Second Law.

the advent of a new era of generative AI, allowing more powerful automation and a greater ability to operate at scale, more of the same issues can be expected. A thoughtful approach is needed about embedding the guardrails and the ethical principles needed to manage the risks posed by these new developments. A close interaction will be needed between the industry and regulators in this perspective.

Wherever possible, regulation should focus on outcomes, the industry speaker believed, rather than prescribing how to get to those outcomes, as this may allow the achievement of a better balance between innovation and risk mitigation objectives. It is also important to make sure that the AI regulation is well targeted, focusing on what is truly believed to be AI and the novel risks of opacity and complexity associated with that, rather than tackling issues raised by more traditional data analytics and statistical models.

An official observed that when standards such as ethical standards are developed at industry level, there is no reason for the regulator to try to impose additional requirements if the standards are appropriate.

2.2 The European AI and Data Acts

When it comes to the AI Act specifically, it is necessary to remember that financial services are already highly regulated, an industry speaker emphasized, which means that many issues addressed in the AI Act are already covered in the EU financial services acquis. In addition, most financial services AI use cases are not considered to fall into the high risk category. However, it is necessary to adopt a more outcomes-based approach to AI legislation, because many of the models that might fall into so-called high-risk areas are not necessarily high-risk in themselves. A really granular assessment of the risks, of the mitigating factors and the likelihood of these scenarios occurring is needed.

A public representative stressed that, in addition to the AI Act, data regulations, such as the Data Act, need to be considered. Data is a challenging area to regulate, but it is of crucial importance, because data is the critical raw material for AI and digitalisation. The consumer protection aspects need to be considered, as well as the opportunities from a greater use of data. Accountability and transparency are important in this area, as well as privacy and security with increasing cyber-risks. Users must have access to the information about how their data is being used, shared and implemented in all AI-based applications and algorithms in particular. The Data Act is important because it sets a certain number of ground rules such as assigning an economic value to data, which should contribute to increase awareness about its importance. The Data Act also empowers consumers, giving them control over their personal data and the data they have generated using financial services for example and also giving them the power to decide how this data should be used and whether and with whom it should be shared. This greater control by the consumer should open the way to a wider use and sharing of data, which is likely to help create more innovative and tailor-made products, providing consumers with new opportunities and more choice. The public representative added that the Data Act also applies to businesses and should lead to an improvement of the level playing field for SMEs in terms of access to data and the ability for these smaller players to leverage their data to enhance innovation.

An official stated that the AI and Data Acts are two key regulatory frameworks for fostering the digitalisation of financial services in the EU. Since fundamental rights are already included in financial regulations to a certain extent, these frameworks do not cover areas that are totally new. It is now up to the European Parliament to have its say on the AI Act. Customer consent is essential for the development of AI and also for new developments such as open finance. One of the solutions for ensuring consumer consent and checking how the data is being processed, by whom and in which way is implementing an EU digital ID. This has implications in different areas including open finance and Decentralized Finance (DeFi). However, to enforce an EU digital ID there is a need for interoperable standards. The Data Act is quite a broad platform covering different industrial sectors that all have their own data standards and APIs. The question is what should be the best interoperability standard for data-based solutions to work across industries. At this stage it is not clear whether much progress is being made in this important area.

2.3 Regulatory approaches to AI in the UK and US

A regulator stated that the UK FCA is approaching digital finance regulation in a technology neutral and a principles and outcomes-based way. The UK government set out its approach to the regulation of AI in a recent white paper. The intention at this stage is not to propose a cross-economy regulation, but to put forward some recommendations that may be taken up by sectoral regulators for developing regulations in their own domain. Close attention is paid to the OECD AI principles around safety, security, transparency, explicability, fairness, and accountability.

An official explained that there are many different initiatives concerning AI in the US but these are convergent. Given some of the legacy issues in the US around disparate impact on vulnerable populations and discriminatory practices, much focus is given on the client facing applications of AI and ML in the policy approach to AI. The main focus is on bias risks and ethics in AI, particularly concerning credit underwriting and scoring activities. The priority in the US is exploring ways to ensure responsible AI with adequate fairness, accountability and transparency in AI-driven decision-making processes concerning clients. There is on-going work on these issues led by the National Artificial Intelligence Initiative Office, which recently published some guidelines for AI. The National Institute of Standards and Technology also issued in January 2023 the version 1.0 of its AI risk management framework. The financial regulators are also working on these issues. For example the CFTC is currently exploring how responsible AI and ethics in AI can be applied by exchanges and financial services providers. US regulators already have broad capabilities that allow them to oversee customer-facing activities, therefore their focus is on operational risk management requirements, including model risk management and third-party risk management, to ensure the effective oversight of AI applications. More broadly, concerning digital financial services, work is being done on digital engagement practices with targeted examinations performed by the FINRA, SEC and the CFPB looking at how to prevent algorithmic bias and automated valuation models and checking whether data privacy controls and policies are in place, as well as algorithmic transparency and cybersecurity.

3. Data standardisation and quality issues

An industry representative stated that more effort has to be made in terms of public and private collaboration to improve data quality and standardisation, which remain a major obstacle to the adoption of AI and ML in an effective way. Data quality in financial services is insufficient with simply not enough clean data to train AI models at a time when AI models, including generative AI, are requiring an increasing amount of data to be trained in the traditional way. The way models can be trained also needs to be optimised looking at specific use cases and better capitalising on different approaches such as unsupervised, supervised, and even reinforced training of the models. For addressing that, an effective cooperation is needed between the private and public sectors. The availability of data scientist skills is also an increasing issue for improving data quality and appropriately training AI and ML models.

An official stressed the importance of interoperability when defining data and API standards. In the process of defining its standards, the EU should consider building on standards used at the international level.

Digital operational and cyber-resilience

Introduction

The Chair stated that the speed of the digital transformation of financial institutions is unprecedented providing many opportunities but also greater ICT (information and communication technology) and cyber risks. This includes malicious attacks against financial institutions and their customers, which are on the rise, as well as a growing exposure of financial institutions to operational resilience risks due to the complexity of their ICT systems and their increasing reliance on tech third parties such as cloud service providers (CSPs).

The Digital Operational Resilience Act (DORA) is part of the wider EU digital finance package and aims to implement uniform requirements across the EU financial sector relating to digital operational resilience. DORA entered into force in January 2023 and will be applicable to financial firms from early 2025. Besides DORA, the reviewed Network and Information System directive, NIS2, which aims to strengthen and harmonise cybersecurity laws across the EU, is due to enter into force by the end of 2024. The enhancement of cyber and operational resilience is also a priority at the global level with guidance and principles recently published by CPMI-IOSCO and the BCBS and on-going work at FSB level on achieving greater convergence on cyber incident reporting and the management of third-party risk.

1. Evolution of ICT and cyber-risks in the financial sector with increased digitalisation

An industry representative stated that there are three main areas of ICT and cyber-risk: geopolitical risks, technological risks and the risks posed by new market entrants. Concerning geopolitical risks, nation-state actors are becoming more prevalent. These threat actors are well funded, well-coordinated and persistent, which means that they probably represent the largest threat for the financial sector. Secondly, while technological change is providing many opportunities in terms of efficiency and enhanced customer service in the financial sector with the implementation of new technologies such as cloud services, artificial intelligence (AI) and blockchain, security measures need to keep pace with these changes, otherwise new vulnerabilities will emerge. Thirdly, the tech firms that have entered the financial services sector, providing financial products, supporting the supply chain or both also create new vulnerabilities. Public and private sector participants need to continue to find ways to identify and quantify these risks and develop strategies to address them.

Adversaries are always looking to take advantage of new technological developments and sophisticating their approaches, the industry speaker emphasized. Statistics show that adversaries can begin to permeate through networks within 84 minutes of an initial breach, which mandates very rapid reaction. Figures also show the magnitude of breaches. There has been a 112% increase in advertisements selling user credentials recently and 71% of initial detections are malware-free, since once adversaries have access to systems, they use user credentials and their own tools and techniques to further permeate the network and no longer need malware. There has also been a 50% increase in interactive, hands-on keyboard attacks. The increased sophistication and intelligence of threat actors demonstrates the vital importance of regulations such as DORA, which aims to ensure consistency across the EU in the fight against cyber-risk.

A regulator agreed that while ICT provides many benefits, transforming the operations of financial entities, it also increases their exposure to new threats and risks. Financial entities have been outsourcing activities to third-party ICT providers (TPP) for some time and are already facing significant cyber-resilience challenges. These trends are due to accelerate with stronger digitalisation and changes in the business models of financial entities. Previously, banks created idiosyncratic information from their day-to-day businesses that was used for risk management or to grant credit. All this happened in-house. Now they are relying on external providers for many activities and some of these providers have become critical to the provision of their services, so it is essential to ensure that resilience is preserved in this context. DORA is an ambitious and welcome European response in this context.

A second regulator agreed that digitisation introduces new risks and changes the profile of existing risks in the sector. Operational risks in financial services are increasing in terms of complexity, volume and speed. When thinking about improvements in risk management and resilience outcomes, digitisation is also helping to reduce human error in both front office and back office functions. Repeat processing and legacy systems have also improved thanks to technology, reducing risks and increasing resilience. Cloud services in particular are helping to improve resilience relative to traditional on-premise systems, with better firewall technology and back-up or failover arrangements that help to improve continuity of service from an individual firm and system-wide perspective. However, the increasing use of technology is also introducing new vulnerabilities. There are vulnerabilities drawn from concentration, with a relatively small number of providers such as CSPs providing firms with core and critical ICT services. Where services cannot be substituted at speed, vulnerabilities become more acute.

A second industry representative stated that the different players operating in the financial sector have a responsibility to make the entire ecosystem more resilient and secure in a rapidly changing landscape. The financial services industry is one of the most advanced industries in terms of cybersecurity, resilience and privacy and on-going collaboration between financial institutions and ICT providers is helping to sustain this position. CSPs contribute to this objective by providing the possibility of a more seamless and secure continuity of service. CSPs are constantly fending off cyber-attacks using sophisticated tools. Their clients benefit from their learning curve in terms of cybersecurity and resilience and also from the opportunities offered by the cloud computing environment to integrate new technologies such as AI in a more effective way. This is however a journey of continuous improvement where there is no end destination of total safety. It is imperative for financial institutions to have comprehensive ICT risk management mechanisms in place, including identification, protection, prevention and detection tools. CSPs and other ICT providers are supporting them in this regard by providing a broad set of build-in cyber-resilience capabilities. They are also investing massively in enhancing their cybersecurity toolkit, contributing to ensuring stability throughout the ecosystem[1]. This is important because the threat landscape is always evolving. In the future, AI and built-in tools, coupled with quantum computing and post-quantum cryptography (PQC) capabilities, will move the security of the industry and the ecosystem to a new level. ICT providers look forward to supporting partners in the ecosystem as they embrace these new technologies. Digital operational resilience testing such as penetration testing is a further area on which CSPs are working to ensure business continuity for financial institutions.

2. Implementation of the EU DORA framework

2.1 Main objectives of DORA

An official stated that DORA is a timely, well-designed and ambitious text that includes some unique features. One is that it is completely cross-sectoral, making no distinction between banks, insurers, securities firms, asset managers and payment firms and applying to firms of all sizes and levels of complexity. Implementation will still be a challenge, but the legislation's approach in terms of proportionality should help. DORA is also unique in that it asks European supervisors – the national competent authorities (NCAs) from all member states and EU level supervisors, including the ESAs, ECB, ENISA, SRB and ESRB - to jointly implement the legislation in a completely integrated way. The ESAs Joint Committee has thus established a dedicated sub-committee to work on the implementation of DORA and support the establishment of the Level 2 standards and required policy tools.

DORA addresses three main issues, the official explained. The first is firms' risk and threat management. Secondly, incident identification and reporting both of major and smaller incidents, as the latter incidents can also have significant implications. Thirdly, the oversight of critical third-party service providers (CTPPs). This oversight concept is completely new in that it concerns third party ICT providers that are not regulated or supervised at present. Designated CTPPs are now so important for the resilience of the financial sector that they should be brought into the scope, with a system of audit and engagement allowing oversight to be conducted in a cost-effective, proportionate and reasonable way.

The Chair noted that the scope of DORA is ambitious and cross-sectoral and asked if some sectors are better equipped than others in terms of cyber-resilience. The official stated that there is healthy divergence, with each financial sector having strong points to draw from. This is an opportunity to learn from existing best practices and to define a more integrated pan-European way forward.

A regulator emphasized that the DORA response regarding CTPPs is about oversight rather than supervision. It aims to ensure that financial entities remain in control so that the system is able to continue operating. The oversight of CTPPs will be jointly handled by the three ESAs (European Supervisory Authorities): EIOPA, ESMA and the EBA, with a lead overseer designated for each CTPP.

A second regulator noted that firms and supervisors must manage risk both at the individual firm and system-wide levels. Financial firms and TPPs such as CSPs collaborate with a shared responsibility model, which introduces a dual set of responsibilities shared between them. Currently, there is legislation going through the UK Parliament concerning CTPPs that will introduce a framework mandating supervisors to identify, oversee and influence them. Financial firms will also be required to implement playbooks introducing minimum resilience standards and recognising in particular the possible effect of multiple firm failures or disruptions. Supervisors will also be provided with a stress testing toolkit including scenarios for the testing of material services. Sector-wide exercises are also needed with the participation of CTPPs that provide services for a wide range of institutions. This will also contribute to enhancing the cyber resilience capabilities of the public authorities.

An industry representative stated that the EU supervisory authorities should also ensure that DORA is closely aligned with NIS2. Harmonising reporting timelines, cyber incident criteria and cyber incident thresholds with existing standards is needed in particular. This will enhance legal certainty, establish clarity and trust in the ecosystem and allow cyber-resilience measures to be adapted and applied sustainably. However, cyber-resilience measures will continue to evolve. It is important

1. Microsoft for example has been investing more than $1 billion in cybersecurity measures every year over the last few years and has quadrupled that amount in 2023. The aim is to reach a total of $20 billion of investment in cybersecurity by 2026.

to ensure that regulatory changes are flexible, principle-based and harmonised so that all players operating in the financial ecosystem are able to apply them and contribute to the resilience, security and continuity of the overall financial sector.

A second industry representative stated that resilience is mostly about building capabilities. The aim is to assess, test and identify weaknesses and then implement capabilities likely to build sufficient resilience to operational stress events. Secondly, when thinking about concentration risks, it is important to focus on the risks from this concentration rather than the concentration of providers itself. Concentration exists in many parts of the financial market providing economies of scale or improved liquidity and is not a problem per se. What is needed is considering the possible risks associated with this concentration and proposing specific risk mitigation actions.

2.2 The DORA implementation approach and challenges

An official illustrated the challenges associated with the implementation of DORA, which needs to be completed within 20 months. A joint committee has been established by the ESAs to take the work forward in an integrated way, and progress is being made quickly. There are three core operating principles. The first is momentum. This work has to be completed quickly. The second is pragmatism. Rather than pursuing perfection, the work needs to be completed in such a way that a first basis is in place 20 months from now, on which iteration and a lessons learning process will continue. The third principle is quality. The implementation work on DORA will be carried out on the basis of three consultations. There will be a first consultation starting by the beginning of June 2023 in response to the Commission's request for advice from the ESAs on the concepts and criteria to use in identifying CTPPs. Secondly, there will be a consultation starting in late June, with a focus on aspects such as risk management and registers of incidents. There will then be a further consultation starting towards the end of this year on remaining issues relating to the implementation of DORA.

A regulator stated that regarding the implementation of the oversight framework for CTPPs, the ESAs are in the process of building an oversight model on which feedback will be sought from the financial industry and third-party providers in the coming months. The approach proposed will follow four main principles. The first principle is to build on the available experience at the European level and at the NCAs, which will be working together in an integrated way in the context of the DORA implementation sub-committee. The second principle is that the oversight scope should be broad enough, covering both contractual arrangements and system aspects. The third principle is to leverage the experience in terms of prudential and conduct supervision to identify weaknesses and areas of focus. In future, an oversight forum will allow all information to be brought together in order to make decisions. The final principle is the importance of proportionality. Using those four principles, the aim is to build an oversight system that will be organised in three main blocks. One is about identifying criticality regarding TPPs. A first exercise has been run to collect data from financial entities in order to conduct a criticality assessment. A discussion paper will be issued in May including first indications about criteria to use. This criticality assessment will also lead to the appointment of a lead overseer for each CTPP identified from one of the three sectors. Secondly, the resources from the three ESAs will be brought together to work in an integrated manner on the onsite and offsite oversight of CTPPs and the planning of activities and actions. There will be a need for coordinating across sectors and EU member states to ensure consistency of the oversight, the identification of best practices and also the possibility for agreements with third countries on cooperation arrangements. The final area will involve issuing recommendations to CTPPs and following-up their implementation, making sure that CTPPs take into account the needs of the three main financial sector in their processes and activities.

A second regulator stated that DORA and the stronger harmonisation of the supervision of ICT and cyber threats in the EU that is aimed for is an ambitious and important step towards ensuring the resilience of the EU financial system. DORA is however more an evolution rather than a revolution. There are already many regulations supporting adequate levels of information management, information security and business continuity. DORA provides a more specific set of tools for tackling ICT and cyber risks, but it is important to be able to use these new tools efficiently. Supervisors already authorise and monitor the outsourcing of activities to ICT TPPs, but DORA will increase the level of oversight, notably with the new role of lead overseer for CTPPs. Conceptually, this approach is similar to the joint supervisory teams (JSTs) of the ECB in charge of supervising significant banks under the single supervisory mechanism (SSM). There will also be stronger cooperation on AML issues with the forthcoming implementation of the AML Authority (AMLA). There are still pending questions about how the lead overseers of CTPPs will work in practice and how this approach will differ from the JSTs. The availability of sufficient ICT and cyber-security skills within supervisory authorities is another challenge, as there is already a scarcity of these profiles in the market.

The proportionality of DORA is a further important point to consider, the regulator emphasized. The principle of proportionality is clearly stated in the Level 1 text and should also be clearly established in the Level 2 RTSs in order to facilitate the implementation of the DORA requirements across the financial sector and the EU member states in a coherent way.

The Chair agreed that with a stronger role of the authorities in the ICT and cyber-resilience space, it is important to ensure that they have the adequate skills and resources to conduct this mission. Coordination is also crucial among the different stakeholders concerned in the EU in order to make the financial system more resilient in terms of operational risks, as well as international cooperation and ensuring that the global perspective is taken into account.

3. Policy approach to digital operational resilience at the international level

A regulator stated that a global regulatory response is important to ensure a sufficient level of digital operational resilience, as global financial institutions are relying on TPPs able to operate on a cross-border and global scale. Financial firms are centralising technology and operations for efficiency purposes, potentially creating new critical points of failure. It is important for the supervisory community to continue learning, sharing and iterating its policy approach to these developments. The consultation due to be published by the FSB by summer 2023 on third party risks and outsourcing will be an important element in this perspective.

There is a great deal of commonality between the UK and EU in the thinking around digital operational resilience, the regulator observed, although the UK has picked up on a few additional points around operational incidents in particular. Since it is inevitable that operational failure will happen at some point, firms are asked to set impact tolerances that will not lead to financial disruption at a systemic level. Firms need to be able to continue their business services within their impact tolerances, even after an extreme but plausible stress scenario. This requires that firms analyse their end-to-end risks and identify the critical business services that may have wider repercussions for the financial system and on which they need to share information with the authorities.

An industry representative stated that work is underway in the US on improving the cybersecurity framework and providing additional guidance in this area. In March 2023, the SEC proposed a broad suite of cybersecurity rules including policies and procedures to address cybersecurity risk, written incident response programs, public disclosure requirements with new types of SEC filings, and an extension of the Systems Compliance and Integrity (SCI) regulation to large broker-dealers and other types of firms under an expanded Rule 10 (Cybersecurity Risk Management Rule).

A second industry representative stated that international collaboration is important in this area to ensure that jurisdictions adopt a consistent and principles-based approach when introducing new regulatory measures, and also that there is sufficient coherence between existing legislative measures and those still in development and that new legislative measures are sufficiently proportionate.

Open finance: ambition and policy approach

1. Open finance use cases and current stage of development

1.1 Open finance objectives and use cases

The Chair explained that Open Finance refers to the sharing with third-party providers and subject to the approval and control of the customer, of personal and non-personal customer data held by financial sector intermediaries and other data holders for the purpose of providing a wide range of financial and information services. This concerns both individual customer data and company data. It is an extension to a broader range of data (credit, savings, investment, insurance, pensions) of the Open Banking concept which focuses on payments and the sharing of bank account data.

A regulator suggested that the starting point for open finance is data, so for it to work financial services firms need to be enabled to better use data. Some have started to leverage the experience of tech companies, which have developed significant know how in this area. There are a number of use cases for open banking, from helping people to manage their finances through to helping customers who have credit-worthiness issues to prove that they are able to access credit. If people accept to share more of their financial information, this will enable more useful and innovative financial products and services, extending potentially beyond financial services. Insurance companies for example have a great deal of non-financial information that is important for providing the right level of insurance cover. Getting access to more of that kind of data will allow providers to better hone products and services for individual customers and firms and to better manage risks.

An industry representative emphasized that open finance creates many opportunities in terms of new services, risk prevention and improved underwriting in the insurance industry, beyond the sharing of insurance data with some third parties. With open finance the insurance sector could collaborate with banks in novel ways. When a bank agrees a mortgage, it collects a great deal of data from customers. Insurers could reuse that data to make an offer for real estate insurance for example. Open finance can also facilitate the switching of insurance, which involves knowing the claims history of a customer coming from another insurance firm. Open Finance can moreover be used for steering increasingly complex supply chains and anticipating problems, using the internet of things (IoT) and satellite data. There are many examples of data sharing already. The speaker's firm has for example developed a digital commercial platform for its business customers, which aims to enrich the data for customers so that they have better risk control.

A second industry representative observed that open banking has created an expectation for frictionless user experiences, which is not yet a reality in the insurance sector but could be supported by open finance. Flight delay insurance products historically required the filling up of long forms and the provision of extensive evidence of the costs incurred by customers for example. Open finance allows new products to be developed such as a time-guaranteed flight delay insurance product, whereby if a flight is delayed by 30 minutes, the service is automatically triggered and payment automatically enters the customer's account within an hour of them reaching their destination. This is the type of frictionless experience that customers are expecting in a digital world. Open finance also enables options that were not possible in the past by linking different parts of an ecosystem in a more efficient way supported by computation. This is the case of rapid damage assessment, which uses real-time aerial photographs to handle natural catastrophe events combined with proprietary models powered by AI. This helps risk managers to send the right response very quickly. Another example concerns risk and data services. The speaker's firm, a major insurer, has partnered with a leading data analytics organisation to develop a supply chain resilience solution for corporates' supply chain risk managers. With this tool risk managers can identify the main vulnerabilities of the supply chain network and monitor risks such as climate-associated risks.

1.2 Stage of development

An industry representative stated that open finance already exists in the market and has preceded regulation. Open finance has started in two ways: banks as a platform (BAAP) and banks as a service (BAAS). With BAAP, customers of the bank such as SMEs can benefit from an enriched banking offer, with the integration of financial and extra financial innovative services from external partners, such as access to legal advice, insurance or bookkeeping services. With BAAS, the bank provides its core banking services (e.g. payments, fight against fraud) to third parties such as distributors in an embedded way. Open finance therefore works both ways with financial institutions integrating some non-financial services, and vice versa and is about creating interactions between finance and providers from other sectors, which is supported by European data regulation, such as the Data Act.

A regulator agreed that open finance is already a reality in the market, because the fintech world did not wait for regulation to implement new services. The Payment Services Directive 2 (PSD2) regulation written over 10 years ago focused on payments and account information services for individuals to obtain a consolidated view of their personal finance, but it was already outdated when it started to be implemented. B2B business models sharing data beyond the scope of PSD2 such as accounting information e.g. to support accounting activities or evaluate credit-worthiness were already starting to emerge. In addition, while PSD2 focuses on payment accounts, fintechs are already accessing savings account and insurance data by web scraping.

2. Expected benefits and challenges of open finance

2.1 Expected benefits

A public representative emphasised that open finance facilitates access to more financial information in a concise manner, which could help with the provision of credit scores and risk assessments for individual and corporate customers. For an individual, there is the opportunity for improved credit assessments and access to financial products that are more tailored and to innovative personal financial management and investment solutions. For businesses, open finance can support accounting processes, as well as facilitate access to funding. Cashflow management could also be conducted in a more effective and efficient manner. One of the most important benefits and use cases of open finance is that it will likely facilitate the access of smaller companies such as start-ups and SMEs to effective financial solutions and funding. This is an opportunity to level the playing field with larger firms, provided the latter players do not capture all the advantages of these innovations. The public representative noted that open finance can also enhance competition in the financial sector by allowing the emergence of novel services and new players such as fintechs. Open finance can therefore also contribute to the digital transformation in the financial sector.

An industry representative added that data sharing with appropriate security measures could generate a great deal of benefits for the customers of insurance companies by e.g. streamlining the access to services through pre-populated information, simplifying underwriting processes, or improving risk prevention with data monitoring and analytics.

A regulator observed that many benefits have already been seen from the implementation of open banking in the UK. Today, over 7 million consumers and 750,000 SMEs are using open banking products and services to manage their money and to make payments. The tax authority, HMRC, is also a major proponent and user of open banking.

2.2 Potential challenges and risks

A regulator remarked that there is a trust challenge with open finance that needs to be resolved. There is a need to prove to consumers and SMEs that there are strong benefits in terms of sharing their data. For customers to consent on a regular basis, they need to understand that it is safe to do so. Therefore, we need to address the potential risks of data sharing and ensure that players who control, use and manipulate the data can be trusted.

The Chair agreed that trust is key in this area. Customers need to know what is happening with their data and be able to control it, which links to the issue of consumer consent. The younger generation however seems to care less about what happens to their data.

A regulator observed that PSD2 had been implemented to build trust. A number of actors were already operating in the payment space before PSD2 and the legislation was put in place to regulate these actors and to ensure that accounts were accessed in a more secure way. This helped to build trust between consumers and the financial counterparties involved such as banks and new service providers. Replicating this approach and building trust in a broader environment is the core issue to be tackled for making open finance a success.

3. Main issues to consider in the EU open finance framework and lessons learned from PSD2

3.1 Main objectives and issues to consider in the open finance framework

The Chair stated that the Commission is working on a legislative proposal on open finance. The aim is to empower consumers and also to foster innovation in the provision of financial services, building on the experiences of open banking and PSD2. To encourage open finance further there is probably a need for additional rules. A key question is what can be learned from the PSD2 experience, which was quite challenging to implement. PSD2 is being revised in parallel to adapt it to today's challenges. There are questions about what regulation is needed to foster open finance, what further incentives policymakers and regulators can build into the regulatory framework to encourage future developments and how this interacts with existing EU horizontal data frameworks, in a context where the use of data may go far beyond the financial sector.

An industry representative suggested that there are some prerequisites that need to be considered to make open finance useful and beneficial for customers and to contribute to innovation in the financial ecosystem. The first concerns the type of data being shared. Insurers have a great deal of intellectual property in their data, for example concerning the way tariffs are fixed and tariff structures which they can probably not share. Secondly, there is a need for a very clear legal, and also probably contractual, framework defining the conditions under which data can be shared and the use that will be made of it. Thirdly, a case-by-case or step-by-step approach should be adopted in the policy approach, because the number of use cases is vast and their specificities need to be taken into account. Additionally, it has to be ensured that the required technical infrastructures are available in Europe to implement open finance, because much of the technology needed to support such concepts is currently provided by big tech companies, which are typically outside of Europe. The conditions need to be in place to ensure that European organisations are not prevented from leveraging the data that they manage and produce in the first place.

A second industry representative noted that the implementation of a new technology always has to start with the question of what business problems it aims to solve and then which underlying technologies are best suited e.g. APIs[1], blockchain… Otherwise there is a great deal of unnecessary hype. Secondly incumbent players no longer need to build a specific digital strategy, they need to think first about how their business strategy should be adapted to a new digital world and how new technologies and data can be used to support this new business strategy. Companies should focus on the business problems that need to be solved and the related use cases and then evaluate how technology can help them to achieve this.

A regulator emphasised that the role of regulators is not to create new markets, it is to avoid market failures and remove obstacles to the emergence of new services. For example, incumbents not sharing their data or creating the appropriate incentives in terms of standardisation, liability and level playing field for the market to develop effectively. Open finance regulation should therefore be an enabling framework. It was easier to start with open banking because there was available current account data, deposit data and suchlike in standard formats. For pensions, investments or insurance, which are due to be covered by open finance, there is a great deal of inconsistency across firms in the way data is held and in some cases, it is not available in a digital format. These are key issues that will need addressing. It is also very important to anticipate the data sets that will need to be used in an open finance and data sharing economy and to ensure that there is full access to that data and information, because much of it sits in places beyond Europe.

A public representative noted that all of the regulatory tools needed to support the development of open finance and create a level playing field in this area are present in Europe, with the AI Act, the Data Act, the digital finance package, PSD2 and its revisions. Now there is a need to look at the use cases that will emerge in the market and the players concerned and what additional rules may be needed.

3.2 Potential areas of focus for the open finance framework

3.2.1 Standardisation

An industry representative stated that insurance activities are not particularly standardised, either within markets or across markets. There is some work to be done to standardise data and to be able to feed APIs so that data are transportable and transposable. Insurance companies due to their legacy systems still have much work and investment to do to get their technology up to a standard that can be applicable everywhere and the same is true for banks. The Chair agreed that standardisation is a key issue for open finance. The framework should work across all financial sectors and also consider the international dimension outside the EU.

An industry representative highlighted the importance of effective integration. For cross-sectoral data sharing, the architecture needs to be modernised and API-based, leveraging existing API standards. This will be challenging for incumbent companies due to their legacy systems. A regulator agreed that API standardisation is essential. This is one of the main lessons from open banking.

3.2.2 Operational resilience and cybersecurity

An industry representative stated that the framework needs to consider cybersecurity and operational resilience. That is probably the most important aspect for ensuring customer confidence and market integrity and will be quite challenging, although the necessary technologies are available. A public representative noted that data privacy and cyber security issues will evolve as the technology and the market for open finance develop. This will be an on-going process with a constant need for revision or extra protection.

3.2.3 Level playing field

An industry representative emphasised the importance of neutrality in the open finance framework. There has to be a true level playing field between the different players operating in the open finance ecosystem and all players should be on equal footing with respect to the portability of data.

A second industry representative agreed about the need for fair competition for example between banks providing non-banking products and non-banks providing financial services. The question is whether the regulation should be changed in a faster and more effective way to make sure that it captures all of the players, or if new players should be placed into the existing regulation. The first option seems preferable, the regulation should be changed because players are evolving. The industry speaker also stressed that there is a question about which data to open to third parties, because some of it is proprietary data. A bank's credit opinion is indeed based on their own know how and experience, and there might not be comfort opening it up to a third party.

3.2.4 Economic incentives

A regulator referred to the importance of economic incentives. We should ensure there are sustainable business models with products and services flowing through APIs that can be supported by commercial agreements. This would allow providers to make money on them. That puts skin in the game for the incumbent institutions. Being an incumbent means there is legacy to share and engage on.

3.2.5 Customer control and consent

A public representative remarked that transparency and customer control are essential particularly when

1. API : application programming interfaces

data is being used across service providers, which is the basis of open finance business models. Customers should know how their data is collected, used and shared, and that information should always remain available to them. The regulation needs to provide the conditions to ensure customer trust and guarantee protection in an open finance environment with adequate transparency and customer control.

An industry representative added that customer consent is essential to build trust. The General Data Protection Regulation (GDPR) should be relied on to explain how to manage the consent of customers for data that relates to them personally.

3.2.6 Liability and responsibility issues

A regulator noted that liability is a further issue to address as it becomes more complex to figure out with open finance and open data sharing across sectors. The issue is what happens when something goes wrong in an open finance environment. Ways for dealing with this have to be found, with consideration of skin in the game. If an entity is handling data, for example as a third party service providers (TPP), it has a responsibility towards the SME or the customer concerned. However, it may not be the same responsibility as for a bank, depending on what the entity does with the data.

An industry representative agreed that there are questions of responsibility to tackle, when opening data to other providers. For example if a bank's credit opinion is used by a third party for making a credit decision the question is who is responsible in case there is a default or a mistake. In addition, in that case the bank does not have skin in the game, which might create risks in the financial system, similar to those witnessed during the 2008 financial crisis when rating agencies were providing inadequate opinions on risks with no skin in the game and risky loans were sold to other players or divided into small tranches and re-aggregated. In banking operations there has to be a link between the opinion making and the risks taken.

3.3 Lessons from the implementation of PSD2

A public representative suggested that the open banking framework should not just be replicated for open finance. There is a need to look at the lessons learned from open banking to be able to properly move forward with open finance. An industry representative observed that although PSD2 provided greater security in the system, it did not generate a great deal of financial innovation. The reason for this is that PSD2 did not create a valid economic model. If access to information is free, the available information will be limited and innovation will be restricted. There has to be caution, when broadening the scope of data sharing with open finance, to provide the different players in the ecosystem with the opportunity to find an economic interest in moving ahead with the implementation of open finance.

The Chair observed that despite the issues mentioned with regard to PSD2, a great deal of financial innovation has happened over the last 10 years, since the implementation of the legislation and it continues to evolve quickly.

A regulator noted that PSD2 was implemented in the first place because there was no agreement between market participants about data sharing. Banks were refusing access to accounts for third parties and were putting a great deal of pressure on consumers to not share their credentials. At that time, there were no market standards to exchange data, and banks were very critical of web scraping, considering it as anti-competitive, which is why regulators had to step in to allow access to data in a secure way and establish standards about how to exchange data. The issue however is that standards had to be established from scratch for the new environment of PSD2, which was very time consuming, notably concerning APIs. The situation now is somewhat different. There are at least two API standards in Europe that can be built on, although there are still implementation issues with standards that remain optional in some aspects. There is also a more uniform level of service across banks and national markets, with all banks having developed APIs. The main elements needed for open finance are captured in PSD2, which is in the process of being fine-tuned. The question is how to use the open banking framework and infrastructure to go to open finance.

The regulator considered that the main issue for developing open finance is for market participants to find valid business models. Market participants are best placed to deliver and implement the standards needed to support open finance and to find the appropriate business models. Regulation can provide a framework for an appropriate development of open finance but cannot create the market and the less regulation there is the better it will be for all market participants. Progress is being made in terms of standardisation. The European Payments Council has developed a scheme for premium APIs that allows the exchange of data outside of payments data. That should facilitate the development of profitable business models. On the market participant side, there is also a need to work towards more consistent implementation, because differences have been observed across banks in the implementation of the same open banking standards.

Digital Euro: use cases and design

1. The future of the digital euro must be decided on the basis of clear and compelling use cases

The Chair stated that the majority of central banks are investigating or implementing central bank digital currencies (CBDCs). Currently, the ECB is in a two year investigation phase, which will report back to the ECB's Governing Council in autumn 2023. The aim of the investigation is to explore the possibility of creating a European CBDC retail payment solution. As a central bank, the ECB wants to ensure that citizens continue to have access to central bank money in an increasingly digital age. The ECB's first, second and third progress reports provide a complete overview of the ECB's analysis of the project and the decisions it has made so far. The current phase is the holistic review, in which the ECB interacts with market stakeholders to determine whether its decisions might need to be adjusted. This conversation is only one part of the discussion taking place across Europe. With the legislation now being drafted, the political debate has started. As the digital euro will touch everybody in Europe, it is important to continue these exchanges and work together to create the best possible version of the digital euro.

1.1 The key success factors for developing a European CBDC

An industry speaker emphasised that this is an important moment to explore the issues around CBDCs. The G7 principles were a significant step forward and established some very important guardrails. The principle of 'do no harm to financial stability' is an important anchor point to avoid the financial disintermediation possible with a completely unfettered CBDC. The G7 principle of competition and innovation is also important. There are 'dos' and 'do nots' in this regard. In a digital world, it is important not to create a single point of failure. If something happens to a particular infrastructure, consumers and businesses need to be able to switch to a different payment mechanism. Resilience is important both within a particular infrastructure and systemically. Therefore, the infrastructure of the digital euro cannot be isolated. In Visa's view, the principle of competition and innovation requires the use of existing infrastructure. Otherwise, the digital euro will not have the platform or the standards to bring in other players.

Much of the debate focuses on use cases, but central bankers are not the best forecasters of the future. If central banks create platforms and standards, innovation will create use cases. As the economy moves away from the cash world, it is important to remember that fiat currency is defined as a store of value, a unit of account and a means of exchange. In a digital world, the 'means of exchange' piece becomes incredibly important. There are three prerequisites to creating a credible means of exchange. The first is security and resilience. A digital currency has to have the availability and security that citizens expect. Equally, citizens must be protected against fraud. All of the parties involved should participate in that protection. If one party in the system is the sole owner of fraud, that will create moral hazard and risk. Cybersecurity is the other important element of resilience in the digital space. The second prerequisite is value. The digital euro must create value for end users and merchants, and the use cases should take account of value in people's lives. Thirdly, consumers must have choice. In the digital world, consumers are given options.

1.2 The digital euro can address the key issues caused by the declining use of central bank money: trust, financial stability and EU autonomy

A Central Bank official explained that there is an increasingly large gap between people's digital lives and 'analogue' central bank money. The proof of this is the shrinking use of cash. This is a risk because the convertibility of private money is important for stability and trust in the financial system. While it is clear that cash will remain, the digital euro offers an additional way for people to pay in central bank money. Sovereignty is a key topic in this conversation. At the moment, there is no widely available payment solution, usable both online and in brick and mortar stores, that offers a unique user experience, is operated on a European infrastructure and is governed from within Europe. The events of the past few years have clearly shown that dependency always comes with risk. Alternatives and fallback options are needed to guarantee the resilience of the European economy.

1.3 The main use cases for a digital euro

A Central Bank official noted that the question of use cases depends on whether the digital euro is a complement to cash or not. First, cash is something that is used in stores. E commerce is one of the main use cases because that is where people want to use cash. Secondly, cash is commonly used in transactions between individuals. These peer to peer transactions are also an important use case. Finally, it is important to remember that one use case of cash is hoarding. A large amount of cash is not used for transaction purposes but is hoarded. This function will not be one of the purposes of the digital euro.

An industry representative highlighted the importance of cross border payments. The issues that exist with cross border payments do not need to be taken into account in the initial design, but they will need to be addressed at some point. The key issues are access by non residents such as tourists and spill over effects to third countries. In some countries, the impact could be relatively strong. In this regard, it is very encouraging to see the work being done by central banks and the Bank for International

Settlements (BIS) to coordinate on CDBCs and use wholesale variants of CBDCs.

1.4 The design of the digital euro must ensure financial inclusion, guarantee user privacy and contribute to anti money laundering (AML) and fraud prevention

1.4.1 Ensuring financial inclusion

A consumer representative stated that the digital euro is a project for the people, but there are still many questions about how it will be implemented. However the project is realised, it must be tested with the people. The digital euro is necessary because of the rise of digital payments and the fact that cash is increasingly not available or not accepted. Digitalisation is one part of progress, but no one should be left behind in the transition. This need for inclusion is the main problem with the digital euro. If someone cannot pay, they are not part of society. Sweden experimented with a cashless system, but it ultimately reversed this decision. It is important not to rush into digital, as there can be downsides to moving too quickly. BEUC has received similar feedback from its Norwegian members. In a survey of Norwegian consumers, up to 25% of consumers indicated that they have had problems making digital payments and 43% of consumers said they struggle to make payments online.

A Central Bank official agreed that the digital euro can help ensure financial inclusion. The design of the digital euro should be simple, and the needs of people who are illiterate or visually impaired must be taken into account in its design. It is important to remember that there will always be a group of people who want to use cash, regardless of any questions of digital skills or privacy.

A consumer representative emphasised that people hoard cash at home because they do not trust the banking system. The number of people who want to use cash will probably increase rather than decrease. This is not a question of generation but of age. When people age, they lose cognitive skills and find it harder to adapt to new interfaces, and their fine motor skills deteriorate. Given Europe's aging population, this factor will have to be taken into account. Including the conditions of the European Accessibility Act in the rollout of the digital euro would help to ensure that people with poor digital skills or those who are less able to use a smartphone can use any identification method that is implemented.

In terms of inclusiveness, the digital euro should be legal tender and free of charge, certainly for daily services. Additionally, it is important that it is not described as a commercial project. The digital euro is a public project, even if there will be commercial intermediaries. This is one reason why people trust cash. There will still be a need for distribution by commercial intermediaries, including a dense network of ATMs and branches with the possibility of human interaction. To be properly inclusive, the project will need to target people who are not digitally skilled and who need human interaction to take part in society. Of course, this will require investment. At the moment, there is a tendency to have fewer branches and fewer ATMs. If a person cannot use digital payment methods, they are effectively out of society. Any inclusive system will need a dense network in order to enable widespread access to the entry points of the digital euro.

1.4.2 Guaranteeing user privacy

A consumer representative suggested that a consumer centric digital euro would protect privacy in the same way as cash. As a consequence of digitalisation, different industries hoover up people's personal data. This data is not always kept within an industry. In this way, people become commodities. This should be prevented.

A Central Bank official stated that privacy is a key reason why people use cash. Cash gives people more privacy compared to transferring funds from one bank account to another. The fact the digital euro is being provided by the authorities will not necessarily make it more acceptable to the public. Privacy has been one of the big issues in the debates about the digital euro in the Dutch parliament, and it is going to be an issue across Europe.

A Central Bank official agreed that privacy for end users is a key consideration. The focus groups performed during the ECB's investigation phase demonstrated that many people care about privacy when making payments for a variety of different motives. Some commercial and digital services have proven themselves to be untrustworthy holders of private data, and many people distrust state run services. The ambition for the Eurosystem should be to have the highest possible level of privacy and data protection. This should include clear routes for minimal data use and maximum control for users. The digital euro must be constructed to ensure Eurosystem control over the ledger, and thus the amount of currency in circulation, without enabling access to data. This will ensure privacy vis à vis the Eurosystem while also reducing the risk of hack attacks against a centralised pool of data.

1.4.3 AML and fraud prevention

An industry representative agreed that privacy and financial stability are both important topics, noting that privacy was the main consideration in the ECB's consultation. It is important to remember that the existing solutions in the market provide a high degree of privacy while also enabling AML controls to be applied. The digital euro should also seek to accomplish both of these aims. Privacy will be at the core of any solution, but this must not compromise AML and fraud prevention. There is an idea about reinforcing privacy for transactions below a certain threshold, but it seems somewhat paradoxical to have a higher degree of opacity in a public solution than in a private solution. Not every aspect of cash should be replicated; the digital euro should only replicate the aspects of cash that make sense.

2. The digital euro in practice: expectations and requirements

2.1 Banks, non bank payment institutions and e money institutions are best placed to distribute the digital euro

A Central Bank official observed that people often ask whether they will have to open a digital euro bank account with the central bank. Central banks will not be doing this because they are not good at it. The European central banks have decided to distribute the digital euro through regulated entities: banks, non bank payment institutions and e money institutions. These institutions have the right experience and knowledge to bring the digital euro to citizens. This will have several effects on these institutions, and their roles will change. The current design of the digital euro means that the financial players will play the roles they know best, such as user management, transaction management and liquidity management. User management entails the management of digital euro accounts or wallets, including the onboarding of customers, know your customer (KYC) and AML checks and the provision and management of payments instruments linked to the digital euro. Transaction management is about the initiation of transactions, ensuring that user authentication is done well and that transactions are correctly validated and settled. Liquidity management is about the funding and defunding of digital euro accounts.

2.2 The arrangements for the digital euro must preserve innovation and competition

An industry representative stated that access to payments data will allow banks and other service providers to offer greater personalisation and improve financial advice. If customers want to access these services and functionalities, they should be able to.

A Central Bank official emphasised that, alongside banks, non banks will also play a role in the new infrastructure. Today, non bank players play an increasing role in the acquiring of payments in the euro area. This should be acknowledged and fostered, and non banks should be explicitly included. Secondly, the digital euro will use public digital infrastructure, on top of which private parties can build their own innovative products and services. This will promote competition while also rewarding innovation. Finally, the digital euro should not crowd out existing players. Ideally, it will coexist with Europe's existing payment solutions. The digital euro is being launched for resilience reasons, not to make a competitive statement.

An industry representative observed that there will be a need to rely on existing and future infrastructure, especially since the use cases considered in the design overlap with existing solutions. It makes sense to exploit the synergies between the digital euro and instant payments, for example. The European payments industry should work on the interoperability of different instant payment solutions and connect these with the infrastructure being developed by the ECB. In Spain, a proof of concept has estimated the potential savings from using existing infrastructure at more than 50% of the investment cost. In addition, using existing infrastructure will enable the digital euro to be deployed at a faster pace.

A Central Bank official agreed that it would not be desirable for the digital euro to compete against the private sector. The digital euro is a complement to the private sector. There is still much to do to create a single European payments area. Happily, the European Payments Initiative appears to be taking off. It is incredibly important, but it is not a use case for the digital euro.

Another Central Bank official agreed that innovation is a key issue. The European payments industry is creating a completely new infrastructure, and it must be future proof. It should enable technological progress, innovation and a degree of competition. In this regard, it is similar to energy networks, which need to be upgraded in many countries. The challenge is about making planning assumptions about future performance needs and equipping the network with features that will realise their potential in the future. In the energy context, for example, while there are still comparatively few use cases for smart grids, the move in this direction will create the foundations for new products and services on a large scale. Equally, the infrastructure for the digital euro must be high performing and scalable. Similar to smart grids, the Eurosystem needs to ensure the digital euro's infrastructure contributes to further innovation and digitalisation in the future.

2.3 There should be a fair compensation scheme which incentivises the different stakeholders and users throughout the payments value chain

An industry representative stated that intermediaries should play a role in the scheme being developed by the ECB. The key question is about the incentives and responsibilities for public and private institutions. The intermediaries will be in charge of onboarding new customers, managing accounts, wallets, customer support, authentication, security and fraud prevention and post trade services. These functions have costs that must be compensated, which the ECB has acknowledged. The ECB's proposed compensation model contains four key principles: it should be free for individuals; intermediaries should be compensated; merchants should not extract excessive commissions; and the Eurosystem should bear its own costs. Overall, the ECB's principles and sensible and consistent. To the extent that the digital euro is free for citizens, there must be compensation elsewhere. However, it is important to define some of the concepts in the discussion. If basic services are going to be free of charge, terms like 'basic services' and 'value added services' must be clearly defined.

2.4 To avoid any disruption to financial intermediation, which could threaten financial stability and increase the cost of credit, limits on holdings should be considered

An industry representative stated that there seems to be a broad consensus that central banks should not compete with private banks when it comes to provision. The digital euro should avoid a disruption of financial intermediation and an increase in the cost of credit. This is why limits on holdings make a good deal of sense. This would be preferable to the idea of tiered remuneration. The level of the limit would have to be sufficient to cover citizens' day to day needs. The linkage of the digital euro to a bank account through a waterfall mechanism means there is no need for a very high limit. In any event, the limit must be stable. If the limit and the procedure for setting it were easily alterable, it would introduce uncertainty into the scheme.

3. Barriers to success: outstanding challenges to implementation

An industry speaker outlined the key aspects of the digital euro project: it is core to national life and values, conceptually very hard and technically very difficult. As the G7 principles are translated into targeted outcomes, it is important to understand whether the project has solved these three challenges. Visa welcomed the very detailed work being done by the ECB and the level of engagement that is taking place between the public and private sectors. Clearly, no one institution has the answer to all of the key issues; it is important that everyone contributes to the project.

A Central Bank official highlighted the importance of trust. If there is no trust in the digital euro, it will be a failure. Citizens trust their bank notes. This project will require engagement with the public, but it will also require a proper consideration of the issues. If it is rushed, the digital euro will not succeed.

A Central Bank official agreed that trust is a key success factor, alongside a sound legal underpinning. There needs to be a very smooth and user friendly onboarding process and a very thorough communication campaign aimed at end users and merchants. The digital euro should be treated as a digital bank note, which means it should be free for basic use and usable offline. Mandatory acceptance through legal tender status is also very important. Finally, there needs to be common European branding to ensure that any digital euro is recognisable.

PSD2 review priorities

1. Assessing the impact of Payment Services Directive 2 (PSD2)

A public representative noted that the European financial industry has learned a number of lessons from the application of the PSD2 rules. The European Commission is expected to make a proposal on the review of PSD2 in the coming months, which means it is a timely moment to consider this question.

An official emphasised that it is difficult to make a precise and complete assessment of the impact of PSD2 without considering the huge changes that were taking place in the sector as a result Covid. It is hard to assess its impact without considering what would have happened if PSD2 had not been on track when the pandemic hit. Within that context, PSD2 has clearly had a very positive impact.

1.1 Despite its cost and complexity, strong customer authentication (SCA) has increased citizens' trust in electronic payments

An official highlighted the particular importance of user confidence in payment services. If users are able to make safe payments, it is to the benefit of all. Therefore, fraud prevention is the most important aim of the regulatory framework. In this context, PSD2's biggest achievement has been the introduction of SCA. This transition has not been friction free, but the rate of credit card fraud has dropped significantly since the new rules were introduced.

An official agreed that confidence is a particularly important issue. The reduction in fraud is a good starting point for consumer protection, which is one of the most important objectives. The second objective is about innovation and competition, which must happen alongside each other. The necessary improvements in transaction security usually come with a cost, but it is important to remember that customers who are satisfied and who feel protected will continue to use a payment service.

An industry representative emphasised that PSD2 has been one of Amazon's priorities for more than five years. This has been a positive journey for Amazon and e commerce more broadly. Earning customer trust is central to Amazon's DNA. In that regard, PSD2 has given Amazon another reason to invest in earning customers' trust. Uniquely, PSD2 has also provided an opportunity to reduce fraud. Amazon's fraud rates are extremely low, and they have dropped as a result of its work on PSD2. PSD2 has been a success for businesses, customers, the payments industry and the broader financial services industry.

1.2 PSD2 has fostered innovation and enabled third party providers (TPPs) to compete

An official noted that the other important set of rules in PSD2 covers the regulation of third party providers of payment services. The practical impact of the regulation on the Swedish market is difficult to quantify because many of these services were offered in Sweden before the directive came into force. There was an important change of mindset, though. The banks that controlled the payment market infrastructure had to allow other payment service providers (PSPs) to use this infrastructure to create new and innovative services, which contributed to achieving a level playing field for PSPs.

An official stated that there is clear data on innovation and competition. There has been an increase of at least 5% in the number of TPPs. New business models have emerged in areas such as payment initiation, aggregation and account information services. When the door to innovation is opened, it is hard to say where it will lead. At present, the interaction between TPPs and the traditional banking system is adding value for consumers and increasing competitive pressure. It is also leading to a reduction in the cost of service and an increase in customisation. This competitive pressure puts the industry on edge, however. With so many partnerships and synergies, it has become harder to see where traditional banking ends and where neo banks begin. It is important to ensure there is transparency on who is behind a service so clients and investors understand their rights and obligations.

An industry representative suggested that PSD2 has forced Amazon to innovate, which has been a real asset. As Amazon has so many e commerce use cases that fall outside the typical flow of shopping on a browser or mobile device, it has had to innovate and develop new ways for customers to have these experiences. Indeed, the team at Amazon were able to file patents on the things they invented. The team became quite energised by something that could have easily become a 'not very fun' compliance project. Additionally, there has been excellent collaboration during this process. The dialogue between merchants, authorities and banks has been very open.

An industry representative noted that SCA has become best practice and has now expanded to other regions. American Express has developed new technology and new services such as Amex Express List, which can be used to avoid authenticating with every single merchant a consumer shops at. There are many other examples of this kind of innovation.

1.3 PSD2 enables citizens to access banks via a variety of channels and facilitates multi banking, but it has been difficult to define an efficient interface

A public representative noted that the banking sector played a key role in PSD2 implementation. In the past, open banking has been very closely linked with the review of PSD2. An industry representative emphasised that the banks are the institutions delivering the data.

The other players in the payments landscape simply receive data from the banks. Despite this, banks generally have a positive view of PSD2. The saving banks in Germany took an open approach to PSD2. They conducted workshops and questions and answer sessions with fintech companies and tried to forge connections with them. As a result, 56 of the TPPs in Germany now work with the saving banks' infrastructure and exchange data with them. There are now 73 million transactions per quarter. These are bank customers using banks via TPPs, which means that banks are serving their customers by having open architecture.

German savings banks are also using PSD2 to offer multi banking to customers. Almost 3% of customers use this functionality. There are problems with the PSD2 interface with other banks, which is a significant hassle. The German banks now understand both sides of the interaction. This difficulty is caused by PSD2's mixture of very defined and very open regulation. Sometimes, the industry needs the regulator to say, 'This is the right way to do it'. It would be helpful if the legislation were introduced in a different way.

A consumer representative observed that the payments sector is the nexus between consumers and the economy. It has a fundamental role in the wellbeing of citizens. With this in mind, the regulatory framework around PSD2 has been a success story. It has opened up markets and increased the security of payments. As a consumer organisation, BEUC's members look at how consumers are experiencing these systems. The data from Norway, which is usually considered to be a highly digitalised country, shows that up to 25% of consumers have faced problems making online payments. This can be due to a lack of skills, literacy or equipment.

2. Areas for progress in the payments industry

2.1 Fair access to data will ensure the emergence of new entrants and business models and provide new opportunities for incumbents

An industry representative emphasised that American Express wants to contribute to the Commission's objectives for PSD2: fostering innovation, enabling competition, customer protection, harmonisation, etc. Clearly, innovation is a key objective. In the digital new economy, data can be leveraged to create more value and protect customers more effectively, etc. There are new entrants and new business models associated with that. There have been some bumps along the way in terms of implementation, however. Open banking is definitely a good example of innovation. Ultimately, open banking needs to evolve to open finance and eventually to open data. It would be preferable to have something that operates in two directions and is not one way. The portability of data, with the right privacy measures, can be leveraged to enable consumer protection and better customer service.

An industry representative highlighted the fact that the banking industry has to pay, implement and provide all of the data, while other firms simply consume the data. Firms such as Amazon can build business models using PSD2 interfaces, but the banks have to pay for it. If there is not a balanced approach, not everybody in the banking industry will be as supportive of open banking as the saving banks. If there were a more balanced approach, more banks would be fans of open banking. 3% of German savings banks' customers use multi banking. This is almost 300,000 customers, and it is possible because savings banks in Germany have a 50% market share. However, the level of usage is not as high as was expected. Consumers might not want multi banking integration because they only have one savings account or they want to see different kinds of information. If multi banking and open banking is the goal, the discussion should not only be about banks delivering data to everybody else for free. There must be more data from other sources, which would provide a better overview and help customers.

2.2 The regulatory framework has become increasingly complex

A consumer representative described how the regulatory framework for payments has become extremely complex in the last few decades. A multitude of factors intervene across the supply chain, all of which governed by different pieces of legislation, such as the E Money Directive, PSD2, Single Euro Payments Area (SEPA). Supervision can play a key role here, but the competent authorities have limited powers to supervise companies located in different countries. From the point of view of conduct and consumer protection, there is also confusion about the different SCA systems implemented by different players.

2.3 Inclusiveness and fraud remain important issues

A consumer representative highlighted the importance of inclusiveness. It is essential to ensure that everybody benefits from the protection granted by SCA. To take a banal example, access to a recent model of smartphone can be the difference between being able to pay and not. Payment fraud is also a key issue. Although SCA performs an important role, payment fraud is on the rise. The issue of authorised and unauthorised transactions continues to exist because different rules apply to this question across Europe. The key problem is the sophistication of payment fraud. Consumers simply do not understand it. This is a question of education, and BEUC is strongly in favour of financial education from a very early age. At the same time, it is also important to think about market design and the incentives for players to implement measures to reduce the risk of people falling victim to fraud. To provide one example, BEUC members have reported that firms are abusing the concept of consumer negligence in payment fraud. It is easier to say, 'This is your fault' than it is to implement measures to prevent fraud from happening.

A consumer representative noted that IBAN-Name Check has been successful. The data from the Netherlands suggests that it has reduced fraud and error in payments. This goes hand in hand with the question of how consumers can identify payments. In many cases, bank accounts only show a company's name, which might be the name of the legal entity but not necessarily the name of the shop where the money was spent. This could be solved with a relatively simple solution.

2.4 The development of instant payments has huge potential

An official stated that the European payments market has not yet seen the full potential of open banking regulation. In particular, instant payments still need to be developed. Instant payments will dramatically change the infrastructure that is used for payments. When banks are able to send and receive instant credit transfers, there will be highways where previously there were only muddy country roads.

3. How to achieve the objectives of PSD2 and fight fraud: harmonisation, technology and creativity

An industry representative noted that there were several key opportunities to enhance PSD2. The size of Europe makes the practical execution of a framework like PSD2 difficult, but this could be solved by implementing outcome based targets. It is important to know what success looks like. This could be framed in terms of fraud rates, authentication success rates or availability. The regulatory and supervisory community should set a bar for what 'good' looks like and then allow banks and other TPPs to innovate. These businesses will hit or exceed the target, and they will probably invent interesting things along the way. One extension of this is harmonisation. Amazon has found it difficult to develop a consistent customer experience across Europe. Specifically, stronger guidance on the use of exemptions would be useful. There could be guidance on best practice, but firms should also be able to innovate.

A public representative queried whether this remark was an invitation to the regulatory authorities to force more innovation on the industry. The industry representative agreed that regulators and supervisors should force the industry to innovate.

The public representative observed that savings banks are in the unique position of being on both sides of the data supply chain. An industry representative agreed with this. Fraud prevention is the savings banks' number one priority, but it must be done in the right way. Instead of implementing fixed requirements, the legislation should use targets. The industry needs to allocate greater financial means to fraud prevention, and it is important to increase the exchange of information about fraud between and among the industry. Until now, the legislation has focused on specific measures and excluded everything else. It must be more principles based. It is better for fraud prevention to be an aim or to use a particular success factor to measure it. Ultimately, these questions should be left to the industry. Alongside this, large scale pilots, such as DG Connect's digital identity pilot, can help to prove whether it is helpful, successful and practical to implement a proposal. Experimenting through large scale pilots prior to legislation is preferable to the cost intensive hassle of organising everything afterwards.

An official suggested that technology is a transversal vector in this discussion. Firms must be properly incentivised to use and develop new technology. It is good to see technology this being used to tackle inclusion, for example. The industry needs to understand how to use technology to achieve a specific target and avoid excluding sections of the population, such as the elderly or the digitally illiterate. It is possible to use legislation to ensure that nobody is unable to use digital payments.

A consumer representative agreed on the need to design the legislation correctly, noting that there is a decision to make on whether it should be principles based. Certainly, the legislation should be technology neutral at level one. Principles can be difficult to enforce, however, and they leave room for interpretation. Therefore, it is important to strike the right balance between flexibility at level one and enforceability. The idea of targets has some merit and should be discussed with the European Banking Authority. It will be essential to ensure the targets correctly defined and effective, however.

An official observed that one industry representative is asking for the legislation to be more principles based and another is asking for it to include more guidelines. This is quite understandable, however. It is the job of the public authorities to strike the balance and create good regulation. In material terms, fraud prevention is the core of the regulatory framework. Another panellist raised the issue of data sharing. Fraud often involves a number of people with a number of bank accounts in different banks. Banks and PSPs need to be able to see the whole pattern to detect fraudulent behaviour.

An official agreed that targets be a solution to the question of whether to have principles based or detailed legislation. Targets are a good way to legislate, but they can be difficult to calibrate properly. One option would be to have very tough targets, particularly on some of the specific issues. However, the targets that are set must be enforceable.

4. Bespoke and harmonised regulations will create fair competition by addressing the specificities of different players and payment systems

An industry representative noted that PSD2 has led to new entrants and new models, but some of the important details have created additional barriers and prevented smaller players from competing with the dominant schemes. Sometimes, a one size fits all approach does not work. The regulation is designed to enable competition with big schemes, but sometimes applying the rules to smaller players has had the opposite effect. Trying to adapt is not only a challenge for the firms themselves; it is also a challenge for supervisors. For example, some supervisors have fed back to American Express that they do not know how to apply particular rules.

As a specific example, open access in PSD2 assimilated three party schemes into four party schemes in certain circumstances where four party scheme rules had to be applied to a three party scheme, which is simply not feasible. This led to American Express closing down its operations in 18 different countries and shutting down millions of relationships with customers. The issue is easy to fix, however, and American Express would like it to be corrected. Another example would be payment institutions' ability to operate on credit cross border beyond 12 months. The obligations of payment or e money institutions are different to those of credit institutions, but this competition could be enabled through the use of the right rules and controls. This is also relevant for the upcoming regulation on instant payments and the digital euro. Payment institutions, e money players and other regulated entities need to have access to these schemes as well as credit institutions.

The industry representative highlighted the importance of harmonisation. For American Express, there is also a very specific question around surcharging. Not all member states apply the same rules, which makes it hard for players, supervisors and customers to understand how to operate them. A consumer representative agreed on the need to move to a uniform approach to the interpretation of the payment framework, which will ensure that consumers are equally protected across the EU.

5. PSD2, open banking and data access

A consumer representative noted the important interplay of PSD2 with open finance. The two proposals will likely be published at the same time. Certainly, they share many synergies, especially regarding the important question of access to data and privacy.

An official emphasised that data belongs to the customer. When everything is structured around data usage and data sharing, it is important to remember who the rightful owner is, not only in terms of protecting particular pieces of data but also compensating for the use of data.

Cross-border payments and global infrastructures

1. Introduction: FSB roadmap on cross border payments

1.1 The FSB roadmap gathers broad support

A Central Bank official stated that the initiatives taken by the G20 in 2020 and brought further by the Financial Stability Board (FSB) and the Committee on Payments and Market Infrastructures (CPMI) are important and must be further pursued. Innovation in payments is happening very quickly, making payments faster, safer, cheaper and more efficient, but the cross border area is lagging behind. Authorities and the financial sector can make a valuable contribution, as cross border payments relate to the interests of citizens across the world.

An industry representative explained that BNY Mellon welcomes the prioritisation plans the FSB proposed to the industry last autumn. The three pillars – technical foundations and facilitators, market infrastructures and regulatory and supervisory frameworks – are all essential. The whole project will struggle in the absence of one piece.

A Central Bank official stated that the Sveriges Riksbank has been a strong supporter of the G20 roadmap since it started. Much analytical work has been undertaken, but now it is time for implementation. The quantitative targets that have been set will promote that development. The implementation priorities for all stakeholders have to be followed closely. The central bank world can do much good work, but it will fall short without support from other stakeholders.

A Central Bank official commented that there is a broad consensus regarding the improvement of cross border payments. An industry representative stated that his institution fully supports the roadmap and the FSB and CPMI's work in addressing the barriers to cross border payments, in particular the efforts around the facilitation of increased adoption of payment-versus-payment (PvP). An official observed that the priority blocks are interconnected. The US Treasury supports the work being done with the cross border payments roadmap, both in the cross border payments committee at the FSB and at the G20 level. The selection of priorities in the roadmap seems correct, as those are the thorniest and most difficult to implement issues.

1.2 No single solution exists to allow the different types of cross border payment, use cases and business models to tackle innovation challenges, which requires strong private and public sector commitment and cooperation globally to strike FSB quantitative targets and priorities

An official explained that the world is two and a half years into the G20 cross border payments initiative. The FSB, the CPMI and other authorities have completed the foundational stage. Detailed analysis of the opportunities and the frictions around cross border payments has been completed. Best practice guides for authorities and the private sector have been developed. High level outcome targets have been set and machinery has been set up to track progress and hold organisations to account.

Progress has been made. 75% of payment system operators have implemented ISO 20022 or plan to do so by 2025. The CPMI and the private sector have worked over the last year to avert the possibility that the new data standard could be implemented in different ways for different use cases. The CPMI is close to establishing common standards and avoiding further fragmentation. The hope is to apply that approach to developing common standards for APIs, and enable payment systems to be linked across borders.

Interlinking of faster payment services is developing as an area of opportunity. The BIS Innovation Hub has developed various projects exploring multilateral platforms. Nexus, a project in Singapore around interlinking faster payment services, may well form the basis for the interlinking of the faster payment systems of the ASEAN 5. A large number of central banks have either made their operating hours continuous or are planning to do so in the near future. Expanding the global settlement window will make a huge difference.

The implementation of a practical project by the public and private sector across the whole range of payment services, jurisdictions and regions has started. Those projects need to cover three key areas. First, they need to cover improvements in both hard and soft infrastructure. The second area is the legal supervisory and regulatory frameworks for banks and non banks. The third area is technical standards and regulatory frameworks for data exchange.

The public sector needs to improve the infrastructure it provides and avoid regulation causing unnecessary friction. It needs to use its convening power to develop common standards and track progress. The private sector needs to improve its infrastructure and systems, help develop common standards and take advantage of reduced frictions to develop better payment services. If banks do not invest in change, current business models will be left behind. The public and private sectors need to work together in this next phase. The FSB convened a high level payment summit last autumn. Preparations for two public private taskforces are in place, one led by the FSB covering legislation, regulation and supervision and one led by the CPMI on payment system interoperability and extension, and the first meetings are expected to take place soon.

There is no single global solution to improving cross border payments by 2027. Different types of cross border payment have different use cases and business models. Needs and levels of certification differ between jurisdictions and regions. Some issues will be common across all payment types, but progress will be heterogeneous. Questions around what the main challenges are, which areas for improvement will provide the biggest payoff and what value chain opportunities there are will be crucial in the next phase. The need to identify where progress can be achieved is ongoing and success must be reinforced in those areas. The new public private taskforces will create a high level channel to answer those questions.

2. Key elements driving progress on cross border payments

2.1 Quantitative targets regarding further availability and enlarged access to settlement systems for smaller direct participants, and the development and interlinking of instant payment systems are key drivers for improve cross border payments infrastructures

A Central Bank official observed that improving central bank settlement services is a priority for central banks. Making settlement services available around the clock is clearly necessary to speed up cross border payments, given that countries are in different time zones. Promoting access for smaller banks and relevant non bank players will also be very important to shorten transaction chains and increase competition. Sveriges Riksbank tries to lead by example: the number of direct participants in our system have increased by 100% over the last five years and we have also extended our opening hours.

The introduction of settlement payments for instant payments will contribute to the goal of being open around the clock. The Sveriges Riksbank is working on this jointly with the ECB on their platform, the TARGET Instant Payment Settlement (TIPS). The next logical step is to interlink the instant payment systems that many other countries are also introducing. That would create a more competitive landscape by granting smaller actors access to foreign systems that they had not previously enjoyed.

A Central Bank official commented that the main points with regard to the improvements in the infrastructure are clear. One is longer opening hours, to create more overlap between existing payment systems in different time zones. Others are improving access to and interlinking payment systems, to shorten transaction chains and improve the speed and reduce the cost of payments. Ideally, this interlinking would focus on fast payment systems such as TIPS, making them continuously accessible all year round.

In this regard, project Nexus, is a promising initiative and TIPS has already completed a pilot with the Central Bank of Malaysia and the Monetary Authority of Singapore. Whether other links will follow remains to be seen. This seems less a question of the technical interlinkage than a legal and governance related challenge. A welcome initiative to link the euro area with the Swedish fast payment system is in place. Emerging countries often do not have fast payment systems and developed countries may need to deliver technical assistance to address this situation, but this is not really a challenge.

An industry representative stated that there has been good progress on the important areas of technical foundations and market infrastructures. The developments around interlinking of market infrastructures are really encouraging and show that this is possible, even if there are lessons to be learned.

2.2 Global standardisation and regulation harmonisation are key since money is moving around the globe

An industry representative observed that standardisation is key. Any player in the payment industry will realise that there is a lot going on and wonder where their focus should be. Harmonisation around messaging and data standards makes everything much simpler. Progress has been made on the ISO 20022 implementation, with successful implementations in Europe and some coming up in the UK. SWIFT has done great work, but a number of lessons learned can be addressed.

A really important pillar is the harmonisation and execution of regulatory and supervisory frameworks, both in the long run and today, because customers have immediate needs and some of the challenges that will come up along the roadmap exist in the ecosystem at present. If some of those initiatives can be moved forwards, they can also very quickly improve the experience of the existing infrastructure.

2.3 Wholesale payments mainly require improving currency related liquidity rather than higher speed availability or further interlinking, which supposes strong political support

An industry representative noted that retail payments, wholesale payments and remittances have different challenges. While the roadmap is right on retail payments and remittances, the wholesale payments system is working quite well. However, more can be done to increase the overlap between countries in the operating hours of real time gross settlements (RTGSs) and the work on standardisation will reduce costs and increase efficiency The main challenge for wholesale payments is not time or interlinking but ensuring there is the right amount of liquidity at the right time. Moreover, settlement risk mitigation on a PvP basis needs to be available for wider range of currencies, in particular from emerging markets. Related challenges are less of a technical but more of legal, regulatory, and also geopolitical nature.

An industry representative commented that liquidity is key but sometimes gets forgotten amid the discussion about technical and regulatory details. If money moves faster around the globe, it must be in the right place at the right moment. There is a lack of experience across the industry regarding what it means to move a lot of money very quickly around the globe. There is a lot of learning to do and this must be done collectively, with central banks supporting commercial banks.

A Central Bank official observed that making more currency available for payment versus payment (PvP) settlement is important. This is less a question of technology than of politics. Changes in the geopolitical situation in the last 14 months have made things more difficult, because it is important to have an atmosphere of trust both between countries and between public and private sector to improve cross border payments. Given this increased difficulty, it may be necessary to adapt our ambitions. An official concurred that high level political support was key.

2.4 Deepening interconnectivity, however, entails additional attention to risk management, which is a key focus point for international cooperation

An official stated that more payment system interconnectivity creates greater operational interdependency between systems, increasing the sharing of operational risk between systems and generating a need for interoperable technology and messaging standards. That means rules need to adhere to common international standards. It is necessary to highlight not only the work of the FSB here but that of the CPMI, both elaborating further on the Principles for Financial Market Infrastructures (PFMI) and discussing the implementation of interlinkages, which complements the BIS's work.

Payment systems are part of the broader economic policy community's efforts to create an open and stable global financial system that benefits from cross border coordination and manages risks effectively. There is a broader perspective around international financial stability, growth and development that is important to add to some of the technical elements that have been discussed so far. Working in the central banking space makes clear how significant technical challenges are, including liquidity management, because real time payment systems are substantially more liquidity intensive. Broad based consultation is also clearly essential, and the roadmap's focus on public private engagement is commendable.

3. Challenges and success factors for achieving the FSB roadmap on cross border payments

A Central Bank official remarked a number of challenges had been mentioned. Bringing about engagement between private and public sectors was not easy in a global context. The question of the part of the value chain that would most benefit from the roadmap is also important, as are the incentives required to achieve commitments from the private sector towards the G20 targets.

3.1 A shared vision, a clear division of responsibilities between the private and public sectors, leveraging the strengths of each, and programme coordination and cooperation

A Central Bank official commented that it is necessary to think hard about how to achieve the shared vision and the required level of commitment by all participants. There is a natural division of labour between the public and the private sector. Central banks have a unique capacity in reducing risks, as they print risk free central bank money. Basing a platform on central bank money is a starting point, but that platform has to promote competition in the private sector. The private sector is good at innovation and can complete the infrastructure of the system to the end user.

There are strong incentives to end up in that division of labour. There are big negative externalities to address on the central bank side. Considering this question through a domestic lens is wrong, as international financial stability must also be considered. The private sector will be interested in a new business case, and institutions that do not take part in this process risk missing out on benefits. However, central banks have to be prepared to play a broader coordinating role. The division of labour is endogenous and there must be a rethink if this progress does not materialise. It would be interesting to hear how the private sector views this, to see whether they share a common understanding of where to start, of the obstacles to progress and of how central banks can help overcome them.

An industry representative observed that business cases depend on predictability and reliability, and how a business case looks both at present and in the future must be considered.

A Central Bank official noted that improvements in cross border payments need not lead banks' earnings to decrease. When transaction costs fall, all sides will gain, so this is not a big risk for market participants.

3.2 Supporting public private sector partnerships is part of the solution

An industry representative stated that he strongly believes in public private sector partnerships. CLS is a success story of a public private sector partnership, created in 2002, following a public sector push to encourage the private sector to mitigate settlement risk in foreign exchange transactions. CLS provides such risk mitigation through PvP. The roadmap identifies PvP as a key element of particularly wholesale FX transactions and the public sector's continuous support of the private sector is very important. At the same time, the Global Foreign Exchange Committee (GFXC), composed of central banks and market practitioners, encourages the exploration of ways to further mitigate risk by adopting a best practice approach to FX settlement risk management. CLS currently provides PvP settlement for 18 of the world's largest currencies, which represent approximately 80% of all FX trades. The remaining 20% mainly involves currencies that are legally or geopolitically complex to connect. Solutions to these challenges can only be identified through G20 efforts.

3.3 A strong focus on making the various types of rules existing throughout the cross border payment chain and ecosystem consistent. This requires strong political will due to the underlying competition issues

An industry representative commented that it is clear that standardisation works and that the interlinking of payment networks is technically realisable. The key challenge around the interlinking of payment networks is the question of which rule framework applies when multiple payment systems are linked. If there are 60 instant payment networks around the globe, interlinking these would produce a very large number of connections, resulting in significant uncertainty around the business case. The centrality of rules is also seen in the technical implementation of ISO. If the description of the format makes reference to 'agents', this might include banks and other entities in one country but only banks in another. This creates uncertainty around whether banks can rely on the regulation of other entities in other countries. The good work started by the CPMI taskforce must be continued, because this will increase the certainty of industry players that their investments will have the returns that they anticipate.

A Central Bank official noted that anti money laundering (AML) and countering the financing of terrorism (CFT) requirements have increased and vary between countries, raising a problem for banks. Some improvement is necessary, but these risks should not be increased.

An official observed that the core technology is not the issue. Experimentation in payments is principally about innovation in legal technology and ensuring certainty across different environments. Soft infrastructure is as important as hard infrastructure. However, the frictions in cross border payments are often intentional, slowing things down to minimising risks around fraud or payment failures. Addressing those frictions is not just about overcoming inertia, but about ensuring that the balance of risk and efficiency is correct in conversation with publics. The G20 support for the roadmap is important to sustain that political willingness to discuss how to make those trade offs in a way that achieves the goals of the roadmap.

3.4 Achieving data privacy without impeding data flowing across borders

An official stated that data is critically important, as meeting the goals of the roadmap is going to require more cross border data flows to support payments, at a time when localisation policies are being implemented to mitigate legitimate concerns around privacy and competition.

Instant payment attractiveness for EU citizens

1. Instant payments are promising though unevenly developed

A policymaker stated that instant payments are currently available in around 60 countries worldwide. The European Commission's conclusion is that instant payments can deliver benefits for all types of payment users. In the European Union the average uptake of euro instant payments is quite moderate, at around 14%. That 14% is driven by the strong performance of a small number of member states. The uptake in the remaining member states has been quite weak, and in some of them it is still around 1%. That is why the Commission has concluded that the situation would require some legislative action.

1.1 A versatile, reassuring and swift payment is good for individuals and merchants

A Central Bank official noted that when they are talking about instant payments, they are referring to the payment standards as defined by the European Payment Council: the Single Euro Payments Area (SEPA) Instant Credit Transfer (SCT Inst), because it is the best and the most used instant payment in the European Union. There are no limits to the possibilities to use instant payments. The most obvious use case is at point of sale. E-commerce would be a great use case to have instant payments, and then peer to peer. Notaries or intermediaries will not be needed. For P2P transactions there is a large value added in instant payments, because at that moment there is no intermediary.

An industry representative stated that instant payment is everything for EPI, because it focuses and bases all its transactions on instant payment, even though it does not just use the European rulebook. EPI also has its own rulebook. Merchants want something very complete and do not want specific niche use cases. They are interested in a solution which can address all needs, and be addressed in a better way with instant payments than with cards. There are clear advantages for the merchants, as receiving the money directly in e-commerce is of substantial value for them.

Instant payments can work everywhere. EPI tries to manage all requested payment use cases, fragmented, deferred, split payments, and all advanced use cases that are necessary to make it a complete payment means and not just an instant transfer. EPI sees instant payments as the choice of the consumer if they do not want to do card transactions. It is very interesting that instant payment provides total control to the consumer, because at all times they perfectly know their financial situation. It would be a pity if Europe misses out on its positioning in the international frame, where there are so many real-time instant, immediate, faster payment solutions emerging.

1.2 Some use cases also address B2B transactions

A Central Bank official noted that it is not only citizens who can use instant payments. There is also a use case for corporates. If a company has urgent transactions to do such as a treasury transaction then instant payments will be a great tool to do that, because the funds can be wired to another account very easily or very quickly. The possibilities of instant payments are almost limitless; although the scheme foresees a cap of €100,000 there is no obligation to do so. In Belgium the financial industry opted to not have the cap.

An industry representative observed that on the corporate and SME side it is a bit different, as there the B2B case is probably less obvious given the offer already provided and the specific needs. Companies do not run an infrastructure for free, so they need to be certain that someone is paying at the end. If companies want to have that working then they need to be sure that costs are borne, be it investment in IT, anti fraud, or the cost of fraud, which is still higher on instant payment, and also on anti money laundering, which is one of the points that is still under discussion in the proposed legislative framework. Still this framework is welcome.

1.3 Instant payments also offer opportunities to improve cross border payments

A Central Bank official noted that it makes little sense to talk about use cases for instant payments because they can be used in any circumstance, but there are some areas where their growth potential is the greatest. One of these is the payments at the point of interaction, and another is cross-border payments. There are very interesting experiments going on, because fast payment systems are particularly suitable for interconnecting different currency areas. There are important initiatives, both from the private sector and the public sector. The private sector has the IXB pilot by EBA CLEARING, TCH and Swift, which is very well advanced. In the public sector there is an important project by the Bank for International Settlements (BIS) called Nexus, which interlinks many different platforms.

1.4 Many initiatives are underway to improve and accelerate cross border payments

An industry representative stated that Swift welcomes the Commission instant payment proposal and supports its overall 2020 Retail Payments Strategy for three reasons. As a European company with a global scale Swift aims to connect the world, making it possible for individuals, SMEs, and businesses to trade, invest or send or receive payments all over the world, and to do that in an instant and frictionless way. Swift is embedded into the European payments and financial ecosystem and ensures connectivity to all major market and payments infrastructures, including the instant payment systems of the Eurosystem TIPS and that of EBA

CLEARING RT1. Swift's core mission is to achieve instant and frictionless cross-border payments at the cross-border level and to contribute to this economy growth, because it has been well-documented that there is a clear link between rapid payments and economy growth. It has a network of 11,500 financial institutions, which in turn connect four billion accounts in the world.

Financial institutions and big corporates can use Swift to send billions every day in a quick and secure way. 50% of those wholesale payments are processed in less than five minutes, two-thirds in less than an hour, and 99% in one day. Swift has recently launched an initiative called Swift Go. Retail and SMEs can also benefit from highly competitive, quick, transparent, international payment from their bank accounts. Swift now has 600 banks on that solution. Another initiative is linked to what the Commission is trying to achieve with the International Bank Account Number (IBAN) and name check, which Swift calls "Payment Pre-validation". At the international level it is very important to try to minimise the friction in the process and pre-validate essential account data before the payment is sent. Swift also has sanctions screening services at the international level, which is very important because it can immediately inform the user that there is something suspicious.

2. Getting instant payments' full value requires achieving critical mass and accessing the benefits of network effects

A Central Bank official added that, although those situations exist and not every use case has the same value added, they are still a big supporter of pushing forward instant payment, because in the payments market the one word that count is volume. Volumes need to be created to generate the network effects to make payments effective in the time that it takes to process them, but that are also cost effective. All use cases need to be catered for to create network effects, as well as introducing and advocating instant payments in use cases where the added value is not that large at first.

The different payment means should be focused on certain needs to leverage their specificities and avoid costly duplication also sources of complexity.

A Central Bank official stated that, while instant payments in Europe can take advantage of the Eurosystem's TARGET Instant Payment Settlement (TIPS), the real question is not whether instant payments have use cases, but whether non instant payments have use case. In a long-term perspective, Europe may find itself in a payment ecosystem in which ordinary credit transfers will no longer be available. This will depend on whether or not the option to settle in one day has economic value. If it does Europe will continue to have ordinary wire transfers in the future. The one-day delay could be used, for example, as a cooling-off period in purchases, a payment reconciliation period, or to provide a payment guarantee. If such use cases continue to be of value to payers and payees Europe will continue to have a mixed system in which there will be both instant and non-instant payments.

An industry representative agreed with most of what has been said so far. There is probably a different use case for the needs of individuals and of corporates. It is clear on the individual that there has been progress on instant payment. At a point in time cash payment and credit card payment can be replaced, as we noticed with contactless. Possible usages of instant payments are vast and it is clearly something that is there to stay. The question is for which proportion of the payment that will be done. La Banque Postale was the first large French bank to offer free instant payment at the beginning of 2022, making it simple for clients, because it is the default option. If clients want, they can easily switch to the non instant payment transfer. It is working but the challenge is that the infrastructure needs to run with two ways of functioning.

3. Instant payments: Key success factors and actual threats

A policymaker observed that there is great potential while are a lot of challenges that Europe needs to master, both legal, technical, and commercial.

3.1 A demanding multipronged change management programme in a complex and fast evolving regulatory environment

An industry representative commented that she sees many challenges, as there are a number of legislations to implement on various issues. One of the challenges is to move on environmental, social and governance (ESG), transition and on a number of topics at the same time. When it comes to clients, habits are difficult to change. They have evolved a lot in the past three years due to external factors such as the pandemic and a higher ceiling for contactless payment, and because payment habits may not be exactly the same in every country. Payment providers need to reassure customers, especially elderly customers or customers that are less comfortable with technology or suffer from illiteracy. Some customers are completely ready for new technologies, and they think companies are moving too slowly, but other customers are not ready. The challenge is to onboard everybody and not to have two-party systems.

Companies need to see that as the mass market, which would address all needs. That is on the client side. It is moving, but there are parts of the population that have not started to move that will be more complicated to integrate and to reassure on those topics. La Banque Postale have done a lot of pedagogy on a collective basis. Big banks have been the other actors in the system, as well as public authorities.

The technical infrastructure has to be profitable in the long run. Supervisors are also looking at that, so companies need to be sure that what they run as a whole is profitable. Resilient infrastructures are needed. If someone needs to make an instant payment in 10 seconds they first need an alternative when it does not work. Companies will make everything so that it works on a permanent basis, but there is still operational risk. Those risks need to happen as little as possible, meaning that there is the need for stronger investment on the surveillance of the system. Companies need to be sure that it is also safe from a cybersecurity perspective, because everyone is interconnected if there is an attack or a threat.

One additional topic that is more on the fraud side is anti money laundering, which is to reassure the bank and the management of the banks, because banks have high responsibility when it comes to anti money laundering. It is important to ensure that the rules are clear and that they are implementable, otherwise it puts banks in an extremely complex position to implement the directive. The faster it goes the less time a bank has to check that there is anything wrong, and that they have looked at things like the list and the transaction screening.

3.2 Significant fraud, inadequate pricing, and fragmented EU payment are limiting instant payment cost effectiveness, adoption and credibility

A policymaker agreed that there are lots of benefits in having a very quick transfer, but also challenges to address as e.g., money laundering suspicion where time is of the essence.

A Central Bank official stated that two factors hold back the development of instant payments. The first is the fragmentation of the market on the supply side and the second is the slow pace of change in people's habits. In both cases intervention by public authorities and public-private cooperation could be very helpful. Regarding market fragmentation, it is important to keep in mind that different automated clearing houses that Europe already has cannot ensure a full, pan European reachability of payment system providers. This is the issue with fragmentation, and this is why the European authorities have asked players to open an account on the Eurosystem instant payment platform TIPS, without any obligation to use it, in order to allow each payment system provider to be reachable.

The slow pace of change in customer's habits has already been mentioned. There are two factors that make people reluctant to use instant payments: cost and frauds. As costs are concerned, the greater competition that Europe will be able to achieve through the interconnection to the full reachability of payment system providers will play a role in putting downward pressure on costs. Another important development for costs are two recent proposals by the European Commission that the price of instant payments should not exceed the price of non-instant payments, and that the provision of non-instant payments should be accompanied by the provision of instant payments.

The incidence of fraud in instant payments is much higher than for non instant payments for normal credit risk transfers, which is a significant problem. The recent Italian experience with public private cooperation is very reassuring, because in Italy a very large share of the frauds in instant payments have been blocked or the funds have been recovered, thanks to a protocol that was defined by the Italian banking association, together with Banca d'Italia. This is a very successful example of industry initiative. Another example of useful initiative is in the field of awareness raising campaigns. Banca d'Italia, as well as industry associations and players in the Italian banking and insurance sectors are carrying out important awareness raising campaigns for a safer use of digital channels and tools.

A policymaker agreed that Europe sees a lot of fraud happening, and the timing is a challenge. What to do if the money is transferred requires a lot of innovative steps.

3.3 Further harmonisation and steep efforts to achieve payment systems and CBDC interconnectivity and interoperability at the global level should help a swifter implementation

An industry representative noted that Swift has been discussing the instant payment regulation with many European banks. Consensus is that a large proportion of SEPA credit transfers will become instant payments, especially for the retail flows. There are challenges that remain in terms of the timing of implementation, investment in the different pillars, and non-European standards for value-added services like the confirmation of payee i.e., the IBAN and name check. The check is a technical challenge, but it will be very important because the industry wants to avoid the creation of a patchwork of confirmation of payees all over Europe that will use different systems and standards. Even though there are some convergence in global infrastructures there are many differences that remain in terms of systems, jurisdiction and standards, which make it very difficult to interconnect them and to ensure truly instant payments across borders.

Interconnectivity and interoperability is an issue that the G20 leaders have made a priority to improve cross-border payments. There are different targets. One of them, which was raised in February 2022 as a priority, is interoperability between payment systems and instant payment systems. Europe is a key player in the global payment space, as it has world-class market payment infrastructures and is at the forefront of innovation; t should ensure that its payments infrastructure will be future proof, meaning that they can be interlinkable and interoperable with the other instant payment systems so that the value can flow more easily. That point needs to be tackled from the beginning.

Swift will play a role in the interoperability of payment systems. It has done that with the correspondent banking systems and connecting non-instant payment systems, but it will also have a role in the instant payment space in whatever the money or the value can take as a form. Central bank digital currency (CBDC) will be discussed at a later date, but there are 100 central banks looking at CBDCs. Based on the Digital Monetary Institute at least 25% of them will issue a CBDC in the next two to three years, but they will use different technologies and standards. Interoperability is needed. Swift made a very large-scale experiment with 18 commercial and central banks to ensure that they can exchange CBDCs between themselves, but also with fiat money, with real-time gross settlements (RTGS) and traditional systems.

A policymaker stated that an important project that is being worked on at the European Union level, together with the European Central Bank, is the digital euro. Many questions have been received, such as the impact of the digital euro on instant payments, whether a digital euro is needed if there are instant payments.

3.4 Given the still missing level of instant payment acceptance and fragmentation, possible digital euro mandatory acceptance is a concern

An industry representative highlighted that EPI would try to ensure as large a usage of the payment solution as possible. There is the possibility to integrate the digital euro into the EPI solution to make it available for all use cases. There can be synergies. For EPI it depends on what the final design is, which is why it is participating in the compatibility working group. EPI is trying to make instant payments big, and then the digital euro comes up. EPI has to be mindful about the potential confusion in the market, because it hears it in conversations with the merchants. Merchants want to understand where the priorities are and how that will be implemented. One particularly big question mark is mandatory acceptance. EPI hears that the digital euro should be accepted as the current fiat euro, so then it is everywhere and it is mandatory acceptance. The same is not true for instant payments. That will create a difference and a competitive advantage for the digital euro only, therefore pushing back the acceptance of instant payment.

What is missing is the acceptance of instant payment by the merchants, because Europe either has no solutions or fragmented solutions. That is why EPI is trying to address this and overcome this, to have one solution which will have one unified functioning which allows merchants who have just one integration and not one per market. The challenge is to understand how Europe functions with the digital euro. Europe is still struggling to become independent in payments. A public private partnership is needed to make it work, to allow competition in the market and fluidity, and to ensure it is understandable for the consumer and for the merchant side.

3.5 To avoid financial players slowing down investments on instant payment, the digital euro should be focused on replacing cash for specific use cases

A Central Bank official expressed their hope that the digital euro will come. The digital euro is partially a reaction to the declining use of cash. The use of central bank money in transactions is declining. One of the reasons to introduce the digital euro is to keep providing central bank money to the public so that citizens can use central bank money. Since it is digital it will be another means of payment. It will be another possibility to pay in stores, peer to peer or e-commerce. In that sense it will become a competitor for the existing payment methods already in place, but it can provide a boost for instant payments.

A digital euro will almost certainly be instant, so Europe will probably introduce the digital euro through a staggered approach. Not all use cases will be available within the first release. Europe will probably start with peer-to-peer transactions and also e commerce possibilities for instant euro. A CBDC would take slightly longer than two to three years to introduce the first release, but at that time the hope is that instant payments will have already penetrated through the market, and at that time that will be the standard. If that is not the case then it can offer a boost to instant payments, because if central banks are providing a solution that will be instant the commercial players will have to follow and 'beef up' their offerings to the public. In that case it can be beneficial for the penetration rate of instant payments in the market.

There can also be negative effects for the existing private sector. The uncertainty on the impact linked to the introduction of the digital euro on the payment market may slow down investments today by private parties to invest heavily in introduction of instant payment possibilities. A digital euro will not be introduced as an instrument that wants to crowd out all the commercial payment possibilities. When looking at European studies, before the pandemic almost 80% of transactions in the Eurozone at point of sale were paid in central bank money with cash. After the pandemic that percentage is now at about 50%. The National Bank of Belgium has experienced a 30% decline in market share from its payment method, which is something that the private parties have captured for themselves.

The payment market is big enough to have a central bank offering in those possibilities, and private parties can build on what central banks are going to offer. Central banks will offer a basic product, and then it is for the private and commercial parties to build on top of that with innovative solutions like conditional payments. The two can go hand in hand. When looking at the final balance the digital euro can provide a boost for the penetration of instant payments.

Sessions

IV

THE EU AND GLOBAL SUSTAINABILITY AGENDA FOR FINANCE

Avoiding greenwashing in the financial sector

1. Introduction

A regulator stated that the European Union has developed an ambitious agenda to shift its economies to a more sustainable state. The financial sector has a critical role to play in financing this transition. Given the speed of the transition, more and more firms are making claims about moving to net zero, being green or offering green products. The risk of unsubstantiated claims or greenwashing is increasing. This matters because greenwashing could undermine investors' trust in the system and impede the sector's ability to finance the transition.

2. Definition and importance of greenwashing

A regulator noted that there is a growing interest in sustainable products. According to the European Insurance and Occupational Pensions Authority's (EIOPA) Eurobarometer survey, 25% of people are aware of green insurance products. Many providers are trying to portray themselves as being more conscious of sustainability. On the other hand, 63% of those surveyed do not trust the sustainability claims that providers make.

Together with the European Securities and Markets Authority (ESMA) and the European Banking Authority (EBA), EIOPA currently defines greenwashing as a practice whereby sustainability-related claims do not reflect the underlying profile of the product, entity, or service. It can be intentional or unintentional. There is also a concern from the industry side because there can sometimes be unconscious mistakes as a result of the fragmented means of achieving a complete legislative framework. This can be a point of attention for the supervisory community. Greenwashing can mean not giving information at all or giving incorrect information to clients. Now that there is an agreed definition, the European Supervisory Authorities will publish their progress reports, and then continue to work on the Commission's call for advice.

An industry speaker stated that greenwashing is a gap between reality and perception induced by false, unsubstantiated, or outright misleading statements or claims towards customers, investors, or employees on the sustainability of a product, service, or business operation. The green transition will not happen without support from financial markets in moving and channelling capital into low-carbon industries and supporting the huge investments that are needed. Zurich Insurance is fully committed to contributing to the green transition as an insurer, investor, and employer. Greenwashing is clearly an obstacle to the green transition. It impedes capital allocation, makes it more difficult to assess climate-related impacts and exposes companies to new reputational and liability risks.

An industry speaker stated that greenwashing originated at the very beginning of green development and is now at the top of the agenda. Greenwashing harms the commercial banking sector's credibility, which is its most vital asset. Investors invest in green bonds and many people invest in green-linked savings. They trust banks with their money, so any greenwashing is harmful. There are clear green development targets for 2030 and 2040 in the EU, the US and east Asia. All these targets have a tight schedule. Greenwashing will delay this schedule and the banking sector's efforts.

The EU is a frontrunner in addressing greenwashing. It has four pillars when assessing: disclosure and reports, taxonomy and ESG ratings, data, and modelling. Greenwashing happens at all four levels. There are false ESG ratings; false information is disclosed; there is false reporting and cheating in terms of classification or taxonomy; in terms of obtaining reliable and qualified data, companies will cheat. There are three pillars and three levels of greenwashing. The private sector, the banking sector and the insurance sector must be emptied of greenwashing at all levels. Regulators must issue guidelines and mandated conduct rules to follow in order to achieve real green development.

A regulator stated that supervisory authorities need to worry about greenwashing because there is a risk of losing trust and confidence in financial markets. The problem is that it is not clear what greenwashing is, so it is impossible for supervisors to get enforcement right.

3. Why is it difficult to avoid greenwashing and what is the way forward?

An industry speaker stated that the commercial insurance side of Zurich Insurance supports large, multinational, and complex customers with a global footprint. Zurich Insurance is dependent on comparable data and understanding what underpins that data in order to make sound insurance and investment decisions. Greenwashing impedes dialogue about sustainability. It creates barriers to measurable and comparable metrics. If these challenges are not addressed, insurers and other investors could be unable to make sustainable investments at the pace and volume required. The fast-moving and evolving regulatory framework and scarce data availability could also lead to an increase in unintentional greenwashing. The lack of widely accepted definitions, standards and metrics is adding to that risk. Customers are facing challenges in the complex environment that they operate in, with different legislation in different parts of the world.

An industry speaker stated that SMBC EU considers the risk of greenwashing to be critically important in terms of its sustainability commitments, such as its membership of the Net Zero Banking Alliance and its status as a signatory to the Poseidon Principles. Greenwashing could impede SMBC's commercial opportunities as a bank and expose it to the risk of stranded assets. It is not enough to be one of the leading providers of financing for renewable energy projects. There is an ambition to further grow that. Greenwashing does not require intent, but rather a lack of data-driven standards, which the EU has had a leading position on in terms of oversight through the EU taxonomy. To address this, SMBC has invested in training, clearly documenting its standards and implementing transaction-level oversight.

SMBC is grappling with the question of gauging the materiality of impact from one market to another. SMBC EMEA covers the EU, the Middle East, the UK, and Africa, and acknowledges that its clients are starting from a diverse baseline, so applying a single standard is very challenging. The interoperability of standards would support the ease of measuring impact and speed up implementation, enabling SMBC EMEA to get to the real business of decarbonisation.

A regulator stated that there is already a regulation that information should be clear, correct and not misleading, so supervisors can already tackle the clear cases of intentional greenwashing. It is not worth focusing too much on grey areas as most people have good intentions, either due to intrinsic motivation or the fear of reputational damage. In the Netherlands, there are cases of firms underrepresenting the greenness of their activities for fear of losing their reputation.

To tackle greenwashing, it is best to go after the clear and intentional cases of greenwashing. Grey areas should be approached from a positive rather than negative angle. The best way to combat greenwashing in this grey area is to build a well-functioning and understandable system to channel the money to places where it is needed to green the world. This system includes the whole chain: issuers, financial markets, manufacturers, distributors, and marketeers. A clear taxonomy is needed, as well as good regulations that are clear, timely, and correctly ordered. The Sustainable Finance Disclosure Regulation (SFDR) is a start.

An industry speaker stated that Mastercard has a unique perspective as a bridge to the financial services industry that also touches the real economy. When discussing greenwashing, it is important to remember that the financial sector is trying to fight climate change and to better society. The centrality of data is an important point. The financial sector often talks about data not being good enough, but it is important not to make the perfect the enemy of the good. There is a growing database in ESG, sustainability and increasingly edge areas like biodiversity and nature-based solutions. Secondly, it is important to be specific about which data matters for decision-making and risk assessment. Mastercard uses data to communicate to clients about their carbon footprint.

The financial sector should think not only about the Corporate Sustainability Reporting Directive (CSRD) or European Sustainability Reporting Standards (ESRS) perspective, where the European Financial Reporting Advisory Group (EFRAG) is doing a fantastic job of defining what data is needed for transparency, but also about what is practical at the product level. Sustainable finance is not just about the asset management level, the insurance level, and the banking level. Financial institutions are allocating capital every day. The power of Mastercard having 3 billion customers around the world quickly starts adding up when considering the transactions that may be directed towards more sustainable means by using the data disclosed.

A regulator stated that it is important to guide investors to the right places. The Dutch AFM did a survey in the Netherlands and found that there is no full alignment between what investors say they want and what they do. They want to contribute, but most of the time they invest their money in companies that are already green, so the net effect is small. The current system pushes investors towards values alignment. They invest in companies whose values align with their own. That makes them feel good, but they are only investing in companies that are already green. It is clear that these investors need help.

SFDR is a disclosure regime. It was never meant to be more than that. In the survey, fewer than 5% of investors use SFDR to make decisions, so it is of limited use in guiding investors to the right places. To bridge this gap, there is a clear need for better consumer-oriented guidance. A system of labels and classifications is needed that allows investors to recognise products with an impact approach, either new capital or engagement at transition. When retail products are marketed, markets should relate the products to these objectives and make a convincing case that their products contribute to them.

A regulator noted that accompanying and educating investors to make sure they understand is an important challenge.

An industry speaker stated that there have already been several important disclosure regulations such as SFDR and CSRD. They are fundamental to green development and anti-greenwashing. Companies can provide their ESG ratings, but the banking sector's in-house system is vital. As an international bank, Bank of China has a single internal ESG rating that covers all assets and portfolios. Linked to that, the development of new modelling methodologies can address false information. Investment in IT infrastructure is needed in order to digitalise the green development process and systems, making data cleaner and more reliable so that investments are truly green.

The EU cannot do anti-greenwashing by itself because there is always arbitrage. Worldwide standards are needed. In 2021, the EU and China joined the Common Ground Taxonomy (CGT). Bank of China also issued CGT-backed green bonds. Without global standards, arbitrage will make it impossible to avoid greenwashing of financial products and real goods from all over the world. Therefore, any solution must be worldwide.

A regulator noted that the EU has an evolving taxonomy and is working to deliver on consistency. There are plenty more taxonomies outside the European environment and, as such, international consistency and interoperability is challenging, but essential.

An industry speaker stated that there are a huge number of frameworks and regulations, especially in the EU, but definitions are not completely harmonised. When making buying decisions or allocating capital through the financial systems, there is a worry about getting it right. This leads to some obtuse behaviours. At the corporate and product level, there is the concept of 'green hushing'. This is when an institution does not disclose its ESG credentials or sustainability metrics because of a worry about unintentional greenwashing. That happens at all levels, from the biggest asset managers through to individual households. There needs to be more granularity at the data set level to build strong frameworks that match up to the great work that has been going on at the principles level. The taxonomy is still not mapped to those data building blocks or data sets.

The data points are the foundations of the house. Nobody will buy a house with poor foundations. Each of those ESG or sustainability data bricks, if they are not really defined, might be estimates or proxy data. The financial sector is building regulations on top of that and deciding how to allocate capital. There can at least be movement forward with baseline data. The European Green Deal is a fantastic place to start because it has long arms into places that touch the consumer. Thinking about the circular economy directive helps in considering which data are needed in order to hold the financial sector to account. There is also encouraging thinking going on about a digital product passport. There are huge amounts of data points that can be rolled up into the corporate and financial level, but also back down into the consumer level so that consumers can make choices that are good for the climate.

An industry speaker stated that interoperability of standards between regions is a key issue for SMBC EU. The taxonomy category of transitional activities could be a practical concept to compare markets when looking at green loans in southeast Asia versus Europe or the Americas, especially in terms of intermediate performance. SMBC sees the risk of green bleaching when the gold standard is allowed to discourage meaningful, incremental progress globally. Data providers have an important role to play in streamlining and enabling comparability. SMBC will look to partners who provide those data sources to help make that practical and allow SMBC to remain competitive in the European market.

An industry speaker stated that greenwashing has the potential to alter the data and metrics used to make sound decisions. A company that is heavily dependent on its underwriting needs to be able to rely on the data points. In order to avoid greenwashing and realise the true potential of sustainable finance, the regulatory frameworks need to be completed and fine-tuned. Financial market participants need adequate time to fully understand and consolidate implementation of the new provisions.

Zurich Insurance also wants to see harmonised reporting frameworks for companies. In terms of international complexity, how the financial sector looks at data and interacts with different regulators is not to be underestimated. Transparency and common ground should be encouraged regarding the methodologies that underpin the data, such as rating models and analytical tools. Finally, market incentives and tools to drive savings and investments towards the green transition are increasingly important. That could include different vehicles in life insurance products to complement the carbon tax.

A regulator stated that supervisors need to help investors by simplifying the framework. The public consultation recently launched on SFDR is a step in the right direction. It is about avoiding jargon and helping people visualise the characteristics of different products in order to make well-informed choices. Financial literacy is one way to enhance people's understanding. Supervisors also need to help at the point of contact with people.

There are already some general requirements in place. Information needs to be clear, complete, and not misleading. For example, EIOPA published a guidance for distributors of insurance products on how they can integrate the sustainability preferences of the potential investor with the suitability assessment. A lot can be done to help clients, investors, or distributors to make informed choices.

In terms of regulation, the focus should be on consolidation and making existing regulations usable rather than introducing new ones. There is still something to be completed on the SFDR. The more important part is to implement it. The answer is to do the job as supervisors. Here, supervisors may be helped by technology, because a large amount of information needs to be checked. SupTech can help to screen what focus the supervisory community should have. Supervisors can also help in assessing the way in which products are sold.

For example, sustainability preferences can be addressed and considered in the suitability test and supervisors can monitor this via mystery shopping. In the recent review of the European Supervisory Authorities (ESAs) a coordination mandate has been given to the ESAs. When it comes to greenwashing, it is important to look at not only whether there is intention for greenwashing, but also other aspects. For example, whether the provider performed the necessary due diligence, acting with negligence when using information from third party services etc.

A regulator concluded that greenwashing is a risk to the credibility of individual firms and employers and the whole transition journey, so it is a material issue to tackle. Regulators can use SupTech tools and can already enforce existing regulation on clear, fair, and not misleading information. Regulators also need to continue working on the framework. There is an acknowledgement of the need for more clarity, better definitions and understanding, and international consistency.

If the data at the very beginning of the chain is not good, it will filter through reporting and disclosures. Besides the usual regulatory and supervisory tools, the most important feedback is to focus on the consumer and the end investor. The framework needs to work for the citizen. By considering consumer behaviours and incentives, looking at the point of sale and the advisers, and trying to make the framework understandable and simple, the financial sector will go a long way.

Transition of financial activities towards net zero

1. The financial sector has to identify the key decision points through which to deliver the fast-approaching net zero target

An official was of the opinion that the various factors the financial sector must be aware of to inform its journey towards the fast-approaching net zero target should be addressed. Market participants, regulators and central banks globally are impacted by the climate crisis, but delivery of the transition to net zero is only in the early stages. To achieve meaningful decarbonisation, there must be behavioural change and technological processes, such as innovations in hydrogen, must be harnessed. This requires capital and political will.

The EU is taking a leading role with its taxonomy to marshal the capital required and disclosure is being addressed. Gaps in the net zero regime are being filled through stress testing, supervisory practices and roadmaps, but remediation only at the EU level is not sufficient. Firms are concerned about carbon taxes, possible poor returns on sustainable investments and the longevity of transition infrastructure.

The panel will focus on what the financial sector should prioritise in transition planning in order to make a realistic contribution to greening their activities. It will also interrogate the role of public decision-making, policy formulation and capital marshalling in driving the transition to net zero.

What the non-financial information firms are asked to disclose will help the financial sector to provide a sound and efficient support to the fundamental change triggered in the economy by net zero public policies

An official stated that both upstream and downstream measures had a role to play. Upstream measures would be large and impactful changes to the economy, like the re-pricing of carbon pioneered by Sweden over 30 years ago. The EU Emissions Trading System (EU ETS) has lately taken over this dominant role, alongside policy frameworks such as the Carbon Border Adjustment Mechanism (CBAM). Some parts of Europe are also taking new perspectives on nuclear energy.

The finance sector's primary role is in downstream measures, the response to the fundamental changes in the upstream. It must take advantage of the new opportunities presented by the increased demand for investment in net zero projects. Financial intermediaries will be required to facilitate the allocation of capital, assess borrowers' credit worthiness, ensure savers a good return on investment and manage risk. Regulators must continue working as before to ensure the smooth operation of the financial sector, while being mindful not to create barriers to success when establishing new layers of regulation and reporting. The information firms are asked to disclose must be relevant, consistent and comparable.

An official summarised that upstream measures generate the business proposition that is then supported by the financial sector in the downstream.

2. Clear net zero public policies should provide clear price signals and enable firms to plan their transition. However, economic players need support, notably from the financial sector

2.1 Beyond general technology and economic directions, transition requires cooperation and support

An official noted that German corporates request a clear price signal in every case, as well as streamlined planning and approval procedures in every member state in which they wish to invest. Such alignment is essential to progress. The German Federal Ministry feels that collaboration between the financial sector, regulators, policymakers and industry is vital if the net zero target is to be achieved.

Small and medium-sized enterprises (SMEs) can sometimes find it difficult to comply with European-level regulations, reporting requirements and taxonomy. A forum must therefore be created to allow such enterprises to seek support from financial services firms and enhance their transition planning. A key cornerstone of reaching the net zero target is facilitating smaller corporates moving from the brown or yellow to the green phase.

2.2 The financial sector should demonstrate its effective commitment to net zero actual transition beyond it displaying related targets

An industry representative commented on the financial services industry's significant responsibility to take on downstream measures to capitalise on work done in the upstream. Now that the taxonomy exists, the financial sector must help corporates understand the importance of the project. The next step might be to increase the constraints placed on such enterprises. The financial sector should consider sharing milestones in liabilities, loans and bonds with investors, beyond the targets currently required. This would demonstrate that the sector is taking the challenge of the net zero transition seriously.

2.3 ESG ambitions must be translated into specific and credible objectives and embedded in companies' governance and strategy

An industry representative observed that 91% of CNP Assurances' assets are under ESG-focused scrutiny, demonstrating that decarbonisation must be addressed at every stage of asset governance. The matter must be considered first at the board level, with positive sentiment translated into specific objectives. CNP Assurances does this through membership of the UN Global Compact, commitment to achieve carbon neutrality by 2050 and significant exclusions on exploration projects. Science-based targets and KPIs are used to assess the organisation's trajectory. It also holds itself to account by publishing the carbon footprint and energy consumption of its operations.

2.4 Financial institutions must be able to understand where their customers will be on various time horizons and how they contribute to their greening

An official highlighted the value of active planning. Planners must determine the right questions to ask before establishing the complementary strategic choices to be made. Both vocabulary and broader capability must be built up. It is vital that financial firms be involved in this process, and put pressure on others to do the same, because the sector acts as an intermediary.

The financial services industry should consider where firms might be in 10 or 15 years' time and keep close watch of their exposures, rather than solely reporting on a firm's emissions today. There must be a strategy in place to ensure longevity of the net zero project and not only short-term commitment.

3. The financial sector, however, must remain wary of financial stability and investor protection with the backdrop of new and emerging stakes and risks

An official stated that the financial sector should also be wary of the potential conflict between fiduciary duty and investor protection. Investors are keen to receive information about firms' sustainability initiatives, but the simple dichotomy between green and not green might not be the end of the issue. Debates can also be had about whether 'green' is green enough. Those firms with the potential to become green in future, with the right investment, must not be dismissed out of hand.

From a regulatory perspective, the financial sector is of systemic importance. Regulators must ensure that such firms are abreast of the new risks associated with the net zero transition and dealing with them appropriately. As aforementioned, what is disclosed and how is of utmost importance. The International Organisation of Securities Commissions (IOSCO) is currently working on these issues, investor protection and regulation, with close involvement from the Swedish Financial Standards Authority (FSA). An official agreed that intra-operability of regulation and political policy is a key consideration.

An industry representative stated that a collective approach is vital, with all committing to pursue the goal of carbon neutrality by 2050. CNP Assurances has a strong and proactive shareholder base, interested in these issues. The firm has intervened in 103 general industry meetings on climate change.

The impact of climate change on biodiversity, conservation and ecosystems is also significant. CNP Assurances is taking practical steps in this regard and is the first private sector owner of a forest in France. It manages 57,000 hectares of land. Recent measurement has also indicated that 26% of the firm's investment activity is dependent on just one ecosystem. The right choices have to be made other prevent unnecessary pressure on ecosystems, the environment and microhabitats.

An industry representative noted that Mizuho in December 2022 announced its policy on net zero and publicly committed to financing whatever activities necessary to facilitate the transition, while influencing the industry as a whole on decarbonisation. The bank is focused on evaluating new technologies to assess their long-term impact. The government also has a key role to play in setting the direction of the industry. Dialogue with government had aided Mizuho in alleviating the uncertainty inherent in the newly created market on decarbonisation.

An industry representative observed that Société Générale has already commenced the transition of its financing activities and has joined the Net Zero Banking Alliance (NZBA). It is important to determine a universal approach on transition. This requires cross-jurisdiction cooperation, particularly for global financial institutions impacted by differing laws and concepts. Geopolitical factors and extra-territorial effects must therefore also be a consideration in discussion of the financial sector's role. EU-designed rules might prevent the financing of transition projects outside Europe, a particular concern when there are already a small number of projects available fitting these strict criteria.

Transition planning should also include objectives beyond the strict bounds of climate, such as energy sufficiency and social acceptance of transition measures. Financial firms on the whole feel that alignment of interests between companies, banks, investors, and public authorities, informed by easily accessible and comparable data, is a more productive path forward than transition based on penalisation.

An official added that public decision-makers can help financial institutions attain the information they need from corporates as to their transition progress. The Corporate Sustainability Reporting Directive (CSRD) and European Sustainability Reporting Standards (ESRS) are important components of this, with corporates also held to account by the International Sustainability Standards Board (ISSB). It is vital that policymakers find coherence in the various pieces of legislation, difficult for the real economy to manage, to deliver comparable data to the financial sector.

An industry representative said that it is essential for financial institutions and regulators to work together on the net zero transition as part of an integrated, long-term strategy for both firms themselves and the planet. A focus on net zero must come from senior management at corporates, who are financially incentivised to pursue the matter. Plans might also be voted on by stakeholders, meaning that targets and delivery will be of great importance.

In terms of whether decarbonisation targets are effective, an official noted that the debate is taking place at the national and supranational level, with the EU considering firming up its targets to encompass all financial firms. As the negotiations continue it is clear that relevant parties have differing views. Financial firms should take note that the relevant Corporate Sustainability Due Diligence Directive (CSDDD) was prepared by a climate ministry, not one with a finance focus.

The most useful targets are likely to be interim, to facilitate benchmarking, but these must be aligned to science-based, long-term objectives. Most effective is consideration of a range of targets. The operation of financial firms should also be considered. It is significantly easier for a car manufacturer or steel plant, for example, to comply with the EU's requirements on climate and the net zero transition. Asking financial intermediaries to do the same requires some creative thinking and stretching of definitions. Such firms should do more with the regulatory perimeter and consider that regulations likely would not be uniformly imposed across the sector.

An official stated that collective action is needed and that global standards must be defined to facilitate this. The intersection of policymaking and firm-level strategies should be carefully considered to marshal the capital required to drive the net zero transition. While interim objectives are necessary to assess progress, there must ultimately be system-wide alignment on investment strategies.

ESG issues in the asset management area

1. ESG Labels: more convergence in the EU is needed

An industry representative stated that ESG labels can be an efficient tool to attract finance towards the transition of the economy, but the difficulty remains that there are diverging rules from one label to another. Their firm considers that there should be ESG labels developed for the European level, rather than various national levels. This would be very positive for the industry and end investors because it would provide clarity with common standards, principles, and constraints.

Consistency and coherence are essential for sustainable finance and ESG. There are different pieces of EU legislation and a lack of consistency, which means that there is a difficulty across Europe. The development of an EU labelling scheme within the SFDR framework would ensure more consistency. The European Commission is going to launch a consultation on SFDR improvements, and an EU labelling scheme should be considered within this because it would create consistency and simplicity for the end client. These are success factors for the development of ESG European labels.

An industry representative stated that ESG labels can solve the problem of information asymmetry, because they are a shortcut for the user to make a choice on the integrity and quality of a product, based on the work of others. The complexity of the EU sustainable finance system means that this is especially important in the retail sector. A recognised set of labels that are comprehensible to the end investor will avoid misallocation and potential greenwashing. From there, the market can scale around a specific standard.

The Article 8 and 9 classification designations are perceived as labels, but they are actually disclosure frameworks. Therefore, there is a problem with the sustainable investment definitions that incorporate the articles.

It is interesting to see the European supervisory authorities raise concerns about the mismarketing of the classification systems as labels, which shows that this is a risk that needs to be addressed. At national levels, there are existing labels that are not aligned or are incompatible with the taxonomy of the SFDR, which has created the divergence and fragmentation of the landscape with pseudo-labels. This is not a good thing from a risk perspective.

A pan-European labelling regime is one of the missing pieces in addressing the challenge of how best to move away from the current problems. A simplified and standardised labelling regime that communicates with the end user is another missing piece. If done correctly, the introduction of a labelling regime as an evolution of the SFDR would solve the information asymmetry for EU investors.

A regulator commented that the labels are currently self-regulated. Lux-FLAG in Luxembourg has been working on labelling for many years, and it has been encouraging that the integration of sustainability-related considerations has been discussed. It is a much broader debate than just labels and is also about having the right systems and risk management processes to deliver on commitments made to investors.

The sustainability labels play a key role in the regulatory landscape and make it easier for investors to compare products via a standardised process. They also provide some assurance on the greenness of investment products by introducing minimum requirements. Clarity and transparency are necessary so that is understandable and comparable for investors.

The Commission de Surveillance du Secteur Financier (CSSF) is not broadly in favour of creating a European regulation and supervision of sustainability labels by national control authorities supervising the financial sector. This should remain with national labelling agencies, but the CSSF strongly supports the Ecolabel that is being discussed at European level. It needs to be clear to the end investor, which is a common mission for all regulators both inside and outside of Europe.

In terms of the work of the European Securities and Markets Authority (ESMA) on sustainability issues related to ESG labels and ratings, and action on greenwashing, a regulator updated that the workstream on greenwashing had originated from a call for advice from the European Commission. ESMA as well as EBA and EIOPA are faced with the task to provide a report, which will be provided in a coordinated manner with the other ESAs at the end of May 2024.

The second ongoing workstream is a public consultation on the use of fund names. The public consultation has already finished, and ESMA is currently evaluating the answers and comments.

The third workstream is waiting for the proposed legislation on ESG ratings and scores from the European Commission. This is expected in June or July 2023.

It is very clear that labelling and fund names are important because they give easy to digest information to the customer. However, if the name or rating is wrong, then there is a serious problem. An ESA call for evidence has revealed quite a list of misleading qualities from sustainability claims. These include empty claims, omissions, lack of disclosure, vagueness, inconsistency, a lack of fair and meaningful comparisons, claims with no proof, outright lies, misleading imagery and sounds, irrelevant and outdated information, and a misleading usage of ESG terminology. As a result, there needs to be consistent regulation that gives correct and understandable answers.

2. ESG ratings: What should be the content of an EU regulation?

The Chair commented that the issue of ESG labels was connected to that of ESG ratings. ESG ratings delivered by different providers also creates divergent results which adds extra challenges to the credibility, comparability, and transparency of ratings.

A market expert stated that they welcome the European Commission's proposed ESG ratings regulation due on 13 June. This is because the ratings are being widely used by fund providers to underpin sustainability assessments, and they are being used by investors who think they will achieve a positive impact with their investment if they see a good sustainability rating. The ESG ratings have been mentioned by supervisors like the European Central Bank (ECB) when they try to come up with proxies that will assess ESG risks in bank portfolios. There is a wide disparity between these ratings because different concepts are being put into these ratings by rating providers. Retail investors have also looked at the ratings as an assessment of a company's impact in the ESG space, and investors have looked at financial materiality, i.e. risks that the ESG factors pose to the products and entities they invest in. The way that impacts and risks have been combined into a single metric is very different across different ratings.

'Environmental', 'social', and 'governance' are very different dimensions so that it is not meaningful to aggregate them into a single metric and the ways different rating providers aggregate them are also different. There is no single ESG rating. Unlike credit ratings which aim to assess probability of default of the rated entity, ESG ratings do not have a common underlying metric and are proprietary measures of different rating providers. These different measures are inconsistent among each other in what they assess: Some assess absolute performance, others best-in-class performance; some evaluate the positive or negative impact to a company from ESG factors (i.e., risks), others the impact that a company has on ESG factors. It is also possible to find companies that are harmful to the environment in some ESG-labelled portfolios. All of these create a recipe for greenwashing because of the misunderstanding and confusion that results, which undermines trust in the sustainable investments.

There is a clear need to regulate this area, so the European Commission's proposal is welcome. There should be at least three elements to the proposal. The first is transparency about what is being assessed. There should not be a single ESG metric, and instead there should be a clear distinction between 'environmental', 'social', and 'governance'. There should be requirements of how the ratings align with the taxonomy to achieve sustainability outcomes, and requirements on the data used and whether the data has been verified.

The second element should be the supervision. ESMA should be tasked with supervising ESG rating providers. There should be oversight over the governance structure, resourcing arrangements, and the procedures to prevent conflicts of interest.

The third element is the prohibition of conflicts of interest. ESG rating providers should not rate the companies that they provide other related services such as advice on sustainability-related matters. Shareholdings between ESG rating providers and the companies they rate should be limited to restore trust and give objectivity and clarity to the users of ratings.

An industry representative stated that the standardisation is not desirable at present because the market is not mature enough. Another concern is that there is a lot of indemnification by companies and investors who pick the provider that makes them look best, or do not have consistency because they do not use the same data source for the same reason. This is something that regulators should also clamp down on.

It is hoped that the legislation will cover data quality and ensure that there is more transparency, accountability and the managing of conflicts of interest. Often, the data that has been used is backwards-looking, and the question has to be asked whether that is relevant and means that a company is effectively managing the transition. The ESG rating does not provide any of that information, even though the information is critical to allocate capital to the right companies. There is no notification when a data point is updated or a methodology has changed, and it is instead the role of the asset manager to check with the data provider. Money is being paid for this service, and so it should be flagged when changes are made.

An industry representative expressed the view that ESG ratings have to have integrity and transparency. The methodology must be transparent and publicly available, and the ratings need to be produced in a way that they are not subject to conflicts of interest. There should be regulation for ESG ratings. Their firm has been constructively working on this with the International Organisation of Securities Commissions (IOSCO) for four years. A number of jurisdictions are already implementing the recommendations that IOSCO came out with in 2021. It is important to stay faithful to the principle of the IOSCO recommendations when they are implemented and codified.

It must be clear what an ESG rating means. There are NGOs and asset managers that provide this as a service, so this needs to be a level playing field. The independence of ratings providers should be prioritised. The homogenisation of and political interference in methodology should be avoided if there is going to be objectivity. If this is a service that going to be integrated into financial markets, there needs to be regulation like credit rating agencies.

It may be unlikely to see convergence in the ESG rating space because there is imperfect disclosure which may never be solved perfectly because this is a global capital market. The second reason is that ESG ratings measure a wider spectrum of issues than credit ratings. The amalgamation is a problem and disaggregation is a solution. Ratings providers are trying to unpack it and deep dive into the data to the source of the information of an ESG rating.

The methodologies of the ESG ratings are different. Some providers try to only measure financial risks, while others try to measure impacts on the environment or society, and others measure both. It is critical that there is clarity as to what the product is measuring in the data and ratings spaces. There should be consistent regulation across jurisdictions that link to the IOSCO recommendations. There should be a minimum standard of quality.

3. SFDR: How to improve its implementation

A regulator stated that there are different steps in the implementation. The requirements by ESMA from the private sector and supervisory authorities had been shown in the ESMA supervisory briefing. Investors should be asked whether the broader transparency has been achieved. From discussions with asset managers, it was clear that there was still need for improvement. The SFDR has brought some level of transparency even though it may not have reached the stage ultimately desired, but there has been some clarity on the roles of financial market participants in the financial product levels.

There have been positive outcomes. This has triggered a lot of challenges for financial market participants and regulators. There needs to be a further stabilisation, strengthening and harmonisation at the European level. The European Commission has recently issued a Q&A on the definition of sustainable investments, but a clearer definition of that concept is still sought, and then we will ultimately have a clear definition of greenwashing.

There are other issues in the inconsistencies and interlinkages between the SFDR and the taxonomy regulation, where more work maybe needs to be done. This needs to be a European initiative that avoids the creation of market fragmentation, following-up on the work which has been done by ESMA. If rules are considered for product names using ESG or something similar, these rules should be introduced on all types of product fund names because SFDR relates to more than investment funds.

Having a range of different national interpretations should be avoided because there should be collaboration with the EU to find a better process. The creation of ESG disclosure templates is the important step towards targeting standardised and comparable disclosures. That is ultimately what must be achieved, and the disclosure templates need to be worked upon to enhance their comprehensibility and comparability. The disclosure templates have been reworked because of recent nuclear and gas disclosures. That was a very short-term measure to take and that is something which should be avoided in future in order not to put undue costs on end investors.

A regulator commented that prudential actions are not the main issues. The creative chaos around the ESG on financial markets should stop and clear rules were needed so that there is transparency and the removal of legal uncertainties. The right level to regulate that would be at the EU level so that there is a common definition of ESG across Europe.

For there to be transparency, there needs to be sufficient data. It should be easily recognisable whether a product is already green or in the process of becoming green, and investors should know whether they are in investing in green or best-of-class products in advance.

SFDR is not a prudential law in itself as it is a disclosure regulation. The Sustainable Finance framework must be made consistent, and therefore there needs to be a clear rule and system of what ESG means. The solution is not additional prudential buffers.

A market expert stated that there was a need for a clear definition of sustainable investment in the regulation. Different methodologies are being used by investment product providers to say what is sustainable and how the level of sustainability of a product is determined. This also applies to how the consideration of principal adverse impacts is assessed, which are currently part of the SFDR disclosures. Lack of consistent definitions impact sustainable investments do not ensure comparability between investment products of different providers.

From the perspective of the transition and growth of the sustainable sector of the economy, the grounding principle of the whole SFDR should be whether the products and instruments are allocating funds to real economic activities. There are many complex products and unresolved issues with respect to their sustainability assessment (such as derivative products), yet their resolution should follow the guiding principle that the goal of sustainable finance should be the allocation of funds to sustainable activities. This transition is rarely seen, and this is concerning.

The second element that should be tackled is the inconsistency and disparity between the definition of sustainable products per SFDR and of financial instruments per MiFID, because there are certain financial instruments that are not captured under SFDR. The question of the assessment of sustainability of those instruments remains open and at the discretion of product providers.

The question remains whether SFDR should continue to be a transparency regulation as intended, or whether it is a semi-labelling regulation where articles 8 and 9 are effectively being used as labels. There is clearly a lack of minimum requirements for article 8 and 9 products to be recognised as sustainable. There should be certain criteria with respect to sustainability performance, engagement policies, and the effective capacity of the instrument to allocate funds to economic activities. Addressing these issues is crucial to for the trust of investors into sustainable finance, because only then what is labelled or disclosed as sustainable will fulfil that role.

An industry representative noted that there is agreement that clarity was needed on many key concepts. Standardisation and comparability with other products should be allowed for to avoid diverging interpretations within the industry and by national authorities. The goal is to simplify the access of this product because intelligibility for retail clients is key. If there are concepts or products that are too complex, they are not going to meet the expectations of the end clients.

On funds naming, the ESMA proposal to introduce guidelines is welcome, but that this note should be done with absolute thresholds as they could have unintended consequences that lead to greenwashing. Instead, the actual proportion of sustainable investment should be looked at and compared to the investment benchmark. The ESG and sustainability-related terms can be applied if the proportion is above the benchmark. This is how funds naming guidance can be quickly fixed.

It is important to have the possibility to make the assessment of sustainable investment at the issuer level and not at activity level. There is ongoing consultation on the SFDR which includes the simplification of what is already in place. This consultation is welcome because it is necessary to simplify the templates. There is also a need to review the treatment of derivatives, which has not been done so far. It is important to see how they can be taken into consideration when they contribute to the ESG dimension of the product.

The availability and reliability of data is central to the issue. The proposals made on new indicators make sense, but the question is whether the data is available or reliable.

Global convergence of sustainability reporting standards

Introduction

The Chair welcomed panellists to the session on global convergence in sustainability reporting standards. Across many of the discussions about greenwashing, ESG and sustainable asset management, there are common issues such as the access to high quality and credible data and the need for comparable and interoperable disclosure and reporting. In response to concerns about the comparability of ESG disclosures and the quality of climate risk data, standard setters are beginning to turn disclosure guidance into sustainability reporting standards. The central questions are whether the baseline reporting standards are aligned with financial materiality and whether international convergence can be achieved, or rather interoperability will be sufficient. There are different timeframes for implementation, different metrics, and different concepts of materiality. The understandable increase in reporting obligations may well create temporary burdens, such as implementations, from SMEs in Europe to corporations in emerging markets.

1. The progress made by International Sustainability Standard Board (ISSB)

ISSB is finalising its reporting and has made great progress so far. Establishing global baseline standards for sustainability reporting is a major milestone. An official confirmed that ISSB is on track to publish its S1 and S2 standards in June, which will establish a global baseline for disclosures. Primarily, ISSB wants to ensure it provides information that meets investors' information needs. The term 'financial materiality' is often not sufficiently all encompassing. When it comes to investors' information needs, it is important to understand that ISSB requirements will include information on greenhouse gas emissions, for example, because investors need to understand the transition risks produced by those emissions. This is not a question of single materiality; the disclosures include information about the impacts of entities on the environment and society when necessary is to meet investors' information needs. ISSB wants to make sure the information provided enables investors to make global comparisons, looking at global capital markets and the need to make allocation decisions around the world. ISSB's goal is to enable companies to communicate information about sustainability risks and opportunities to investors alongside their financial statements. This type of reporting uses the same filter as a financial statement: it does not include every possible piece of information; it only includes information that is significant to investment decisions. To make this baseline global, ISSB is working hard to ensure the process takes account of global input. ISSB received 1,400 comment letters on its first two exposure drafts, and it has a jurisdictional working group that includes the UK, the US, Europe, Japan, China, and the International Organization of Securities Commissions (IOSCO). As part of this effort, ISSB and partners are working to make sure its baseline is fit for use around the world. IOSCO endorsement of the standards, for example, would signal that they are fit to use as a basis for reporting around the world. Once the standards are finalised, ISSB will ask jurisdictions to adopt them as a global baseline.

Finally, while the role of the IFRS Foundation and the ISSB is to meet investors' information needs, there are other important information needs and other users of information. This is why it is important that the ISSM has taken a building block approach. The global baseline can be used to meet investors' information needs and then incremental disclosures can be added to meet the needs of others. This demonstrates why interoperability is critically important. It will be more efficient if companies report using a global language. If there is a need for incremental disclosures to meet other needs, those can also be included. This illustrates why ISSB's partnership with the Global Reporting Initiative (GRI) is very important. Between ISSB and GRI, a broad range of information can be delivered to meet different information needs.

An industry representative noted that Morgan Stanley has advocated a phased approach, and it is exciting to see that ISSB has built on some of the things Morgan Stanley has already implemented, such as the Task Force on Climate-Related Financial Disclosures (TCFD) report and the Sustainability Accounting Standards Board (SASB) standards. ISSB has indeed used those as building blocks and then added other kinds of innovation, such as the methodology developed by the Partnership for Carbon Accounting Financials (PCAF) to quantify the emissions of finance, which is very material for banks. Ultimately, it is very gratifying to see that ISSB is in touch with the reality of the situation for banks. There are significant issues around data quality, the lag in some of this data and the question of scope three reporting relief for banks. If banks are going to hit their net zero goals, their clients will have to decarbonise. For that reason, the banks must be part of the conversation.

2. The progress made in the European Union

In terms of moving above the baseline, Europe is in the lead. An official described how the European Financial

Reporting Advisory Group (EFRAG) started its journey September 2020 in the context of the European Commission's policies on sustainable development and sustainable finance. In April 2021, the European Commission tabled its proposal for the Corporate Sustainability Reporting Directive (CSRD). EFRAG delivered its technical advice to the European Commission in November 2022 and there are now draft 12 standards. There is one general standard of definitions and critical concepts; one cross cutting standard to ensure there is no repetition regarding the interaction between sustainability matters and the company's governance, strategy, business models and management of impacts risks and opportunities; and 10 topical standards that address the environmental, social or governance matters that are generally considered as key.

This creates a comprehensive system. To develop it, EFRAG used a process involving exposure drafts, public consultation and a streamlining exercise following the consultation. The Commission will now determine how to take action through a delegated act in summer 2023. The goal is critical, but it is also important to bear in mind the need for phasing in and streamlining. To avoid greenwashing, there is a need for real substance that extends beyond a single topic. This can be done on a step by step basis or by starting with comprehensive coverage and then reducing the size of the step on day one and progressively phasing in the implementation. EFRAG is also working to produce precise comparisons to ensure there is interoperability between the most acknowledged sets of standards.

A policymaker emphasised the need for this issue to be discussed regionally and internationally. Climate change is global. It is everyone's problem, and a massive amount of public and private capital must be allocated to the transition and to green and sustainable projects. Many global companies need to be part of the transition. The more consistent, convergent, and interoperable the various frameworks are, the easier it will be to ensure that global firms can do the necessary reporting. This need for international discussion also demonstrates why the European Commission supports the work of ISSB: it is a baseline to build on, while some jurisdiction may wish to go further. Europe has been on this journey for some time already, which means it has a wider scope of its reporting obligations and has already looked at areas beyond climate.

In terms of double materiality or financial materiality, it is important to focus more on the substance of what is being said and less on the words being used. Double materiality is core to the EU's CSRD framework. The European Commission firmly believes in the need to look not only at how companies impact the environment but also at how the environment impacts companies. It is clear that financial materiality and company impact are intertwined. This comes through in some of the standards being developed by ISSB. Almost all of the adverse impact throughout the supply chain will also have financial materiality. This means there is a large intersection between CSRD and the work of EFRAG. There can also be a useful intersection between the European Sustainability Reporting Standards (ESRS) and the standards being developed by ISSB. There is broad scope for alignment here, such as using the same definitions. However, it is worth remembering that different institutions have slightly different mandates. CSRD fulfils many policy objectives which are clearly not in ISSB's mandate. This should not be a distraction: there is considerable common scope and a substantial amount of common good work going on.

An industry representative noted, as a preamble, that one objective of sustainability reporting is to bring transparency on how and whether a company is really embedding sustainability at the heart of its business activities and development. It is also a means to encourage a behavioural change.

EFRAG's significant efforts to produce a comprehensive set of standards in a limited time should be acknowledged. It took on board many comments from the exposure draft stage, including calls to further align with the direction being taken globally where possible. Indeed, interoperability is critical for global players. The existence of a dialogue between EFRAG, ISSB and GRI on interoperability is very positive. It will be important to see the outcome of such dialogue when the respective final standards are issued.

It is expected that ESRS will incentivise companies to think about their sustainability practices and, as a result, they have the potential to promote changes in companies' behaviour. However, they set the bar very high. They are comprehensive, extensive, and occasionally very granular. This will represent a major challenge for companies, particularly newcomers that are unfamiliar with the preparation of non financial information. The quality of sustainability reporting is contingent on the quality of the standards, but it also depends on the quality of the information systems and internal controls. In that respect, the smaller companies being brought into CSRD are not yet sufficiently equipped with the requisite systems and controls. As a result, these firms will need time to implement. It is essential to acknowledge that it will take time to get quality data. This means there is a need for a greater degree of phasing in.

It is important to remember that Europe's sustainable finance action plan is very ambitious. It is not only CSRD; there are plenty of other new texts to apply, such as the environmental taxonomy. Companies have been struggling to implement the reporting for the two climate change objectives in the taxonomy for the past two years. Earlier this month, the Commission released its draft delegated act for the four other environmental objectives and made changes to the requirements for the climate taxonomy, with an application date for reporting in 2024. This means companies should already be collecting 2023 data to report in 2024 while also working on preparing the upcoming ESRS reporting. Taken in sum, these new requirements create a significant implementation burden. It would be appreciated if the European Commission could ensure a greater degree of coordination and take a broader view on enabling companies to implement these very important regulations. The European financial industry needs the resulting information, but coordination, streamlining and phasing in are necessary to ensure that good quality information is produced.

3. The situation in the USA, Switzerland, and Japan

An official (Hester M. Peirce, speaking only for herself as an SEC Commissioner) reported that the Securities and Exchange Commission (SEC) has proposed a set of requirements around managing climate risk and identifying weather or climate related effects on financial statements at a very granular level. This includes a large number of quite particular disclosure requirements, which are designed to make climate a bigger part of companies' decision making. The SEC's limited scope of authority is important to bear in mind as we discuss convergence: its role is to ensure that there is financially material information, which is information that affects the long term financial value of companies, not to provide information to other stakeholders. A large amount of the feedback received by the SEC has focused on Scope 3, and there were also questions around the impact on smaller entities and the timing of disclosures. Additionally, the Supreme Court's 'major questions' doctrine, could affect the scope of the final rules.

An official stated that Switzerland is an example of a jurisdiction that will not introduce its own disclosure rules. Switzerland has decided not to add to the fragmentation of the market. It is not worried about comparability, interoperability, or convergence. Instead, it is focused on the development of feasible, reliable, credible, and effective disclosure. Switzerland's work in this area is principles based. Its disclosure rules have been introduced for large listed-companies and will come into effect in 2024, which will include all three scopes, double materiality, and transition plans. When ISSB has published its work, Switzerland will decide whether to converge or introduce it into its standards. The use of forward looking metrics is particularly important because these are more relevant to climate decision making. Science based targets are also a key topic in Switzerland. Switzerland wants comparability, comprehensiveness, and reliable data. It will remain at the forefront of this topic, taking a principles based approach.

An industry representative emphasised that Japan is in a similar position to Switzerland in the sense that Japan is looking at the US, Europe and ISSB. As of April 2022, Financial Services Agency Japan (JFSA) and the Japanese stock exchange required large companies listed in the prime market to report based on TCFD or an equivalent standard. As of March 2023, JFSA is requiring all companies issuing securities to report their sustainability strategy. This requirement is broad based, though there is some detail regarding human capital. It is understood that JFSA is taking this broader approach because it is waiting for ISSB to finalise its standards. The Sustainability Standards Board of Japan (SSBJ) will be drafting its standards based on the ISSB's. The issue of convergence, comparability, interoperability in the area of sustainability reporting is something Japan will have to address down the road. As a comparison, on the accounting side, there are four different standards (IFRS, modified IFRS, US GAAP, Japanese GAAP) that can be used in Japan. Hopefully, this type of fragmentation will not happen again in relation to sustainability reporting.

4. Implementation challenges: scope 3, SMEs, and capacity-building

An official (Hester M. Peirce, speaking only for herself as an SEC Commissioner) outlined the SEC rule's approach on Scope 3 disclosures. In the SEC's proposal, if a firm has public Scope 3 targets or its emissions are material, it must disclose them. Even if a company only has to disclose them if they are material, has all companies may have to calculate them to determine if they are material. A safe harbour was also contemplated, but the SEC received many comments indicating concerns about whether the proposed safe harbour was adequate. Smaller companies such as farmers and other small businesses have also pointed out that public companies with Scope 3 burdens will mandate that the companies in their supply chains also comply with these rules. Even if the SEC does not adopt a Scope 3 requirement, other requirements within the proposal deal with value chains and thus entities in public companies' value chains may still feel the effects of the rule.

An official noted that ISSB received extensive feedback on the importance of proportionality. In finalising the standards, ISSB has done several things to address this issue. For example, companies with more limited resources can provide qualitative instead of quantitative information in some instances. ISSB has also developed a measurement framework for scope three emissions that requires firms to do what is reasonable for them. The use of estimation rather than direct measurement is acceptable if the process is explained. Onboarding is crucial. ISSB is keen for firms to start on this journey. ISSB needs to help people learn this new language, and eventually they will become fluent in it. At the beginning, there will be estimation, approximation, and qualitative information. It will become more quantitative over time.

The work of ISSB begins with drafting the standards, but it will quickly move into capacity building. The discussions about capacity building were initially to do with the global south, but it has become clear that capacity building is needed across markets globally. This is a new way of reporting even for sophisticated companies in developed economies.

An official noted that EFRAG is also working on capacity building. First, it is going to provide implementation guidance and open an access point for questions and answers because it is somewhat difficult for people to navigate the ESRS. Secondly, it is going to create an ESRS e hub where documentation will be available. Finally, it is collaborating with other bodies on education. Additionally, biodiversity is high on the agenda politically and economically. Everybody realises that it is a key goal. However, the field is much less mature than climate. EFRAG has produced a draft standard called E4, which is a significant step because it is highly principles based. The Commission will have to make a decision on phasing, but EFRAG is prepared to work with TNFD and others on biodiversity. ISSB will also be consulting on the agenda in respect of how and when to approach biodiversity. In general terms, sustainability-related data is currently nowhere near where it should be. The European financial industry needs to do what the Romans called festina lente. 'Hurry but do it in proportion'.

An industry representative agreed that capacity building is a challenge. The auditing profession is investing in accompanying companies meet these challenges. Investments are being made in the audit and professional services firms to elevate professionals' knowledge on ESG matters, to recruit ESG experts and to develop tools and methodologies. Auditors' institutes are also playing a significant role here to embark not just the large players, but also the smaller and medium size audit firms, as there is a need for capacity-building in this audit segment as well. The smaller non-listed entities included in the CSRD, and those in value chains, are not necessarily audited by large networks. They also need to be accompanied by their auditors on the journey.

An industry representative emphasised that, while Morgan Stanley thinks about capacity building both internally and externally, it is important not to tamper with innovation. In Morgan Stanley, there is a considerable degree of governance, controls, and oversight on ESG related activities. It is important to make sure innovation is encouraged inside financial services and capital continues to be directed to the technologies and solutions that can help decarbonise and reduce, capture and lower emissions at the necessary rate of speed.

5. Progress on biodiversity and other nature-related reporting standards

An official highlighted that biodiversity is high on the agenda politically and economically. Everybody realises that it is a key goal. However, the field is much less mature than climate. EFRAG has produced a draft standard called E4, which is a significant step because it is highly principles based. The Commission will have to make a decision on phasing, but EFRAG is prepared to work with TNFD and others on biodiversity. ISSB will also be consulting on the agenda in respect of how and when to approach biodiversity. In general terms, sustainability reporting is currently nowhere near where it should be. The European financial industry needs to do what the Romans called *festina lente*. 'Hurry but do it in proportion'.

An industry representative agreed with these comments, including the need for *festina lente*. TNFD is trying to be what TCFD has been for ISSB's S2. A lot is being learned from EFRAG's work. Although TNFD copies much of what TCFD has done, it has also developed six new general requirements. The first of these requirements is about the approach on materiality. TNFD is trying to be neutral on materiality and let the reporter explain their approach. The building blocks are similar to what is in the Global Biodiversity Framework (GBF). It includes impact, dependency, risk, and opportunities. TNFD is taking a maximum approach that is also flexible and allowing companies to choose which materiality approach to take, so that the framework will be interoperable across jurisdictions.

An official noted that Switzerland is very supportive of TNFD. As another speaker has mentioned, there is a need to bring companies to the point where they can use the standards and make disclosures in a meaningful way. Switzerland created a national consultation group amongst its financial institutions and companies to test the TNFD recommendations before they are finalised. This is helpful for TNFD, but it also gives Swiss companies the chance to gain some experience of the standards before they enter force. It is essential for ISSB and others to build closely on the TNFD network when considering the approach to take in biodiversity. The complexities and challenges are well known. In this context, it is also important to bear in mind the need for location specific data and the acceptance of more diverse situations than apply to climate.

An official explained that ISSB would soon be publishing a request for information to determine its next focus. Four candidate projects have been identified by staff's research: biodiversity, ecosystems, and ecosystem services; human capital, such as diversity, equity, and inclusion; human rights, such as supply chain issues; and whether ISSB should work further on integrating the reporting between financial statements and sustainability reporting. ISSB wants to know which of these projects are important to market participants for prioritisation, how it should proceed and which existing materials it should refer to, to build upon.

The Chair noted that the panel had identified three key challenges to progress towards reporting standards. Clearly, substantial progress has been made. There are implementation challenges, but all of the panellists' organisations are trying to develop practical ways to overcome the challenges and bring their respective stakeholders on board. Additionally, biodiversity is becoming part of the reporting agenda. In light of the important progress that has been made so far, efforts are underway to support the inclusion of biodiversity risks and opportunities in the mainstream of sustainability reporting in the years ahead.

Climate change insurance needs

1. Rapidly rising climate change risk impacts citizens as well as non-life insurance and reinsurance companies

1.1 The occurrence of natural disasters is increasing significantly

The Chair introduced the session on the role of insurance when dealing with natural catastrophe and how society risk can be managed. These are happening more frequently, are more intensive and damages are going up.

An industry representative noted that catastrophe impact depends on the business an entity does. For life business, there has been limited impact in Europe. Weather events and heatwaves can claim a lot of lives, but it does not show in premiums. On the other hand, there is a major impact on property and casualty lines. In France, droughts that happened every five years now have a 95% chance of happening every year, according to the Intergovernmental Panel on Climate Change (IPCC). Yet with European storms, there is not any visible change so far in the pattern. Then there are events that have not been seen before, such as hailstorms so severe than they trigger business interruption. Weather events previously cost to Groupama 7% of its property and casualty (P&C) premiums. Last year they cost us 14% of our P&C premiums. The impact on reinsurance is also stark. Reinsurers will not pay those claims in future. Insurers will keep more of the tail risk, but t in any case he public bears the brunt of it, which is going to change the economics of the P&C business.

1.2 Increasing natural disasters lead insurance companies to address the issues of possible moral hazards and insurability of certain physical exposures, beyond the necessary adaptation advice to their customers and insurance policy repricing

An industry representative explained that underwriting is where the insurer assesses the risk and has dialogue with the client regarding the risk exposure. Insurers tell clients that risks will be twice as frequent and severe in the future. The challenge of pricing is about not only an increasing risk but also insurability, mutualisation, and responsibility. Some assets may become uninsurable. Insurers have to reconsider the question of the balance between mutualisation and responsibility. It is the responsibility of individuals to pay for the real risk. Pooling is the solidarity between high exposed risk and low exposed risk. The price signal of the risk is also crucial for the education of the system.

Crop insurance in agriculture is facing another challenge. There is a lack of symmetry in terms of information. Farmers do have a better understanding of their real risk in comparison to an insurer. There needs a better-balanced knowledge of the risk. Technologies like satellite imagery and crop modelling will be instrumental.

1.3 Fast evolving nature-related risks impose further forward-looking risk assessment approaches leveraging shared swiftly-updated data

An industry representative advised that there is a need to share some risk data, though some is at the core of companies' strategy and may impede the competitiveness. Data on losses is very difficult to share. Model building is important. The European Insurance and Occupational Pensions Authority (EIOPA) has standardised some measures to adapt to climate change in contracts. The framework is the same to analyse the potential of the dedicated prudential treatment of those risks and impact on the solvency requirement. It is very important to have common rules.

The Chair stated that EIOPA receives a lot of data and tries to share it, recently publishing the climate change dashboard. Some data does become less available, because it becomes a commodity.

An official reported that the International Association of Insurance Supervisors (IAIS) is turning attention to the liability side to collect data.

1.4 Insurers' assets are also significantly exposed to climate related changes

An official stated that IAIS has been looking at the impact of climate change for insurers at the global level, A pilot exercise was conducted in 2021 looking at insurers' exposure from the asset side to transition risk. Within the sample, 33% to 40% of investments were exposed to climate-related assets. Depending on scenarios on transition, it was clear that there could be a wide range of impacts. There was no scenario where the impact would led to insolvency, but in the too little too late scenario the impact were significant.

2. Challenges posed to insurance companies by non-insurable natural disaster risks

2.1 Main points of concern: transition and adaptation costs, and lack of skills

An industry representative stated that things no longer being insurable depends on the clients' markets. Those who are most educated about climate change and what they need to do to be insurable are farmers. At the other end are governments and public partnerships. In the middle are the retail markets, but there is an issue that is not just for insurance. Homeowners can save energy by insulating their homes, but that is costly and will take years for the cost of insulation to be recouped through lower energy costs. People will not spend to proof their homes just to capture lower insurance premiums. A few customers may be convinced by the economics of proofing, but most people do not spend time with insurance intermediaries; they simply compare insurance prices over the internet.

The Chair noted that 75% of the natural catastrophe risks in the EU that EIOPA and the European Central Bank (ECB) identify are not insured.

2.2 Key success factors: risk awareness, premium reductions and updated insurance products encompassing support services

An industry representative stated there are three main levers to make consumers buy insurance. One is risk awareness. The second is improving the terms and conditions and any things that have an impact on the product. The last is renewing the insurance offering.

On the first lever, loss preventions can be done through loss prevention activities. It is important to also activate services such as alarming. Through the usage of artificial intelligence, there can be campaigns to inform people of what is going on and how it could be better. On the second point, it is easier to understand how to adapt with the increasing understanding of the risks. The insurance industry has to better reflect the terms and conditions, and the impacts of adaptation and mitigation measures, making the product more affordable. On the third lever, one example is parametric insurance. If insurers think about the ability to connect the service around the adaptation, they can service clients, explain the risk and offer services that helps to reduce losses.

These pieces depend on different dimensions of retail versus small and medium-sized enterprise (SME), versus corporate, or emerging market versus developed market, or even a different line of business. Two points are crucial. One is the financial education. The second is, if a good natural-based solution is implemented at the government level, the cost of adaptation and the cost of product for insuring will be lower.

2.3 In the challenging context of rising natural catastrophes, the sustainability of insurance schemes requires combining a wide insurance coverage, systematic prevention approaches, state-managed solidarity mechanisms, and compulsory deductibles reducing moral hazard

The Chair raised that claims going up are already causing a problem. Insurers can incentivise adaptation and mitigation, without which there will be a bigger issue. In natural catastrophe risk, preventions should be taken in order to capture damage. Public-private partnerships need to be considered.

An official stated the long-term resilience of an insurance scheme requires dramatic promotion of climate-related prevention and adaptation measures to reduce risk and limit moral hazard. The first step to promote prevention is to offer a wide insurance coverage of climate-related risks. France is offering a compensation scheme based on a public-private partnership with private insurance and a non-mandatory state-guaranteed public reinsurance through Caisse Centrale de Réassurance (CCR). The system is based on solidarity through an additional premium set by the government at a mandatory uniform rate on P&C contracts and responsibility, with a minimum compulsory deductible. In the framework of the natural catastrophe scheme, local public authorities which set up adaptation measures are charged with a lower premium and can avoid a higher deductible. In 2019 the CCR introduced incentives for insurance companies expanding prevention actions.

3. EU and global policy priorities in the context of rising climate related natural events: achieving the insurance sector soundness and economies transition without overregulating

3.1 European and national policy makers have an important role to play in triggering and sustaining the virtuous circle necessary to achieve an effective reduction of insurance gaps

An industry representative stated that there are four elements in the EU agenda on protection gaps. One is financial and risk education. The second one is the pooling and layering of risk: insured have to participate to reduce moral hazard, then risk can be pooled at insurers level and diversified at EU level, which will be the most cost effective at government level. Insurers have to be able to measure the protection gap and ensure that any solution can be equally measured in terms of benefits attached. Otherwise, it is speculation on something that it cannot be monitorable. Two important aspects have to be kept on the associated protection gap. First is thinking of the mitigation. The second is to support the transition. Adaptation and mitigation can be done at the same time. It is important to have EU-orchestrating ambitions with more robust fiscal stimulus on top of the Net Zero Industry Act. In order to scale up, what has been seen in the US with the Inflation Reduction Act is a game changer. In fact, is already visible the move of industrial companies to US.

3.2 Fostering both adaptation and economic development proves difficult including on the re-insurance area. This deserves further political coordination and structured cooperation regionally and globally

An expert stated that the problem globally is enormous. In Southeast Asia, the production of rice is falling and population is growing. Rice is the biggest producer of toxic carbon and methane. There is a contradiction with incentivising growth in the manufacturing industry and agriculture. The rules Europe has are principles in the West but are difficult to impose on countries which need industry development. They need electricity, produced by power plants, which function with coal and fuel. They have no renewables, no nuclear and cannot invest in those. Europe has certain models, but the system relies on a good reinsurance system. Some local insurance companies cannot find reinsurance, because environmental, social and governance (ESG) is fashionable and big reinsurers do not have the capacity nor the willingness to accept risk coming from the local insurers. There is a problem of coordination with Europe tacking in account the future of the flows of population.

There should be transition plans for the long-term set up where local companies could present to reinsurers a portfolio where, for instance, the classical production of electricity would be reduced and a growing share of renewables, so those local companies would be accepted by reinsurers. This requires probably a dedicated fund at the level of the United Nations, with the help of the advanced countries to facilitate the creation of a reinsurance mechanism or incentives, with the United Nations Industrial Development Organisation (UNIDO) and probably the Food and Agriculture Organisation (FAO).

An industry representative mentioned two sources of inspiration for the role of public-private partnerships. In agriculture, Spain is the model source of inspiration for the French system. It is a public, private and producers' partnership in force since 1978. A second source of inspiration comes from Africa, with the African Risk Capacity (ARC), which is a sovereign fund launched by the Africa Union to help countries manage their risk at a continental level. They think at a continental level and have pooled the means, the risk and the knowhow. They use cutting-edge technologies and pay quickly just after the claim (one dollar paid by insurance immediately after disaster is the equivalent of four dollars paid by ex-post aids 6 month later).

3.3 Identifying and addressing emerging insurance gaps and achieving an appropriate insurance sector tool kit with regard to climate related rising risks, are key priorities globally

An official highlighted that addressing climate-related risk is and should remain a top priority for the US Treasury Department, the Federal Insurance Office, the insurance sector and public policy conversations. There is growing evidence indicating that climate change is associated with a decline in the availability of insurance coverage in certain parts of the country. Carriers are rising rates or pulling out of markets. That has significant consequences, particularly for homeowners and property values, and can spill over to other parts of the interconnected financial system. Traditionally underserved communities are having an increasingly hard time finding affordable insurance coverage. President Biden's Executive Order in May 2021 tasked the Federal Insurance Office with assessing issues or gaps in the regulation and supervision of insurers in this important area, and assessing where there is potential for major coverage disruptions in areas that are particularly vulnerable to climate change impacts.

The Federal Insurance Office is preparing a report looking at issues regarding regulation and supervision. It is also focusing on the need for granular and decision-useful information. Quantitative work will assess the physical risk of underwriting liabilities from P&C insurers' current and historic exposures. FIO issues a proposed data collection at the ZIP code level on homeowners' insurance, tied to a specific subset of insurers, to help develop a nationwide understanding and assessment of how the US is being affected by climate-related events. Public-private partnerships can be useful in addressing climate related impacts, especially around issues like mitigation and resilience.

An official added that the ability to get informed, evidence-based information is very important. IAIS needs to consider the outward risk of climate in the insurance sector towards the rest of the economy. There will be an important statement on protection gaps, showing which direction should be worked on.

The Chair commented that in the US interesting public private initiatives are happening at the municipality level, but the world is bigger than the EU and US. There are entities that come from being insured but then lose insurance because risks become too large. But there are also parts of the world where entities never had an insurance , while more damage is caused by climate change.

3.4 Climate risk is considered as an amplifier of usual risks. The challenge is thus to effectively embed these new amplifiers in existing insurance risk frameworks and practices. In addition, however, running stress scenarios will help to address the forward-looking nature of these amplifiers and attention will be paid to greenwashing risk

An official stated that the IAIS sees climate risk as a driver or an amplifier of current risks. It does not see the need for major change to global standards, because they are risk-based and there are plenty of tools to aid dealing with risk. IAIS needs to help the supervisors and the industry to make the best use of the global standard, developing guidance and supporting material. Everyone should look at the open consultation on what to do in terms of policy work. The first step in the public consultation is on where climate risk is positioned within the introduction of the global standard. There are also changes being made to the supporting material, using the supervisory toolkit to address this risk and stakeholders are being asked about the IAIS overall agenda in terms of climate and whether things need to be added.

At the end of this year, IAIS will look at scenario analyses, stress testing for climate to propose more guidance and look at issues related to market conduct and the risk of greenwashing. In 2024, IAIS will consult on potential issues related to valuation and disclosure. There is also a lot of capacity building.

3.5 Over-regulation would play against transition

A public representative stated that the European Parliament represents more than 400 million European citizens and thus its role as a legislator must reflect their priorities. . Climate change impacts everyone. An immediate concrete and collective European response is needed. The role of insurers is crucial in the green transition, but they are only one piece of the puzzle. As long-term investors they need to be drivers of the transition. Moreover, they need to set the example and better embed climate risk in their practices. This is the aim of the Solvency II review being conducted at the European Parliament. The addition of climate scenario analysis is a push to better embed stress tests and best practices in the text.

The EU is leading the way globally with an ambitious, sustainable finance framework and regulators need to let insurers play their role. The European Parliament is pushing for an upgrade of the current rules with the Solvency II review, but there is still a margin to improve. Sustainable finance started with nothing and is now ending up compiling a mountain of legislation (taxonomy regulation, Sustainable Financial Disclosure Regulation (SFDR), Corporate Sustainability Reporting Directive (CSRD) and so on).

Currently the main worry of insurers is overregulation and regulatory coherence. If those concerns are not addressed, there will be a risk to see companies depart from the green transition. Regulation should not condemn insurers and companies but help them. Ambitious rules need to be fit for purpose and coherent. Inconsistencies can be prevented with better stakeholder consultation for example.

Sessions

V

CMU NEXT STEPS AND CHALLENGES

CMU: short and longer term priorities

1. Progress made on the Capital Markets Union (CMU) initiative

The Chair emphasised that the CMU initiative is a subject of immense importance to the future of the EU. In its latest conclusions, the European Council urged Europe to move forward on the CMU and called on the European Parliament and the Council to finalise work on the pending legislative proposals in that area before the end of the current legislative cycle.

A policy-maker stated that building the CMU is a long term project for which there has been a continuous support from European leaders since the launch of the initiative. Remarkable progress has been made in some areas of the CMU, but it is not yet finalised and work has to continue. The Commission is currently focusing on the pending proposals of the CMU action plans published in November 2021 and December 2022. The immediate priorities include the adoption by the Council and Parliament of the proposals that were made at the end of 2022 on central clearing, corporate insolvency and the Listing Act, and also the publication of two additional proposals by the Commission that are expected in the coming weeks: the Retail Investment Strategy (RIS) due to be published by the end of May, and a proposal on withholding tax aiming to simplify and accelerate procedures and also tackle tax fraud. There is an increasing sense of urgency as the end of the current political cycle is nearing to get all the proposals that are on the table adopted by the end of Q2 2024. This message has also clearly come out from the March 2023 Council conclusions.

A public representative stated that so far, the CMU's potential has not been unlocked, despite the large number of initiatives that are underway. Compared to other jurisdictions, the EU is falling behind when it comes to developing its capital markets. Our European markets still remain highly fragmented, overbanked and do not incentivise retail savers enough to invest in them. Improving regulation is part of the solution, but the CMU project needs to be addressed through a cross-sectorial approach and mobilise everyone around the objective of further developing it, i.e. citizens, businesses, supervisors and financial institutions.

A regulator observed that the completion of the CMU is progressing step-by-step. Current proposals such as the Listing Act and the European Single Access Point (ESAP) are steps in the right direction, but they are not game-changers. The Listing Act will bring useful but marginal improvements; as for ESAP, if a single access point in Europe is necessary, implementation will however take years and be costly. Regarding the remaining proposals of the CMU action plan and notably the MiFIR review, care is needed to make sure that the compromise does not distort the initial proposal of the Commission and does not maintain a fragmented approach, which is in contradiction with the CMU.

An industry representative highlighted that the CMU project had been revived five years ago, which created significant interest and hope. The two key ambitions at the time were the further integration of the capital markets in Europe and the development of retail participation, but the expected level of progress in the development of EU capital markets has not been achieved. 2022 was a bad year for capital markets, with poor performance both for fixed income and equity markets, damaging the investments of European and global investors. Even EU mutual funds, which are meant to be the backbone of cross border investment in Europe, saw €300 billion of net outflows. Retail investor participation is declining again, after an increase during the pandemic. This puts immediate urgency on not just developing a RIS to increase retail participation, but also on adapting regulations to evolutions happening in the real world, such as increasing digitalisation and consumers using their phones to invest. Some obstacles to digitalisation need to be removed, such as the obligation for all fund documentation to be physically printed and sent out.

A second industry representative stated that a key objective of the CMU is to have a more integrated market, which means breaking down barriers to the cross-border flow of investments and savings across the EU. Frictions increased in the EU financial market after stress events, such as the 2008 financial crisis and the 2010 sovereign debt crisis; these have subsided, but there is still a significant level of structural fragmentation in the market. This suggests that the measures taken to prevent and mitigate fragmentation originated by crises such as a banking crises have been effective, but there is still much work to do on the more structural areas of fragmentation in the capital market, such as corporate insolvency. Some issues that are being worked on in the context of the crisis management framework for banks can be a source of inspiration in this regard. Progress is needed on two aspects, resolution and liquidation. Areas for improvement include the clarity of definitions, the protection of creditors' interests, and reducing the complexity in the timeline of the proceedings.

A regulator stated that the objectives when the CMU was launched in 2015 were to further integrate capital markets in the EU and also to develop and deepen the markets. Much progress has been made on the first front, but not on the second one with a level of development and depth of European capital markets that remains very poor. In terms of integration, a wide range of harmonised frameworks have been adopted concerning prospectuses, market abuse, financial reporting standards and market infrastructures such as CSDs (Central Securities

Depositories) and work is underway on proposals to enhance listing, corporate insolvency rules and to set up a European Single Access Point (ESAP) and a consolidated tape. There is no issue of markets integration either when it comes to cross border investment flows in the real economy. For example only 2.5% of the assets under management of Spanish investment funds are invested in the domestic equity market. The investment flows into Spanish companies also come mainly from the rest of Europe and from non-EU investors. Capital markets across Europe are also far more integrated than banking markets.

Further growing European capital markets should be the main objective of the CMU going forward, the regulator stated. Europe still has underdeveloped markets compared to the size of its economy and also to other major economies such as the US. The EU still has three times less market-based financing than the US, and in many EU countries the primary equity markets have run dry in the last two years. 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, deeper capital markets EU companies will not be able to finance the huge investments to accommodate the two large transformations: digital and green. There is also an issue of resilience because economies for which there is a higher level of capital market financing absorb shocks better than those mainly financed by banks.

An IFI representative agreed that it is easy to invest cross border in the EU and that capital does not remain within the same country where it is raised, but at the same time there are still major differences across the EU in terms of market depth. More measures are needed in the CMU to encourage investors to invest in less developed regions. This could be done in the context of the ESAP project, by providing investors with information on investment opportunities across the EU, allowing them to make the best investment choices. Developing equity markets across Europe as shock absorbers also makes sense from a macroeconomic point of view as this should help to de-risk the European economy.

2. Main short term priorities

The panellists highlighted two main priorities that the CMU initiative should focus on in the short term: developing the participation of retail investors in capital markets, and further diversifying the financing of SMEs.

2.1 Retail Investment Strategy (RIS)

A regulator emphasised the importance of the upcoming RIS. There is a real problem, especially in Southern and Eastern European countries, in terms of risk averseness of the general public and reluctance to invest into equity. There is much discussion about inducements in the context of the RIS, but the objective of improving value for money for investors seems more important, as well as enhancing advice. Supervision is another key issue to be considered in this context, as there is still no direct supervision at the European level. Many of the complaints that national competent authorities receive from retail clients concern risky products that are sold by financial institutions based in other member states and that operate through the freedom to provide services provisions, with no local branch. Work on supervisory convergence is undertaken at ESMA level but these processes are extremely time consuming and complex to manage. The home host authority relationship needs to be reflected upon, to allow the host supervisor to intervene more easily in exceptional situations of significant problems with its national retail investors.

A public representative considered that the RIS is a key short term priority of the CMU. Access to financial advice needs to be preserved and access of retail investors to capital markets needs to be increased. On paper, all EU citizens can be investors, but the reality is very far from it. 70% of consumers in the EU have never invested in financial products. There is a need to address this significant investment gap, notably through enhancing the quality of advice and ensuring a higher degree of transparency.

In terms of policy objectives concerning retail investors, the public representative suggested that the first step is to ensure a more consistent application of existing European rules and to preserve local financial market ecosystems, in order to ensure that customers can easily access advisors locally in all European member states. Rules on financial advice already exist in the MiFID Directive and need to be implemented appropriately across financial sectors, while preserving local networks. This would ensure that as many consumers as possible have access to advice with sufficient proximity. A second priority is to nurture EU competition, so as to preserve the strategic autonomy of the EU in this field. Thirdly, there is also an urgent need to promote financial literacy in Europe, both for consumers and for financial advisors.

The public representative emphasized the importance of the role played by inducements in the areas that have been mentioned and was opposed to a ban, as it would potentially lead to a substantial increase in the cost of advice and less access to advice for investors. A ban on inducements would also raise competition issues, because it could have the effect of opening the door more widely to non-EU players that do not have their own local distribution network and may end up being the main providers of financial advice to European consumers. What is needed is more regulated inducement practices, with more transparency, more availability of information for investors and also better implementation of value-for-money principles.

An industry representative stated that the priority in the short term is to develop retail participation. Retail investment will be needed to fund the green transition across the EU. In addition, with persistent inflation in the EU, the capital of savers who do not invest in capital market instruments will be eaten away day after day. Increasing retail participation in capital markets requires addressing a wide range of issues including financial education, the provision of appropriate advice, the adequate handling of non advice channels and leveraging technology. As all issues may be difficult to cover in a single proposal, a sequential approach could potentially be adopted.

On inducements the industry representative was open minded, but suggested that the issues need to be tackled in a sensible fashion. Before any dramatic changes are made to a system that is working it will be important to make sure that the alternative non-advised channel is up and running. Lessons can be learned from the UK and Dutch experiences of banning inducements. In the UK it led to an abrupt change and a significant advice gap. Many people fell out of the system with no more access to financial advice, which should be avoided in the EU. In addition, some hurdles such as insufficient digital identification are preventing customers from accessing easily investment solutions, limiting their access to the capital markets. Technology such as the use of open finance can help to facilitate the customer journey with one common access point to financial advice and can also support non-advice investment channels.

A second industry representative suggested that there is often a confusion in the debates around retail investment rules between harmonisation and uniformity. A uniformity of products and services should be avoided, because financial institutions have different types of customers with different characteristics that need different kinds of services. Different types of financial advice and information should be available at different costs, because customer needs differ. For example, retail investors have different needs in terms of information depending on the frequency of their investments, their investor profile and the size of their investments. Striking the right equilibrium in the rules with sufficient flexibility to accommodate different types of investors and financial services should be aimed for.

An IFI representative considered that while retail investors are a priority, more also needs to be done to foster institutional investment. There are a great deal of savings in the insurance sector for example. Some changes in the insurance regulation could foster more investment from these investors in the real economy. During COVID there has been an increasing level of savings which needs to be passed on to the real economy.

A regulator suggested that a further issue that needs to be considered for fostering more retail investment into capital markets is to improve awareness about the long term benefit of capital market investments compared to bank deposits or real estate, in order to reduce some investor biases.

2.2 Diversifying the financing of SMEs

A public representative stated that the financing of SMEs is another important priority. In the EU, more than 99% of companies are SMEs but the current regulatory framework is not incentivising them to diversify their sources of financing. Although more needs to be done, the Listing Act proposal which aims to reduce the administrative burden of companies wanting to list on the stock exchange is a great example of legislation aiming at increasing the attractiveness of the EU financial framework for smaller companies.

Answering a question from the Chair about whether SMEs have access to sufficient financing in the EU, an IFI representative observed that the access of SMEs to equity needs to be facilitated. The Listing Act is particularly relevant, as it will help to cut the red tape and reduce the bureaucracy that SMEs face when they go public, which they are not well equipped to handle in many cases. The implementation of the ESAP for financial and non-financial information on EU corporates is another relevant initiative, as this can help investors to have access to information related to a wider landscape of companies. This can potentially help them to diversify their investments and facilitate the flow of investment towards companies situated in less developed regions of the EU.

Regulation is however not sufficient to make markets function properly and efficiently, the IFI representative emphasised. There is also a role for public institutions acting as anchor investors to increase confidence in the market. The European Investment Fund (EIF) is playing an important role in promoting risk capital investment to support the development of SMEs, especially in the startup phase. In addition, since the launch of the CMU project a significant development of venture capital (VC) and private equity (PE) funding has been witnessed in Europe. The sector is more dynamic now. Institutional public institutions like the EIF and national promotional banks have played a key role in structuring and developing the market and supporting start-ups. However, further along the development cycle, when SMEs reach the scale up phase and are in an IPO or pre-IPO (initial public offering) position, many of them, particularly the more innovative ones, seek funding outside Europe, in the US or Asia where larger players are able to fund large tickets. What Europe needs is the development of larger funds which can put large tickets in the firms which require more funding. Over the past five years non EU investors have accounted for 64% of lead investors for fundraising rounds between €50 million and €100 million in EU companies, and 76% for fundraising above €100 million.

There is an increasing political interest in the question of the funding of scale-ups in Europe, the IFI representative added. The EIF is running an initiative for several EU countries in the context of the European Technology Champions Initiative that will create a fund of funds of almost €4 billion, due to invest in large funds which have the ability to provide tickets at least as high as €50 million. Such strategic initiatives are necessary to keep the most innovative and the most promising enterprises in Europe.

An industry representative emphasised the importance of helping SMEs to further progress on their sustainable and digital transitions. Supporting information technology improvements in SMEs is vital, because SMEs that have better access to quality information have better options for diversifying their sources of funding.

Answering a question from the Chair about the level of access to equity financing of Spanish SMEs, a regulator stated that Spain is seeing a very similar situation to most other European countries, except some Nordic countries, with a declining number of IPOs and a limited use of capital markets, due notably to interest rates close to zero and high levels of private equity financing.

The main problem concerning SME financing is that not enough companies want to go public and issue bonds or equity in the markets. The Listing Act should contribute to facilitate the process for companies of going public or issuing further secondary capital by reducing the complexity and the costs of listing processes, without putting investor protection at risk. One measure of the Listing Act need reconsidering - the proposal to eliminate insider lists, which is a mistake in terms of prevention of market abuse – but overall it is expected that this initiative will facilitate the access of SMEs to equity funding.

The DEBRA (Debt-equity bias reduction allowance) initiative, which aims to reduce the fiscal disincentives that European companies face when raising equity compared to debt financing could also be a game-changer for fostering more equity financing, the regulator suggested. It is moreover important to avoid imposing on listed companies non-financial requirements that are not strictly related to investor needs. ESG requirements for example should be imposed on all companies, not only on listed ones, otherwise that will create further disincentives to listing. The IFI representative agreed that the DEBRA initiative is relevant because the debt equity fiscal bias is an obstacle to equity issuance. A regulator also concurred that care is needed regarding market abuse and insider dealing measures.

3. Further priorities of the CMU

A policy-maker stated that the first priority for the next five years regarding CMU is to correctly implement all the legislations that are currently on the negotiation table. Member states and the financial industry will have a significant responsibility in that regard. It is also necessary to take stock of the progress that has been accomplished over the last few years to identify pending issues. Europe's capital markets are too small compared with some other major jurisdictions, there is too much fragmentation, and there is an issue of facilitating access to the market for investors. There are also new challenges, because the world has changed since the launch of the CMU project. The transition to net zero and the fast moving digitalisation of the economy have become key objectives for which capital markets can play a role. The importance of pensions is also growing, both as a societal issue and as a challenge for the further development of capital markets in the EU. Putting the development of pension funds in a more prominent place in future CMU action plans would seem logical, although EU prerogatives are limited in that space. The Chair observed that pension funds are the bedrock of US capital markets in many respects. The development on a pan European basis of pension funds could support the development of EU capital markets and should indeed be part of the CMU agenda.

Additionally, a public representative noted that European strategic objectives to which the CMU can contribute, such as channelling private investments into the green and digital transition and enhancing Europe's strategic autonomy, should be included in the future steps of the CMU.

3.1 Cross-border supervision and supervisory convergence

The Chair asked whether more should be done to develop cross-border supervision and support supervisory convergence.

A regulator was favourable to increasing the scope of direct supervision at the European level in order to better address cross-border markets, although this is a topic that has been politically sensitive in the past. At ESMA level a peer review was recently conducted regarding the home-host relationship and the supervision of cross-border activities of investment firms under Article 16 of ESMA's legislation. For the third time in ESMA's history, use was made of Article 16, which is an exceptional clause to better monitor some players. The peer review helped to identify areas where certain NCAs needed to improve their approach to authorisation, ongoing supervision and enforcement work. Supervisory convergence however remains a cumbersome, time intensive and resource intensive process.

An industry representative added that in terms of supervisory convergence, it would be useful to make the reporting requirements for funds more scalable and usable by different authorities, and to have common definitions and benchmarks so the same piece of information can be used by different authorities and for different roles.

A second regulator observed that single supervision is not beneficial in all areas. For example it would not help companies to go public, and if they considered local processes to be too cumbersome they would just move their listing to another country.

3.2 Supporting the green transition

A regulator stated that green and sustainable finance is an example of an area that the Commission should push harder on in the future stages of the CMU, as this can foster growth which is a key objective of the CMU. Many regulations are on the table to foster sustainable finance, but following multiple political compromises at the European level during negotiations on the texts, they have ended up being very complex to implement. The Sustainable Finance Disclosure Regulation (SFDR) has different definitions of Article 8, Article 9 and Article 6. In addition, Europe has to be more ambitious for measures that may support the financing of the transition. The transition criteria are only partially taken into account in the current Corporate Sustainability Reporting Directive (CSRD) taxonomy and the related green and sustainable criteria. Transition objectives need to be reinforced in the policy framework. Green Bonds are another area where criteria may need adjusting. If the compromise on EU green bond standards leads to taxonomy criteria that are too strict, it could be difficult for the financial sector to use these tools. A more comprehensive tool is needed, but mainly targeted on the financing of the transition.

3.3 Contributing to Europe's open strategic autonomy

Answering a question from the Chair about the implications for the capital markets of the EU open strategic autonomy agenda, a regulator noted that it is necessary to consider concrete examples in the capital markets space where this may be relevant. In the EU it is necessary to develop an alternative to the UK in the clearing field for example, because clearing is strategic. The new clearing obligations proposed in December 2022 - e.g. to have active accounts at EU central counterparties (CCPs) for the clearing of a portion of certain derivatives - should contribute to the objective of encouraging more clearing activity inside the EU, which is perfectly legitimate. The difficulty with the active account obligation, however, is for regulators to define exactly what is covered by this obligation. A second example in the capital markets area that is relevant from a strategic autonomy perspective is the delegation of portfolio management activities outside the EU for EU investment funds. There is value in management companies delegating portfolio management activities to investment service providers based outside the EU, but a situation that results in shell companies being used in the EU with most of the activities based outside of the EU should be avoided. This risk has been pointed out in the ESMA peer review related to Brexit. An important aspect for supervisors is also to preserve a complete access to service providers based outside the EU in their supervisory activities.

A public representative agreed that recent proposals aimed at reducing the EU's exposure to third country CCPs would contribute to pursue the EU's strategic autonomy.

EU capital market competitiveness and integration

1. Main objectives and issues at stake

The Chair noted that competitive capital markets need to be sufficiently liquid and deep and function as efficiently as possible with the least frictions possible. Developing more competitive capital markets in the EU is an important objective for enhancing the financing of the real economy and also optimising the distribution of risk across actors and investors based in different EU member states.

An industry representative stated that competitive EU capital markets are needed to support the strategic autonomy objectives of the EU. There is a permanent tension between this objective and the desire to increase competition in the EU market which usually involves widening the access to the EU market for non-EU players in order to answer the immediate needs of consumers. In essence, the EU has a choice between being a 'finance-maker' and a 'finance-taker'. Europe has traditionally been a continent of finance makers, where many European and global financial institutions have developed. However, European regulation over the last 20 years has resulted more in opening up the EU market to competition from non-EU players, than strengthening the EU financial industry. There is also an unbalance at the international level because EU financial institutions do not benefit from the same opportunities in most non-EU markets. This could result in a progressive marginalisation of EU players and a reduced availability of competitive financial services in the EU. While developing one's own financial sector is much more difficult than just buying services from foreign companies, that is essential to make sure that Europe's future economic growth and the European social model can continue to be funded. Europe should ensure that it controls the key financial players and infrastructures needed to support this objective.

A second industry representative agreed that stronger capital markets could enhance the resilience and growth prospects of the EU economy. This is the objective of the capital markets union (CMU) project launched in 2015. At present, there is a high degree of product bias in the EU, with enormous amounts of wealth held in bank deposits. Roughly 40% of household wealth is in deposits in the EU, compared to 13% in the US. This capital is not flowing into the capital market and not contributing sufficiently to the financing of the real economy. There is also a very strong home bias, where people tend to buy local securities if they buy any at all. Europe has demonstrated a greater accessibility of its market to foreign investors than other regions. 44% of euro area equity is owned by non-EU actors, compared to 17% in the US or 30% in Japan.

A third industry representative stated that Europe must be a finance-maker and build sufficiently competitive financial markets, otherwise all market participants will lose. Continuous innovation is crucial in the capital markets industry. Self confidence is also important, because Europeans tend to unnecessarily talk themselves down, particularly on the global stage. There should be more focus on promoting and further developing European best practices and strengths. This will provide a positive momentum for the CMU. One strength of Europe is the very deep talent pools. Every country in Europe has very good universities training students in subjects that are relevant for finance and capital markets. In addition, there is a strong desire among market players to make progress on the CMU and strong political support for this objective, which needs to be capitalised on.

An official noted that there has been much focus for a long time on consumers in European legislation. Strengthening EU capital markets, which is the overarching objective of the CMU, requires enhancing the competitiveness of the EU financial sector and of the main EU financial players. Strong actors with international reach, with headquarters and substantial teams based in the EU, are needed to contribute to the massive financing that is required to support innovation. Staying competitive with regard to China and the United States is the main challenge facing Europeans in the years ahead. Financial actors that are here to stay, even in bad times, are needed to meet this challenge because foreign actors tend to reduce their activity abroad in times of crisis. During the 2022 energy crisis of last year, having strong actors based in the EU able to tackle the issues posed by the crisis proved to be crucial.

A regulator commented that there should not be a trade-off between regulation and attractive markets as is sometimes suggested in discussions about competitiveness and strategic autonomy. Deregulation should be avoided because it might lead to a race to the bottom. On the contrary, a sound, strong regulatory framework and well-designed rules support well-functioning, orderly markets. Markets are particularly fragile in the present complex economic and geopolitical situation. The EU needs well-functioning markets to weather those storms. Deep capital markets that can finance the growth of economies and support the green and digital transitions are urgently needed. Brexit has put the spotlight back on the importance of developing EU capital markets and strengthening market participants based in the EU, which is positive for the future.

An official noted, with regard to earlier comments about strategic autonomy, that an effective CMU will only function if it is open to the rest of the world. Care must be taken not to build a fortress but to attract capital from other regions into Europe.

2. Main areas of improvement in terms of capital market competitiveness

An industry representative emphasised that at present, there is not one single European capital market but a series of separate capital markets, which reduces the overall level of competitiveness of EU capital markets. Capital markets represent around 40 to 50% of GDP in the EU on average, compared to roughly 150% of GDP in the US. In terms of level of coverage of issuers by analysts, the EU and US are similar with roughly 22 analysts per company greater than $30 billion market cap in the US, compared to 19 in the EU. This suggests that the lower level of capital market financing in the EU is not due to the poor coverage of firms, but rather to fragmentation and the smaller size of capital markets.

A second issue is that savings are not being channelled sufficiently into productive capital opportunities to power the growth needed in Europe. Improving the financial education of European savers to empower them as investors should be a priority. There is already a positive dialogue between the European Commission and the OECD on these issues but this needs to lead to a more concrete plan to mobilise the savings capital. Further reform in the pensions area is also needed to channel more deposits to the EU capital markets. One of the best elements of the CMU action plan is the idea of exploring auto-enrolment, following the example of the German *aktienrente*.

A number of other areas could be harmonised, the industry speaker suggested. There are very different rules in terms of corporate control in the EU. Public takeovers are regulated differently despite the 2006 takeover directive and there are different thresholds for mandatory offers and different treatments of parties acting in concert. There is also the notorious issue of the lack of harmonisation of corporate insolvency rules. Not only the insolvency framework but also the process must be harmonised. Without a common approach to insolvency and foreclosure, there is no hope of unlocking the securitisation market in the EU either. The collateral that is viewed and is ultimately accessible as a credit enhancer should also be available in a similar way.

A third industry representative stated that the liquidity and the volume of EU capital markets are not sufficient relative to the size of the EU economy. From a global perspective, ground has been lost by the EU since the 2008 financial crisis. Despite the declared intention to further develop EU capital markets and reduce dependency on bank financing, the perception in the market is that insufficient progress is being made. Priority has been given to regulation over innovation. In addition, doing business in Europe is still like doing business in 27 different nations. Investors continue to confront diverging tax regimes, insolvency laws and post-trade practices. For example, market-making activities face different regulatory treatment across member states. In effect, there is a single rulebook but no harmonised supervision or enforcement of that rulebook, with the result that member states implement EU rules differently. A further issue is that too few retail investors are attracted to the capital markets in the EU. Increasing retail participation would benefit EU citizens and the economy and contribute to individuals' retirement savings with more diversified and competitive investment choices. A greater diversity of market participants also contributes to a more sustainable growth of capital markets and to more resilient and robust markets. Further transparency of markets, with lit order books, clear rulebooks and central infrastructures such central counterparties (CCPs), will also foster more liquidity in the EU capital markets, improving their competitiveness.

An official echoed the comments made about the insufficient competitiveness of EU capital markets and the need to adopt a more ambitious course of action with the CMU. In Europe there is still a high reliance of corporates on banks compared to the US and capital markets are under-developed. Banks represent 55% of corporate financing in Europe compared to 33% in the US. Equity markets in the EU are three times smaller than they are in the US. Moreover, only 11% of EU SMEs reported that equity funding is important for them in a recent survey. Venture capital, which is essential for financing the green and digital transition is also insufficiently developed in the EU, representing 0.2% of GDP, compared to 0.6% in the US. Cross-border equity and debt holdings have hardly changed since 2014. The important role of capital markets in terms of risk sharing and resilience also needs considering, but capital markets contribute only 5% to risk sharing in the EU, compared to 35% in the US, where they play an important role in shock absorption.

A regulator commented that although much has been done collectively to develop a single rulebook and harmonise rules in a number of areas such as consumer protection, wholesale trading and financial market infrastructures, progress is still needed in some key areas. Equity markets and IPOs are still lagging behind. There are also some frustrations around cross-border fragmentation that need further work.

An industry representative stressed that while some CMU actions, such as the Listing Act, which aims notably to introduce a single prospectus in Europe similar to the S1 form in the US, are relevant for the development of capital markets, too much energy is spent on issues that are not essential. This is slowing down the overall reform process. In the ongoing debate about the consolidated tape, most of the discussion is about how to reduce the cost of real-time transaction data for sophisticated professional users such as asset managers and market-makers, but this type of data only represents 15% of the total cost of data for the finance industry in Europe. The remaining 85% of the cost of data for European users, which is mainly provided by the major US and UK data and information consolidators, is totally outside of scope of the EU work.

3. Measures needed to enhance the competitiveness of EU capital markets

3.1 Improving the supervisory approach to capital markets in the EU

An industry representative stated that the role of ESMA and whether further supervisory coordination is needed at EU level to support the development of EU capital markets should be re-evaluated. The implementation of consolidated supervision in the banking sector under the aegis of the European Central Bank (ECB) has been very positive, but there has not been the same development in the securities market. Work is ongoing on supervisory convergence, but that might not be enough. Some other measures should be considered. For example no-action letters which have proved to be effective in the US could also be used in the EU to support innovation in the capital markets, by providing relief from certain rules until they are clarified or amended.

A second industry representative was in favour of working towards a single supervision of EU capital markets. The current fragmentation between a small group of countries with large capital markets and regular IPOs where national competent authorities (NCAs) have the necessary competences to handle the supervision of market activities and many smaller capital markets where the NCAs do not have this experience and level of competence required, is not conducive to the further development of the EU capital market. Below a certain level of IPO and trading activity, it is difficult to maintain a sufficient level of expertise. Consolidating supervision at EU level would ensure further consistency in the level of supervision and create real integration in decision-making, particularly for cross border activities.

An official added that progress towards more coordinated supervision at EU level will help to strengthen trust and confidence in the single market and ensure a level playing field. These are important factors in the development of EU capital markets.

An official agreed that the possibility of implementing a similar type of set-up as in the banking sector needs to be considered. In this set-up the supervision of the main banks operating in the EU is coordinated at the EU level through the Single Supervisory Mechanism (SSM) and the Single Resolution Mechanism (SRM).

The Chair acknowledged the comments made about the different levels of maturity and development of EU capital markets and the challenge this creates in terms of supervision. However, the argument also works the other way around. Some local authorities supervising the larger and more sophisticated European capital markets may be reluctant to delegate their powers to a central supervisory authority that may not have the same degree of specialisation or level of staffing.

A regulator stated that ESMA, with all the NCAs, is trying to foster effective supervisory convergence in the way EU rules are interpreted. It is not enough to just have the same rules; they need to be implemented on the ground in a consistent way. A great deal of progress has been made in that regard with the support of ESMA.

Answering a question from the Chair about whether a harmonised rulebook can be achieved without a single supervisor, the regulator observed that that depends on the topics in question. Decisions should be made case by case. Some issues should be addressed directly at the EU level and some are better addressed at the national level. With respect to credit rating agencies for example, there is one set of rules, one interpretation of the rules and direct supervision by ESMA. In other areas, for example retail markets, a different approach may be needed. When there is investor detriment, investors will naturally turn to the national supervisor for mediation or redress. There is a need for proximity in those direct retail situations. Coordination processes are in place to develop a consistent approach with common supervisory actions, agreed between ESMA and the NCAs. Consultations are organised in the different national markets and a common guidance is developed based on the outcome. It is a relatively lengthy process by this type of coordination allows the achievement of a convergent approach.

The regulator concurred with some previous comments that further progress could be made in terms of agility in responding to market developments. Currently, amending or updating certain requirements in the framework requires revising the ESMA regulation, which can take many years due to lengthy legislative processes. Some of the issues raised by the application of existing rules could be handled more effectively at the supervisory level with no-action letters issued by the European Supervisory Authorities (ESAs). A no action letter is a legally sound tool that can be used to inform the Commission of the need to suspend the application of a flawed provision until it is fixed, confirming to the market that it can opt not to apply or to delay the application of this rule. This could be useful for addressing some issues raised by the MiFIR regulation for example, such as being able to lift the derivatives trading obligation (DTO) in certain circumstances. ESMA can release statements at present, but these are not legally binding. Similarly, the ESAs could be entrusted with reflecting evolutions in reporting and data requirements, when technical changes must be made. This could be done more quickly at the supervisory level, rather than going through the whole political process.

3.2 Improving the legislative process with a competitiveness test

An official suggested that a competitiveness check should be introduced in the EU legislative process to verify the impact that new regulations may have on the competitiveness of EU markets and EU-based actors, such as banks, asset managers and market infrastructures. A systematic check would help to ensure that the framework supports greater competitiveness over time.

An industry representative was favourable to a competitiveness test, but observed that it needs to conducted on the final legislation. The Commission already performs an impact assessment before legislative proposals are published. That type of assessment is useful, but there are so many subsequent changes made to the legislation throughout the trialogue process that the final outcome is often quite different from the initial proposal. The Commission should perform, as an input to the trialogue process a second, possibly shorter, impact assessment on the expected benefits and impacts of the final legislation for EU markets and players. The Council and the Parliament would then be aware of the implications of changes proposed to the legislative proposal before it is finalized. This would help to avoid unwanted consequences of legislations notably in terms of competitiveness.

3.3 A more ambitious approach to the integration of EU capital markets

An official stated that the upcoming Commission should forego the current piecemeal approach to the CMU initiative and instead opt for a 'big bang' approach aiming to implement a single capital market. That would make it easier to communicate the ambition of the CMU to the general public and build political momentum around the project. Instead of constantly revising the different components of the capital market framework in an incremental way, a more fundamental review should be launched. That would also allow to better take into account the impacts of technology, which are significant.

An industry representative stated that decisive progress on the CMU will not be possible without identifying priorities for the greater good, likely to drive sufficient political support. Otherwise, CMU will likely remain a series of technical initiatives that will progress incrementally. Achieving the ambition of creating a common European capital market with the CMU may require concentrating operational or supervisory activities in certain financial centres and possibly conducting certain activities at the EU level. These types of choices were made with European monetary union and the Schengen agreement and the same should be done for CMU.

An official noted that lessons can also be drawn for the best practices that exist in the EU for channelling savings to the capital market and funding innovation, such as what can be observed in Sweden.

3.4 Better taking into account the role of different players in the capital market ecosystem

An industry representative stated that banks can play a key role in the development of EU capital markets. Wholesale banking is quite integrated in the European Union and acts as a powerful access point to capital for issuers and investors, channelling the capital from pools of capital that want to invest to corporates that need the investment. These flows can be intermediated on a pan-European basis by these wholesale banks. This illustrates the connection between the CMU and Banking Union initiatives.

A second industry representative suggested that the characteristics of different types of players must be better considered in the financial framework and particularly those providing innovative services, as this can contribute to fostering the CMU. When developing prudential rules for investment firms for example, policy-makers set out to create a bespoke regime for a diversity of market participants. However, this resulted instead in a one-size-fits-all application of banking rules to firms with no banking activities.

An official added that is it important to ensure that all the necessary actors needed to provide key activities for the CMU are available. In the clearing space for example, it must be ensured that there is sufficient clearing capacity in the EU and that EU clearing members are able to provide the services needed, notably in times of market stress. This issue is currently being discussed in the context of the on-going EMIR review. This is also true in the asset management sector, where excessive delegation to investment service providers based outside the EU may be detrimental.

Retail Investment Strategy: key issues

1. The upcoming Retail Investment Strategy proposal

The Chair stated that the upcoming Retail Investment Strategy (RIS) proposal due to be published by the end of May 2023 will be a key element of the Capital Markets Union (CMU) action plan. Retail investment is a key driver of the development and growth of EU capital markets, and beyond this, the RIS is also about increasing the interest of savers in investing for their future, matching investor needs with the funding needs of the economy and improving the effectiveness of the investment process.

An industry representative noted that the RIS should help to fund the transition to a green economy. It should also contribute to diversifying retail investments and boosting their return in a context where purchasing power and savings are eroded by the current high inflation rates.

An investor representative stressed that the CMU should not only work for the economy but also for people. Increasing citizens' participation in capital markets is essential.

2. Inducement rules: possible approaches and related implications

2.1 Potential benefits of a further restriction or ban on inducements

The Chair noted that the Netherlands (NL) banned inducements 10 years ago and is the only country in the EU that has chosen that approach so far.

A regulator stated that the ban was introduced after the NL had had a mis-selling scandal on top of the banking crisis in 2008. There was a realisation that the culture in the financial sector had to change and also a broad consensus within the financial sector that investors' interests needed to be better taken into account. This led to a ban on inducements which took 2 years to implement, as industry players had to alter business models in order to accommodate this new rule.

Suppliers now compete on the price and quality of products and focus more on investor outcomes, which has led to much lower costs for investors. The NL has among the lowest investor costs in the world, which is very beneficial for consumers. A reduction in costs of about 50-basis points makes a significant difference in the overall outcome for investors when compounded over many years. Advisors have also started advising simpler products, such as Exchange Traded Funds (ETFs) instead of more costly structured products, because there is no longer an incentive to sell complex products if these do not correspond to investor needs. Advice is also provided through digital channels in quite an innovative way. It is a misconception that inducements allow the provision of free advice, the regulator stated. It is not free because the costs are paid elsewhere and it is often more a sales pitch than advice.

In terms of enforcement, the ban on inducements has required supervisors to step in to make sure that rules are not circumvented through other forms of payments. There is also a risk of supervisory arbitrage and unlevel playing field if companies based in countries that have a different system target Dutch customers. However, despite these challenges, the experience in the NL after 10 years is satisfactory, with lower costs, simpler products, and a lively advisory sector and it is hoped that the EU can move towards more consistency in this area.

2.2 Issues raised by a potential ban on inducements

An investor representative agreed that inducements can create undue costs for consumers and also conflicts of interest, but more generally the main problem in the EU is the scarcity of independent or bias-free advice, which is a major obstacle to the development of retail investment in capital markets. The non-independent advice currently provided, that is paid for by inducements, results in limiting the exposure that customers get to lower cost products such as ETFs and listed securities and reduces investment returns over time. Statistics show that over the last five years, the funds sold with advice returned half as much as the non-advice ones, which is a huge detriment.

Differences in the structure of retail investment markets and distribution channels across the EU however need considering, a regulator stressed, because this may lead to different effects from an inducement ban. In some markets, such as France, where bank branches account for most of the distribution of investment products and also hold major investment management and insurance activities, the impact may be quite detrimental. Those banks are already under some pressure in terms of profitability and it can be expected that a ban on inducements would lead to a reduced availability of advice for low to median income households who cannot afford upfront advice fees. In addition, bank networks would have a strong incentive to limit distribution to in-house products, which would not encourage competition and probably not be beneficial for consumers either.

An industry representative emphasised that the different levels of maturity, financial knowledge, purchasing power, regulation, and access to capital markets that exist across the EU need to be taken into account in the implementation of the measures proposed. A common need across the EU is empowering people to take the right financial decisions for themselves, and to understand the opportunities and risks of different investment options. This requires a continued effort to develop a mature decision-making process among citizens regarding investments. That effort needs funding, and part of that funding comes from inducements. Inducements are used to offer free financial advice, which enables people with different levels of wealth to participate in the markets and have information to take the right investment decisions. A majority of people are indeed not ready to pay for advice upfront in most EU countries.

An industry representative observed that while inducements currently raise certain concerns, a ban would be disproportionate because of the various unintended consequences. It would reduce choice for customers leading to a stronger focus on domestic and in-house investment products. In addition, it may lead to a reduction of the availability of advice. The ban on inducements in the UK following the Retail Distribution Review (RDR) led to an advice gap with many customers no longer having access to advice. With about 7% of fees charged for advice on average, only the wealthiest and more financially literate people now use financial advice in the UK.

2.3 Alternative approaches regarding inducements

The Chair noted that the debate on inducements was often binary, but there are some intermediary solutions worth considering.

An investor representative suggested that alternative solutions to a ban have also to be looked at. One key measure would be to ban inducements on transactions where there is no advice and where it is obvious that no payment should be due. Other areas for consideration include the improvement of transparency on inducements and ensuring that investors get value for money and are dealt with fairly. A third area is to assess how competition can be encouraged in the market to tackle high costs in the provision of retail investment products. Finally, the conflict-of-interest rules across different product categories should be harmonised and MiFID rules that cover conflicts of interest in particular and that only apply to 15% of savings and investment products at present, should be extended to other categories of retail investment products, such as insurance-based products and cryptoassets.

A regulator commented that the prevailing distribution model in Europe is non-independent advisors recommending inducement-paying products. The implementation of MiFID rules has not led to a significant change in that regard. Consumers do not wholly understand what they are paying for, which means that disclosures are ineffective in this area and that increasing disclosure on inducements would not be very helpful. There need to be more radical proposals and significant changes to the current market structure to deal with the issues and encourage investors to engage properly in the financial markets.

An industry representative noted that the insurance product market is not in the same situation as the NL market was 10 years ago. There is a strong EU regulation in place, the Insurance Distribution Directive (IDD), that has resulted in a decrease of customer complaints in a number of key EU markets. The aim of life insurance and asset management products providers is not to maximise commissions but to be able to leverage the use of different distribution channels in the best way to serve their customers. At present major insurance firms sell their products through different channels, some, where commissions are paid and other that use fee-based advisory models. What is needed is to move towards a real open architecture where product providers can provide products through different distribution channels, and savers can use different types of channels in a transparent way, with or without advice and with an understanding of the implications e.g. in terms of costs. Referring to a previous remark about the possibility of enhancing consistency across the rules applying to different categories of investment products, the industry speaker acknowledged the importance of this issue, e.g. for insurers that operate both in the asset management and insurance sectors, but it is easier said than done.

A second industry representative stated that there is room for improvement on the inducement and the advice mechanisms in the EU without actually banning inducements. There are examples of best practices across the EU that need considering. Increasing the adoption of digital advice is an area of improvement, as well as enhancing disclosures to allow for digital engagement. It is essential that citizens are better informed about savings and what they can do to obtain better outcomes.

A third industry representative had a neutral position on the question of inducements. What is important is to ensure that clients' long term goals are taken into account and that recommended products and solutions are aligned with these goals and provide appropriate outcomes.

A regulator mentioned that, in certain countries, financial guidance is provided through public bodies, which could be a cheaper and impartial option worth considering, particularly during a cost of living crisis, as a stage prior to the provision of regulated advice, to help consumers identify their options and narrow down their choices, but not telling them what to do or which product to buy.

3. Main priorities and areas of focus to be considered in the upcoming Retail Investment Strategy

The panellists highlighted a number of areas on which the Retail Investment Strategy should focus, beyond the questions of inducements and advice. These include product governance, value for money, the need to adapt rules to the digital age and to enhance cross-border supervision.

3.1 Product governance and value for money

The Chair observed that suggestions have been made that the design and governance of products upstream in the value chain should be addressed in the RIS in addition to tackling point-of-sale issues such as inducements.

A regulator noted that the value for money of investments is an important element for savers on which progress is needed. 40% of them consider that the products that they are sold do not provide sufficient value for money, according to a recent Eurobarometer survey. The objective of improving product design and governance is taken into account in the Product Oversight and Governance (POG) requirements that require insurance firms to consider the best interest of customers during product design and throughout the lifecycle of a product. Proposals have been made about how to measure POG and implement it in a consistent way across EU supervisory authorities. The same should be done for value for money, so that it can be assessed in a consistent way by the national competent authorities (NCAs). Monitoring tools should be introduced, allowing the supervisory authorities to intervene, when the basic requirements in terms of value for money are not there, both at national and European levels. There should be a consistent approach to this issue across the Union because many investment products are sold across borders.

An investor representative suggested that a further objective should be to facilitate the access of retail investors to simple investment products such as ETFs, and listed securities. The retail bond market has mostly disappeared in recent years due in particular to inducement-based retail distribution and high investment thresholds. The focus of many intermediaries has instead been on more complex products such as structured retail products, e.g. based on complex indices, that have offered limited or negative returns over the last 5 years.

A regulator stated that the end outcome for investors and the value for money ultimately obtained are essential for investors. There has been a decrease over the last few years in the costs that investors face, but these remain significant and can represent up to 30% of the initial investment over a period of 10 years.

An industry representative stressed that value for money needs to be considered across the value chain, taking into consideration all intermediaries. A consistent framework is needed to achieve this because clients need to trust that value for money is assessed in the same way whatever distributor or product provider they select. This is important to build trust in the market and increase individual saver market participation. However, besides value for money, many other factors need to be taken into consideration such as performance, suitability and service levels. A European Long-Term Investment Fund (ELTIF) will always be more expensive than an ETF, so clients' preferences need to be looked at from a holistic portfolio perspective.

It is also important to build on best practices observed in the EU in terms of retail investor experience and tools used to facilitate investment, the industry speaker suggested. An example of best practice is the Investeringssparkonto (ISK) in Sweden, which is an investment savings account that is very efficient in terms of administration and how capital gains taxes are managed. More than 3 million Swedes use the ISK structure for their investments, more than one third of the population. A further example are the ETF savings plans that exist in Germany that are used by a growing number of retail investors. More than 3 million clients have signed up to plans which involve monthly investments into ETFs. These are two mechanisms that are replicable in other markets and can help to support savers in their investments.

A second industry representative stated that existing EU regulations such as the MiFID and UCITS directives already set high standards in terms of products, distribution and investor protection. The UCITS directive has been adopted by a large number of retail and institutional savers in the EU, Asia and Latin America. Concerning value for money, it is important to consider that value is not the same as cost and the two should be distinguished in regulatory discussions. An excessive focus on product costs may lead to unintended consequences. For example a charge cap imposed on defined contribution pension plans in the UK has led customers to choose the cheapest products that were not necessarily the most beneficial ones or those offering the highest value for money, which may have adverse consequences in future. It is necessary to adequately take industry and customer perceptions into account for achieving appropriate regulatory outcomes.

A regulator added that while the risks and costs associated with investment need to be taken into account, sufficient attention should also be paid by regulators and supervisors to the risk of not investing and losing money from leaving money on deposit accounts.

3.2 Adapting the retail investment framework and disclosures to the digital age

The Chair noted that digitalisation has significant implications for retail investment. ESMA recently published recommendations on so-called finfluencers who issue investment recommendations. How disclosure may be adapted to digital channels also needs considering.

A regulator suggested that there should be a clear emphasis in the Retail Investment Strategy on digital tools and digital disclosures which can play an important role in enhancing the interaction with retail investors and facilitating their access to capital markets. Digital tools can make disclosures more appealing and bespoke, with an effective layering of the information and, can facilitate a more seamless investment journey for investors. Information provided in digital form can also support the development of comparative tools for investors, for example a fund comparison tool that could be very useful for investors.

A second regulator emphasised that information and disclosures need to be fundamentally reviewed to fit an increasingly digital world - e.g. with visual layering - and adapted to the online behaviours of customers who tend to read less and less information before validating choices. Actions undertaken in different countries to improve pre-contractual information, guide investment choices, and increase retail participation thanks to digital tools have been used as a source of inspiration, in particular when defining the precontractual information for the Pan-European Personal Pension Product (PEPP), with the aim to provide customers with information in a more user-friendly way.

An industry representative observed that the provision of adequate disclosures can be challenging. There are lessons to be learned from fintechs in terms of user-friendliness and of simplicity and accessibility of the information provided. Some fintechs have indeed succeeded in making complex information on products and services much more accessible and engaging for customers, presenting information in a more visual way.

An industry representative added that the objective should be to provide customers with useful information that they can understand, rather than piling it up. Layering can play an important role in making information more accessible. This applies both to the pre-contractual information that is provided during the sales process but also to after-sales reporting. A great deal of time and effort is spent by financial institutions in providing platforms that customers can use to follow the performance of their products, access market and product information, and adjust their investments. This is an important part of the investment value chain, as many products are long-term investments that customers hold for many years.

A second industry speaker observed that it is essential to provide investors with information, advice and decision-making tools both in a physical and digital form to increase their ability to participate in the capital markets. Order execution should also be possible on digital channels with a better adaptation of documents to the digital environment.

3.3 Enhancing supervision at the cross-border level within the EU

Answering a question from the Chair about the issues raised by the cross-border distribution of products to retail investors, a regulator stated that these issues are not sufficiently considered, particularly in discussions about digitalisation. The digitalisation of the distribution of financial products should be further encouraged, as it is a way to improve competition in the retail market, but the regulatory and supervisory framework needs to be adapted to this evolution. The current regulatory framework was built when a physical presence was required to serve a customer base in a given member state. This provided the host NCA with a number of powers notably in terms of investor protection, but digitalisation has facilitated the development of remote businesses with no physical presence. In such a case, the host authority has no power to intervene in case e.g. of mis-selling according to the current rules, and the home authority is not incentivized to act quickly because the problem is not happening in their jurisdiction. The business models that rely on freedom to provide services provisions often concentrate most of the problems that are raised by consumers regarding investment products at present. This is a structural weakness of the retail single market that should be addressed in the upcoming Retail Investment Strategy. The simplest way to address that problem would be to give the host authority the same power under the freedom to provide services model, as under the branch model. Other possibilities include enhanced cooperation mechanisms between home and host authorities.

A second regulator agreed that there is a gap in supervision to the detriment of the investor when it comes to the cross-border distribution of investment products within the EU. This problem could be solved by centralising the supervision of cross-border activities at the EU level, but that is not on the cards for now. The second-best way is to increase the powers and competencies of the host supervisors, as suggested by the previous speaker.

A third regulator echoed the comments made about the opportunities offered by digital tools for developing cross-border investment and the need to take this into account in the supervisory approach. ESMA has committed to enhancing supervisory convergence in order to build collective trust in the EU single market, by making sure that there is a proper understanding among supervisors of sales processes taking place at home and abroad, and ensuring that supervisors have the data and information to properly supervise that and intervene if needed.

3.4 Improving financial education

An industry representative suggested that more emphasis should also be put on improving financial literacy throughout the lifetime of savers, starting from school. This needs to be taken into account in the upcoming RIS. There are also many actors in the market that give financial advice or information in an unregulated way. Allowing customers to continue having access to financial coaching and information that is not classified as advice is important as this can contribute to improving their financial literacy.

An industry representative emphasised that empowering people to take the right financial decisions for themselves, based on an assessment of the opportunities and risks associated with investments, should be a common objective across the EU. This requires financial education to improve the average level of financial knowledge among the general population and also among financial advisors, as well as providing access to appropriate information and decision-making tools both in physical and digital form. It is very important that formal and informal education tracks include financial literacy and sustainable investment aspects so that savers can learn how to invest for their future in a coherent way with their values. The information provided and the level of protection offered should also be segmented according to the level of experience of investors. Moreover, fiscal incentives are needed to encourage people to build wealth in an effective way.

MIFIR review: pending questions

1. The Consolidated Tape Provider (CTP) proposal

1.1 Objectives of the CT and expected benefits

The Chair noted that the negotiations between the co-legislators on the Markets in Financial Instruments Regulation (MiFIR) review proposal are in their final stage. The proposal to implement a CT for equities, bonds, derivatives and ETFs is a key element of this proposal.

A public representative emphasised that the intention of the MiFIR review is not to codify the past, but to allow capital markets to expand in order to channel capital where it is most needed. One of the areas where capital is most needed are innovative firms and projects contributing to the green and digital transformations. Innovation in these areas is supported in part by public funding, but private funding provided through the capital markets is also essential. An effective regulatory framework is necessary to support the development of capital markets in the EU, covering areas such as the provision of market data, which is essential for the functioning of capital markets. The consolidated tape (CT) proposal is therefore a cornerstone of the Commission's MiFIR review proposal. If the CT is designed properly it will provide incentives for cross-border investment and will deliver meaningful and easily accessible data for investors.

The public representative explained that the European Parliament's position is that all asset classes need to be covered by the EU CT. A phased implementation of the CT has been agreed in Parliament, starting with bonds and there could be a similar agreement in the Council. The initial idea was to start with equity because an equity CT is easier to implement, but it was finally decided to start with bonds, followed by equity then derivatives. A regulator considered that the proposed sequence, starting with bonds, then equity, then derivatives and ETFs seems the right approach for implementing the CT.

An industry representative noted that the equities and exchange traded fund (ETF) tapes will also be a valuable tool for market resiliency, because they will lessen the dependency on any one single venue with a constant stream of market data that can support trading.

A second industry representative stated that consolidating market data and bringing transparency to the market has tremendous value. Stock exchanges have significant experience in these areas and can contribute to this objective. However data on its own is not sufficient to develop capital markets, attract investments to Europe and channel capital to where it is most needed in the economy. There are many other issues to tackle such as tax, legal and post-trade implications that all need to be addressed in a holistic way. When the Nordic and Baltic exchanges were consolidated one of the objectives was to facilitate investments coming from the Nordics to the Baltics, but more than 10 years after this consolidation, no Nordic countries allow trading in the Baltics, despite having the same trading system and the same data feed on the Nordic and Baltic exchanges.

1.2 Key elements of the equity CT proposal and pending issues

A public representative explained that in the Parliament's view, the equity tape should cover real time, pre trade data up to the first five layers of the order books, in addition to post-trade data. When entering the trialogue, the position of the Council was different, calling for an equity CT that only shows pre trade data together with post trade data, therefore with a delay. Evidence gathered by the Parliament and discussions held with potential users show that the inclusion of real-time pre-trade data in the CT is technically feasible. It will also maximise the value of the CT and will serve more use cases, particularly critical use cases such as liquidity risk management and trading and portfolio management.

An official highlighted some pending questions related to the equity CT raised in the Council's position. One of the main questions is whether real time pre trade data is needed from the start for the equities CT, or whether it can be introduced later on. The Council supports a two-step approach on the equity CT, starting with post-trade data only, including top of the order book and best offer data in the form of a snapshot at the time of execution, leaving time to further reflect on the inclusion of a pre-trade CT. The data would be delivered as close to real time as possible. A post-trade tape would already be a major step forward for the EU and answer many use cases other than trading, such as providing a consolidated view of liquidity and the possibility to verify best execution requirements. A post-trade tape would also avoid the concerns around data quality and latency that have been raised regarding a pre-trade tape. There are serious concerns due to latency in particular, because of the high number of trading venues in Europe and the long distances that separate them. This could result in providing a false benchmark that could be misleading for investors, particularly retail investors. In any case, it is a very good signal that major trading venues in Europe have agreed to establish a joint venture to implement a close to real-time post-trade CT and deliver data.

An industry representative considered that for the equities CT, starting with the setup proposed by the Council seems the right approach and is a viable way forward. The first step should be a close to real-time post-trade tape, including the European Best Bid and Offer (EBBO) snapshot. Further steps may then be elaborated based on that experience, possibly extending the CT to pre-trade if necessary, but how that may be done needs to be further assessed. The CT needs to be fast to implement and cheap for users. An ESMA study concerning a possible pre-trade CT clearly underlined that a real-time CT is a much more complex setup, with higher IT costs and higher costs for the users in the market, and also with a much longer implementation horizon. Data quality is an issue also. One of the reasons why a viable CTP did not emerge following the initial MiFID II requirements was the insufficient level of data quality, especially coming from alternative execution venues such as systematic internalisers (SIs). 90% of the data of SIs is now available within the first 30 seconds after the trade execution, but 10% is still missing. The industry representative agreed with the previous speaker that latency is a key issue on the pre trade side. There is a risk with a real time pre-trade CT of building a two-tier market in Europe where front running may be possible. There is also a question about the usability for humans of a pre-trade tape with constantly changing prices. This may only be useful for computer-based trading.

A second industry representative noted that latency is a much greater issue in European equity markets than in the US, because of the fragmented geography in Europe. In the US there are much fewer data sources. Many firms have said that they will not use the tape to trade due to the latency. If a real-time pre-trade tape is implemented it will create an unlevel playing field in the market. The tape also needs to have true transparency, which means having 100% of the trades and bids, including non-price forming transactions, so that all transactions can be seen by all market participants.

A third industry representative considered that the announcements made in recent months by various consortiums of exchanges and trading venues that they would be participating in the competitive tender process to be a CT provider is a positive development, because it further evidences the viability and validity of embarking on the project. While there is a debate regarding the equity and ETF tapes about the inclusion of pre-trade data, it is important to note that the final negotiating positions from both Council and Parliament contemplate collecting pre trade data in real time. There is then a question of whether this data should also be disseminated in real time or just after, together with the post-trade data. If the infrastructure investment to collect pre trade top-of-book data from all the exchanges and multilateral trading facilities (MTFs) across the EU is being made, the speaker felt that this data might as well be disseminated on a real time, pre trade basis in order to maximise the return on the investments made. That was the approach used in the US for the equities and options markets.

A fourth industry speaker mentioned that time-to-market issues need to be closely considered to be able to implement an effective CTP. There is significant pressure to bring a CTP to market very quickly. That is not a major technical challenge, because the activities of collecting, aggregating and discharging the data as a data feed are similar to those currently performed by approved publication arrangements (APAs). The potential challenges will come from the regulatory requirements that will be imposed on CTPs and the interaction with ESMA that remains to be defined.

A regulator suggested that the optimum may be the enemy of good. The CTP project needs to move on and in that perspective an agreement on the objectives of the CTP is needed. If the objective is to implement a system that allows having an understanding of prices and liquidity across Europe for a given stock before the checking of best execution then a post trade CT that embeds pre trade elements, as proposed by the Council, is sufficient.

1.3 The specificities of non-equity markets for the CT

A public representative observed that most of the discussion about the CT has focused on the equity CT so far, but the tape is also very important for bonds and derivatives, because those asset classes continue to suffer from a lack of transparency.

An industry representative stated that the specificities of fixed income markets need to be clearly taken into account in the MiFIR review CT proposals, because equities and fixed income are two very distinct markets with very different requirements for bringing a successful CTP to market. This raises an issue of prioritisation, because while it has been recommended that the bond CT should be the first one brought to the market, its specificities have still not been properly considered in the current trialogue discussions, which are mainly focusing on the equity CTP.

The industry representative added that for corporate bonds, post-trade data has much more utility than pre trade data, given the limited frequency of corporate bond transactions, but for sovereign bonds pre-trade data has significant utility. The transparency of EU sovereign bond markets also needs to be improved to enhance the competitiveness of EU capital markets, in line with the efforts currently being made in the US to increase the transparency of US Treasuries.

An industry representative suggested that transparency needs to be improved more for bond and derivatives markets than for equity markets. Bond and derivative markets not only require a CT, but a rationalised and harmonised deferral regime so that there is useful and timely information to disseminate in the tape.

A regulator noted that there is a discussion concerning non-equity markets around whether the CT should also take care of the full function of harmonised deferral regimes and whether to embed it or not. That would be much more complicated, so that issue should be addressed separately, aiming for a full harmonisation of deferrals regime. In addition the sovereign bond market is already quite concentrated and transparent. Supervisors know where prices are formed and how the market functions, so increasing transparency does not seem to be a major priority.

1.4 Revenue distribution and sharing issues related to the CT

A public representative stressed that the unintended consequences of the tape for EU stock exchanges need to be addressed so that they can continue to play a critical function in the European markets. Both the Parliament and the Council are committed to introducing safeguards related to the revenue sharing mechanism and the opt-out or opt-in mechanism for smaller venues. The tape will also give greater visibility to smaller venues that are currently under-used because of the high cost of market data thus potentially increasing liquidity pools for trading. An official noted that the Council agrees with the revenue sharing mechanism and the carveout for smaller markets and trading venues that have been proposed.

An industry speaker stated that it is important for encouraging effective price formation in the different European markets to make sure that small exchanges do not lose out from the CT. The industry representative added that a better definition is needed of what market data comprises and what providing it on a reasonable commercial basis (RCB) means in the measures being considered. The cost of data usually refers to exchange data, but market data is not just exchange market data, as connectivity also needs to be considered (i.e. the conduits and terminals needed for providing the data). Creating exchange data has a high cost. When exchanges create data products, they use a cost-plus-margin model, but in many cases data is given out for free. Some exchanges allow their members to use the exchange's data for free to trade and provide real-time exchange data to non-professional users for a small fee. Introducing RCB concepts into legal obligations seems inappropriate at this stage, as it would pre empt the ESMA peer review. Markets are only now adjusting to the RCB guidelines which came in January 2022 and are extremely difficult and burdensome to implement and adjust to for exchanges and for their customers.

A second industry representative agreed that the revenue sharing and coverage of costs aspects are important for the CT project, as well as the definition of RCB, which is currently more a concept than a defined practice. If RCB has to be applied to the CTP or the corresponding market data contributors then a proper definition of RCB will be needed. ESMA will also need the proper competences to ensure the monitoring.

A third industry representative considered that the commercial impact of the CT on exchanges has been somewhat overstated. Exchanges will still be able to sell direct market data feeds to participants who require them for their own purposes, which is also seen in the US. Exchanges in the US do share in the revenue from the CT, and that has sustained exchanges and venues of different sizes.

A regulator observed that providing the right incentives in terms of revenue schemes and opt in is important also for driving data quality. Data quality is something that cuts across asset classes. Data vendors should be included in the discussion as they are an important gateway in the provision of data on an RCB basis.

2. Market structure and transparency measures

The Chair asked panellists to give their thoughts on the other main issues covered in the MiFIR review proposal including market structure, transparency requirements, trading obligations, and payment for order flow.

2.1 Transparency regime and deferrals

An industry representative emphasised the importance of the deferral regime for non equities and bonds. Getting information about the pricing of these instruments into the marketplace as soon as possible is essential to further deepen and develop the EU bond markets. The principle that should be embraced is one that is embodied in the Parliament's final text, which says that price deferrals should not be beyond the end of the day. ESMA would be empowered to appropriately calibrate that.

The industry speaker stated that a more ambitious and shorter deferral regime is needed for the bond market and the OTC derivatives market in the EU. The euro interest rate swap market is measured in the tens of trillions, if not hundreds of trillions. It is used by pension funds, asset managers and many other end investors who could benefit from having fairer and more competitive pricing. When the US phased in the post-trade transparency regime for its corporate bond market it was done over a three-and-a-half-year period, the industry speaker explained. The subset of securities that it was applied to was gradually expanded and the deferral timeframe shortened. It is now a 15-minute max deferral, and the Financial Industry Regulatory Authority (FINRA) already has a consultation out to shorten that to one minute. Bond markets can work very well with that level of transparency and there are many benefits with respect to pricing, liquidity, removing information asymmetries, promoting competition and deepening market resiliency. The usual counterarguments that dealers somehow cannot efficiently intermediate markets with that level of transparency are untrue. A dealer making the market for a given bond can effectively hedge most of the associated risks, because it is managing an entire inventory of bond positions and it has a number of different hedging instruments available to it with. A dealer does not need multiple days to work out a position because they are able to hedge their risk, often within 15 minutes or an hour.

An industry representative noted that improving transparency is the cornerstone of the MiFIR legislation, but there is a need to be realistic about the possible outcomes. Transparency will be improved but it might not necessarily improve liquidity. It is also unlikely to improve costs. Market data vendors act as a conduit for the producers of market data, such as exchanges, from the source to the delivery. The actual cost itself is collected by the market data vendor to be supplied back to the originator of the cost. Better transparency is not necessarily going to improve the costs, because the cost is always in the hands of the source of the production of the data. The harmonisation of deferrals is positive but there are calibration challenges ahead which should not be overlooked.

2.2 Derivative trading obligation

An industry representative stated that the EMIR derivatives trading obligation (DTO) is a rational approach to the harmonisation that is happening in the over-the-counter (OTC) derivative market. The DTO requires financial counterparties to conclude transactions in standardised and liquid OTC derivatives in scope, only on regulated trading venues. The possibility introduced in the MiFIR review to suspend the DTO for certain investment firms that would be subject to overlapping obligations when interacting with non EU counterparties on non-EU platforms seems adequate.

A regulator noted that after Brexit there was a migration of the clearing of credit default swaps (CDS). In an emergency situation sufficient powers are needed to have some management of extreme situations. That is something that needs to be addressed with powers at ESMA level.

2.3 Systematic Internaliser (SI) regime and dark trading cap

An industry representative stated that MiFID II was intended to deliver more transparency, especially on equity markets, but the opposite has happened. Transparency has diminished and fragmentation has increased, particularly due to the SI regime, which has created an unlevel playing field. The SI regime was intended for large in scale institutional orders to avoid market impact, which is quite relevant, but the reality in the market is quite different. A study from the French Autorité des Marchés Financiers (AMF) showed that the average execution size of orders on SIs amounted to €37,000, but a more recent report from Liquidnet shows that the average execution size is now only €11,000. This means that there has been an increasing divergence over the years from the initial intention of the SI regime, creating an unlevel playing field in the market. Going forward it is necessary that SIs should be restricted from executing orders smaller than four times the standard market, although this would still be far away from large in scale transactions. In addition, introducing pre-trade transparency on the quotation side is an absolutely critical piece. Mid point matching opportunities must clearly be restricted for all the smaller trades.

A second industry representative noted that a level playing field with SIs is a problem in both equity markets and fixed income. A regulator stated that one must be mindful of what is likely to happen in other European countries on the SI regime. It is important to stay aligned and to reintroduce some qualitative elements in the definition. There should also be supervisory scrutiny, particularly for illiquid instruments, because SIs still represent a significant source of liquidity.

The first industry speaker added that the dark trading cap has received too little attention in the discussion. The double volume cap did not work and the Parliament and Council agree that there should be a single volume cap, but if it only includes the reference price waiver it will be pretty meaningless. The ESMA data clearly shows the usage of the negotiated trade waiver. Up to 25% of all the trades currently run under it, so ambition is needed on this measure. What is needed is a single volume cap (SVC) that ideally encompasses SIs, frequent batch auctions, and generally as much of the market as possible to make it an effective tool. ESMA also needs a very strong and clear mandate to ensure that any future SVC is a meaningful tool to combat disproportionate dark trading.

A public representative agreed that the MiFIR review provisions on market structure are essential, but did not believe that the situation in terms of transparency was so critical in equity markets. The MiFIR review is about creating conditions for all market participants that enable them to contribute and benefit from the framework. On the equity transparency rules the proposal is to empower ESMA to refine the threshold for the use of both reference price waiver, as well as for SI quotes and execution. Parliament also maintains the Commission's proposal of a single volume cap set at 7%, and also mandates ESMA to regularly assess the threshold and the scope of the cap. The Council's position is to remove minimum sizes for the reference price waiver and for size, and sets the volume cap at the level of 10%. At this stage, it is difficult to judge what the final outcome of the joint work of co-legislators will be, because there is no easy answer to the question of the exact best calibration of the different measures.

When referring to transparency the issue of competitiveness is extremely important. The challenge is that the size of the trading can dilute markets. Parliament is mandating the calibration of the volume cap and the thresholds for the reference price waiver and SIs to ESMA, but this must be very carefully done. It must also be considered that different execution venues serve different execution needs. Some investors trade in large sizes and want to avoid market impacts, others want to trade fast and in smaller sizes, and some also combine different trading strategies. Artificially restricting the choice of execution venues should be avoided, as trading volumes could disappear rather than move somewhere else within the EU capital market. Parliament is also proposing to empower ESMA to take more data driven decisions.

Finally, the public representative added that a delicate balance needs to be struck in terms of market structure in order to strengthen European markets as a whole. It is important to introduce flexibility into the system, whatever decision is made on the levels of transparency, on caps and on thresholds, so that requirements can be adjusted at the supervisory level over time according to market evolutions. This can be done through the Level 2 legislation.

2.4 Payment for order flow (PFOF)

An official stated that PFOF - a practice whereby retail brokers forward the orders from their clients to traders in exchange for compensation and make this transparent - is a new business model that has succeeded in bringing retail investors to the market in some member states, particularly younger investors. Any compensation must be transparent, but the question was, whether a ban of PFOF is the right instrument and the decision was made in the Council not to ban it. Possible conflicts of interest can be tackled and addressed through other means.

A regulator observed that some supervisors were initially sceptical about a ban on PFOF. The optionality mechanism proposed has allowed moving towards a harmonised position. Consideration is needed of segmenting the implementation of PFOF by client nature, as envisaged by the Parliament.

3. Wrap up

The Chair wrapped up the discussion by emphasising the need for sufficiently ambitious measures in terms of transparency, market structure and CT to provide an effective market for both investors and companies. ESMA will have much responsibility in the implementation of the different measures of the MiFIR review and stands ready to take them on. There are also operational challenges that need addressing for a successful implementation of the MiFIR review proposals, which will require collective work between the private and the public sectors.

Strengthening EU clearing

1. Strengthening EU clearing and reducing over-reliance on offshore clearing

1.1 Proposals made by the European Commission to review the EMIR framework (EMIR 3)

The Chair stated that, about 16 months ago, ESMA published a report on the risks resulting from the overreliance of EU entities on UK-based central counterparties (CCPs) for euro-denominated derivatives. Three clearing services considered to be systemically important for the EU, particularly in times of stress, were identified: interest rate derivatives denominated in euro and Polish zloty and short-term interest rate futures and credit default swaps denominated in euro. The factors considered included the size of exposures of EU market participants, interconnections between these services and the EU and the availability of alternative services in the EU. The Commission then proposed a review of the European Market Infrastructure Regulation (EMIR 3). Since then, a number of events in the banking and CDS markets have demonstrated the need to continue paying close attention to the resilience of CCPs.

A policy-maker stated that the EMIR 3 review, which is part of the latest Capital Markets Union (CMU) action plan is as much about CMU as it is about Brexit. Recent years have shown that overreliance on a single external supply source in critical sectors can be risky. Supply chains can be broken, so one needs a minimum domestic capacity in key areas and then to diversify the rest. This reasoning applies to critical financial activities, including central clearing, although diversifying is difficult in clearing because it is a market where economies of scale and scope encourage concentration. There is also a need to build a domestic capacity in clearing as a basis for a large and integrated EU capital market as part of the CMU initiative. The strategic dimension of clearing appeared more acutely with Brexit, because a large part of the capacity was outside the Union for certain instruments. Following Brexit, the risk emerged of significant divergence in the rules. There has since been no evidence of divergence in how CCPs are regulated, but political rhetoric in the UK about potential deregulation created concern in the EU, which impacted on the framing of the technical discussion. Strengthening EU clearing, which is one of the main objectives of EMIR 3, is an important issue both in terms of strategic autonomy and of market development. There has been some modest movement in onshoring critical clearing activities since Brexit, but it is not sufficient.

The proposal that the Commission adopted on 7 December 2022 has three main objectives, the policy-maker explained. First, to create a clearing ecosystem in the EU that is sufficiently competitive, with measures to streamline administrative procedures and to better reflect the risk-reducing role of CCPs in counterparty credit risk. The second objective is to improve the safety and resilience of the EU clearing ecosystem, with enhanced supervision of EU CCPs and a reinforced EMIR framework. The focus is on improving monitoring of cross-border risks and strengthening EU supervision. The third objective is to enhance the economic security of the EU with measures such as the introduction of mandatory active accounts in EU CCPs. For these different measures, the European Commission will define the principles, while ESMA determines the parameters. The market has been consulted on these proposals, which aim to create positive incentives rather than new restrictions. The costs of fragmenting liquidity with these measures have to be balanced against the strategic objectives. These issues will be fine-tuned, once EMIR 3 is adopted by the co-legislators.

The Chair noted the need for a certain agility given the constantly evolving environment. ESMA will contribute to the fine-tuning of the measures with further assessments if needed.

1.2 Implications of the strategic autonomy objectives of EMIR 3 for the EU clearing market

An industry speaker stated that care should be taken to meet the objectives of EMIR 3 without negatively impacting the competitiveness of EU clearing members and their clients. EMIR 3 will provide useful improvements and simplifications in different areas such as the authorisation of new clearing services, the recognition of smaller third-country CCPs and eligibility of new forms of collateral at CCP level. However, some measures may impact the competitiveness of EU firms if they are not appropriately calibrated. For example, the proposed Pillar 2 prudential rules could be an additional barrier for EU clearing members in providing services to clients, while non-EU banks would not be subject to the same rules.

A second industry speaker explained that the global IRS clearing market grew significantly following the 2008 financial crisis and the measures mandating the central clearing of standardised derivatives. The problem is that the market has tended to concentrate in one location now outside the EU. This raises issues of open strategic autonomy for the EU and also of market structure due to limited choice and competition in the market. This has led Eurex to build an alternative liquidity pool for Euro swaps in the EU over the last five years, which has now reached 20% market share in notional outstanding amounts.

1.3 Issues raised by the active account provisions

An industry speaker welcomed the EMIR 3 proposal requesting market participants subject to the clearing obligation to maintain an active account at an EU CCP for systemically relevant products. This targeted measure should allow the rebalancing into the EU of a proportion of clearing activities currently performed at Tier 2 UK CCPs, whilst simultaneously allowing for flexibility with the possibility to continue clearing in London. If non-EU clients of an EU bank prefer to execute a trade in London, that should be possible if the client does not fall under the EMIR clearing obligation. The clearing market structure in the EU will need to satisfy the EU's objectives while remaining accessible to global clients.

This proposal strikes a good balance between EU financial stability interests, the protection of EU taxpayers, and market participants' competitiveness concerns, the industry speaker believed. It is important to have a starting threshold at Level 1 for this measure to prevent uncertainty while technical standards are elaborated, which can take up to 2 years, in a context also where the temporary recognition of UK-based CCPs will expire at the end of June 2025. 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. European banks should not be disadvantaged.

A second industry speaker considered the active account measure would be a workable solution if it was designed as a qualitative requirement. If rigid quantitative thresholds are imposed, that will likely result in a spread between euro derivatives cleared at EU and at UK-based CCPs, creating a major barrier for the provision of clearing services by EU financial institutions, unlike non-EU ones, at the expense of EU clients. This measure needs to be carefully calibrated, excluding from its scope non-EU clients and EU clients not subject to EMIR clearing obligations.

An official emphasised that the systemic risks identified in 2021 by ESMA posed by the exposure of the EU to UK-based CCPs have not diminished. The tensions regularly observed in the markets warrant a strong commitment on the part of the public authorities to reduce these exposures. At the same time, the situation in the market is evolving. The building up of clearing capacity in the EU in the CDS and IRS markets may lead to a rebalancing of exposures over time. The implementation of the active account requirements should be looked at very closely in this context. Quantitative requirements are needed to provide incentives, but they should be appropriately calibrated. For the sake of simplicity, it might be best to start from a large basis and then adjust requirements over time according to how the level of systemicity evolves. Intermediate steps can be taken to reach a final target of ensuring that systemicity is no longer substantial.

It is also a matter of monitoring by the authorities, the official suggested. First of all, there could be target-setting in the Level 1 legislation or the regulatory technical standards (RTS). There could then be regular points of review to ensure that the process allows an appropriate reduction of risk, that there are no disruptions to the markets and that participants can absorb the costs. This measure can be implemented intelligently through dialogue with the industry. The measurement of costs and benefits is also very important. A second official agreed that calibration is essential in relation to the active account measures. Caution is needed when calibrating the provision in terms of timing and size.

An industry speaker stated that clients generally do not want to be mandated to keep an active account at EU CCPs. With the June 2025 deadline coming up, their priority is to be able to have continued access to UK and other third-country CCPs, but if the choice is made to implement this measure, then the implications need to be clarified. It targets the clearing services considered by ESMA to be systemically important for the EU, but the broader context needs considering. The EU firms operate in a global market. They represent 17% of the total interest rate derivatives notional traded or cleared, and the euro is about 30% of the total market, but the vast majority of the euro traded and cleared is traded by non-EU firms. As is proven in the data, most clients in the EU will trade as much non-euro as euro instruments. Clients need to continue to be able to access the global liquidity pool to manage their risk and remain competitive.

What is driving market participants in their decision-making is not speculation, but the hedging of underlying real economy risks, which is why there is a difference of opinion in the market about the active account measure, which will remove these efficiencies. There can be a trade-off between efficiency and EU economic security, but it is necessary to be conscious that this will damage EU firms' competitiveness and increase costs if measures are not appropriately designed. An appropriate balance needs to be found between these two objectives. An active account requirement may also damage the safety of the overall ecosystem, because a mandated market fragmentation will lead to a smaller pool of liquidity with more directional risk.

Alternatives exist for solving these challenges, the industry speaker suggested. Some elements of EMIR 2.2 designed to address cross-border risk, such as cross-border supervision and cooperation, can be used. LCH for example is directly supervised by ESMA and also by the US CFTC. This is a proven model that has worked including during periods of stress. If there is a need to go further e.g. in terms of recovery and resolution, that can be defined between ESMA and the Bank of England using the EMIR MoU. The bottom line is that supervisory concerns need supervisory solutions rather than structural fragmentation.

The Chair summarized that the substantial systemic relevance of certain clearing activities cannot be suitably tackled with the existing framework or even by some incremental improvements of the current cross-border supervisory structure. Additional measures are needed that appropriately balance the different necessities and intentions. There should not be too many expectations attached to the active account concept as a single measure however. ESMA has been calling for an array of complementary elements that may help reduce risk and enhance the attractiveness of EU markets.

1.4 Improving CCP supervisory processes in the EU

The Chair noted that the EMIR review will also affect the supervision of EU CCPs. There are still supervisory issues to deal with in this respect. A clear example was what happened recently in the energy and gas markets, with issues of concentration and interdependency that require an adequate supervisory framework and an EU-wide perspective. The Commission has made some suggestions to streamline the supervisory approach to CCPs and enhance its consistency. ESMA also has a critical role in ensuring that sufficiently robust and accessible data and reporting requirements are available.

An official was favourable to a strengthening of the role of ESMA in the supervision of CCPs, but observed that in order to do that effectively, two conditions have to be met. The first is to maintain a clear division of responsibilities between the national competent authorities (NCAs) that are responsible for supervision and the European supervisory authorities (ESAs) responsible for the convergence of supervisory practices. These are two strongly interrelated but different objectives. The second condition is that the new measures proposed should not add complexity to an already complex supervisory framework. Greater involvement of ESMA in key supervisory activities and in emergency measures concerning more than one CCP is important. Granting ESMA a voting right in the EMIR colleges also seems an adequate solution, but the current situation where both ESMA and the NCAs play a leading role in steering the supervisory colleges should be maintained, rather than evolving towards a sole chairmanship by ESMA, because the ultimate responsibility for the safety of CCPs and the fiscal responsibility rest at the national level. In addition it is important that the responsibilities of the national and European authorities are not confused. In this regard, it is not advisable to give ESMA and the supervisory college the power to issue opinions on the results of the annual reviews and assessment processes of CCPs conducted by the national authorities.

The official added that, five years ago, the IMF, in its Financial Sector Assessment Program for the euro area, had suggested that the Eurosystem should further harmonise CCP access to central bank accounts and liquidity provision for financial stability and also competition reasons. Progress still needs to be made in this area, which is under the responsibility of central banks.

An industry speaker welcomed the Commission's proposals to improve the EU supervisory framework. Enhancing the competitiveness and robustness of EU CCPs is vital for EU long-term prosperity and the stability of the financial services industry. In particular the proposal around streamlining the approval processes for new products and services is positive although it was long overdue. Time to market, both on new products and services, is important in a globally competitive market. Similarly, the ability of CCPs to adjust and improve their risk management quickly but sensibly is critical in times of market stress.

2. Measures taken in the energy markets

2.1 EMIR 3 proposals regarding energy markets

A policy-maker stated that much of the political attention paid to the clearing of energy derivatives in the EU was triggered by the stress that some participants experienced in 2022 in meeting their margin calls. Prices went high and became volatile, as well as margin calls. That was expected, but for some companies in the market, that stress resulted in a need for public intervention, mainly in the form of liquidity guarantees.

The European Commission decided to take the opportunity of EMIR 3 to address some of the issues and sources of stress underlying those events, the policy-maker explained, by proposing a wide range of measures for improving the current rulebook. The measures include providing an improved transparency of CCP margin models, improving CCP participation requirements to be met by corporates, broadening CCP eligible collateral in line with the temporary measures put in place during the energy crisis, enhancing reporting requirements on the intra-group derivative exposures of corporates to improve the calculation and review of clearing thresholds, and fostering a greater consideration of the impacts of intraday margins. The proposed amendments came rather late in the legislative process and were not included in the impact assessment, so they will be finalised through targeted consultations with the market, involving people who can have an expert view on these matters.

2.2 Issues to be taken into account in EMIR 3 measures concerning energy markets and margin requirements

An official supported the structural measures proposed in EMIR 3 regarding energy markets and added that the decision was also taken to introduce a cap on the price of pipeline gas as a temporary one-year measure. It is a variable cap because it is linked to the price of liquified natural gas, which is widely traded. It is not the objective of public authorities to intervene on market prices, but last summer was an extraordinary period. At the end of August 2022, the price of pipeline gas in Europe was 10 times higher than its 10-year pre-Ukraine war average. ESMA was tasked with monitoring this price cap mechanism in order to identify any unintended effects. The mechanism only entered into force two months ago, so it is still too early to fully evaluate its effects. In addition, the market situation has improved since. It is however essential to appropriately assess any unintended effect in a timely manner.

The Chair noted that there are some specific technical aspects on market functioning and price formation to keep a close eye on. ESMA is currently reflecting on the potential consequences of this measure and whether it should be perpetuated. In addition, there is also an on-going discussion about the procyclicality effects of margin models. The technical standards in this regard are being reviewed and it is being considered whether the recent stress events necessitate a rethink of the approach. The revised RTS will soon be published, but this goes hand in hand with the need to have transparent and predictable margin movements.

An industry speaker welcomed the transparency improvements in EMIR 3 about margins. The new obligation for clearing members to inform their clients in a clear and transparent manner about margin calls and CCP margin models, including in stress scenarios, providing them with margin requirement simulations under different scenarios is quite relevant. The recent events on the energy markets have shown that huge changes in margin calls coming from CCPs could happen, including on an intraday basis. For clearing members and their clients, meeting these huge margin calls in cases of stress requires significant efforts in terms of liquidity management and also the use of appropriate tools to interact with clients, in particular in stress periods. Unexpected movements in margin calls could indeed cause additional stress for clearing members and their clients and could ultimately hurt financial stability.

The industry speaker regretted however that there is no equivalent requirement for CCPs vis-à-vis their clearing members. This makes it challenging for clearing members to fulfil their requirements. The CCP transparency obligation that currently exists is limited to initial margins (IM), whereas the clearing members' obligations extend to all margin requirements including variation margin (VM). Moreover, the information currently given by CCPs is sometimes insufficient in periods of stress and may be subject to various disclaimers regarding completeness or accuracy. The obligation would be more manageable if clearing members were systematically and adequately notified before any significant change, e.g. in the context of the CCP risk committee.

2.3 The approach to margin procyclicality issues at the global and US levels

An official stated that margin calls are procyclical by nature. It is when stress comes up that additional margin is needed in the system, resulting in margin calls. The real question is about how to mitigate procyclical effects effectively, enhancing the liquidity preparedness of market participants potentially entering into stress situations with regard to their derivatives portfolios. This has been a topic of discussion at the international level for a few years now, particularly since the pandemic hit in March 2020 and the markets experienced unprecedented volatility. Central banks had to engage in decisive interventions to support and preserve stability. This led to a data-driven exercise under the combined efforts of the Basel Committee, CPMI and IOSCO. The CFTC has been co-chairing this project with the Bank of England.

Based on an empirical assessment of margin dynamics, a report was published at the end of 2022 setting out areas for further work that could lead to policy proposals or considerations. Six areas were identified aiming to make the system safer. One is increasing transparency of CCPs vis-à-vis clearing members, and of clearing members vis-à-vis their clients, so that market participants are better prepared for tackling margin call increases. Other areas of possible policy development include liquidity preparedness measures that market participants may undertake to brace themselves for the impact of potential margin calls and to have resources available when stress times hit, tackling data gaps and improving transparency to regulators and market participants where appropriate.

The official added that VM, which can only be met by cash, typically eclipses the size of IM in terms of calls by an order of five to six times, leading to substantial liquidity demands. The enhancement of VM processing within the clearing ecosystem is a topic under discussion. On the responsiveness of IM to stress, which is the topic of procyclicality, two main issues are being considered. Firstly, how to improve the understanding of market participants of the responsiveness of IM. Secondly, how IM procyclicality can be dampened. These issues concerning VM and IM are also being assessed with regard to the non-cleared OTC space. This work is in its second phase, the policy phase, and is likely to produce a consultative document in mid-2023 that will be shared with market stakeholders.

3. Further issues in the clearing space (uncleared derivatives, digitalisation, crypto...)

An industry speaker stressed that the uncleared derivatives market remains a major pain point. Some of the recent crises have showed this. Many of the lessons learned from clearing can be applied to the uncleared derivatives market and the assessments and policy work underway in that space are welcome and should be pursued.

An official stated that the impact of digitalisation on clearing is a further area to be considered by regulators. So far, DLT has mainly been used in the settlement space, but it is likely that the technology will also be tested by CCPs. New activities such as the clearing of derivatives on crypto assets also need considering from a policy perspective. These activities raise some new challenges for both CCPs and regulators because cryptoassets have specific risk profiles in terms of liquidity risk and high volatility. CCPs would have to adapt their risk management framework and ensure that they capture the right data. The market is quite limited in depth, which is a challenge for regulators and it is fairly recent so there is not that much data. The regulatory framework will have to be adapted to this new type of activity and a careful monitoring of the development of these activities and the related risks will be needed.

The Chair concluded the discussion by noting that the impacts of digitisation in the post-trade clearing and settlement space need considering, because they bring both new opportunities and potential risks.

Impacts of digitalisation on trading and post-trading

1. Key new technologies for the securities market

An industry representative observed that there is a great deal of variability in the way that technologies such as artificial intelligence (AI), cloud computing and those that underpin digital assets such as distributed ledger technology (DLT) and smart contracts are being used in the securities market. For all these technologies, however, there is still significant room for maturity and opportunities to take advantage of. The technology with most maturity in terms of implementation and with the greatest potential to be used in production for large scale applications in the securities space, at least in the short term, is cloud computing. This is followed by AI, which is already used for a number of smaller scale use cases, and blockchain, which has been extensively tested by the securities industry.

It is important to identify the added value of new technologies compared to existing ones, the industry representative stressed, and how they may better serve evolving client needs, e.g. in terms of product improvement, new product features and opportunities for compressing the value chain. The new generation of users coming into the market is also asking for new services and ways of consuming financial services that may change the value chain. One challenge is that the main users of market infrastructures are often relatively conservative and tend to focus on currents needs and challenges, rather than anticipating how these needs may evolve and what would be needed to support them in a more disruptive way. Possible future evolutions need considering when implementing new technologies.

An industry representative noted that the potential of new technologies has been explored for many years by different players operating in the securities value chain. Recent years have seen a major leap in technology offer and capacity in DLT, data analysis, AI and quantum computing and client expectations have grown in parallel. It is now time for financial institutions to roll out these technologies and deliver the expected benefits. Many companies operating in the securities market are however not large enough to manage all these developments in house, so partnerships have to be developed with tech companies in certain areas. Financial institutions should identify core services and focus in-house developments on the areas where they can build a competitive advantage or need to retain control when implementing these technologies. The speaker's organisation, a major asset servicer providing custody and fund administration services is focusing in-house developments on three main areas. DLT technology is such a potential game changer for the securities industry that it should be managed internally as far as possible, in close relationship with regulators and with participation in as many marketplace trials as possible. A second area is digital asset custody that also has significant potential. A third area is data analysis and reconciliation, which is at the heart of an asset servicing firms' value proposition and is a major differentiating factor. Sometimes data held with third parties is inaccessible, so it is preferable for asset servicing firms to perform data analysis internally, in order to retain the capacity to provide accurate and reliable information.

For technologies outside the asset servicing provider's core offer, or those requested by a low number of clients, such as AI applications to conduct predictive investor behaviour analysis or to obtain usable ESG data, it is necessary to find a cost-efficient way to implement them, the industry speaker stated. Rather than purchasing and integrating a solution as a white-labelled product, which may be costly, the best solution is for financial institutions to negotiate a cooperation agreement with a technology provider. 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. Specialist staff with experience in the securities industry is also needed to ensure an effective implementation of those technologies.

2. Use cases of new technologies and lessons learned

The Chair noted that experiments with various technologies are being conducted across the value chain. There has also been a move from experiments to live use cases in production. Some use cases enable significant optimisation and efficiency gains and help to overcome difficulties experienced in the traditional world. These are also some challenges around maturity, scalability and operational resilience that need to be overcome. The Chair asked the panellists to illustrate how new technologies such as DLT, cloud and AI are used to enhance efficiency and resilience in the securities trading and post trading space and the related opportunities and benefits.

2.1 Cloud computing

An industry representative explained that cloud computing has been used for over a decade by securities market infrastructures and there are many live applications in the securities sector. These focus mainly on data management at present, but many opportunities exist around using data analytics in the cloud to drive better insights for clients and transferring applications to the cloud in order to drive further standardisation and efficiency. The speaker's organisation, a financial market infrastructure, has over 50 non mission critical applications in the cloud, Progress is being made to ensure that applications can be implemented in the cloud with a level of resilience and performance and a capacity for recovery in line with regulatory requirements.

A second industry representative noted that some markets have started moving to the cloud. The speaker's organisation, a stock exchange, has moved one of its options trading markets to the cloud and work is ongoing in the US to move some equity derivative clearing activities of OCC to the cloud in 2025. There is significant interest from customers about moving central clearing systems into the cloud, but regulators must also be brought into the conversation. Many regulators are using cloud applications themselves. Cloud is also a prerequisite for using AI and machine learning applications effectively, as it enables the scale and elasticity of data without which using those technologies would be very challenging.

2.2 Artificial intelligence (AI)

An industry representative stated that currently AI has many interesting albeit relatively small scale use cases in the securities market. The challenge is the availability of sufficient standardised and quality data to train AI models, despite the data-driven nature of securities activities. Opportunities exist around the use of natural language processing (NLP) and optical character recognition (OCR) technologies for collecting and digitising unstructured data and for effectively processing the data by eliminating human error. These technologies can also be used to create better data insights for investors and issuers and support better trading and portfolio management decision-making. The new generation of generative AI should also allow a further enhancement of clients' and employees' experience, help to optimise software development and contribute to reducing friction in the value chain e.g. for transaction execution.

An industry representative noted that AI can be used to manage securities markets more efficiently. New dynamic order types can be created that use AI to determine the time period e.g. evaluate based on data whether an order should stay as a resting order or time out. AI-based approaches are also being used in the US for determining equity options strike prices.

2.3 Blockchain and tokenisation

An industry representative stated that blockchain, including DLT and smart contracts, is expected to significantly impact the securities industry in the coming years. The industry has been testing and evaluating the impact of this technology for some years and it is expected to reshape the securities value chain, even though it may not be adapted to all asset classes. Broad adoption has not yet been seen but many experiments have been conducted. There are 34 examples at the global level of bonds being issued on the blockchain by multiple parties and 13 examples of private equity being issued in a tokenised form. While these are not yet repeatable formats because the technology to allow this is not yet available, these experiments are helping the industry to understand and validate various models for using blockchain in these areas.

However, every single one of those issuances has used a different protocol and different underlying technology, the industry speaker stressed, so currently there is fragmentation. Thinking is underway about the core capabilities that are needed in the securities space and how to establish the standards and frameworks that are needed. For custody and control activities, this requires defining roles and responsibilities in a blockchain environment and how clients and counterparties can secure agreements. It also means identifying the specificities of digital asset securities and how these can be managed in different use cases such as mutual funds or private equity funds. This seems feasible since the number of stakeholders and the level of interconnection is currently lower than in public equity or fixed income markets.

A second industry representative noted that blockchain and smart contracts are already being used in a number of markets and there are several examples in the Nordic region. The Nordic Sustainable Bond Network has been using smart contracts for two years. A project called Puro, trading carbon credits in tokenised form on a permissioned blockchain, is due to go live by the end of 2023. In the US, subject to regulatory approval, the speaker's firm is preparing the launch of a digital assets subsidiary that will provide crypto asset custody services on a public permissioned layer 1 DLT. Work is also underway with a South American CSD in conjunction with the central bank to tokenise government bonds. In this case the existing CSD technology will be used and the delivery versus payment (DvP) settlement will be processed in the CSD, with a digital layer on top of the traditional settlement layer. Customers around the world are indicating in the same way that they want to leverage their existing technology in the new digital environment in order to preserve existing legal protections and settlement finality. This is however challenging to achieve and is not only a question of technology.

DLT can be used to modernise securities markets and enhance their efficiency, the industry speaker observed, in a context where trading message traffic is exploding. Pre-pandemic there were about 50 billion messages a day in the US, it went to 120 billion during the pandemic and now a volume of 200 billion a day is being anticipated. Clients are also expecting 24/7 trading and the related liquidity. How new technologies such as DLT may support these evolutions is being assessed. Current use cases of DLT centre on executing transactions more efficiently and transparently, but they are not designed for handling intensive processing. Payment and securities transaction platforms must be able to run in a highly intensive and continuous way in the future, as these are the expectations for market infrastructures.

A third industry representative explained that their organisation, a multinational bank, has been working on tokenising trade finance, which is one of their core businesses. A project was conducted with the Hong Kong regulator and the BIS Innovation Hub to move to a more public blockchain with more participants. The objective is to build a proof of concept for programmable payment tokens that can provide SMEs with supply chain finance. There is also on-going work with the Singapore regulator to develop that concept further and introduce a layer of securitisation. Underlying supply chain finance transactions would be pooled together and asset backed securities technique would be applied to this pool of receivables in order for it to be tokenised. This means not just tokenising the supply chain receivables, but also the securitisation layer. This introduces new questions and complexities, but would help to maximise the potential of the underlying technology. One of the key priorities for reaping the full benefits of DLT is to ensure that DLT systems are interoperable, to support the transition from a series of private blockchain transactions to a public chain and the interoperability between DLT platforms and existing technology.

An official explained that the Banque de France has adopted a learning by doing approach to the testing of new technologies such as blockchain. The aim is to explore how blockchain can optimise some market segments which are not yet sufficiently automated. Areas being explored include the use of blockchain technology for wholesale payments and DvP in domestic, cross border and cross-currency contexts[1]. Multiple DLT platforms are being tested, including public and private blockchains. The central bank is agnostic about these models, provided it can retain control over its CBDC. The current focus is on two major types of use cases: the settlement of tokenised assets and cross-border payments. Experiments showed that CBDCs can simplify reconciliation flows for tokenised assets and reduce trade to settlement processes, and that implementing digital cash on the ledger can maximise DLT benefits and optimise post-trade functions. Interoperable CBDC and multi-CBDC arrangements also have significant potential for improving cross border payments, especially remittances, notably by optimising correspondent banking models. Tests are also being conducted in other areas, such as automated market maker (AMM) applications[2] for optimising liquidity management. Several aspects remain to be further tested, notably the scalability and resilience of such solutions and the interoperability of DLT systems between them and between DLT and legacy systems[3].

A second official observed that temporary solutions have been proposed for combining existing payment systems with a DLT securities platform, to speed up the uptake of these solutions. A so called trigger solution has been tested by the Bundesbank to provide a technical bridge between DLT securities platforms and the existing payment systems in the euro area. Starting with this temporary solution for the settlement leg of transactions seems preferable as a first step for allowing faster progress, rather than trying to achieve a full implementation of a DLT system integrating wholesale CBDC settlement from the start. Settlement in central bank money should however remain the final target, to mitigate payment settlement risk.

3. Risks from the use of new technologies in the securities trading and post trading space

The Chair suggested that the use of new technologies in securities markets may create new challenges and pose risks that need to be clearly identified.

An official challenged the idea that risks may significantly diminish or disappear with the use of new technologies. They merely change form. For example, the use of atomic or instantaneous settlement with blockchain reduces settlement risk, eliminating replacement cost risk and principal risk in exchanging funds against securities. However, because this method requires pre funding almost by design, it might bring new risks in the form of reducing liquidity in the market, in particular in times of stress. If that is the case, this new technology might just be shifting risk from settlement to trading. Risks must therefore be thought of in a holistic way and a healthy dialogue between the industry and regulators about the potential risks as well as the benefits is necessary. There should be an iterative and dialectical process to identify the key issues and produce the best solution for tackling them.

There are four main potential risks from the use of new technologies for securities trading and post-trading processes, the official highlighted. First is the risk associated with settlement finality. There is an issue arising from probabilistic settlement in the use of DLT, and this is similar to issues associated with the use of DLT for stablecoins. The CPMI issued guidance on the application of the Principles for Financial Market Infrastructures (PFMI) international standards to stablecoins and on issues around settlement risk and finality in the use of DLT for payments. These discussions are also relevant to the use of DLT in securities settlement, because the decentralised structure might make it difficult to prevent or redress any mismatch between the technical and legal settlements. In many jurisdictions, systemically important payment systems or CSDs enjoy statutory protection of settlement finality in the event of a participant's failure. This same level of protection may not be available to DLT based solutions. This issue needs clarifying. Secondly, there is a risk associated with the safekeeping of underlying securities upon which tokens are created and circulated. The

1.For example, in the Jura project, there was a DvP transaction involving the exchange of a Swiss franc central bank digital currency (CBDC) and a euro CBDC. This project was carried out by the Banque de France with the Swiss National Bank, the BIS Innovation Hub and Accenture. It showed that cross border and cross currency transactions could be optimised, especially where they involve long intermediation chains. This could imply changes to the role of intermediaries in future.

2. The Banque de France tested the AMM in a project with the Monetary Authority of Singapore (MAS) and the BIS Innovation Hub, and worked with the Swiss National Bank on Project Mariana.

3. An experiment is ongoing with SWIFT to interoperate DLTs with the Banque de France's real time gross settlement (RTGS) system.

underlying asset should be kept in custody and should not be used while related tokens are in circulation. Otherwise, there is a double duty and it would effectively lead to the unauthorised creation of securities, which is a violation of the very fundamental principle of custody of securities. Thirdly, there is a risk of a lack of transparency in the wider use of decentralised DLT solutions as opposed to centralised solutions, as quality data is more difficult to obtain in a decentralised environment. Fourthly, operational cyber resilience must be ensured. This is not unique to the use of DLT or tokenisation and decentralised structures may be more resilient against cyberattacks than centralised ones to a certain extent, but once a cyberattack happens, it may be more difficult to react to this situation in a decentralised manner.

A second official agreed on the importance of anticipating and tackling these risks in a context where technology is developing quickly, in order to avoid operational issues and the creation of new vulnerabilities.

4. Expected impacts and benefits from the DLT pilot regime

An official explained that the DLT pilot regime, which came into force in the EU at the end of March 2023, will facilitate the testing and benchmarking by market participants of new blockchain technologies and solutions. This should not solely be a prerogative of regulators and supervisors, and the private sector should also contribute. Experimentation and interaction between market participants and regulators in the DLT pilot regime will help to identify areas where regulation may need to evolve and regulatory barriers that may need alleviating. Fundamental policy objectives and principles should not change however and remain focused on avoiding market fragmentation, protecting investors and enhancing financial stability.

An industry representative explained that the DLT pilot regime is essential for increasing the market's comfort with using DLT platforms for exchanging tokenised financial instruments. The DLT pilot regime allows testing and learning around these platforms, which is vital for the uptake of the digital asset market. This will facilitate the involvement in these new projects of more traditional players, who were concerned by the initial objective of suppressing intermediaries with the implementation of blockchain. Their involvement is important because new technologies can strengthen existing traditional markets by improving the way securities are exchanged and custodied.

A second industry representative agreed that the learning by doing approach of the DLT pilot regime is relevant. Their organisation's DLT based Project Ion is a small use case but the technology was put into the production environment, which is highly regulated, and this allowed the consideration of performance, scalability and architecture issues, which are not possible to evaluate in an experimental environment.

A third industry representative added that it is necessary to consider how regulation should evolve to support a further dematerialisation and decentralisation of finance and the possible disappearance of certain intermediaries from the ecosystem. This could make it necessary to consider embedded regulation and how operational resilience can be achieved when there is no central entity to regulate or supervise.

A second official observed that, when thinking about the regulatory approach to the use of new technologies such as DLT and tokenisation, it is important to distinguish between their use by regulated and unregulated entities and also for retail and for wholesale activities. In addition, standards should be built recognising the different ways of achieving the same outcome, as with the PFMI principles, to remain applicable when technologies evolve or new technologies appear.

A third official welcomed the DLT pilot regime, which should allow the exploration of the conditions needed for the efficient implementation of DLT and of wholesale CBDC for effecting payments in central bank money on the blockchain. More activity is due to take place around wholesale CBDC at the Eurosystem level, in addition to the Digital Euro initiative focusing more on retail applications. Progress can only be made on these initiatives however if there is close cooperation between central banks and the private sector.

SME equity funding: Listing Act and ESAP proposals

1. Current state of SME equity funding and listing in the EU

1.1 Opportunities and challenges associated with SME equity funding

The Chair stated that small and medium sized enterprises (SMEs) are the basis of the EU economy and need adequate financing but there are conflicting trends in the market. A massive number of companies – more than 30,000 globally – have delisted from the markets since 2005, with higher figures in Europe and the US than in other regions. At the same time, the equity market structure has positively evolved in the EU in recent years, e.g. with a relative success of multilateral trading facilities (MTFs) that are likely to support SME access to equity markets.

A policy-maker agreed that improving the financing of SMEs remains a key objective, given their importance for the EU economy, which is higher than in other jurisdictions. The right financial tools are needed to support the growth of these companies and notably an improvement of their access to market-based funding. A survey conducted by the Commission together with the ECB in 2022 on the access to finance for enterprises in the EU showed some surprising results however. Only around 11% of EU SMEs reported that equity funding is important for them. That reflects the current overreliance of SMEs on bank lending in the EU. Further diversifying the financing of SMEs is essential, particularly for the more innovative companies.

There have been quite a few fluctuations in the SME equity funding market recently, due in part to the macro environment, but the main issue is that SME markets remain underused, the policy-maker stressed. Market financing was very limited in 2020 due to the Covid crisis. Firms turned more to credit lines from banks, as they were often guaranteed by the state. 2021 saw a significant increase of private equity (PE) and venture capital (VC) funding, together with a record number of SME IPOs following the creation of SME growth markets, but that boom was short lived and in 2022 market funding declined again. Rising interest rates could have favoured equity funding, but at the same time the economic uncertainty and volatility due to Russia's invasion of Ukraine and rising inflation impacted negatively equity primary and secondary markets.

An official observed that there is huge potential in the growth of innovative SMEs in the EU, and particularly in the Central and Eastern Europe (CEE) region. It is essential to fuel investment to these companies. According to some calculations, the growth potential of SMEs in a country such as Slovakia is almost four times Slovakia's GDP.

1.2 Main drivers and obstacles to SME equity funding

A civil society representative noted that the situation of SME equity markets is quite heterogeneous in Europe. Strong growth has been seen over the last 20 years in the Nordic countries, mainly due to a high level of retail participation and investment culture. This had led to an increase in household wealth particularly in Sweden and Denmark. In Denmark household financial assets represent 426% percent of GDP, while in Romania, where most assets are held in cash and bank deposits, they are limited to 79%. In the Nordics, up to 80% of household financial assets are held directly or indirectly in capital market instruments, with a strong role played by investment funds, insurers and pension funds. This shows that retail participation can create a virtuous circle or a vicious cycle depending on the countries. A second aspect to be considered is that the increase in company listings is also often correlated to the interest in investing among the population and the proportion of households actively participating in the markets. If this dynamic is not created then there will be fewer listings, and vice versa. The statistics showing that half of the trading on the Nordic stock markets in SME shares is done by retail investors is telling in this regard.

The civil society representative also observed that the strength of relationship banking in many parts of Europe can be an obstacle to the further development of capital market financing. Banks want to preserve their relationship with SMEs and the corresponding revenue streams coming from interest income. This means that they do not always encourage their customers to increase equity and bond financing or to go public, because the amount of fees for supporting the listing of a company is probably lower than the income that they can gain from more traditional financing activities.

An industry representative added that the high cross-border transaction costs within the EU are another obstacle to the development of SME equity markets. This contributes to a home bias in the purchasing of stocks in most member states and when retail investors buy foreign stocks they usually prefer US stocks to other EU stocks because of the high execution costs. These costs are due mainly to post-trading which is fragmented, with multiple infrastructures and no legal harmonisation across the EU. With regard to SMEs more specifically, a further issue is that the investments of retail investors in IPOs have not always been profitable in the past notably because of the lack of liquidity. Investors who have lost money on IPOs will not invest again in those kinds of stocks.

A policy-maker observed that barriers to the investment in SME stocks also have to do with information asymmetries, the higher costs of investing in SMEs compared to large caps and also the reluctance of company owners to open up their capital to external investors, in order to retain full control over their business.

The Chair summarized that there are supply and demand drivers to be considered related to the access of SMEs to equity markets and to the demand for SME stocks. Sweden has been particularly successful in putting these different drivers into play resulting in a high number of listed companies and significant market cap and retail participation. There are also external factors to consider such as the macro environment, monetary policy and the availability of alternative source of financing.

2. Legislative proposals to improve equity funding

2.1 Proposals made in the context of the Listing Act and ESAP initiatives

A policy-maker stated that some new initiatives have been proposed by the Commission to support SME financing, as part of the Capital Markets Union (CMU) action plan. These include the recently published Listing Act and the European Single Access Point (ESAP) initiative, which aims to facilitate the access to financial and non-financial information on companies across the EU.

The objective of the Listing Act, the policy-maker explained, is to facilitate the listing of companies, especially SMEs but not only, with improvements of the legal framework in terms of proportionality and simplification. Proposals have been made to better adapt listing requirements to companies of different sizes. Adjustments are also proposed in terms of transparency. While transparency is very beneficial, providing an extensive amount of information can be very cumbersome for smaller companies and first time issuers The Commission has proposed a streamlining of prospectus requirements to alleviate the burden for first-time issuers and also those who are tapping public markets repeatedly. There is also the objective of making the approval process of new prospectuses shorter and more effective and predictable. A second objective of the Listing Act is to improve the proportionality of the market abuse framework, while preserving its effectiveness. The sanction regime could be made more proportionate, when it comes to non-core infringements in particular, because the risk of being caught with the current rules due to negligence or unintended actions may discourage smaller issuers. A third aspect of the Listing Act is a new proposal of multiple vote share structures, aiming to address the reluctance of some company founders or controlling shareholders to give power away and allowing them to retain some decision making powers in the company if it is listed on public markets.

A civil society representative noted that with regard to the proposal to establish a so-called cross market order book supervision in relation to market abuse, there is a risk of an uneven playing field, because bilateral trading venues are not in the scope. That needs to be taken into account.

The Chair summarized that the proposals of the Listing Act and ESAP could make it easier not only for SMEs but for all companies to access capital markets and to seek additional market funding through an improved entry point to company information. These proposals build on similar measures that have already been implemented in some OECD countries and EU member states.

2.2 Expected benefits from the Listing Act and ESAP proposals

A civil society representative stated that from their perspective, the proposals of the Listing Act are a significant step in the right direction. If appropriately implemented, these measures, together with the other proposals of the CMU action plan, could help to enhance retail investment culture and generate more listings, creating a virtuous circle for the development of capital markets in the EU. The proposal to implement a multiple voting rights regime, which seeks to achieve a minimum harmonisation of national laws in this area - allowing company owners to retain decision-making powers in their company while raising funds on public markets - is particularly important. Sweden, Finland and Denmark have such regimes in place and this has contributed to the listing of companies and the growth of capital markets in these countries. This should therefore be extended to all EU countries and the current fragmentation of national rules should be tackled. This is important in particular for encouraging family-controlled companies to consider listing. In Germany, 90% of companies and 43% of companies with sales of more than €50 million are family companies. In these companies, the fear of losing control is usually one of the main factors why they do not list. The proposal to streamline prospectuses is also very welcome, as this may help to significantly reduce the costs and burden for issuers.

An official observed that the Listing Act and ESAP are key elements of the CMU, which is a key driver of future growth in the EU and is needed to react to the US Inflation Reduction Act. A stronger integration of EU capital markets is needed to make better use of economies of scale in the financial area and more active capital markets are needed to provide the investments required for the green and digital transitions. As shown by the mandate given to the Eurogroup by the Eurozone leaders following the March 2023 Euro Summit to further develop the CMU and the op-ed article signed in March 2023 by the chairs of several European institutions[1], there is a strong momentum behind the CMU initiative.

The ESAP and the Listing Act are addressing both the demand and the supply sides, aiming to find a new balance between investors and issuers and develop synergies between the two, the official noted. Another positive feature of the Listing Act proposal is that it

1.Channeling Europe's savings into growth – Op'ed article signed by the Presidents of the European Council, European Commission, Eurogroup, ECB and EIB – 9 March 2023.

addresses the whole listing process from the pre-IPO to the post-IPO phase. Concerning the pre-IPO phase, there is already a general approach on the multiple-voting rights regime and the Council is ready for negotiation. This measure could be extended beyond SME growth markets. For the IPO stage and the improvement of prospectuses, the main issue is achieving sufficient proportionality. Defining the appropriate threshold for streamlining prospectuses that allows a preservation of investor protection still needs to be done. A range can be defined where all member states can feel comfortable. There are also some legal questions to tackle in relation to the language used. Finally, concerning the post IPO stage and the market abuse aspects, these are more technical questions so there is no political obstacle to these measures. A further positive measure of the Listing Act for countries such as Slovakia is to make it easier for SMEs to access the market infrastructure of countries with more developed capital markets. ESAP will also address the fragmentation of cross-border information, providing another added value for smaller member states and markets in terms of visibility.

2.3 Issues to be further considered

An industry representative suggested that more could be done to reduce capital market fragmentation in the EU. The Listing Act is a step in the right direction in this regard, but more could be done in the post trading area in particular, with more harmonisation and integration in the settlement space. The framework applying to market-making also needs to be further harmonised to avoid market fragmentation. It is currently difficult for companies listed in different European exchanges to have the same market maker in order to maximize efficiency and liquidity and diminish costs. The ESAP should also encourage more cross-border trading, but the precise status of the project needs to be clarified. A further issue to consider concerns the research unbundling rules of MiFID II, the industry speaker stressed, that require unbundling brokerage commissions and investment research fees. Currently there is an exemption from the unbundling rules for issuers whose market capitalisation does not exceed €1 billion. The proposal has been made to increase the current threshold of €1 billion to €10 billion, but this remains a complex rule to implement.

A social society representative supported the recommendation to increase the threshold for unbundling requirements to €10 billion, but noted that the debate about this threshold is irrelevant in many EU markets where the large majority of companies have a market cap smaller than €1 billion. Beyond this measure there is a need to encourage independent research. There are several examples of market-led initiatives that are worth considering. For example, there is a research institute supported by the stock exchange in Spain, which is providing independent research on companies that do not benefit from sufficient coverage. Such initiatives should be encouraged.

An official agreed that more harmonisation is needed in European capital markets. Many heterogeneities remain to be tackled. For example, there are different distribution models and different levels of access to capital across member states. There are also some actions of the CMU action plan that are particularly relevant for the CEE region and that still remain to be implemented. The first is Action 5 of the CMU action plan, which proposes to implement a process for directing SMEs to alternative providers of funding in cases where they have not obtained requested financing from a bank. This is something which is already used in the UK and can be replicated in continental Europe. The second action is Action 7 concerning financial literacy, competencies and education on which more focus is needed in the next stages of the CMU, because support from the wider public is needed for the success of the initiative.

A policy-maker added that the Commission has been working on the setting up of an SME IPO fund for quite some time that should provide additional support measures for SMEs and enhance their confidence in capital markets. The project is moving forward with the recent completion of a call for expression of interest for fund managers.

Investment product frameworks: trends and further issues

1. Current market trends and related opportunities and challenges

An industry representative stated that the UCITS and AIF (Alternative Investment Funds) investment fund segments have both experienced significant growth over the last few years. Assets under management grew by more than 25% from 2018 to 2022. In 2022 there was significant growth in funds investing in alternative assets such as private equity, real estate and infrastructure both at the EU and global levels. These positive trends in the EU concerning retail and non-retail investors are the result of a combination of factors including investor demand, the wide range of funds provided by the industry and the regulatory framework, which allows for a comprehensive range of funds to be offered. A further trend in the EU is the increase of the proportion of funds marketed cross-border and bought by non-domestic investors from 27% in 2017 to 33% in 2021.

A second industry representative explained that initially the insurance-based investment products (IBIPs) marketed by insurers focused on unit-linked products with capital and income guarantees. Following the 2008 financial crisis, insurers moved away from guaranteed products towards unit-linked products without guarantees. Guaranteed products were indeed difficult to sustain, because of the high cost of the reinsurance and collateral arrangements needed to provide guarantees long term, in a context of higher volatility and uncertainty. The evolution of IBIPs towards unit-linked products raises the question of their added-value compared to other investment products such as investment funds. Insurance companies are trying to package products differently than asset managers, with products either mainly unit-linked with some protections or that offer protection with some unit-linked diversification, and therefore offer long-term investors more potential value. Solutions are also proposed within IBIPs to follow a person's lifecycle in terms of how investments should evolve across the asset categories over time.

The industry speaker noted that providing adequate pension products remains an important objective in the EU. The Pan-European Personal Pension product (PEPP) was designed to facilitate the provision of pension products across Europe and includes a guarantee meant to be beneficial for investors. Unfortunately, providing that guarantee has proven to be too expensive, so very few PEPPs have been launched so far. The challenge with the PEPP is meeting public policy objectives of encouraging long term retail investment while achieving a commercial viability, allowing firms to offer this product on a wide scale.

An industry representative suggested that the success of a product can be measured by the volume of assets managed and whether it is part of customers' investment choices. Exchange-traded funds (ETFs) are one of the most significant new product developments of the last few decades at the global level based on those criteria. From their launch in the early 1990s, about €9 trillion have been invested in ETFs globally. In Europe, that amount is about €1.4 trillion, which remains a small percentage of total outstanding assets, so ETFs have much room to grow. That success and growth has been possible thanks to the very broad range of investor types that have chosen ETFs as an investment vehicle. In the EU ETFs are structured as UCITS funds, so they are designed to be relevant for a wide range of investors from retail to high net worth individuals, and also pension funds, endowments, institutions and sovereign wealth funds. ETFs are a telling a story about the democratisation of investment, because all investors share in the same share class and the same vehicle is used across all investor types. There are not multiple share class structures, different tiers of fees or different transparency requirements with ETFs. All investors follow the same rules and are served by the same portfolio managers, which also means that with ETFs retail investors get access to the same efficient products as institutional investors.

2. Expected impacts of the AIFMD and ELTIF reviews

The Chair reminded the audience that the European Long-term Investment Fund (ELTIF) regulation seeks to foster investment with a long-term horizon in unlisted companies such as infrastructures and certain listed SMEs. ELTIF 1.0 was very narrow in its scope and disappointing in its take-up and has been reviewed in the context of the Capital Markets Union (CMU) action plan.

The AIFMD and UCITS directives have been very successful and are now global brands. The review of that legislation is currently in the trialogue stage and aims to update it to reflect recent market developments, while remaining a trusted brand.

2.1 AIFMD review

A regulator considered that the success of the UCITS and AIFMD frameworks has been impressive and has led to providing a coherent approach regarding investment funds in the EU. There is room for improvement in some areas however, which is to be provided by the ongoing review. The ESMA peer review conducted following Brexit showed that there is work remaining to be done on the harmonisation of delegation structures and substance requirements across the EU. The AIFMD needs to be reinforced in that regard. The other aspect is the need to widen access to liquidity management tools (LMTs) across the EU. It is important that there is adequate and sufficient availability of these tools for AIF funds across the EU.

An investor representative stated that the AIFMD and UCITS directives have become gold standards and globally recognised brands, appreciated both by retail and professional investors, as they allow the pooling of investments and provide an effective diversification at relatively low cost. Improvements have been proposed in terms of harmonisation, delegation structures and LMTs available.

2.2 ELTIF review

An industry representative agreed that the first version of the ELTIF regulation was not a success at the EU level. It has been possible to structure domestic AIFs in several member states including France that resemble ELTIFs in the composition of their portfolios, investing in private assets, real estate, infrastructure or private equity with an evergreen structure. 80% of the subscriptions in some of those funds come from investors who put in less than €10,000, which shows interest in these products from retail customers. One-third of the assets under management for such customers are private asset funds. This shows opportunities for such funds at EU level. It is hoped that the Level 2 measures of the ELTIF reviewed legislation will allow competitive ELTIFs to be launched, providing for an actual development for such funds through the European passport.

A regulator explained that funds contribute to the development of capital markets, which is an important objective for achieving a more balanced funding of the economy. In Portugal for example, bank deposits still represent 61% of financial instruments. Encouraging more investment in funds could allow the achievement of two key objectives: allowing more investment to be channelled for real economy projects and offering better returns to investors. Better connecting savings to the real economy through investment in funds may also have a positive impact on the way the public opinion perceives financial markets, showing that they are not speculation and not disconnected from reality. Progress is being made with the ongoing reviews of the EU fund frameworks. The ELTIF review is important as it can favour a more balanced funding of key components of the real economy - SMEs and infrastructure projects – and help retail investors to get better returns on their savings in the long term in a context of high inflation.

An investor representative regretted that ELTIFs have not been a success so far, with only 84 products introduced in the EU market. These funds were not opened to retail investors because of the risk that they may not understand the features and risks of ELTIFs sufficiently, particularly the illiquidity of the underlying assets which meant that they may be stuck with the product for 20 or 30 years. A question with ELTIFs is the importance that investors attach to liquidity in their investment decisions. From a retail investor perspective, there needs to be a balance between adequate information and investor protection, and removing some of the burdens in the product that have prevented its development so far. The changes proposed in the reviewed ELTIF regulation are a solution for adapting the consumer protection requirements in this perspective. Improving this legislation is important also to attract retail and institutional investors wanting to invest in the companies and projects aiming to contribute to the green transition, which is an essential objective for the future.

A second regulator noted that no ELTIFs have been launched in certain EU countries, including the Netherlands (NL), despite a flourishing fund market. This is a missed opportunity, because of the potential for portfolio diversification of ELTIFs, particularly with a long-term investment perspective. One of the main solutions proposed in the ELTIF review for relaunching the product is to move to open-ended structures. This raises questions in terms of liquidity mismatch risks however. Gates are a solution, but care is needed not to create a mismatch between the expectations of retail investors and the reality of a product that may not function as intended. The Chair agreed that there is a risk of mismatch of expectations on top of the more traditional liquidity mismatch risk that needs to be addressed in the reviewed framework in order to ensure a successful relaunch of this product category.

3. Further issues to be considered in the ongoing policy initiatives

3.1 Better taking into account the specificities of ETFs in EU legislations

An industry representative suggested that ETFs have contributed significantly to the promotion of the UCITS brand, although ETFs were created in the US and have a more significant market share there. A question is whether more should be done in the review of the UCITS legislation to take into account their specific nature. By and large, they are passive benchmark trackers. European fund regulation consistently takes the perspective of a 'traditional portfolio manager' - i.e. a portfolio manager doing stock picking based on an in-depth assessment of the fundamental value of stocks. That perspective does not translate well for ETFs, where portfolio managers run a fund that aims to replicate a benchmark comprising a wide range of securities that are chosen based on a standardised index methodology with very low turnover. The language in EU fund regulation makes it very difficult to apply to ETFs. This may have negative implications for investors, who have to balance two different languages which can impact their perception of different vehicle structures.

An example of these negative implications can be found with the Sustainable Financial Disclosure Regulation (SFDR) and fund tracking benchmarks that have a decarbonisation trajectory aligned to the Paris Climate Accord, the industry speaker explained. There was initial guidance, which required interpretation for passive funds. The initial consensus was that, subject to certain other criteria, passive funds passing a Paris-aligned benchmark were eligible for Article 9 classification. There was then subsequent guidance, which was written in a different language from a different lens and created ambiguity. The result was that a number of product providers reclassified Article 9 ETFs to Article 8, which is not good for end investors. This issue was raised with the European Commission and it was made clear that the original interpretation of a Paris-aligned benchmark meets the key criteria for Article 9 classification. A number of products are now expected to be reclassified to Article 9. This succession of interpretations linked to the fact that the rules were not initially drafted considering the ETF market seems counterproductive, especially given SFDR's prominence as one of the most significant pieces of ESG legislation globally and the potential for ETFs to support these objectives effectively.

Another specificity of ETFs is that they are both funds and exchange-traded products on the secondary market. Therefore the specificities of ETFs need to be considered in securities trading and post-trading legislation, such as MiFIR and the CSDR regulations. For an effective functioning of the market it is necessary to provide liquidity, ensuring that investors can enter and exit their positions easily. In this respect the two-layer structure of ETFs must be considered because liquidity in an ETF may be derived from the trading of the underlying constituents. Investors also need appropriate market data. The fact the EU legislative proposal on the consolidated tape takes into account ETFs is positive, because one of the reasons the US ETF industry has grown so rapidly is because of the transparency provided by the consolidation of trading information by the US ETF tape. Such a tape would allow investors to make better-informed investment decisions and support best execution, and allow the EU ETF sector to compete with other large jurisdictions by showcasing the true liquidity available in EU-listed products. It would also give regulators a more comprehensive overview of the market during periods of broader market stress.

3.2 Enhancing retail investor protection and value for money

An investor representative stated that the access of retail investors to well-managed investment products needs to be facilitated. There is a risk or cost of not investing because of high inflation and low returns provided by savings accounts, but investors are hesitant to invest in Europe. One obstacle is inducements, which are a barrier to the provision of low-cost investment solutions. Investors do not want to pay every year for services provided only once at the start of the investment and some do not want any advice. In addition, they do not understand how these commissions work and what they relate to. This creates distrust with regard to intermediaries, potentially hindering further investment in securities. The EU authorities should also aim to create a balance in the policies proposed between reducing regulatory burdens where this is relevant and preserving investor protection in order to prevent any tail risks of new crises. The recent banking crisis in the US and Switzerland shows that these risks exist, although this recent crisis only had limited repercussions in the EU. However, with higher interest rates and market vulnerability, the EU financial sector is not immune.

A regulator stated that properly functioning markets must allow retail investors to extract the benefits from the market. Policymakers and regulators should pursue this objective, because they have a general interest mandate and must ensure their decisions have the right impact for the general public. There are a number of improvements needed to ensure that the interests of retail investors are taken care of.

First, it should be ensured that retail investors suffer no undue cost, because the return obtained by the investor cannot be separated from the cost. Costs are mostly under the control of producers and distributors. ESMA has been very active in this area. A second area for improvement is on the quality of information. Investors, need clear, concise and comparable information on costs and expected returns in order to make the right investment decisions. Progress has been made but there are still pending issues. Thirdly, the production and provision of information needs to be adapted to the digital world. Making better use of tools such as natural language processing (NLP) could be an opportunity, although this is up to each firm to decide. The comparability of products is a fourth area of improvement. There is always a balance to be achieved between the comparability, the flexibility and the adequacy of products. Multinational companies also have tensions between centralising and adapting to local needs. That balance is a moving target that requires sufficient proportionality.

Value for money is a further topic that will deserve specific attention, the regulator emphasised. A financial product offers value for money to the investor when the costs and charges are appropriate in relation to the expenses incurred by producers and distributors, and in relation to the expected returns for the target investors. According to ESMA figures, the costs incurred by retail investors can represent up to 30% of the amount of the initial investment over a period of 10 years. This needs addressing to ensure that retail investors get sufficient return from their investments, otherwise they will not participate in the market. The Portuguese authorities in particular are very active in this area and have recently carried out a supervisory exercise that allowed the identification of products with low expected benefits for the target market and relatively high cost.

An industry representative agreed that the objectives of developing the equity culture of retail savers and the flow of savings to the real economy and to the digital and green transformations are essential. The public policy push in this direction is welcome. There is however a question around whether this lead to a balanced approach in terms of risks and who should be taking the related risks. With direct investment in securities, the risk is taken by investors. Sometimes the lines are more blurred when it comes to packaged investment products. For these products, regulatory requirements are imposed to make sure that the management companies are not taking too much risk and are putting capital aside to handle e.g. liquidity or leverage risks. Consumer protection requirements come on top of this. There is still work to do around the holistic risk assessment of this policy objective, the possible side effects and how to address them. One aspect concerns banks. An increase of investment in securities will likely reduce bank deposits, which may impact their resilience. This raises the question of the consequences in terms of risks and financing of the real economy of these measures, and whether the financial system is going to be reinforced by this evolution.

A regulator suggested that there is room for improvement in a number of areas related to investment products, including investor protection, the rules applying to fund distribution and the coordination of supervision in the case of cross-border distribution. Inducements are a first issue. In the NL they are banned, which means that the clients pay upfront for the advice they get. That ban led to a shift in the types of products that clients were advised on, with more focus put on simpler and lower cost products and on understanding retail investor needs. Transparency is a second important area of improvement, particularly with the need to enhance the layering of product information in digital environments and adapting it to online customer behaviour, because simply adding more information will not help investors make the right decisions. A third area of improvement concerns the product offering. The product oversight and governance requirements in the MiFID directive should help to ensure the adequacy of products offered to retail investors. MiFID completes some domestic approaches in this regard. In the NL, firms perform scenario analyses that test how products perform in different stress situations and assess whether this is consistent with the expectations of the target market defined.

An industry representative noted that in terms of value for money, the total costs incurred by asset managers along the value chain need to be taken into account, including the costs that asset managers have to bear vis-à-vis their own service providers. In particular in the context of ESG, especially with the growing concern about greenwashing, asset managers need to obtain value for money when buying ESG data from providers. The European Commission is going to make an official legislative proposal by the summer of 2023 on ESG rating providers, but at this stage it seems that they do not intend to follow the international recommendation made by IOSCO in 2021 to include ESG data providers too. This is a concern, not only because ESG data provision is a significant cost for asset managers, but also as the quality and reliability of ESG data marketed by providers is insufficient relative to the cost at present, despite the regular due diligence performed by asset managers.

Securitisation in the EU: future prospects

1. The European securitisation situation is unique

A supervisor stated that Europe is faced with significant financing needs, not only for funding investment in digital but also for the sustainable economy. The question that arises is where to find the means to fund these changes, and how to push towards the capital markets union and the completion of banking union. There are a number of discussions around the role that securitisation could play in this process. The specificity in Europe is that since the great financial crisis, securitisation has kept delivering below its potential. Securitisation is quite different in Europe in terms of underlying assets compared to other regions.

1.1 Securitisation can help to free up capital and finance investment but a stigma remains

A public representative stated that there is every reason to see a booming securitisation market. In a sometimes rather unstable environment, it would help banks to free up capital. Huge investment is needed in the green economy. Capital is needed and securitisation can be one instrument to help to free up capital and finance investment.

One thing that does hold securitisation back is stigma, though there is no stigma in the European Parliament. In this mandate, synthetic securitisation has been dealt with. There is also green securitisation. Parliament is positive towards securitisation, but is waiting for the market to develop.

A regulator suggested that many factors and parameters play a role in the market not being vibrant. While the market lacks energy, the situation seen before the great financial crisis is not what is wanted. Everything concerning the issuers and the environment, whether they want to use this for shedding risk is one factor. There has been an environment where liquidity was abundant, so the instrument was not needed as there were other sources of funding.

Investors should also be considered. Disclosure is part of the issue. Then there is the regulatory treatment itself. Everybody wants to make sure that the instruments are well designed, well used and do not lead to the excesses of the past.

A great deal of improvements have been made in that area, because of the simple, transparent and standardised (STS) product. There have been large reviews by the European Insurance and Occupational Pensions Authority (EIOPA), European Securities and Markets Authority (ESMA) and the European Banking Authority (EBA) on what can be improved. New proposals continue to be developed. ESMA recently embarked on a review of the disclosure rules.

There is a simpler instrument with STS framework, which could be used much more systematically in the current environment, which also sees a pickup in interest rates. Investors and issuers should embrace that.

A Central Bank official noted that promoting this market could bring benefits and support the capacity of the banking sector to channel lending to the real economy. In addition to the transition to the green economy, there is also the need to develop digitalisation. It also allows the transfer of risk to investors in an appropriate way.

Supervisors also need to see how these benefits could be achieved. There has to be a sound approach. There would be a need to keep good risk management standards, to increase transparency and to increase the simplicity of the transactions. There should be consideration not only from the supply side but also the demand side and how to provide a shift for that development.

A regulator added that the insurance sector could give help, but so far there has not been much appetite to invest in this kind of asset. Even after the introduction of STS, securitisation did not change much. A paper was given to the Commission on revisiting the capital requirement, and in the survey insurers indicated that the main driver for them to invest is the risk return profile, matching the liabilities and the complexity of some of the products. These seem to prevent them from investing, rather than the capital requirement.

A regulator remarked that there is willingness to see securitisation as a tool to manage the transition. In the context of the green bond standard there have also been recommendations that the proceeds of securitisation, rather than the collateral being securitised, could be used for qualifying a securitisation as a green securitisation.

1.2 Securitisation is particularly helpful for green transition financing needs

An industry representative noted that banks have substantial capital levels, but these will also be required by the increase of capital requirements with the Basel III transposition. There is a need for capital markets to relay these efforts and to contribute to these efforts.

Capital markets can finance corporates directly. The granularity and specificity of loans, for example for small and medium-sized enterprises (SMEs), cannot be made by ad hoc financing directly in the market, at least for a large part of these pools. In the US there is a combination of deep capital markets with direct issuance and a vibrant securitisation market. This is also needed in Europe, and that is why securitisation is needed.

Agency risk is addressed by the P-factor. The P-factor means that there is the feeling that when comparing the risk weighted assets (RWA) there needs to be a gap, with the capital requirements a bank has on the assets it holds, with the capital requirements if the bank invests in all the securities and tranches. That is because it is assumed that in the originate-to-distribute model, if the assets are not on the books, the worst assets will be chosen to sell to the markets. There is a need for this gap, and the P-factor is this increased level of capital requirements.

This is not consistent with the European model, which is not an originate to distribute model. When the banks securitise their portfolios, they keep other exposures on the borrowers. There is a genuine structural alignment between the bank's interest and investor interest. This P-factor should be reduced in order to avoid the disincentive both for funding and transfer of risk. When the risk is transferred the entity is not looking for funding. It is kept in the tranches. If the senior tranches are highly weighted, that is a disincentive to keep them on the balance sheet, because it makes the economics of a transfer risk unworkable. If an entity is looking for funding, it sells this in its tranches as well. It is not attractive for banks as investors.

1.3 Securitisation recovered globally

An industry representative remarked that the synthetic technique for risk transfer and managing bank capital is functioning. The introduction of STS for synthetics helped. The EBA released three documents, including on synthetic excess spread and STS eligibility for synthetic transactions. The synthetic technique will likely continue to be used and banks will be able to continue to manage capital. Australia has about a 10 times smaller GDP and a 10 times smaller mortgage market, but it issued 35 billion last year. This lack of recovery is in spite of the introduction of STS.

A Central Bank official remarked that there is a slight increase in the numbers referred to in terms of significant risk transfer (SRT) transactions.

An industry representative noted that the real market that is distributing securities to the market and contributing to the capital markets union is cash securitisation. Europe is the only market that has not recovered. Last year the EU placed about 55 billion of cash securitisations. Without the Collateralised Loan Obligation (CLO) market, it was about 30 billion. Of that market, only 10 billion was prime residential mortgage-backed securities (RMBS).

2. There are many reasons why the EU securitisation market is not taking off

2.1 Why European cash securitisation has not recovered

An industry representative noted, regarding the level playing field, that last year Europe issued more than 500 billion of mortgage covered bonds. With that incumbent large amount of mortgages there is very little left for RMBS. The two instruments are complementary and should work in tandem to support risk transplant funding for banks, but the regulatory framework is not complementary and, in fact, is contradictory.

US insurers buy between an estimated 10% to 30% of the tranches of most securitisations. In Europe, the estimate is that the insurance companies with an internal model last year purchased about 2-5%, and usually of the most senior tranches. From 2007 to 2010 securitisation represented about 10% of the fixed income assets under management of European insurers. Today, it represents 2%. There is a need to fix the issue with the investor base in Europe. There is something about proportionality, which requires specialisation and a high level of expense by the investors.

There are discrepancies in the national implementations. Some banks wanted to increase the share of asset-backed securities (ABS) in their liquidity coverage ratio (LCR) portfolio, but that was not looked upon favourably by national regulators. October 2022 and February 2023 proved that it is very important to have floating rate instruments on the balance sheet. The fact that the banks cannot build up their LCR adequately to 15% with ABS is a problem.

Securitisation is a match-funded instrument. The only flow-back risk exists in credit card master trusts in the UK. They effectively do not exist anywhere else, and the UK regulator is addressing that issue.

There are discrepancies in the interpretations that need to be addressed. There are many visible and invisible barriers, but ultimately the level playing field is not working.

A Central Bank official noted that though there is huge potential for the securitisation market to finance the transition to the green economy, granular data will be needed to identify these pools. The risk might be that then there will be very fragmented information across different access points. Having registered securitisation repositories could be a way to address the issue. The originators will need to start preparing to be able to have these data going forward. Having a transparent market is critical for its success.

An industry representative suggested that nobody is opposing transparency and due diligence, but it has to be proportionate and comparable across instruments. The fact that loan-by-loan data will be collected for every mortgage or auto loan is fine, though it will take time and money, but that is not a requirement for the products. That makes securitisation much more expensive to execute and much more expensive to buy, because it has to be analysed.

European auto manufacturers declared that they are issuing green bonds, but they do not issue green securitisation. They are green companies, but there is no green auto securitisation in Europe.

Insurance companies in Europe currently hold about 7-8% of mortgage portfolios as part of their assets under the management. They bought them from banks, but that is not considered an originate to distribute model. If the banks sold an RMBS to an insurance company that is considered to be the originate to distribute model. That does not make sense.

2.2 In the EU, banks favour retained securitisation in order to address repo needs

An industry representative noted that in the previous year Europe had about 50 billion of securitisation placed. The volume of retained securitisation in the EU was about 70 billion. Retained securitisation exceeds placed securitisation. The ECB holds about 340 billion of ABS in repo. It is easier for an issuer to do ABS, repo it and get the funding when doing public placement. It is easier, faster and cheaper to do a covered bond when looking for funding for RMBS.

In the UK, the placed volume exceeds the retained volume. There is not active use of MBS and ABS in repo, and the investor base in the UK is much more proactive. The pension fund crisis in the UK showed that UK pension funds have bought very large amounts of triple-N double-A securitisation across products. That product found a very easy market in October, but the majority of the purchasers were American asset managers.

European investors could not participate in the price correction for a number of reasons. One was due diligence. If an entity is trading, it has to respond immediately. Additionally, many European risk managers do not allow their banks to buy on the secondary market even if they are holding the same position. Also, much of the paper was sterling, which many EU investors do not buy.

For issuance, the retention is very peculiar for the EU. Australia had a very small retention volume of prime mortgages because the Australian Office of Financial Management established the programme to support liquidity on the securitisation market for about a year during the pandemic, and that is where the banks used some of their RMBS.

Regarding differentiation, Australia, Singapore, Canada and the UK all have visible or invisible asset encumbrance limits for covered bonds. When the banks in Australia reach their limit they have to do RMBS. That does not exist in Europe.

2.3 Prudential demands applied in the EU are tighter

An industry representative noted that the option provided by Basel on simple, transparent, and comparable (STC) is not applied in the US, and nor are the Basel III requirements. The level of interest rates will not be sufficient to trigger a take-off of the securitisation market. Much still has to be done on the prudential treatment. There is still room for improvement on the P-factor, but just ensuring that the situation will not worsen is not sufficient when the EU is far from the development of other countries.

2.4 Making the different regulatory frameworks consistent

An industry representative noted that there are more than 100 criteria to meet STS eligibility, and a large part of the market has been missed. There is a risk that the STS framework is considered the only potential development for securitisation. Currently, it represents 30% of the market, and not because the rest is toxic. The rest is not eligible because of historical data, granularity or homogeneity. Improvements in the prudential treatment should be included not only for STS but also for non-STS.

A public representative commented that there is a lack of a level playing field with covered bonds and securitisation. However, that does not mean there is also a need to boost the non-STS part, because that is not holding back. The distinction between STS and non-STS should be maintained, otherwise there would be a step back to before the financial crisis. The market should be transparent. An industry representative remarked that the idea is not to merge both categories but to improve both while keeping the difference.

A public representative stated the securitisation market is not thriving either because there is not enough room for non-STS or because there is too much room for covered bonds. The latter is more believable. That does not mean that the first has to be boosted. The desire is for a transparent market. A move towards private transactions rather than public transactions is concerning.

3. Conditions for improving the EU securitisation framework

3.1 Improvements cannot be at the expense of banks appropriately managing risk

A Central Bank official stated that the growth of the market should not threaten adequate risk management and capital planning from banks. If it is just used for loopholes to optimise capital then it does not help much. Without trust in the market it will not develop or it will develop in the wrong way.

3.2 Improving the framework require multiple adjustments

A regulator noted that there was a need to improve the consistency, clarity, and risk sensitivity of the framework as a whole, but also to work on other aspects like disclosure and proportionality. A targeted reduction of the risk weights for banks originating the transactions should encourage the banks to originate resilient transactions. There is also investor demand for synthetic securitisation, which dominates the STS significant response from the market.

The P-factor has been looked at very carefully. It does not do just one thing. It is not only about the agency risk model. It is also about avoiding cliff effects in the way different parts of the securitisation transactions are used.

When trying to fix something, unintended consequences should be avoided, such as incentivising banks to invest in under-capitalised mezzanine tranches. It is a fragile equilibrium, and certain things can be achieved with the reduction of the risk weights. There might be a need to revisit, more systematically, the full design of the risk weight formula, but for that there needs to be evidence and the preference is for that to be in a broader context with peers from other jurisdictions.

Market participants should embrace the change and see that it is going in the right direction. It might not meet all of their expectations, but not everything can be achieved at once.

3.3 Analysis of banks' investment needs and the P-factor

An industry representative commented that the banks have historically not been investors in the mezzanine tranche but rather in the senior tranches. If there is concern that it could be a risk in the future then there can be differentiation in the new framing of this P-factor between senior tranche and mezzanine. If the level of the P-factor is maintained to address this point then it will have a very negative impact on other aspects.

3.4 Data is required for recalibration of the securitisation framework

A regulator noted that there is yet to be evidence justifying changing the capital requirement. Even the improvement in the regulatory framework for the non-STS in general needs to be reflected in data, because otherwise the capital requirement in Solvency II cannot be changed in a qualitative way.

The major groups in Europe use an internal model for their capital requirements, and they even charge government bonds with a capital requirement when using the internal model. It is not that those companies invest massively in securitisation. There is investment and there is appetite, but it is not completely different from those who are under the standard model in terms of capital requirements. The others with the internal model look at data. The comparison with the US market suggests something needs to be explored still, but the markets are different and the capital requirements are different.

3.5 Dialogue between policymakers and the private sector is a key success factor

A public representative remarked that over time the analysis has become much more sophisticated. There are probably visible and invisible barriers, and discussion has to be held repeatedly to work towards a credible, transparent and booming market.

A supervisor suggested that there is agreement that it would be useful to relaunch this market. The dialogue is as alive as could be expected. Both sides have to continue having discussions. It is not a revolution. It is important to manage expectations.

Sessions VI

FINANCIAL STABILITY CHALLENGES AND VULNERABILITIES

Financial stability risks in Europe

1. Introduction

The Chair noted that there have been a number of recent stress events (failures notably of Silicon Valley Bank and Signature bank of New-York, loss of confidence in Credit Suisse) from which lessons can be learned. The panellists discussed the themes that were most relevant for the banking market: interest rate risk, liquidity risk, systemic relevance, the rescue of banks in difficult situations and resolution. Panellists also discussed the systemic risks that could emerge from the non bank sector.

2. The process of building a more resilient financial system is far from over

2.1 Financial stability does not mean that all risk is eliminated, and ongoing vigilance is needed to identify new risks

An industry representative noted that the global economy has suffered some substantial shocks over recent years, including Covid, geopolitical elements, energy and supply chain issues. One industry that has fared well compared to prior periods is the financial sector, but recent events have put this to the test. It is a timely reminder to be alert to ongoing and newly emerging risks and shocks. The pace at which such shocks can now unfold is striking. Financial stability can never be about removing risk altogether. The essence of market economies is risk taking which can result sometimes of in failure. That is the balance that the system seeks to strike. It is important to distinguish between the pockets of risk in the financial sector and that which threatens the entire system. Prior to recent banking events, crypto was a prime example, where events surrounding the failure of FTX did not have wider implications.

When considering banking results throughout 2022 and into Q1, it would be difficult to discern that war had broken out on the continent. It appears that these risks have been contained and great progress has been made since the global financial crisis (2008-2009). Many remarks have been made this week on how well capitalised banks are. They have more liquidity. Balance sheets have been repaired from lingering bad debts. In essence, it is about building up shock absorption capacity, but the landscape is changing.

The transition from monetary easing to monetary tightening was rapid. Easing took place in an environment of lower cost of borrowing with lower returns. Certain Covid measures created excess deposits. Subsequent tightening measures were implemented at a pace not seen since the early '90s. Fed funds at this time a year ago were zero. Now they are in the range of 4.75% to 5%. The European Central Bank (ECB) deposit rate was below zero. It is now around 3%. As central banks continue with monetary tightening, the cost of capital is rising and leveraged borrowers and positions will come under more pressure.

Advances in technology and communication have been striking. Tweets and banking apps are used to facilitate the rapid movement of deposits. The activities in the non-bank sector and private credit, as well as changing social dynamics, are affecting key sectors such as commercial real estate. It would be surprising if these dramatic shifts did not have any implications for the financial system.

Distinguishing between the pockets of risk in the system and those that are a threat to the overall stability of the system is a responsibility for everyone. The ability to move 25% of deposits off a bank balance sheet in one afternoon is remarkable. Even banks with good capital ratios can experience a dramatic loss of confidence when fragile sentiment is combined with doubts over strategy and governance. The speed of events requires a speedy and agile response to unfolding issues. The current speed of response is not an accident, because, since the financial crisis, there has been a great deal of work in the regulatory space to bolster the system.

In relation to credit, in simple terms, the risk in the system will find the fault line. Market participants will need to be alert and nimble in identifying that issue and the associated transmission mechanisms. First order is the exposure and the reliance of a particular institution. Second order is whether an issue will cause higher risk aversion and credit tightening. Third is policy response and what needs to change going forward.

2.2 Three financial stability risks to be considered

The Chair noted that the job of the European Systemic Risk Board (ESRB) is to consider which of the vulnerabilities of the sector are not just pockets of risk or idiosyncratic but could instead have systemic implications.

A regulator commented that current events are not entirely novel. In September 2022, the European Systemic Risk Board (ESRB) issued a general warning on the vulnerabilities in the EU financial system for the first time in 10 years. A number of accumulating factors of fragility were intertwined. There was an absolute need to ensure resilience and for authorities to foster cooperation in terms of capacity for responses to adverse developments.

Following that warning, the ESRB has focused on three key issues. The first is the interaction between market liquidity and bank funding. Market liquidity and funding liquidity are inherently connected. When market liquidity evaporates, financial market pricing becomes less reliable and tends to overreact, leading to increased market volatility and higher funding costs. Funding liquidity enables market participants to take exposures onto their balance sheets, thus absorbing fluctuations in demand and supply in the name of efficient market functioning.

The second point is what is happening with residential and commercial real estate. Prices have peaked. Interest rates and inflation are impacting the building industry. There is a contraction in activity in this sector. Credit has tightened. There are also complex interconnections in some sectors with not only banking but also investment funds, insurance and pension funds, and at the international level.

The third area is the macro-financial risk landscape and the implications of persistent elevated inflation, increased nominal interest rates, the movement of long-term yields and how the financial sector is able to address the size and the speed of the adjustment, in terms of movement of interest rates.

Assessing these three factors of risk together also helps providing a perspective on the capacity of the banking sector to withstand other shocks. There is a war and a risk of a further deterioration of geopolitical relations. There are cyber risks. There is widespread political fragility across different countries. All these factors must be considered both at the regional and the national level because the average picture of the European Union is not sufficient, given heterogeneity among countries. Moreover, Europe is integrated in a fragile global financial system. On the other hand, Europe is ahead of the curve in terms of addressing and containing the risk for the first time in many years. A great deal of work has started even before the recent crisis in the US and Switzerland has materialised.

2.3 Financial policies to reassure markets that the EU banking sector is resilient

An official stated that the interest rate risk should not have been a surprise for the financial industry. After a period of low for longer, there is currently a monetary tightening cycle. The ECB will need to continue hiking rates and to maintain tight monetary policy until mid-2024 in order to reduce inflation to 2% by 2025. Monetary tightening is going to continue and needs to stay high until inflation is defeated. Fiscal policy can help. Contractionary fiscal policy will help in the disinflation effort and will allow the ECB not to hike rates as much. This also helps in terms of reducing financial stress, but the disinflation effort should take priority.

Europe has a sound banking system. It is very capitalised, has high liquidity rates, is well regulated and is well supervised. Macroeconomic policy is taking place with this backdrop and therefore can fully focus on bringing down inflation.

There are lessons from the recent incidents for Europe. On the regulatory side, the implementation of Basel III should be timely, with no exceptions and a short transition period. On the supervisory side, Supervisors should 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. With regard to macroprudential policy settings, the plans of raising buffers should continue. This is actually an opportune time, when bank profits are high, because buffers can be built without impacting flow of credit.

Work on the architectural issues must continue. The ESM treaty amendment must be adopted in order to provide the liquidity backstop to the Single Resolution Fund (SRF). Work on deposit insurance must continue and an agreement on European deposit insurance scheme (EDIS) would add credibility to any bank resolution arrangement. The International Monetary Fund (IMF) is supporting the European Commission (EC) proposal to extend the banking resolution framework to smaller and medium-sized banks. Further to that, an exemption for systemic events should be created and more flexibility provided in the use of deposit insurance.

3. Lessons learned from the US and Swiss banking failures

3.1 Constant assessment of capital risk, credit risks and liquidity risks of the banking sector

An industry representative stated that the stark learning from Silicon Valley Bank (SVB) is that there is no substitute for good governance. This is not from the perspective of a regulator but as a practitioner. The other stark reminder is the difference between capital and liquidity. There is constant assessment of capital risk, credit risks and liquidity risks, and they are very different. Capital, or, as it could be referred to, shareholders' equity, is a loss absorption type of measure. These events were not triggered by a lack of capital. Shareholders need to support a financial institution, because that is the capital that can then be levered up and deployed in the system. Therefore, the probability of running out of it is key when it comes to loss absorption ability. The profit needs to then generate an adequate risk adjusted return for the entities that put that equity into the system.

Liquidity cannot be addressed if there is a problem with capital. Lack of liquidity in its worst form is a bank run. A bank run happens when it is not possible to generate the trust required to get the capital in that an institution is contractually obliged to give to someone else. How to avoid losing that trust becomes a key question. There could be refinancing risks, but it can also be linked to capital, namely the ability to raise more of it once there is a concern about profitability, viability or the ability to meet contractual obligations. This was the common theme in all the recent instances. There was an attempt to ask shareholders to commit for the medium to long term and a lack of commitment, triggering follow-on effects. The future regulatory regime is important. Trust and capital should be clearly divided. Trust can be lost in many different ways. Capital is a hard balance sheet number. It is about the shareholder equity availability.

Europe is, for once, ahead of the curve on liquidity. From a European perspective, the way the SVB treasury was run was not appropriate and cannot be done. Some learnings in Europe from the early 1990s changed this type of riding a yield curve or not focusing enough on asset liability management. Competitiveness is rarely talked about. There are pockets of fantastic financial markets and banks in Europe. There is also a competitive advantage for households, governments and corporations to have easy access to available capital, investments, savings and low transaction costs. There is a balance where all industries and relative comparative advantages should be cherished. How to develop them going forward should be considered.

3.2 A bank must have an operating model that is sound and profitable

An industry representative stated that the latest developments on e.g. fast interest rate hikes are not totally surprising and should actually have happened earlier. But he also pointed out that it was to some extent a surprize in Europe how the Silicon Valley case revealed that US banks have two different sets of regulatory requirements depending on the size of the bank. He emphasized how critically important it is to have a harmonized regulatory framework for the entire sector globally – i.e. treat all banks in the same way and that way establish and maintain confidence and trust in the industry.

One important assessment point for banks is price to book – in this profitability and the respective business models are key to be understood. And adding to this also "speed" – as SVB and CS demonstrated, hesitancy and lack of fast response to the need for speed quickly leads to a deterioration of trust. But of course, also the treatment of investors against the common expectations can lead to a lack of trust. So really trust is key and can be maintained by credible and diversified business models in banks with well diversified risks, harmonized predictable regulation and with action that is in line with expectations in crisis.

The operating or business model has to be extremely strong. No regulation can address that, but regulation is needed to ensure that the institutions that are not strong are addressed. A regulation that investors and other stakeholders can rely on is vital. Europe has made some major improvements although there are still some areas of difficulty, such as capital requirements and internal models, which are related to capital. The variance is clearly too big in Europe.

A public decision maker added that it is key to consider how technology may change the nature of risks. If clients are not sure anymore whether a bank sector will get to Friday with their deposits, and everybody has a telephone to move them somewhere else, than the banking sector as a whole risks to be subject to a sort of first-mover-advantage risk, in the same way as investment funds and money market funds.

3.3 The dangers of so-called self-evident things

3.3.1 Small or regional banks may be systemic

A market expert commented that, if small or regional banks are put together and have problems, they can spread the lack of confidence or trust they have throughout the system at large.

3.3.2 Sovereign bonds are risky

There is an idea that sovereign bonds are a good cushion for liquidity because they are riskless. That is not true because a treasury instrument is a fixed rate instrument and, by definition, very risky.

3.3.3 Stress test should be based on realistic assumptions

Stress tests are how the regulator and supervisor identify what situations could cause problems. In the recent application of stress tests in the United States, there was not a sufficiently high assumption of the increase in interest rates. This maimed the instrument and the capacity of banks to adapt.

3.3.4 Interest rate risk must be supervised permanently

It is believed to be self-evident that the interest rate risk should be the object of sensitivity analysis permanently, not once a year. The Basel instrument that allows for that is interest rate risk in the banking book (IRRBB). IRRBB was not applied in the United States. Previously, a bank rejoiced when it had a lot of deposits because it was a less costly way of funding itself than going to the market. Now it is understood that depositors are not the depositors of previous times. They flee at the first sign of weakness of a bank towards money market funds.

3.3.5 Accounting rules should always be applied in a very systematic way

If there is a portfolio of assets held to maturity, there is an expectation that there will not be a problem because there is an ability to wait for maturity and express no loss. However, if, at the beginning of a crisis, a little bit of that portfolio held-to-maturity is sold, the totality of the portfolio must be reclassified as Available for Sale (AFS). This reclassification rule was not applied in the US. That means that the accounting system was not transparent, but it allowed banks to feel comfortable with the cushion that it provided.

A major change is that market interest rates have very quickly reintroduced themselves into a picture where they were absent for 20 years. This conflicts with regulation and supervision, which has been relatively static. Regulation and supervision must adapt to the changes in all jurisdictions.

3.3.6 Basel regulatory and supervisory requirements must be applied in all jurisdictions. Complacency is the worst of all the dangers of the present system

It is a mystery why supervisors in the United States were so slow to adapt. There has probably been too much confidence in the capability of individual banks to manage their interest rate risk and in the ability of the system to adapt itself. Regulation is for the ones that do not instinctively implement the real governance. It is very important to keep the regulatory system alive, even if the big banks do not really need it. Complacency is the worst of all the dangers of the present system.

An industry representative commented on the EU system and specifically which important specific area needs alignment and discussion on a broader EU level. He elaborated and raised a concrete problem in EU in relation to capital requirements, and especially macro buffers. (Unlike in respect of micro buffers where level-playing field is pretty strong,) Macro buffers for banks are currently not at all coordinated nor aligned and are left entirely on national discretionary decisions. This leads to non-understandable outcomes where the relative risk levels do not match the capital requirements of respective banks. This in turn is not at all understood by investors and other stakeholders when they compare banks and leads to an unfortunate un-level-playing field and deterioration of competitiveness. This must be addressed in EU with determination – otherwise we might see similar destinies as we saw in the US.

An industry representative stated that the banking industry should use a different filter than the size of the balance sheet and the counterparties that a bank has. It must be made simpler and identify where a bank is significant. It has been demonstrated that a fairly small player can, with reputable people with a large following on Twitter, make very large dislocations very evident, which are very painful to address. Large banks are regulated with respect to investor protection. Giving advice today is very well regulated, compared to speaking about a company on Twitter with millions of followers. That is free to do and will lead to movements in the market that are very difficult to counteract.

The Chair commented that assumptions based on a past that has maybe been stable for a long time should be questioned. There were assumptions that the system was dealing with risk in a way that was adequate, for example interest rate risk in the banking book. This is not only a US phenomenon. It is a pillar 2 part of the banking regulation. If it is in pillar 2, that means that either the bank or the supervisor has to address it. If it is in pillar 1, it is automatic. If neither the bank nor the supervisor are addressing it there will be problems. It is the most basic risk in banking that has been there since the bank balance sheet was invented.

The nature of the stability of deposit funding should be considered and the liquidity regulation reviewed. This was only invented globally after the last financial crisis to disincentivise short-term wholesale funding. It has now become clear that short-term retail funding is not appropriately calibrated in that regulation. The world has changed in its speed. Liquidity regulation is just about codifying a liquidity stress test and some of the parameters are probably wrong.

4. Strengthening the resilience of non-bank financial intermediation

4.1 Analysis of the lessons of the failure of Credit Suisse is needed, but work on the resolution of GSIBs has made progress

The Chair commented that there are a number of areas of discussion raised by recent events. One of them is where the threshold for systemic relevance is. Under duress, threshold is set lower and lower to avoid psychological contagion. If in doubt, everything is systemic. Adopting this view ex ante would impact the costs of preparing and executing bank rescues. Secondly, there has been a live test in the failure of a global systemically important bank (GSIB) in recent weeks.

An official stated that the recent event was the first time since 2008 that a GSIB experienced stress, so the first real test of the Financial Stability Board (FSB) post-global financial crisis (GFC) reforms, in particular of the key attributes for effective resolution regimes. The FSB is a standard setter for resolution and this raises questions. It is unfortunate that there have been public statements about the credibility of the resolution regime, given that it was not applied. The governor of the Banque de France suggested that some soul searching would be necessary. There has been pre-emptive government or state action, taking account of the resolution planning and the resolution regime.

Analysis is needed, but the current situation is much better than 12 years ago. Resolution authorities have powers. Resolution planning has been carried out. Including Credit Suisse, the GSIBs have simplified their structures and issued bail in able capital instruments. The sequencing of allocating losses can be discussed, but loss absorbing capacity was available. Much has been done to support operational continuity in resolution and continued access to financial market infrastructures. Authorities were served well in recent events by the setting up of crisis management groups, underpinned by cooperation agreements, so officials knew who to contact. Connections were established that facilitated communication in the crisis. Authorities also developed a common understanding of their respective objectives and approaches to resilience.

The fundamental question that the recent Credit Suisse case raised is how to restore the trust and confidence of markets when a bank enters resolution. Banking is fundamentally about trust. 2023 is different to 2008. A Twitter-induced digital bank run is different from a capital crisis where there are toxic assets on the balance sheet and there is time to sort out the situation. Here, there was need for sizable liquidity.

The FSB has identified funding and resolution as a fundamental issue. Much has been done to support and facilitate private sources of liquidity. The FSB considered mobilisation of collateral and vulnerability across jurisdictions. The importance of public sector backstop arrangements was an important lesson. The features that such arrangements need to be effective will be considered in detail. In particular, in Europe the size of the arrangement has been identified as an important issue.

Supporting confidence, certainty and predictability matters a lot to markets. Executing a resolution gives rise to many questions: if total loss absorbing capacity (TLAC) is bailed in, who will run the bank? Who will own the bank? What will be the new business model? Will customers or bankers remain with a bank in times of uncertainty, where it is also not clear how quickly the plan can be executed in a cross-border context?

GSIBs have focused on the development of so-called bail-in resolution strategies. A question is whether more optionality and flexibility, combining bail-in strategies with sale of business transfer strategies, should be considered. The FSB will consider the case in depth, in close collaboration with the Swiss authorities, and study the US cases to understand the implications for current policies.

4.2 Insurers and pension funds have successfully navigated recent stress events but there remain headwinds

4.2.1 A robust supervisory framework based on a mark-to-market full balance sheet approach, covering the whole risk profile of an industry, is key to containing the impact of adverse economic and market developments

A regulator stated that recent events in the US suggest having liquidity data as an insurance supervisor is good, even though liquidity is not the first concern of a supervisor. It enables an assessment of whether the current exposure is concerning. European insurers have significant interlinkage with banks, particularly through investments in bonds and market corrections would lead to mark to market losses for insurers depending on individual exposures. Their significant exposure to banks is assessed, as such, what is happening in the banking sector is very relevant. Considering the insurance sector as a whole, rising interest rates are good news.

The robust EU regulatory and supervisory insurance framework, with a balance sheet that is fully marked to market and a pillar 1 that includes all risks, is not a guarantee for stability, but it definitely helps. It also has an impact. At year-end 2021, there was 10.5 trillion in assets in the insurance market in the EU. That has come down to 9 trillion as of year-end 2022. Nevertheless, liabilities are also coming down and the average (?) solvency ratio remains the same at a comfortable 250%.

4.2.2 Liquidity and synthetic leverage need to be closely monitored

It has already been stated that complacency should be avoided. Liquidity risk must still be monitored, particularly because liquidity risk can sometimes arise much faster than expected. Liquidity risk can be triggered by policyholder behaviour. There are two issues: There is one thing that is really new, which is the cost-of-living crisis. Inflation reduces consumer purchasing power. It might simply be that people, even though they will pay a penalty, they will lose a tax benefit, still see a need to lapse their policies. We slowly see that happening now. It is not at a concerning level, but definitely something to monitor. The other aspect of policyholder behaviour is not taking additional products and not renewing non-mandatory non-life insurance. The question is whether it will be possible to write more business at a time of a cost-of-living crisis.

Synthetic leverage also needs to be watched carefully. In a system where full mark to market is operated, there must be consideration of interest rates going down. This is hedged for. When interest rates go up, there will be margin calls, as happened very quickly in the gilt crisis in the UK market. Speed was very important. A great deal of liquidity in the form of cash was necessary. Acting on that had an impact on the market. How likely this is to happen in the EU can be considered. It cannot be ruled out, but the situation is very different. Pension funds in the UK are a very big fish in a small pond, whereas pension funds in the EU are relatively small fish in a very big pond. Liquidity is deeper in the EU market and the diversity of investment with the different government bonds also makes it less likely that this will happen. Nevertheless, more liquidity testing, or continuing liquidity testing, is also relevant in insurance, particularly for managing this risk.

4.2.3 The pension gap and climate change risks require further consideration

Two important risks from a financial stability perspective are serious but not yet much discussed. First, there is the pension gap in Europe. One in five European citizens is at risk of living in full poverty in old age. 35% of those are women and, in general, women receive 30% less. This is a difficult discussion because a pillar 1 system, social and labour law will need to be combined with events in pillars 2 and 3. This is relevant to the need for more retail investments and for people to be more conscious of how they save for later, again at a time of a cost-of-living crisis.

A second issue is protection gaps, and, in particular, natural catastrophes (nat cat) risks. Because of climate change, the intensity and frequency of events is going up. In the current round of renewals for reinsurance prices are going up by 40% to 50% across the market. There will come a point where that is unaffordable. Together with the ECB, EIOPA recently published a report discussing these risks from a financial stability perspective. How to increase the capacity of an insurance market together with other parts of the financial industry must be considered. How the public-private partnerships can stand ready should also be discussed.

4.3 The FSB has undertaken work to assess and address the risks from NBFIs

The Chair noted that work on non-bank financial institutions (NBFIs) has been ongoing since the last financial crisis but sometimes seems to be less of a priority. Pulses of systemic risk and contagion in the markets have come from this sector.

An official confirmed that the FSB has been monitoring the NBFI ecosystem since the global financial crisis, publishing an annual report. As a result, much more is now known about the size and the risk from a systemic perspective. However, regulators have not kept up with the very significant growth of the sector. The lack of transparency did not enable them to effectively monitor it.

After the 2020 market turmoil, a holistic review was conducted and a work plan developed, which contains deliverables to the G20. These include a consultative report on addressing liquidity mismatches in open ended funds that will be published in the coming month. There will also be further assessment of the vulnerabilities associated with non-bank leverage, how to address sources of liquidity imbalances and developing a more comprehensive toolkit that is also effective from a system-wide perspective.

4.4 Financial stability risks from energy derivatives markets

A regulator commented on the need to reflect on past mistakes. He explained, for example, that, when the ESRB had to express a view on the systemicness of third countries' central counterparties (CCPs), it immediately excluded all those that were working in the UK and the US with commodities, because they were considered relatively small. Shortly after, a potentially serious incident in the nickel market in the City was avoided only because the stock exchange there decided to do something that nobody had thought of, i.e. cancelling one entire day of orders. The rules of the game were changed to preserve markets from a deeper collapse. That is the equivalent of the Swiss changing the order of preference between equity and bond holder and the Americans extending the guarantee to everybody. Also, last summer, there were widespread liquidity problems after large margin calls at the Title Transfer Facility (TTF), due to a war-driven squeeze on gas prices. To avoid energy market failures in a highly delicate geopolitical situation, several governments had to intervene with credit lines and other subsidies. Also unthinkable, a few months before.

We need to ask ourselves critical questions on whether we would need to take the same exceptional measures in the future in case of materialisation of much more severe tail-risks. If the CCP world is exposed to tensions for relatively small-sized derivative markets like those for nickel and gas, what would happen if there were a sudden, unexpected interest rate shock in the financial sector, which would bring to a very large and sudden margin call request? I mean, a huge one. Interest rate swaps are a much bigger market than commodities. Whether CCPs are strong enough to cope with much larger, almost generalised episodes of fragility has been of course subject of severe stress test exercise by ESMA (which is an institution with a high reputation), and with good results (also with the ESRB's support), but of course remains to be tested in real life. Simply, reality is sometimes beating what we expected to be the worst scenario. These are topics for the future.

An industry representative commented that there was an issue with electricity in their region. A utility client was asked to post €9 billion of collateral in one afternoon. The client had 30 minutes. That demonstrates the impact of liquidity on the most reputable, highest creditworthy counterpart. This is not about solidity. It was not possible to generate liquidity at that speed.

How to regulate shadow banking, not so much in respect of reputable pension funds or insurance companies, but more in respect of fintechs and start-ups, should be considered. However, innovation and the spirit of trying something new should not be stifled.

The Chair commented that, until the very significant pulse of risk came out of the UK pension sector, it was surprising that, with the rapid change in the environment, there had not been more spill-overs out of the non-bank sector. If what one family office, Archegos, caused in terms of losses for the banking system is considered, there was a concern that more of these incidents could arise, because the sector is much less transparent. He added that there is an idea that things that have happened elsewhere would not occur in Europe. This thought should be treated with caution. What could happen here should always be considered. Some of the dynamics discussed are globally identical. Everyone who runs supervisory authorities knows that they should be wary of criticising colleagues because the reputation of each authority is only as good as the distance from the last crisis in its supervised sector. There is a need for humility when identifying the weaknesses in a supervised system or observing the weaknesses in others.

Sovereign debt challenges in the EU

Public indebtedness is a global issue, but sovereign debt raises specific challenges in the euro area since there is a single monetary policy but no common fiscal and economic policy

The Chair stated that the very high level of debt is not only a European issue, but is something that is happening everywhere. Even before the Covid and energy crises global debt was at an all-peacetime record. Fiscal responses to the COVID-19 pandemic drove record levels of debt issuance in the OECD area in 2020, with gross sovereign borrowing requirements peaking at $15.4 trillion. Borrowing levels moderated slightly in 2021 and again in 2022 but are forecast to rise by 6% in 2023 to $12.9 trillion.

Europe has a currency without a state, so the specificity could have consequences that would not be the case elsewhere. It is timely to discuss the topic of sovereign debt challenges in the week that the Commission produced a draft reform of the Stability and Growth Pact (SGP), even though some rules are enshrined in the treaty itself or in the protocol. It is also very timely because of the war in Ukraine and climate change. The need to keep room to manoeuvre to face shocks is more acute than ever before.

1. Euro area sovereigns face debt sustainability challenges

1.1 The heterogeneity of public debt levels in the eurozone varies widely

An industry representative explained that Moody's offers investors guidance on credit risk. In terms of sovereign debt sustainability challenges, particularly in the EU, the very simple answer is look at the Moody's rating, because that is exactly what it speaks to. It speaks to the ability of governments to manage their debts without having to refinance in a disorderly way or a default. At the moment in the EU there are still a number of top rated Aaa sovereigns including Germany, the Netherlands and Sweden. The lowest rated sovereign Moody's has in the EU is Greece, with a Ba3 rating, which is a 12 notch difference. Moody's publish data on rating performance and defaults back to 1920. A one notch downgrade corresponds to about a 50% to 60% increase in relative credit risk. There is substantial heterogeneity within the EU.

Moody's assessment is not that different to the one it made just after the global financial crisis. Ratings have not moved in a huge way. Debt to GDP is not a sufficient statistic to determine sovereign creditworthiness, as it is only one indicator in one part of Moody's sovereign approach. Beyond a broader assessment of fiscal strength, there are three other factors – economic strength, institutions and governance, and susceptibility to event risk – that are distinct from fiscal issues. Moody's examines lots of other indicators as well before it overlays judgment. Obsessing about one piece of data is not healthy.

In conversations from policymakers and politicians about debt to GDP ratios, they really like talking about GDP. There is always a strong focus on growth. Moody's understands that, because when it thinks about debt dynamics it thinks about the economy rising, probably in line with trend real growth and target inflation over the long term. On the top it thinks about interest rates and the price paid for borrowing money. History has shown that depending on the denominator does not definitely deliver desirable debt dynamics. One should also worry about the numerator.

The last rating action that Moody's took on an EU sovereign was to upgrade Ireland to Aa3 in May 2023. Ireland's debt to GDP trajectory was 120% of GDP 10 years ago, and in 2023 it is going to be about 40% of GDP. Everybody wants to talk about the growth, but they lose track of the fact that Ireland did a significant amount on the numerator. Ireland was running deficits below 1% of GDP by 2016 and was running fiscal surpluses in 2018, 2019 and 2022. Dealing with debt dynamics is a policy choice that can be made. Moody's thinks that debt to GDP in Sweden will be about 34% of GDP in 2023. Sweden went through the same pandemic as everyone else, but was less exposed on the energy shock. That is a 5-percentage point (ppt) reduction in debt-GDP since 2018, but in Italy, Spain or France there have been increases of more than 10%. There is heterogeneity within the EU and policymakers make choices that are different.

1.2 Policymakers want sustainability when discussing the environment but not when discussing debt

A market expert stated that at the previous day's Eurofi panel he had felt a sense of déjà vu, having left the EU 10 years ago and returning to the same debates as 10 years ago. Rules on sovereign debt are being discussed again at this point in time. It is good that the mood among the regulators on this panel is not as complacent as it was on the previous day. Europe needs to prepare for dealing with a new round of problems even if it not yet had be a problem. Europe should be prepared to solve problems if they were to materialize.

On sovereign debt, there is a complacency that '100 (debt/GDP ratio) is the new 60,' which is not true. When policymakers talk about explicit government debt they forget one thing: sustainability is key. Policymakers only and always talk about sustainability when talking about the environment, but not when talking about public debt or deficits, where sustainability is typically seen as a nice-to-have instead of a must-have feature. There are few representatives in this room of the young generation, nor anybody that could speak for future generations. In addition to explicit debt/GDP ratios, which on average are now around 100%, there is a massive implicit government debt problem. Implicit debt is the net present value of all un-funded future liabilities relative to future expenditure.

A public representative appreciated what a market expert (Axel A. Weber) had said, because the matter should be looked at globally. It is also striking how sensitive some people are for climate sustainability and how ignorant they are about fiscal sustainability. Putting aside the issue of economic growth, Europe needs to work on finding out what the main issues are that is slowing it down.

1.3 The coexistence of an increasing public debt on one side and structural deficiencies on the other is worrying

An expert noted that he shares most of the views expressed. It is not the size of the public debt that is worrying, it is the coexistence of an increasing public debt on one side and structural deficiencies on the other. The lethal mixture is when having a rising public debt of more than 100% of GDP associated with low employment, high unemployment or low productivity gains, and an inelastic supplied economy because of lack of investment. When all of that happens together the sovereign debt becomes a problem. Europe has unfortunately seen that some of its high indebted countries were the ones where the structural deficiencies were the most staggering. Whether it is 116% of GDP or 80% of GDP is not the important issue, the important thing is whether Europe is growing. The only way to eventually eliminate too much debt is to have a big denominator growing. The worry is the coexistence of very deep structural inefficiencies leading to low growth and high public debt.

The Chair agreed with this overview. Europe would make a considerable mistake not to look at the question as also a vital question for the European Union, because a default would mean that the project would be killed. Members of the European Parliament can play a role.

1.4 Accumulation of debt is not the result of financing the priority expenditures, but rather the inability to manage ordinary expenditures

A public representative stated that Europe is facing a very strong deficit bias in the fiscal policy. During the times when the left is governing a country it is mostly taking place in the form of increased expenditures. When it swings to the right they often cut taxes, which does not have a counterparty in reducing the expenditures. There is a deficit bias, which is why Europe sees an accumulation of debt. In fact, accumulation of debt is not the result of financing the priority expenditures, but the non-ability to manage ordinary expenditures or to adjust the revenues of the governments accordingly. If a short period of excess spending is not followed by a longer period of normalisation of fiscal policy near a very low level of deficit, then fiscal sustainability can be put in danger, as the level of debt can steadily grow. Politically speaking, most governments believe that there is a very limited reward for managing their fiscal house well, while there could be rewards to overspending money and giving it to some people or cutting taxes and making another group of people happy.

1.5 The policy mix in Europe currently has is creating some financial stability risks in the system: expansionary fiscal policies in the euro area raises the burden on monetary policy to contain inflation

A Central Bank official noted experience from hands-onwork with the SGP and its implementation back in the 2000s. The annual examinations of the programmes took a great deal of care for equal treatment. The examinations were open and transparent. The problem then and potentially now is that pretty basic macroeconomic considerations are too absent from the fiscal framework. The policy mix Europe currently is creating sovereign and financial risks.

It is clear from the imbalance between supply and demand that monetary policymakers need to tighten up monetary policy. At the same time, Europe has a fairly expansionary fiscal policy and in recent years there have been quite a few chunks of expansions working against the ambition of central banks to squeeze out inflation from the system. It is vital to ensure that Europe has an SGP and an implementation which takes macroeconomics and inflation issues into account.

1.6 Europe needs to have the courage to look at its own economic and fiscal data

A public representative stated that Europe should look at the data. In the last 15 years Europe has gone through three very serious crises, and in each of these crises there had been a very strong fiscal reaction and governments had substantially increased the deficit. If this is the new normal, then Europe must be really sure that in any time other than bad times it will create substantial buffers to be ready for those bad times.

Regarding UK data, since the end of the 1960s until 2008 the debt level hovered around 40% of GDP. The outcome of the first crisis was that it jumped up to 70% of GDP. The result of the second crisis was that it jumped up to 100% of GDP. Before the first crisis the GDP per capita in the UK measured in purchasing power parity was just above $44,000. 2021 data showed that it is now below $45,000 per capita. A circuit breaker is needed, otherwise more and more governments will get into similar paths that are probably not as visible.

The Chair added that the UK data was both useful and very sad, but Europe needs to have the courage to look at its own data. A public representative noted that 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 in good times. With the current increase in interest rates the 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.

1.7 Politicians think about the next election and short-term ruling rather than reforming their country to face the challenges of the future

The Chair observed that in the western part of Europe people look at some eastern European countries, including Poland, and say that there is less interest for all those issues.

A public representative stated that if the political class consisted entirely of finance ministers and governors of central banks then Europe would be in much better hands, as they tend to have a longer term view than politicians.

The Chair was of the view that all politicians think in terms of the next election. A public representative agreed with this but noted that finance ministers are slightly different, because the main enemy of every finance minister are their colleagues in the government. Governors of central banks are quasi-independent, so there is a difference. Unfortunately, politicians think about the next election and short term ruling. 10 to 15 years ago Poland did something to harness the explosion of the implicit debt, with a rather dramatic increase in retirement age by seven years, preceded by a transition from a benefit determined to a contribution determined social security system, which immediately decreased the public representative's (Marek Belka's) own retirement benefit by 30% or 40%. Both of these things have since been reversed by another government. Europe tends to invest in the past or the present.

A public representative added that on climate young people in Poland are maybe five years behind young people in Sweden, but the gap is shortening. They tend to think about the future, but they do not vote. The grey lobby votes and is at the pulse, and politicians treat them much more seriously than young people.

2. Ways forward to address debt sustainability challenges

2.1 The current EU fiscal framework should be replaced with a system that combines flexibility with fiscal discipline

A public representative noted that Europe has changed its approach towards public debt with the end of the zero-interest rate era. Some time ago some people tended to treat it lightly, as with zero interest rates they did not care about the public debt level. That has now changed, which has allowed the central issue and the discussion about the reform of macroeconomic management in the EU and also in the European Parliament.

The existing EU fiscal framework does not work, as it is ineffective, procyclical and frequently politically impractical. A new framework should combine three elements. The first is fiscal responsibility, which is the concern of the so called north. The second is the need for flexibility, which is the concern of the so-called south. There is an eternal tension concerning any SGP reforms between the north and the south of the EU. Indeed, the former emphasises the importance of fiscal discipline and adherence to fiscal rules. The latter emphasises that what is needed is flexibility and a system that can react to shocks, especially asymmetric shocks. What one needs is an effective effort to strengthen the fiscal rules to reconcile both sides. The third objective of the revised EU fiscal framework is to stimulate competitiveness and potential growth, and to provide for space for investment.

The blueprint that Valdis Dombrovskis briefed everyone about is an attempt to achieve all these objectives, at least partially. An individual or case-by-case approach is understandable, although it means that the European Commission will have a formidable task in dealing with countries, especially as the discussion, as usual, will be based on the unobservable variables such as output gap and potential growth. Unobservable variables are unobservable by definition, and tended to be dramatically erred upon, especially in turbulent times. That means there will be a lot of 'wiggle room', especially used by the bigger member states.

Simple expenditure rules should be used to alleviate the problem, but it is open how much the Commission will be allowed to treat it as a benchmark in discussions with individual countries. An ideal system will be a combination of simple expenditure rules, although individually determined, and the permanent fiscal instrument to be used in a case of serious difficulties. Even though it is not beloved by all, NextGenerationEU is a testing ground for such an instrument. In theory it could satisfy both the north and south of the EU, but in political practice that is far from the case. Europe is two crises away from such a solution, but Europeans only move forward when pushed against a wall.

2.2 In good time fiscal policy should be restrictive, building up buffers for bad time

A Central Bank official stated that distinctions need to be made between good times and bad times. Looking back through the experience of the 2000s it was very clear that Europe was short of some instruments. When a country could argue that the deficit looked great, and the public debt level was low, in spite of large macroeconomic imbalances that provided clear indications that it would not go on forever, Europe did not have the instruments needed to push for consolidation in good times. An operational criteria for having good times is when central banks need to raise interest rates to squeeze out demand. Europe has typically made large fiscal expansions in bad times and run neutral fiscal policy, at most, in good times. Europe also needs to do much sharper impact assessments on the outcome of the large expansions and their composition.

A separate issue is how the risk of sovereign debt should be coped in the books of central banks, but perhaps more importantly in the private banking sector. Work had been done on that for many years, but a clear solution never came out.

Everyone can agree in the abstract that debt should be reduced, and the deficit should be healthy, but when it comes to the specific policy decisions impact assessments should be undertaken that are transparent across the entire European Union preferably before a decision is taken. If it is not done before the decision has been taken then it is important to do it afterwards, even if it is politically inconvenient to be exposed to the consequences of some decisions. If fiscal policy runs counter to monetary policy in expanding when monetary policy is contracting then the policy mix is raising 'r minus g', which is the famous ratio between interest rates and growth, making the sustainability of public finances more problematic.

2.3 A discussion on public indebtedness and growth is urgently needed at European level. The question is whether Europe wants a change of direction on monetary, fiscal and environmental policy, or whether it wants to continue to talk about these issues without taking action

2.3.1 Overcoming the political cost of structural reforms

An industry representative stated that the one thing that sovereigns typically have is time. There is still time for people to take different decisions, but there is a political cost to be paid for some of these decisions. Harald Waiglein put it brilliantly when he talked about jumping into the swimming pool without wanting to get wet. Europe is now in a situation where it is a deep pool and one has to be sure they can swim, but there are also external checks and balances. Reference has already been made to the reaction seen in UK bond markets last year, but the market reaction to the mini-budget was an incredibly important mechanism. Investors in sovereign debt are much more focused on that. Europe cannot just think about rules for itself, but it has to also engage with the people it is selling the debt to.

A market expert explained that the last time he had looked at explicit debt was when he was on the German Council of Economic Advisors (CEA). Implicit German government debt then had already been 270% of GDP. The CEA had told the head of the German chancellor at the time, Gerhard Schröder, that the government needed to do a pension reform. There is today the same debate in France, only 20 years later. Gerhard Schröder's coalition government did the pension reform, but it was not appreciated by the electorate, and he lost the election. The lesson every policymaker has learned from that is exactly the wrong lesson: if there is a public debt or implicit un-funded government liability problem, then it should not be touched, because it could lose policymakers the next election. The explicit debt numbers are probably now more than 300% of GDP.

2.3.2 Europe spends increasing amounts of money for financing the past instead of investing in the future

A market expert noted that the third public and private liability is the unfunded liability for climate change by less than a 1.5% increase in global temperatures. That is an environmental liability. The current generation is passing the planet onto future generations in the worst condition it has ever been, with a dynamic that continues to be adverse. It is also passing on public finances in the worst condition they have ever been, both in terms of implicit and explicit government debt/GDP ratios. The numbers are staggering. Around 120 trillion of green finance is needed until 2050 to achieve the 1.5 degree maximum global warming target, which is around 120% of global GDP. Within Europe you need to add 100% explicit debt/GDP ratio and a 300% implicit debt/GDP ratio. To illustrate this in a over-simplified way: current generations owe future generations more than 500% of GDP compared to a state of affairs where they achieved sustainability and had their house in order. Instead, they are passing on a huge burden. With an employment ratio of roughly 50% in the average European economy, this is equivalent to 10 years of work for every future citizen to counteract this inheritance.

Future generations protest against inheriting this massive debt and environmental liability should not surprise anyone. It is time that the richest generation of post war people living and retiring today in Europe recognises that our generation of parents and grandparents, who inherited Europe from the ruins of war, did not have the luxury to borrow from the future to get Europe's house in order. They had to work hard and spend their hard-earned money to get Europe back on a growth path. Current generations have the same obligation: live less at the expense of the planet and pass less of a liability to future generations. With interest rates rising again in Europe, governments will be confronted with spending increasing amounts of money for financing their past liabilities instead of investing into the future. What is needed in the discussion around the stability and growth pact is less focus on the numbers and the room for manoeuvre implied. The discussion should be about whether Europe wants a turnaround in fiscal, monetary and environmental policy, or whether policymakers just want to keep talking instead of acting.

2.4 For increasing sustainable growth and reduce macro-risks for the EU wide economy, Europe needs credible fiscal and climate rules

A public representative stated that Europe needs robust and respected rules on fiscal issues. At the previous day's Eurofi it had been said that Europe does not just need benchmarks for the corrective arm, but also for the preventive arm, otherwise the benchmark will be 100% of GDP. With 100% of GDP and the interest rate jumping to 4% then 4% is added to the debt service cost. That is impossible, so benchmarks are needed. Within that there cannot be any exemptions for so-called priority expenditures. Europe needs to start to deliver robust rules for climate. The rules in place are quite stable, but Europe needs to find the obstacles for more mobilisation of private money, because private money must do the trick. Europe cannot expect that public money will pay for that, because it is out of the question.

The Commission has done great work to identify the pension risk, but it is not enough. Europe needs to move to a system when the pension decisions will be depoliticised, because it is a relatively simple arithmetic calculation to make sure that there is not 100% of GDP deficit on the way. Another option is to make voters more aware of the cost of running an unsustainable policy, because most politicians believe that there is a reward for running an unsustainable policy because they can overspend or overcut taxes. A communication line is needed that will make sure people understand that they will pay the price for all the excess spending or excess tax cuts.

An expert observed that Europe does not have a capital market. In the United States when there is a recession or a problem with substates because they are too privately indebted and with not enough sufficient output capacity the result is that a natural flow of funds comes from the wealthier parts of the country towards the less wealthy parts. There is an automatic correction, but Europe does not have that.

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

An expert underlined that the policy of permanently low interest rates has been accompanied by a reduction in productive investment and by a deterioration in the quality of public services in France. Structural problems need to be addressed by structural reforms. A qualitative change in budget expenditure is required. When there is a long period of zero or negative interest rates in nominal terms it makes the life of those who elaborate budgets much easier. There has been a coexistence of easing monetary policy on the one side and easing fiscal policy on the other side.

When looking into the situation of some European countries that have very large public debts and very large deficits it is possible to observe that the structurally important investments like research, justice and the rapidity of justice is an important element in the financial effectiveness. These sectors are sacrificed in a country like France, which has an enormous amount of public expenditure, something like 60% of GDP, versus an average European expenditure of 50%. What is important is not only the amount of deficit, 5% to GDP, it is the quality of the expenditures. The SGP needs to examine all the elements of the budget that are favourable or unfavourable to growth.

2.6 Impact assessments, coordination and more transparency are essential for pricing climate

The Chair noted that a serious question is how to price the structure. Europe does not price climate properly and makes out that it is impossible to price the negative externalities of climate change. The Netherlands Central Bank work shows all of the biodiversity loss. It is important to make sure that the geopolitical pressure from outside, the urgency of fighting against climate change and biodiversity loss and the need to face the spending of aging societies are taken into consideration in all the political discussions.

2.6.1 Transparency in sovereign credit risk assessment is important

An industry representative clarified that Moody's does not price anything. The financial markets do pricing on a minute-by-minute basis, but Moody's is focused on the fundamentals of credit risk. Moody's is increasingly engaged on issues such as how social injustice or inequality affects not just the credit standing of companies but also the credit standing of sovereigns, and the environmental risks, not just in terms of the financial cost needed to mitigate or address the issues, but the damage that can be done from environmental disasters. A lot of Moody's recent focus has been on trying to be more transparent. Moody's has always worried about whether issues are meaningful for sovereign credit risk, but in recent years it has put a lot of time and effort into trying to be much more transparent about doing that. When going onto Moody's website and looking at the rating there are now explicit credit impact and issuer profile scores which explicitly say how Moody's think those factors are impacting on creditworthiness and what the overall effect is.

2.6.2 The European reaction to energy prices in 2022

A Central Bank official stated that on pricing the climate in summer 2022 Europe did the opposite. There was a hard supply constraint on the regional electricity markets and gas markets, so prices went sky high. In a situation with fixed supply, if one starts subsidising the consumption of fuels by hundreds of billions of euros, then market prices will go up accordingly in the short term. End user prices will necessarily with or without government subsidies increase to the point where the market is cleared and demand limited to the supply of energy available. The large subsidies for fuel consumption will thus have a limited impact on end user prices but offer large gains for energy exporters and intermediaries. Over time, of course, such profits for energy producers will boost supply and push back prices again. Impact assessments of the tax incidence, coordination and more transparency would have helped.

The Chair stated it is important to think big and include sustainability in the large sense, and to look at more than just GDP. It is now up to the European Parliament and the Council to deliver the best possible rules. Time has come to make public opinions aware that the need to invest more in our security and in transition to net-zero implies difficult choices.

Managing risks in the banking sector

1. The recent banking turmoil and the deteriorating economic environment raise financial stability issues for EU banks

The Chair noted the recent failure of several US regional banks and the rescue of Credit Suisse by UBS. Globally, including in Europe, the economic environment has deteriorated, raising a number of questions regarding economic and financial stability. However, the EU economy and banking sector has shown resilience to these conditions.

The discussion has focused on three sets of issues: the extent to which European banks are immune to the recent banking turmoil, the main risks and vulnerabilities on the balance sheets of EU banks, and what the development of non-banking financial institutions (NBFI) means for the banking sector.

2. The European banking sector is in better shape than parts of the US banking sector regarding the management of interest risk but all banks including EU ones are exposed to the risk of digital bank runs

The Chair stated that the current challenges relate not to capital or even to liquidity, but rather to interest rate risk. Unlike in the US, all banks in Europe are subject to the Basel rules for managing interest rate risk. The single regulatory and supervisory framework provides protection in the EU against the sort of banking events witnessed in the US and Switzerland. Given the speed of depositor flight in the age of digital banking, it is necessary to review the parameters within the Basel Liquidity Covered Ratio (LCR).

2.1 The situation is completely different in Europe compared to the US: contrary to the US, all banks in Europe are submitted to the Basel rules for managing interest rate risk

A Central Bank official noted that European banks are in a stronger position compared to where they were at the time of the global financial crisis. European banks do not share some of the vulnerabilities that have affected US banks. However, European banks are not immune to the recent banking turmoil. The European banking sector has some specific issues, particularly low growth. In some European banks, there is still an issue with low profitability and the prospect of higher funding costs also increases the downside risks to bank earnings.

Sveriges Riksbank was founded 355 years ago as the result of a bank run. In a system based on trust and in which confidence can very quickly disappear, no bank is immune when there is banking turmoil, but there are some important differences between Europe and the US. In terms of management of interest rate risk on the bank's own balance sheet, Europe is clearly in a better position. The regulatory environment is better in Europe in this respect. There is a requirement to hold more liquidity when exposed to interest rate risks. Here, the European banking sector is in better shape than parts of the US banking sector.

To sum up, there has been a lot of progress since the global financial crisis, but there needs to be a regulatory agenda to deal with some of those issues. Nowadays, there are bank runs by Twitter, and this is something the European banking sector will also have to deal with.

An industry representative underlined that, since the last big crisis in 2008, many regulatory requirements on banks have been implemented. Sometimes banks complain about them, but these actions have strengthened the European banking scene. Most European banks have built up a lot of high-quality liquid assets that can withstand a substantial outflow of deposits. Risk appetite statements constrain how much interest rate risk banks can take. The existing Basel regulation gives supervisors ample room to monitor interest rate risks.

A regulator stated that immunity is a difficult concept. Nobody can say they are immune. A good characterisation of the situation is that it is about 'banks in crisis' rather than a 'banking crisis'. This is different from the crisis 15 years ago. The context is now the same on both sides of the Atlantic. Monetary policy has been tightened at a relatively high speed. This could create a number of cracks. The ultimate impact of this tightening should be felt through the real economy, but it also circulates through different channels and ultimately affects the financial sector. The tightening is supposed to bring down direct demand and, ultimately, inflation. That will have an impact on banks' assets and funding conditions.

Having said that, the situation is completely different in Europe compared to the US. Firstly, the tightening of monetary policy started later in the euro area. There have been a great deal of preparations and discussions about how it would impact banks' balance sheets and risk management. There have been many improvements to the regulatory setup for Interest Rate Risk in the Banking Book (IRRBB). There have also been a number of tests run by supervisors. There is no business model that looks like that of the US banks. Contagion is always a risk. If there are channels that are not fully identified, then that might affect these or other banks, but the banking sector is starting from a very strong position. The regulatory framework is much more systematic in the EU than in the US, with fewer cliff effects.

2.2 The single regulatory and supervisory banking framework provides protection in the EU against similar banking events that we have seen in US and Switzerland

A regulator stated that, for the last 10 years, the EBA has been working on a common rulebook and creating convergence regarding supervisory practices in Europe. The EU banking sector also benefits from the Single Supervisory Mechanism (SSM) within the euro area. There might be nuances and proportionality, but the supervisory reaction functions are very similar. The interest rate risk in the banking book is one of those risks that are monitored on an ongoing basis in the euro area through its impact on both Net Interest Income (NII) and economic value of equity, with limits that trigger corrective action should they be outpaced.

Convergence between the euro area and the non-euro area has been discussed at the EBA table. Topics such as asset and liability management (ALM) and how banks will be able to refund the Targeted Long-Term Refinancing Operations (TLTRO) have been front and centre for more than a year in all those circles. This helps explain why the EU banking sector is in a different position.

2.3 Banks in Europe have built comfortable buffers to face upcoming credit risk

A Central Bank official stated that banks have had to cope with idiosyncratic situations such as a pandemic and a war, as well as a very difficult interest rate environment. The challenges banks were facing during the last 10 years were different from the challenges that are approaching now. The banking sector is seeing a return to traditional vulnerabilities that occur during an increase of nominal interest rates, inflation or the growth cycle, such as credit risks and interest rate risks. Up until now, even during the last 10 years, the European banking sector has managed its books well. The European banking sector has significant buffers in the system to also cover risks that might materialise.

Asset quality could become an issue

A regulator underlined that developments in this year's market could affect other instruments or segments. Banks could be impacted by macro developments such as inflation tightening and monetary policy tightening, but also by unexpected shocks, channels or contagions that are not fully identified within the system. In that context, one key element is transparency. The EBA publishes a lot of data and is already seeing that, on the macro side, asset quality is deteriorating. The EBA sees a rise in bankruptcies and a gradual increase in Stage 2 loans in particular for consumer and other non-mortgage household loans. Within the corporate sector, concerns are mounting about the outlook for commercial real estate (CRE) loans amid falling valuations and investor demand in CRE markets.

In that context, everything that can be done by banks and the public sector to explain where they are will be helpful. That is why the EBA has beefed up the stress test conducted every other year. The EBA included sectoral breakdowns to explain the potential exposures of banks in different sectors and to see which banks might be exposed to types of counterparties that may not fare so well in the new environment of rising rates. The EBA is also collecting additional data to shed even more light on the health-to-maturity portfolios of banks. Everything that aids transparency will also create more market discipline and help people and limit contagion risks.

2.4 Against the challenging economic environment, EU banks appear resilient

The Chair noted that, in Europe, inflation is higher, growth is weakening and there is a high level of indebtedness, both on the private and the public side. This is unusual for the balance sheets of banks.

An industry representative stated that banks are prepared to face this challenging economic environment. Banks have gone through a cyclical change. Whether what happened with quantitative easing and negative rates was good or bad, most banks recognise it as an asset bubble that needs to be gradually released. This transition to a higher, more normalised interest rate has already been anticipated by banks. Banks have already adjusted their risk appetite statements. Most European banks are at a historically low level of Stage 3 non-performing loans, so there is an ability to absorb much more. It is important to consider whether banks are healthy enough to generate new capital to cover what is coming. Given where interest rates are, banks are much more able to generate additional capital to cover any bad loans. The three important aspects are good, strong capital to start, low non-performing loans, and the ability to generate capital going forward.

2.5 No war on deposits in Europe so far

An industry representative stated that, while a war on deposits has not yet been seen, the peak of net interest margins (NIM) has already been reached. Deposit betas are, to different degrees, on the rise across different countries, largely depending on local market competition. Also, the deposit mix is shifting quite fundamentally. Some banks are reporting a shift from sight deposits to term deposits, which has an impact on funding costs.

There has not been a shift into money markets at the same levels as in the US. In the US over the last two months, 900 billion left the banking sector and went into money market funds. Given the lower liquidity and the lower established capital markets in Europe, that has not happened to the same extent. For once, there is a benefit to not having the depths of the Capital Markets Union compared to the US. This also implies that what the banks are working on at the moment is strengthening their deposit gathering strategy. It is about understanding the behaviour of different depositors and then developing the corresponding pricing strategies. Banks are also working on their fund transfer pricing models and incentivising relationship managers accordingly.

A Central Bank official stated that the situation looks a little different from the perspective of a central bank. There is no war because there is no scarcity of liquidity at all. There has been no uptake in the traditional tenders, which would have been a sign of scarcity. What we see is the traditional competition for funds to refinance banks' lending operations. The banking sector has slightly lost familiarity with this in the time of zero interest rates, but competition picks up as interest rates rise.

2.6 Given speed of depositor flight in age of digital banking, there is a need to review parameters within the Basel Liquidity Covered Ratio (LCR)

The speed and size of deposit outflows has been a surprise issue of the recent turmoil

A Central Bank official stated that the European banking sector is diverse and has fewer banks with a high number of uninsured deposits. In that respect, the European banking sector is in a better position than the US banking sector. However, the other issue in relation to SVB and Signature Bank was the extraordinary speed of withdrawals that happened in the US. In an era of digital banking, all banks are equally exposed. This is a new phenomenon that will have to be looked into more deeply.

A Central Bank official stated that each crisis brings about lessons for supervisors. In the case of SVB and Credit Suisse, the key element is pace. It is no longer the case that bank runs involve people lining up in front of branches to withdraw money. Money can be withdrawn within minutes using online banking. For instance, SVB lost $40 billion, 23% of its total deposits, in a single day. This is not taken into consideration when calculating liquidity ratios. Also, the liquidity ratio is calculated based on assumptions of the time within which a certain percentage of the deposits is withdrawn in a severe supervisory scenario that combines bank-specific and market-wide stress. These assumptions may need to be reassessed. Another lesson is that the rapid spread of information leads to an immediate reaction by market participants. In Silicon Valley, venture capitalists instructed the companies they were invested in to withdraw the money within minutes. This is not the type of information European banks base their supervisory and regulatory activities on.

A regulator stated that a traditional bank run has played out in an unconventional manner. The speed of this was new, partly due to the impact of social media. The report from the US authorities is expected to be published tomorrow, so this will certainly be discussed further in different regulatory circles in the coming months. These factors will play out differently depending on the business model and what types of activities a bank might be doing. The public also needs to be informed that there are protection mechanisms for them. Deposit insurance is important. There is also a lot of communication from the public sector side to facilitate differentiation and prevent similar cases in the future.

3. Addressing the vulnerabilities in the European banking sector

3.1 There are differences between markets and countries

A Central Bank official stated that some of the shocks in the past year have been relatively unknown risks. For example, what happened with the UK pensions system was not well understood in advance. SVB was known in some parts of the system, but there was not a lot of transparency. In the Nordic countries, there are well-known vulnerabilities such as high household debt, variable rate mortgages and commercial real estate. Where there is a high level of transparency and risks are well-known, there is preparedness. Both households and firms have prepared for today's situation. A push towards transparency is always welcome.

An industry representative noted that one of the biggest asset classes for financial institutions is mortgages. Structurally, consumers are protected from rising interest rates in markets such as Germany, Belgium and the Netherlands. These are principally fixed-rate mortgage markets, so impacts are on new originated loans. In other markets such as Poland or Spain, the stress is more prevalent. There is probably some more vulnerability in areas of wholesale banking, particularly commercial real estate loans. That is where some discontinuity may happen with rising non-performing loans.

An industry representative stated that low unemployment in Europe is another important aspect. There is a recessionary environment, but unemployment has not gone up. Usually, defaults coming through on mortgages and credit card books are highly correlated with unemployment in Europe.

The first-order impact is fewer transactions on commercial real estate. The leveraged debt capital market is dead, and that has a second-order implication for the back-book of institutions.

There are a few other vulnerabilities to think through in terms of contagion or distortion risk. The view that the crypto world lives entirely separately from the rest of the financial markets is not correct. A significant or further drop in crypto values could have an impact in more regulated asset classes, leading to a flight in safety and further distorting prices in currencies or asset classes that are seen as safe. There is counterparty credit risk that needs to be understood for underlying assets that are not going through central clearing houses. There is also a leverage risk, often driven by high-volume, low-margin products.

In this post-SVB, post-Credit Suisse environment, there will be questions around regulation for banks, but the non-regulated part of the sector, such as credit default swaps (CDS), can also create vulnerability for the regulated sector. Most CDS markets are not highly liquid or frequently traded, so a couple of firms trading in CDSs can trade up the CDS spread, leading to a bank run.

3.2 The two principal model risks for most European banks are around client behaviour on savings and client behaviour on mortgages

An industry representative stated that, with a strong, credible and explainable business strategy and business relevance, there will always be a confidence level in the banking system. There are likely to be good results, resilient balance sheets, good capital and good profits coming out of the Q1 season for European banks. Ultimately, bank runs are largely a symptom of an underlying problem. The best defence against a bank run is a strong, viable business model combined with customer trust. Part of that viable business model is managing interest rate risk to prevent problems when rates rise quickly. It is important to account for potential concentrated or correlated exposures. This is a lesson that was learned long ago for bank assets but is increasingly relevant for liabilities. This is especially important given the substantial sums of deposits in the European banking system, partly caused by past monetary policies such as quantitative easing.

3.3 Quantitative tightening may enhance the competition for deposits by two to three years

A Central Bank official stated that monetary policy tightening is not just about rate hikes but also quantitative tightening (QT). For example, Sveriges Riksbank has relatively short maturity on bonds held and started active QT by selling government bonds. In the coming years, there might be more competition for deposits and an increased focus on the topic of QT.

3.4 Reducing contagion risks from NBFIs to bank requires more transparency on non-bank financial institutions

An industry representative stated that, during the Covid crisis, the cycle was incredibly short. People were concerned about private equity exposure and write-downs, but this did not happen because there was an incredibly quick market recovery. The EU financial sector is now in an environment where more private equity exposures are being written down. There is still a significant amount of money on the sidelines, creating vulnerabilities. Also, hedge fund volumes are higher and the financial capacity that sits behind them is significant.

A Central Bank official explained that the purpose of regulation and supervision is to protect the public good, which is the deposits of the ordinary citizen. One of the lessons from the Credit Suisse case is that there is interconnectedness between the NBFI sector and banks. This may also justify a stricter regulatory environment for these entities. The Chair added that financial stability is also a public good, which justifies a broad look at what happens in this area.

An industry representative underlined that, considering the annual reports of banks and the Pillar 3 disclosures, there is very little that cannot be found on banking transparency. From an industry perspective, anyone doing banking or near-banking should have the same transparency as financial institutions do today. There should be much more transparency so that risks can be managed. Public sector decision-makers should start with more regulation on transparency in non-bank financial institutions. The Chair observed that some would argue that, as the counterparty, this should be the job of the bank.

An industry representative stated that people sometimes expect a lot from banks. Some regulatory support or framework could be put in place. Banks have no regulatory basis to get all the information needed and therefore require back-up from the public sector. Another industry representative noted that aggregation would take a while if every bank was to report. A Central Bank official stated that the vulnerability of non-bank financial institutions is a source of concern. Since financial stability is a public good, moving forward with this will be crucial.

Fund liquidity issues

Introduction

The Chair referred to potential developments in the money market fund (MMF) market discussed at the Eurofi September 2022 event in Prague. The fact that monetary policy normalisation would lead to large inflows into MMFs, representing an opportunity to fix some structural weaknesses of their regulation at a time when the position of asset managers is stronger was discussed. Large inflows in the hundreds of billions of $ into MMFs have happened in the US and UK. In Europe, the net position of MMFs has not changed that much, but there have been important shifts among the categories of funds. A review of the MMF regulation was not launched in the EU, despite assessments and recommendations made at the FSB, ESMA, ESRB and ECB levels.

At the event in Prague it was also suggested that other types of open ended funds (OEFs) would be facing potential liquidity issues e.g. due to sudden bond repricing. Several episodes of market illiquidity have materialised during H2 2022, such as the energy price squeeze in August and September and liability driven investments issues (LDIs) in September and October. Liquidity questions have recently been compounded by the flightiness of the bank deposit base observed during the runs at Silicon Valley Bank (SVB) and Credit Suisse. In the fund industry, structural liquidity mismatches have also been evidenced in some corporate bond funds.

In terms of regulation, progress has been made in Europe with the reviews of the AIFMD and UCITS directives that include inter alia measures to enhance liquidity management provisions with an improved access of funds to liquidity management tools (LMT) and an enhancement of reporting obligations. The legislation has entered the trialogue phase and should be concluded in the current parliamentary term.

1. Money Market Funds (MMFs)

1.1 Recent market trends and related impacts

An industry representative confirmed that although significant inflows into MMFs have been seen in the US, they have been modest and muted in Europe. Since April 2022, which was the peak of bank deposits during the pandemic, reaching around $18 trillion, roughly $900 billion of US deposits have left banks, and $650 billion of these have flowed into MMFs since June or July. In terms of proportions, bank deposits grew by 35% since the start of the pandemic and those outflows represented around 5%, which is limited. Some investors have rotated out of bank deposits and into MMFs, as well as exchange-traded funds (ETFs) and others have moved money to global systemically important banks (G-SIBs). The money has largely flowed into US Treasury MMFs, which have access to the reverse repo programme, introduced in 2013 by the Federal Reserve to bolster the credibility of its policy at the front end. That helps put a floor under the Fed rate by absorbing the excess cash that banks cannot absorb on a collateralised basis. There has been no issue for MMFs in terms of being able to invest that money.

Concerns have also been heard about possible substantial outflows from MMFs and how they could be handled. The industry speaker observed that MMFs, unlike other OEFs that meet redemptions by selling a slice of their portfolios, meet redemptions by cash on hand. Treasury MMFs currently have 60% of the cash available on overnight and their weighted average maturity is just 16 days, so there is little concern about whether they would be able to meet future redemptions.

A second industry representative explained that during the last eight months there has been an interest rate increase of 350 basis points in the Eurozone, which is massive, but European asset managers have not seen major movement in terms of inflows into euro-denominated MMFs, unlike the US. These amounted to approximately €50 billion, which is not massive. In terms of fund categories, low volatility NAV (LVNAV) MMFs were created following the implementation of the Money Market Funds Regulation (MMFR). There was a slight decline in US dollar LVNAV of approximately €30 billion over the last few months, while the US dollar public debt constant NAV (CNAV) MMFs recorded the same proportion of inflows, which was not a major shift.

In the next three to six months a slightly positive trend is expected to continue in terms of inflows, the industry speaker believed, because MMFs are low-risk vehicles and are offering an improved remuneration. Monetary policy will continue to impact the MMF sector in the coming months. The ECB has been lagging behind some other central banks in terms of interest-rate rises, so the anticipation is even more attractiveness of euro-denominated MMFs in the coming months, but not to the same extent as what happened in the US market. With a continued tightening of monetary policy there could also be opposite trends, with a trade-off between having the money in a bank savings account and an MMF. French inflation figures recently came out for example and they are not good, so the expectation is that tightening will continue. The remuneration of bank commercial paper (CP) and bank savings accounts is expected to increase.

The Chair asked whether in the euro segment there are significant transfers from MMFs exposed to banks towards MMFs exposed to sovereigns. An industry representative stated that their company sees that an overwhelming proportion of MMFs are invested in private sector issuers, including banks. Their company has not experienced any outflows in the euro-denominated money market fund sector of that nature. A second industry representative added that their company is the sole provider of government liquidity euro-denominated MMFs. Some inflows have been seen in those funds, but it is up to €1 billion, which is not a significant risk to the European banking system.

A regulator considered that the current flows are rational. When rates started to increase following a long period of expansive monetary policy, there was an unusually high proportion of deposits in the banking system accumulated following the pandemic and also because of the lack of alternative investments. These deposits were waiting to be invested in a better way, for example through short-term instruments like MMFs. At the same time, most banks are currently still attempting to maximise their interest margin by keeping remuneration on deposits and savings accounts low, which provides additional incentives to seek yield elsewhere.

There is also the objective for uninsured depositors of diversifying counterparty risk, the regulator observed. Recent events in the banking sector have brought that risk back to the forefront. These evolutions may put banks that are excessively dependent on deposits in a difficult position, but some of those flows may flow back directly to the banking system depending on how the market evolves, because a significant part of inflows into MMFs go towards non-government-oriented MMFs which invest heavily into financial sector issuers. A part of these inflows into MMFs is therefore not lost funding for the banking system, but the flows are invested in a more diversified way from a client perspective. That is healthier for the client, and it may also be healthier for the banks, because to some extent it takes some of the liquidity risk away from the bank's balance sheet, creating positive market dynamics.

An official explained that during the September 2022 stress in the UK LDI market[1] some MMFs experienced very significant outflows, as market participants drew down funds in MMFs to meet margin calls. Some MMFs came close to their LVNAV collars, a breach of which would lead to a conversion into VNAV funds. Some MMFs had larger outflows than had been seen during the March 2020 'dash-for-cash', but there was more liquidity in the sector so it proved to be more resilient to outflows than in the past. As the LDI sector built its resilience up the money flowed back into the MMF sector. The cash buffers that the LDI funds built up were deposited in MMFs; assets under management (AUM) of MMFs rose by £80 billion over three weeks, which is significant for the sterling market, half of which happened in three days.

1.2 The importance of considering the specificities of MMF products and markets in policy initiatives

A regulator observed that the MMF market can evolve positively in the future as long as MMFs are not regulated as bank deposits. When assessing how to reduce systemic spill-over risks from the MMF sector, the question as to whether MMFs should be treated more as an investment-like or a bank-like product is regularly raised in the regulatory community. Considering that MMFs are a bank-like product is a dangerous option, because the implication is that they have the same liquidity characteristics and therefore need to be regulated in the same way, needing to create lenders of last resort for MMFs as part of the system, which does not seem appropriate. MMFs are investments; therefore any features of these funds that mimic deposits do not conceptually have a place in that market. All funds are as liquid as the assets in which they are invested. Reducing the risk of a demand-side run on the fund by eliminating first-mover advantage and by making sure that fund managers have the right tools and marketing practices in place and adequate communication channels with supervisors is critical to making sure that MMFs do not become systemic risk amplifiers.

An official agreed that not treating MMFs like deposits in regulation is important. Policy perspective concerning MMFs has been ambivalent in the past, sometimes proposing to treat them as deposits in certain circumstances and sometimes to regulate them as investment funds. Greater clarity would be helpful that they are not sufficiently like deposits.to be regulated by analogy with deposits. It is also important take the specificities of different MMF markets into account and avoiding a one-size-fits-all regulatory approach across the globe. Balance needs to be found between providing top-down guidance at the global level via FSB and IOSCO recommendations, and allowing jurisdictions to take into account the specificities of their market in the reforms proposed. That is the way IOSCO and the FSB addressed these issues in 2021. A set of options were proposed and jurisdictions were asked to analyse how these reforms could be best implemented, taking into account their local situation. In 2023 IOSCO will conduct a thematic review of regulatory initiatives taken in the MMF area.

Ireland and France for example both have large MMF sectors, which are different in their structure and behave very differently. There are also significant differences between the EU and the US when considering the recent flows observed in the US and EU MMF markets, the official explained. There are moreover differences in the way that jurisdictions have responded to stress events and in the regulatory frameworks that were subsequently

1. During the liability driven investment (LDI) episode in September 2022, the UK market saw very sharp, unprecedented moves in government gilt of 170 basis points in three days. That put LDI funds, which defined benefit pension schemes use to manage their liabilities in a leveraged way, under stress. The risk was that some of those funds may have to suspend redemptions, which would then have had knock-on effects in the government bond market. Very rapid rises were seen in mortgage rates and a withdrawal of mortgage products in the UK. 1,000 products disappeared from the market during that time, so it had potential real-economy implications. The Bank of England undertook a time-limited intervention to give the LDI funds time to recapitalise. It was a timing issue and a liquidity challenge, rather than a solvency issue. They needed time to get liquidity from the defined-benefit pension schemes that invested in them. The Bank of England conducted a two-week operation to intervene in the market, LDI funds recapitalised themselves, and the Bank of England exited the market and sold all of the government bonds that it had bought.

created, which condition the options for future initiatives to a certain extent if jurisdictions do not want to fundamentally change their framework.

An industry representative agreed that on the policy side there needs to be a clear distinction between banks and MMFs and that the application to funds of rules that are inspired by banking regulation should be avoided. Banking is about identifying profitable assets and then funding them through deposits, which is the opposite of MMFs that take in inflows and invest them in suitable assets. This difference needs to be reflected in regulation. Moreover the current banking stress in the US is fairly idiosyncratic and should not lead to proposing banking-type measures for MMFs such as an LCR (liquidity coverage ratio) for MMFs.

A second industry representative further explained that banks take deposits, which are a debt obligation, and invest them long. Banks are leveraged and have liabilities and liquidity mismatches. Investments in MMFs are an equity investment and they are loss-absorbing. Liquidity mismatch risk is limited because the redemptions are being paid out of cash. That is the importance of the 10% or 30% cash limit. The speaker also concurred with the comments made about differences between fund markets. For example, the US and EU MMF markets are very different, with different types and setups of institutional and retail funds, different investment strategies and different client behaviours. There are also differences in how interest rates are evolving and the implications this may have for MMFs.

An official noted that the UK authorities are working on the specific issues posed by MMFs. In 2022 the UK authorities published a discussion paper seeking views on how to strengthen the resilience of MMFs, and will publish a consultation paper later in 2023 based on the feedback received with policy proposals tailored for MMFs. The first question the consultation paper is attempting to address is the level of daily and weekly liquidity that MMFs need to maintain in order to be able to withstand severe but plausible redemption stresses. The levels of liquidity in the sector are very high at the moment, but they go beyond regulatory requirements. The second question is how to ensure the usability of those liquidity ratios. One of the issues observed with the March 2020 outflows was that when some MMFs reached liquidity levels of 30%, gating had to be considered, which then triggered the risk of further investor redemptions. The third question is how to address the risks posed by LVNAV funds. Those risks include the risk of a fund having to convert to variable NAV (VNAV) in stress, which might impact confidence in the market. Some investors prefer to be invested in LVNAVs for accounting reasons, so a potential conversion and possible exit from these funds raises issues that need to be appropriately handled. The costs and benefits of the possible measures envisaged also need considering, because there is not unlimited depth in government bond markets or in bank CP markets. More liquidity being required to handle MMF issues may therefore affect market dynamics.

1.3 Issues posed by the increasing speed and magnitude of flows

An official observed that due to the interconnectedness in the financial system and the essential role that MMFs play in the financial system as sources of liquidity and as cash management vehicles for corporates and financial institutions (e.g. to meet margin calls and maintain buffers) it is important that MMFs maintain sufficient resilience. There is also a strong cross-jurisdictional dimension to the MMF market with e.g. many dollar and sterling MMFs based in the EU. That is why it is important to implement the global FSB recommendations dealing with the vulnerabilities and run risks associated with MMFs and also to maintain international cooperation in this space. The FSB will review progress by members in adopting reforms to enhance MMF resilience this year, before undertaking a full effectiveness assessment in 2026.

A second official suggested that an important issue to tackle from an international and European perspective is how quickly corporate and financial institution holdings in MMFs move around, at what scale, and the impacts that has on the MMF market. In this regard, it might be helpful to consider the discussions happening in the banking sector related to the liquidity coverage ratio (LCR) around the fluidity of corporate deposits. There is also the need to anticipate better extreme scenarios. That sufficient buffers are in place in terms of overnight liquidity, as mentioned by a previous speaker, is reassuring but there could be a stress scenario where all the recent inflows into MMFs move in the same direction, e.g. out of treasury MMFs into bank-focused MMFs in search for higher return, which could lead to higher stress than during previous events if funds invested in bank-focused MMFs then left the MMF sector together. Care should be taken not to jump to conclusions from previous stress events.

The Chair noted there are also competing movements between bank deposits and funds with liquidity flowing from one to the other at high speed.

An industry representative stated that the competition between bank deposits and MMFs is not new, but what has changed is the volume and the speed of the flows. There have been significant inflows into government MMFs in the last few months that are expected to reverse towards MMFs invested in banking sector issuers at some time. A key underlying factor is technology that allows liquidity movements to happen very quickly and where social media also play an increasing role. This is a concern both for financial institutions and regulators that needs addressing in the future policy agenda. The events that happened at SVB were extraordinarily fast. The 2008 crisis happened in two or three days, not three hours.

An industry representative agreed that the speed of outflows is an issue that needs to be looked at, even though bank robustness has increased. Concerning MMFs, a key point to bear in mind is that outflows are actually a sign of resiliency, because they are contributing to meet real economy needs. In March 2020, when primary and secondary markets were closed, the outflows from MMFs were helping corporates pay salaries and pensions, or helping pension funds provide collateral margin to central counterparties (CCPs). Discussion is needed about the ability of using MMF units as collateral, because the present situation increases the potential volume of flows happening. Referring to a previous comment about the risk of MMFs all behaving in the same way, the industry speaker stated that was unlikely, because of the differences across MMF markets previously mentioned.

An industry representative observed that the March 2020 crisis showed that the EU MMFR regulation that entered into application in 2018 proved to be quite effective in handling the risks from outflows. In March 2020 corporates needed to release money held in MMFs to pay salaries because of lockdown, and the instruments in place such as VNAV and swing pricing made that possible.

2. Open Ended Funds (OEFs)

An official noted that significant progress has been made in the policy approach to OEFs at the international level, notably in relation to crisis management and liquidity management, although some issues remain to be tackled as part of the non-banking financial institution (NBFI) work programme of IOSCO and the FSB. One major area where progress has been insufficient so far is illiquid assets and overnight liquidity, which is still a serious problem in relation to investment funds. This is mainly an issue of fund design. The question is whether asset managers should continue designing funds that invest in illiquid assets and are offering overnight liquidity and, if this is the case, what measures are needed to make this situation more stable. This issue was tackled by the ESRB in 2018 and it was recommended to implement a mechanism for the classification of assets, so that a more intense oversight of funds that have the least liquid assets can be put in place in order to check that they are adequately designed and managed. Work is also underway at FSB level in this area. A caveat however is the potential difficulty of classifying the liquidity of assets.

The official added that jurisdictions need to ensure that OEFs have access to a sufficiently broad range of price based and quantity based LMT options. We need to observe market developments in future to see if, when they have only one LMT, or only one of each sort, this creates a cliff-edge effect because in a stressed situation market participants will anticipate whether the fund is about to trigger the particular LMT available and they may act and run in advance of that. IOSCO's forthcoming guidelines as to how to implement swing pricing in particular will be helpful as this is an important price-based LMT.

A second official stated that the UK authorities are working on these issues as well, in close cooperation with IOSCO and the FSB, and that inter-standard-setter coordination is very effective in this area. In 2017 the FSB recommended that the redemption policies of funds need to be aligned with the liquidity of the underlying assets. When assets are structurally very liquid or illiquid, this is easy to implement. The difficulty is for assets for which liquidity fluctuates according to market conditions. Ensuring that adequate LMTs are in place in order to impose on redeeming investors the costs of their redemptions and reduce the risks associated with liquidity transformation would be important. There were also other recommendations on stress-testing and reporting. The objective is to design rules that may be implemented in a consistent way across funds, but without creating a straitjacket. In a UK survey, some funds appeared to be overestimating the liquidity of their assets. Most funds surveyed used LMTs such as swing pricing, but the differences in approach were very marked and the market impacts of swing pricing actions were not always sufficiently considered, showing the need to enhance consistency in the way liquidity management issues are approached by OEFs.

A regulator observed that the issues posed by OEFs and MMFs are not that different, except that with OEFs there is no risk of confusion with bank deposits and liquidity mismatch can be more acute. There has been much progress on the crisis management tools to be used during a crisis or ex post, but more needs to be done about the ex ante reduction of risk in order to avoid a rush for the exits because there is a proven liquidity mismatch. The proposals made at the global level around classifying assets look pragmatic and wise but may be challenging to implement, because there is a continuum of liquidity across assets and sophisticated techniques are also being used by funds to enhance liquidity. For example some distributors are selling funds to investors, including retail ones, on the basis of largely overstated liquidity. That raises suitability and investor protection issues, even if LMTs are in place. A question is whether investors are aware of their liquidity needs and can cope with the sudden imposition of a gate that they were not aware of.

An industry representative believed that a flexible approach is needed regarding fund regulation. From a liquidity perspective ETFs are different from other types of funds for example. Swing pricing is also challenging to implement in certain markets e.g. in the US because the current market structure makes implementation difficult for investors and intermediaries, notably with time differences and hard time limits imposed. A further issue for asset managers is coping with a broad range of policy objectives at the same time including financial stability, investor protection and fiduciary duty and understanding how they may be translated operationally. Taking care of investors is part of day-to-day operations, but it is challenging for fund managers to understand how they can contribute to the financial stability of global markets in their daily work. Regulators could lay out their priorities in more practical terms and better explain how to translate them into areas of improvement that market participant can work on.

A second industry representative stated that in the EU the reform regarding OEFs is currently being negotiated with on-going trialogues on the AIFMD and UCITS reviews. One of the key proposals is making sure that there is an equivalent access to LMTs across EU member states and a variety of instruments available. Harmonised rules around how these instruments should be triggered and used have also been established.

The final decision should remain in the hands of the asset manager, not the authority, and there should be clear, harmonised conditions for implementing these tools. This is vital to avoid any first mover advantage effect. The industry speaker also noted that possible asset classification measures require promoting greater transparency in the market about the instruments that the client base invests in. This information is held by the distributors but is rarely communicated to the asset managers, making it difficult for them to adapt their approach of the market.

A third industry representative agreed with previous comments about the importance of aligning fund redemption conditions with the liquidity of assets. Addressing issues related to illiquid assets or assets where dealing frequency is limited is the priority. OEFs investing in inherently illiquid assets like real estate seems inappropriate and longer notice periods are needed when daily dealing systems are in place e.g. for asset-backed securities (ABS). In addition, the perception of liquidity can be incorrect if it is not based on market data showing how different asset classes behave in normal and stressed times. Emerging-market debt or high-yield debt is sometimes considered as illiquid, but in March 2020 data shows that there were far more transactions in these instruments as a percentage of outstanding volumes than in investment grade debt.

Finally, it is necessary to use adequately LMT mechanisms such as swing pricing that force the redeeming party to pay the price of the liquidity, to take away any first mover advantages. These mechanisms should be used permanently, when needed, so that clients get to understand how they function. In addition, the swing factor needs to be defined so that there is a sound market impact.

Sustainability risk in the banking sector

1. European banks are still not adequately managing climate and environmental risks despite existing guidance and best practices

The Chair stated that climate change concerns have increased since the 2015 Paris Agreement. Climate change should be addressed globally and in a coordinated manner. European banks, supervisors and other international institutions are working together to build common criteria to deal with sustainability risk.

The Single Supervisory Mechanism (SSM) has carried out a significant number of activities related to climate change. It has expressed the concern that European banks are still not adequately managing climate and environmental risks. The SSM observes that, although 85% of banks have basic practices in place in most areas, they still lack more sophisticated methodologies and granular information. Stress testing exercises also show that banks face significant challenges in terms of data availability and modelling techniques. Supervisors acknowledge that they need to further reflect on areas such as bottom-up stress test scenarios, long-term methodological approaches, and the means to help banks overcome the challenge of data availability.

1.1 From a remote sustainability risk toward a day-to-day issue for banks

A Central Bank official stated that assessing climate and environmental risk is a high priority. For a long time, it seemed to be a long-term risk only, but it now needs to be taken into account in day-to-day business.

As the supervisory part of the European Central Bank (ECB), the SSM is responsible for supervising the 110 largest banks in Europe. The SSM has been working on climate and environmental risks for a number of years. The SSM issued supervisory expectations in 2020 and is expecting banks to deliver on them by the end of 2024 at the latest. After issuing the supervisory expectations, the SSM asked banks to carry out self-assessments of how well they were already fulfilling the expectations. Joint supervisory teams have been closely discussing the issue with banks, and each bank has made a plan to fulfil the expectations by the end of 2024.

The SSM also conducted a climate stress test in 2022. The SSM has carried out a deeper thematic insight into many banks to better understand how they are working. Overall, banks are improving, but there are still laggards. Many banks need to make improvements in many areas. For example, only one out of five banks take climate risk into account when they are granting new loans.

1.2 Limited climate-related data availability and issue appropriation by banks' management and governance are still preventing banks from understanding sustainability exposures and translating the issue into strategic options. Implementing SSM's compendium is essential in this respect

A Central Bank official stated that it is difficult to obtain good data. Many banks are using proxy data. In order to fully understand exposure, more detailed data are required. The SSM is engaged in many discussions with banks on this. Not all managers or boards of directors are focused on the climate risk issue. More needs to be done to be more strategic in treating climate and environmental risk and taking those risks into account in business plans.

This year, the SSM has requested that all banks can categorise their climate risk and will be able to assess the impact on their balance sheets. The SSM has also requested that banks ensure they have a good governance structure in place by the end of 2023. The third pillar is that, by the end of 2024, banks are expected to completely fulfil the supervisory expectations. This will be challenging, but that does not mean the work should be neglected. The SSM tries to be as helpful as possible, but banks need to decide how green they want to be. The SSM would like to see banks account for climate and environmental risk in their risk management frameworks in the same way as they manage other material risks. The SSM has published a compendium including best practices to help inspire banks to do more in this area.

2. The consistency of transition planning and climate-related risk assessment is essential for the banking sector effectively supporting both an early and orderly transition, financial stability, and economic dynamics

A Central Bank official stated that it is important that the financial sector plays its part by supporting clients' own plans to transition. The Bank of England's work was similar to that of the ECB. The Bank of England's supervisory expectations were published in 2019 and came into force at the end of 2021. It also ran an exploratory stress test, the results of which were published in 2022. Climate is now embedded in the day-to-day supervisory discussions between the Bank of England and the banks it supervises. The results of last year's stress test indicated that an early and orderly transition on an economy-wide basis is likely to be optimal from a financial stability perspective. Therefore, it is in the interests of banks, insurers, and other parts of the financial sector to support that transition.

Transition plans are likely to provide financial institutions with the information they need to manage their transition risks. Transition plans will underpin discussions between supervisors and firms. This will enable an overall assessment of the way in which firms are managing their climate risks. Transition plans are going to be of interest not only to supervisors, but to a broader range of stakeholders in the financial sector. As firms develop transition plans, they should keep this broad audience in mind.

In terms of what supervisors will expect from a transition plan, a clear statement of the firm's transition strategy is key, as are the specific steps that the firm is going to take and the associated assumptions and risks. Supervisory discussions will take place around these areas to better understand how firms are assessing the risks associated with their transition plans.

3. Cooperation between the public sector and the banks and their customers, is necessary to enable transition plans to clarify the magnitude of the transition finance required by carbon intensive economic sectors and support the credibility of banks' net zero targets

3.1 Transition planning is a strategic effort to build a credible set of actions that achieves net zero

An industry representative stated that climate risk mitigation should start with the most emission intensive sectors. It is important for banks to take proactive steps with these sectors to drive balance sheet transition to net zero. Banking institutions have two roles. On the one hand, banks are risk mitigators and risk managers. On the other hand, banks are financiers of the real economy, including the pathway to net zero.

Since committing to net zero, MUFG has been actively engaging clients in the hard-to-abate sectors about their own pathways to net zero. MUFG has acted as a chair of the Net-Zero Banking Financing and Engagement group. This group published a transition finance guide to better understand the dependency between banking and the real economy and how banks can support transition. Secondly, MUFG published a transition white paper last October, describing its experience of engaging clients in the top six hard-to-abate sectors in Japan. This work has been the result of senior-level discussions with CEOs and CFOs of large Japanese clients on their net-zero journey.

3.2 The availability of credible carbon intensive sectors' transition pathways supported by legible and globally comparable transition plans is necessary

An industry representative stated that banks cannot achieve net-zero financing unless they help their clients achieve net zero. MUFG's objective is to continue to support its clients in decarbonisation through transition finance. MUFG also wants to draw attention to the differences between the transition stories in Japan and Asia compared with Europe and the US. At the end of the summer, MUFG will be publishing a new iteration of this work focusing on decarbonisation pathways for the hard-to-abate sectors and exploring how best to deploy capital to support Japan's transition to net zero. A credible transition plan is the way to address climate risk. The foundations for transition planning have already been laid out by the Task Force on Climate-Related Financial Disclosures (TCFD) and in the future International Sustainability Standards Board (ISSB) disclosures.

Transition plans need to be credible and globally comparable. The Glasgow Financial Alliance for Net Zero (GFANZ) has already published guidance based on industry best practice. The EU and other jurisdictions should adopt a similar approach and embrace international consistency. The transition plan is an effective strategy for addressing climate change. It should include setting goals, actions, and accountability mechanisms, aligning business activities with the path to net zero by delivering emission reductions in the real economy.

3.3 For climate related transition to be credible, regulatory timetables and objectives should be voluntarist but realistic, and fit to both local and sectoral specificities

An industry representative stated that it is important for banks to facilitate clients' transition plans. The ECB and the policymakers are doing the right things overall, but if the regulatory agenda is pushed too much, then it becomes counterproductive. Technological transitions take half a generation, so it will be 10 or 15 years before society can adjust. Banks need to be credible in the short to medium term. Through target-setting and investing in data, banks need to show how they implement climate impacts in their risk frameworks, credit decisions, education and training among employees. One model cannot be implemented for all. There is a need to respect where institutions are operating and to adjust regulatory requirements to different needs. Regulators and policymakers should not decide which technologies are best for climate transition. That is the role of the open market. Nordea has set a very ambitious target of reducing financed emissions by 40% to a net figure of 50% by 2030 and is well on track to meet that. By 2050, Nordea is going to be one of the net-zero emitting banks.

In terms of how policymakers and supervisors should create structures so that banks can facilitate real transition, thereby mitigating or managing risks, an industry representative stated that there have been many changes from regulators and policymakers with a short implementation time. There should be flexibility and understanding that the time needed to implement regulatory requirements will differ.

3.4 Closing data gaps and progressing on transition planning are the next two efforts banks will have to provide

A Central Bank official stated that the Bank of England spent 2022 assessing UK banks' progress against the supervisory expectations that became effective at the end of 2021. There has been mixed progress, with some firms ahead of others. There have been significant advances around governance. Firms are assigning responsibility for climate risk at board and executive level and discussing the issues. There are two areas that are particularly notable as ones in which more progress is needed. The first is scenario analysis, which is not yet embedded in the considerations that firms make when defining strategies and making core business decisions. Secondly, there are significant data gaps for firms to identify and act upon.

4. Banks are strongly involved in improving the quality of climate related risk assessment, which should converge progressively. The forthcoming provision of sustainability data by corporates will be an essential contribution

4.1 Banks effectively managing climate related risk involves investing, mobilising skills, and producing a considerable amount of new data based on new standards

An industry representative stated that, when financial institutions were asked for the initial data, the structures were very loose, with the intention that the data would be used to clarify what institutions needed to do to improve. It is important not be too hard on financial institutions. Some players are very advanced, and others are less sophisticated, but that is to be expected. More caution is needed in relation to those banks who are currently classified as laggards. Conclusions should not be drawn until corporates are mandated to provide good quality data. Assurance is needed that financial institutions can rely on the data coming in. This is a work in progress and should be viewed as such.

Financial institutions see the societal need for this work, so best efforts are being put in place. In the global fora, many banks are working collegiately and collaboratively to come up with standards. Making sure best practice is known and shared is an important step. There are large firms that can implement this to a very high standard, developing a risk management ecosystem that takes sustainability risk to the same standards as current financial modelling. Other firms will take a lot longer to get there and will need some assistance from supervisors and regulators. The progress made is surprising, because the demands given to the banking sector during early data collection by the ECB, the Bank of England and other regulators around the world were not prescriptive. Banks are making progress, but there is a long way to go, so working with legislators, regulators and supervisors is going to be important.

In terms of the main challenges for corporates in disclosing sustainability risk information as required by the Corporate Sustainability Reporting Directive, an industry representative stated that the entire industry is highly committed towards the transition path. Stock-listed companies in CO2-heavy industries are challenged every quarter to outline their path towards transition. One challenge for financial institutions is reporting. It is possible to buy and sell energy on the spot market without knowing how that energy is produced. Companies have ideas for climate transition, but some of these solutions and technologies will need 10 or 15 years to become more broadly available. There is a clear commitment from society, industry and the financial industry to go down this transitional path. The financial industry is eager and committed to supporting clients in their transitions.

4.2 Working closely with banks' clients and introducing additional underwriting and risk management policies in internal arrangements are some of the challenges posed by sustainability related risk

An industry representative stated that cooperation is important. Policymakers have set the targets and ambitions. Clients are legally obliged to deliver data by 2024. Banks can contribute by working closely with clients. Raiffeisen has a dedicated team in corporate finance to support its clients with best practices. It is necessary to ensure that the loan capacity is available to be repaid, so good underwriting criteria and knowledge of how to underwrite a project are required.

An industry representative stated that it is important to identify best practice and who is responsible for delivering it within an institution. Engagement at the top level is important. One cannot go wrong by adopting the same attitude that already exists towards other risk management processes. Trying to deal with this differently will result in different solutions, which will never be sustainable. The same quality and rigour should be maintained for both ESG sustainability reporting and financial reporting.

5. Improving sustainability-related disclosure and risk assessment requirements while avoiding possible duplication or conflicts globally is necessary and triggered ongoing efforts

An industry representative stated that MUFG appreciates and supports the Japanese government's efforts to ensure that the regulatory framework remains globally consistent. The EU and the UK are well advanced in developing sustainability standards. This March, Japan announced that it will incorporate ISSB standards in its own sustainability reporting rules, to be published in

2024. Also, a public and private working group has been established for finance emissions. Japan is working closely with other Asian countries to support their transition pathways.

A Central Bank official stated that the climate crisis is here now, so it is not possible to wait for regulation to arrive. This is why the SSM has issued supervisory expectations, conducted stress tests and had very close dialogue with banks. The Basel Committee and its taskforce on climate-related financial risk have been working on this for a while. The SSM's Vice-Chair is co-chairing this taskforce. The international view has been merged into the Basel regulation. The Basel framework is important because of the number of global cross-border banks. The Basel Committee has issued a Q&A to make sure there is broad agreement among supervisors on how to apply Pillar 1 for climate risk. Last year, the Basel Committee published a guide to supervisors on how to include climate risk in Pillar 2.

There are a number of initiatives relating to the third pillar on disclosure. The Basel Committee will soon issue a consultation paper to ensure a joint approach on disclosure. There is a holistic approach within the present framework. The ultimate goal is to assess climate risk in the same way that all other risks are assessed on a bank's balance sheet.

Sustainability risks in the insurance sector

1. Lessons drawn from recent stress tests and supervisors' analysis on the insurance and pension fund industries' climate related risk

1.1 Moderate though material transition risk is observed in the EU

An official noted that there are many dimensions to the potential impact of climate risk to insurers, including the asset side, the liability side, transition risk and physical risk. Climate risk drives most of the risk that insurers are exposed to. Globally, exposure to climate-relevant assets is around 33% to 40% of global insurers' general accounts, which is very significant.

A regulator stated that the stress test on occupational pension funds suggested that the impact of a transition risk[1] can be material. The stress test showed a drop in the asset evaluation of around 12%, although this should be considered in the long term. The European Insurance and Occupational Pensions Authority (EIOPA) carried out some sensitivity analysis in 2020 and 2022 on the physical[2] and transition risk. The insurance sector has historically coped well with the physical risk, but its frequency and intensity will increase. The impact of the transition risk was moderate.

A regulator stated that four pension funds from Sweden had participated in the EIOPA exercise. The impact on the undertakings was material but not critical. The funding ratio before and after simulated shocks were compared. There was an effect, but, when compared with the funding ratios in other countries, insurance undertakings in Sweden were still more solid. The observed impact on the Swedish undertakings was mainly due to their investment strategies. However, given that they are well capitalised, they could have held even riskier assets.

1.2 Progress is needed regarding risk measurement, stress scenario definition and possible systemic impacts

An official commented that, from a national point of view, there is a lot of work to do, both in building scenarios and in measurement.

A regulator added that methods for measuring physical risks in a more forward-looking way need to be identified and developed.

An official reported that the results from the global monitoring exercise (GME) suggest that it is very important to have a forward-looking perspective. The pilot exercise in 2021 aimed to consider how exposure can translate to solvency shocks. There is quite a range of possible scenarios, particularly for measuring exposure to transition risk, from an orderly transition to a disorderly 'too little too late' transition. A scenario that would create a major solvency issue for insurers has not been identified, but a 'too little too late' scenario would have a material impact on the asset side in terms of the solvency ratio.

2. Increasing sustainability risk of insurance liabilities

An industry representative commented that sustainability risks impact all the traditional broad risk categories. Sustainability risks are factors underlying investments and liabilities and are themselves drivers of the market and underwriting risks.

Sustainability risks are so intertwined with all other risks that it is difficult to identify them on a standalone basis while avoiding double counting. One should avoid over theoretical and complex approaches and bear in mind that assumptions & approaches chosen will heavily influence the results.

2.1 Identifying the effective sustainability risk factors is complex and challenging

An industry representative introduced that a pure life insurer conducted an analysis that aimed to estimate the impacts of climate change on the life insurance business. The results were that an increasing number of deaths and corresponding death insurance claim payments will lead to an increase of around 0.2% in the 2050s and 0.8% in the 2090s, compared with actual numbers between 2010 and 2019. The emergence of new risks in the future must also be considered through a process of trial and error[3]. The policy risks and opportunities and physical risk were analysed using MSCI's climate value-at-risk methodology.

An industry representative noted that, with respect to the non-life business with the climate hazards and physical risks, models will need to be updated, defining the appropriate frequencies, intensities, geolocation, and other characteristics. There are differences between

1. Transition risks are business-related risks that follow societal and economic shifts toward a low-carbon and more climate-friendly future. These risks can include policy and regulatory risks, technological risks, market risks, reputational risks, and legal risks. https://www.gresb.com/nl-en/products/transition-risk-tool/#:~:text=What%20is%20transition%20risk%3F,reputational%20risks%2C%20and%20legal%20risks
2. Risks related to the physical impacts of climate change.
3. Trial and error is a fundamental method of problem-solving characterized by repeated, varied attempts which are continued until success, or until the practiser stops trying.

modelled results and experience. The help of academics as well as regulators is welcome, provided that they avoid too strong a bias towards short-term observations. Their firm needs to enhance the geocoding of its exposures. Studies on transition financial risk suggest that, while some sectors may be doomed in the long term, they still have good performance and behave better than so-called green assets. Environmental, social and governance (ESG) ratings remain questionable. Transition risk can sometimes be regarded as more a question of reputational and regulatory risk. Political decisions are instrumental in this area.

2.2 Data availability is essential to make progress on assessing the sustainability risk of insurance undertakings liabilities

An official stated that the liability side must also be considered, although there is the challenge of data availability. International Association of Insurance Supervisors (IAIS) members currently identify the main impact of climate change as losses in relation to natural disasters. Going forward, members expect possible material impact in risk management, product design and pricing, and a risk around the creation of protection gaps. The IAIS will issue a statement shortly on the approach to this.

2.3 As well as estimating the systemic dimension of sustainability risks, the double materiality approach adds to the complexity of the tools required

An industry representative noted that introducing double materiality may introduce double counting and will lead to trying to achieve too many targets. Insurers should assess not only the financial losses for their business activities, but also the externalities of their business for the wider society. Those externalities may be subject to bias and even contradictory objectives. Trying to make explicit the link between practical experience, vision, observation, and the broader sustainability goals set by wider society is difficult.

3. Operationalising ESG objectives represents an additional challenge for insurance undertakings

3.1 Perceptible progress has been made by the insurance companies in addressing sustainability risk

A regulator stated that insurance companies were good at addressing sustainability risk compared to a couple of years ago. There has been development in insurance companies' own risk and solvency assessments (ORSAs). An increasing number of companies use stress tests and scenario analysis to compare climate risks. Life insurance companies are taking the transition risk into consideration. National and global supervisors must deepen their knowledge.

3.2 Defining credible long-term objectives and combining them with those imposed by the various insurance companies' stakeholders is essential and challenging

An industry representative noted that there are a number of contradictions around ESG. Despite the E target, but the emergent situation in global energy has created a temporary increase in the demand for coal. Prior to the war, financing weapon production was penalised as part of achieving the S target, but this is no longer insisted upon. In the energy-producing country there is a clear critical divide on ESG investment. Around the globe there are increasing shareholders' proposals targeting ESG issues. An absolute reduction target, aligned with the science-based net zero emissions pathway, is critical for the company to achieve its net zero commitment and more fully address its climate risk. There are more complex situations in the nature positive context. Placing solar panels in less-populated mountainous areas will cause deforestation and devastate the ecosystem. Life insurers, as long-term institutional investors, must focus on the long-term horizon.

3.3 Incentivising the adaptation of policyholders requires accurate risk assessment techniques and development of a combination of dedicated standards, products, pricings and incentives, which requires the involvement of the public sector, insurance regulators and insurance companies

3.3.1 Insurance companies have a role to play in fostering the adaptation of economies

An official commented that an insurance company could contribute to the adaptation to climate risk through underwriting activity. EIOPA has developed an impact underwriting concept and carried out a pilot study.

A regulator confirmed that the pilot had been carried out recently. The underwriting policy aims to encourage citizens to consider adaptation measures. If people implement adaptation measures the

insurance sector should be able to incentivise this through standardisation of terms and conditions and possibly also premium discounts to reflect reduced risk. EIOPA will continue working on measures to incentivise consumer awareness and to improve the offer of products targeted at risk-based climate adaptation.

An official commented that a similar approach has been taken in Italy. Designing standardised products with adaptation measures can be problematic. Also, measuring the effect of those adaptation measures in terms of risks can be difficult. The insurance sector could contribute to this more.

3.3.2 Incentivising policyholders' adaptation should be undertaken in parallel to risk limitation by insurance companies

An industry representative noted that their firm is a non-life insurer, but also a reinsurer, so the physical risks around climate are very relevant. Proper pricing should take into account the climate change impact. All major insurance companies have teams of cat modellers and meteorologists who build models of climate risks that enable the estimation of pure technical premiums in the short-term and improve the knowledge of frequency intensity for the longer term. The historical data series is too short. Limiting the overall exposure to climate risk, especially in the high risk zones, is challenging. Mutual insurance companies s are attempting to retain their market shares in those high-risk zones, whereas some insurers are avoiding the high-risk zones. There is an issue of fairness for citizens. A mutualisation of the risks of the higher zones must be achieved if those risks are to remain insured. The help of the public authorities will be needed to avoid building in these zones or work on prevention measures.

3.3.3 One challenge to address is the cost of adapting to increasing physical risk

An industry representative stated that prevention measures can be costly. For instance, flood shutters are around €6,000 for a regular house; prevention measures against the effects of subsidence on a regular house cost between 15.000€ and 20000€. If insurance companies can encourage their clients to install such measures and can even help them to get in touch with companies providing prevention measures, or help with the administrative work in order to obtain subsidies provided by the government, those costs are very high and cannot be paid for by the insurance companies. Giving a price reduction on the insurance premium won't help the client since insurance prices are too low. Although investing in prevention measures is very important, it won't contribute in an important way to limit future climate claims.

4. Regulatory and supervisory priorities to address sustainability risk in the insurance sector in the global context

4.1 Globally, the targets are to improve data and the measurement of how climate risk develops over time, and to address possible gaps in climate related regulation and supervision of insurers

An official explained that IAIS has three pillars of work with regard to climate risk. The first is monitoring. There is an expectation from the public that the insurance sector will provide evidence of how climate risk develops over time. There are a lot of data gaps, but progress is being made. Members are being helped to do their own monitoring, possibly using developments at the global level as a benchmark.

The second aspect is policy work. The insurance core principles (ICPs) were developed to be able to capture all risks, so no major changes are expected to be necessary. IAIS has been conducting a gap analysis to investigate whether any areas of climate risk development have been missed. Consultation with stakeholders on potential changes to the ICPs has begun. How supervision interacts with the standards is also important. We [IAIS] intends to publish application papers to help members use its standards to assess and mitigate climate risk.

The last element is capacity building and supervisory cooperation. Members carrying out climate stress testing have been helped. More than 200 supervisors have taken part in workshops. Capacity building for supervisors is also a very active area of work. The IAIS can provide a platform for dialogue and cooperation between supervisors. There has been a lot of dialogue with the industry.

4.2 In the EU, in addition to guidance on how to include sustainability in the ORSA, the revision of the Solvency II regulation provides an opportunity to introduce some specific prudential treatment of ESG related risk. The next target is an effective implementation

A regulator stated that there will be a lot of work around Solvency II, although there is some delay related to the negotiation.

The Commission gave EIOPA until June 2023 to deliver a report on the prudential treatment of assets and activities which are associated substantially with environmental or social objectives, but the negotiation is still to come. The plan is to publish a paper further in the current year, depending on progress on the Solvency II negotiation. The present time may be a good moment to consolidate regulation and make it usable.

4.3 Less burdensome and more adequate stress tests are in development

Regarding cross-sectoral stress tests, a regulator explained that the European Supervisory Authorities (EBA, ESMA and EIOPA) and the European Systemic Risk Board (ESRB) received a mandate from the Commission to carry out an exercise to understand the real risks from and to a transition to climate-neutrality. The outcome of the cross-border exercise is expected towards the end of 2024 or early 2025. The aim is to use the data obtained already to lessen the burden on the insurance industry.

4.4 Better identifying and addressing customers' investment sustainability and return preferences is also a priority

A regulator commented that the sector is possibly not sophisticated enough. The new legislation aims to ensure that consumers can invest and save sustainably. Insurance intermediaries and insurance providers need to recommend products to meet sustainability preferences. However, the sustainability preference and what is expected is not clearly defined. Also, the disclosure requirement does not define exactly what a sustainable investment is. Sustainability and returns should be discussed at the same time in respect of saving and saving products. What sustainability will cost and whether consumers are ready to take on this cost must be considered. The level of detail that has to be disclosed may be too great.

4.4 Preserving the risk sensitiveness of insurance prudential frameworks is vital, although sustainability must be incentivised

An industry representative commented that the regulators were doing their best to try to remain balanced. The message from industry to the regulators was to remain risk based and to avoid deploying unsuitable standards that could interfere dramatically with strategic decisions. Pro-cyclical behaviours should be avoided. A long-term approach is crucial. An overly standardised approach overstates the science proof basis. Science is not formed on a consensus but on non-rebuttable evidence.

An official noted that there has been a very intense development of regulations. Sometimes the regulation goes too far compared to the practices and sometimes it is the other way round.

An industry representative commented that European regulators are always well advanced, especially in climate related matters. There is an attempt to incorporate climate elements into the Solvency framework, such as capital regulations to accelerate green investments or repress the brown investments. However, unless evidence suggests that the green investments have lower and the brown investment have higher credit risks, it may not always result in a desirable outcome.

4.5 Regulators should support promoting the transition of economies, not simply divesting, of the insurance sector

An industry representative stated that government is expected to play a role in supporting private insurance companies, which provide funds for transition to the corporate sector. The Financial Services Agency of Japan (JFSA) has been actively working on various measures to promote the private sector's activities, such as the establishment of a sustainability finance expert panel.

AML: key success factors

1. With a uniform set of AML rules and the creation of an Anti Money Laundering Authority (AMLA), the EU expresses its strong legislative will to be up to the AML challenge

A policymaker commented that the issue of AML has been rising up the agenda. The damage money laundering scandals can cause to the reputation and even the existence of institutions is clear. Robust AML regimes are part of environmental, social and governance (ESG) frameworks. AML efforts have recently been stepped up. There is no financial integrity, fair competition or fair pricing without an effective AML regime and the importance of AML to national security has also been recognised since February 2022. Past scandals have revealed that the European system is not perfect. There are a lot of problems to fix, and international expectations are high.

For this reason, the Commission issued a legislative package in summer 2021 proposing a uniform set of AML rules. Some rules are harmonised with discretion at the national level and directly applicable, in particular for customer due diligence (CDD) and for know your customer (KYC) across the EU, preventing arbitrage and limiting the number of regulatory regimes financial institutions deal with. The Commission proposed the Anti-Money Laundering Authority (AMLA) to ensure the uniform application of the regime, the issuance of draft technical standards and the supervision of the industry. The Council concluded its negotiations at the end of 2022 with some material amendments, such as on information exchange between private sector entities and stronger supervisory powers for AMLA.

The European Parliament (EP) defined its position at the end of March. The trialogue is going to be started soon. The panel will take a closer look at the EP's proposal, which includes new proposals and more detail on existing rules to make them stricter. Thresholds for due diligence obligations are being lowered and there is a push for more transparency. The discussion will be split into four parts. The first part is about where Europe stands. The second part will look into transparency. The third part will look at the links between AML and sanctions. Finally, other important elements of the trialogue will be considered.

1.1 The EU Parliament contributed to strengthening the EU's ambition and reinforcing the efficiency and reach of the bill

A public representative commented that the EP's proposals are ambitious, but achievability and proportionality have always been considerations. The proposals are achievable, but this depends on political will. The EP's proposal extends the others', making the AML regime more European and broadening its scope. The list of obliged entities is extended to include football clubs. The EP also extends beneficial ownership (BO) registers, increasing accessibility of real estate registers and including cars, boats, and planes. The focus is on places in Europe where there is a known need to have a closer look.

The EP is also looking for a better quality of due diligence, putting forward a list of high risk countries, institutions, and high net worth individuals. The intention is to arrive at a common definition of ownership with a lower threshold, stronger requirements for obliged entities and better verification of data. Supervision must be very good and very European. The AMLA should take the lead because it would be ineffective to have a college of supervisors who cannot make decisions. Binding mediation is necessary where there are issues, but the AMLA should also have a role in the peer review of financial intelligence units (FIUs) and the BO register. A package of this size and importance has not been discussed enough, so this discussion is valuable. Some pushback is to be expected from member states given that the EP focuses on freezones, which a small number of member states do not have.

An industry representative stated that the package covers some blind spots by looking holistically at risk based approaches and the impacts on the de risking of whole industries as well as on consumers of financial services. The financial industry should always look for improvement in the set up of public private partnerships around information sharing. Although there is currently a gap, it is well positioned to make improvements and stay connected to regulators and supervisors' needs. The one stop shop concept stands to serve the global community very well because splitting suspicious transaction reporting (STR) across countries devaluates it. The benefits of having one place to file a comprehensive view of suspicious activity go beyond AML work. Bringing together supervisors and FIUs is critical because they are not as connected and can provide different feedback. The public private partnerships built into this regime will help improve that.

The ability to file on almost anything must be protected. Financial institutions should not dump more garbage into the system, but it is important that information from one country be shared among other FIUs for the monitoring of illicit activity.

1.2 The package represents real opportunities for efficiency for financial institutions and their international customers

An industry representative observed that this package represents a huge opportunity, particularly for the private sector. Banks trying to conduct AML duties are faced with different situations in different countries, making it difficult to manage the necessary information and increasing costs. The new harmonised approach will allow practitioners to rationalise their internal processes and simplify the requests made of international clients. There are still some challenges. The package is right to argue for better-quality due diligence, but it does not follow that due diligence will be better if the threshold is lower. If a 15% threshold[1] were adopted, organisations would need to review all their internal processes. 25% is most common internationally, though some countries have different thresholds and having the same threshold across Europe is helpful. The request usually goes much lower for tax purposes, so it will not be a huge challenge.

1.3 A widened regulatory scope and improved, and commensurate supervision are necessary to address the rising number of AML cases in the context of technology and innovation

An industry representative noted that the bigger challenge is that new organisations are going to be covered by this regulation. However, this will be positive globally because it is not true that only banks have to provide this information. It is therefore very important to cover a wide scope.

A regulator stated that there are more AML cases every year, in part because national authorities are putting in more effort. Every year from 2016 until 2022 there have been more cases in Eurojust, with the number of cases in 2022 double that of 2016. The challenge is primarily the scope. There are more obliged entities to be supervised and new technologies bring new challenges. It is necessary to adapt quickly and establishing a central database will help supervisors work more efficiently.

AMLA must have sufficient resources to supervise more than 40 groups, as this puts a lot of pressure on the new institution and on the national competent authorities (NCAs). The NCAs must also be provided with more people and the resources for the joint supervisory team must be increased. New products are still being designed to be out of scope of the Markets in Crypto Assets (MiCA) regulation, and more supervision is needed to establish whether they do indeed fall under MiCA. Caution is needed around product classification to avoid spill-over effects from the risks of traditional financial products. The battle on AML is a marathon rather than a sprint and significant effort is necessary to create financial hygiene.

2. Improved transparency and further data sharing between financial institutions and national and international supervisory authorities is inevitable

2.1 When it comes to money laundering, transparency is of the essence

An industry representative commented that transparency is necessary and the proposal around the central database and information exchange will be a gamechanger. Banks must also exchange information, as criminals do not simply use one bank.

A public representative observed that the EP tried to base the high value asset register on existing registers. Money can be laundered through the trade in these assets. The EP tried to ensure authorities have good access to BO data on real estate at a European level and the registers were extended to make clear the source of funding and BO of cars, boats, and planes over €2 million. Art and jewellery were not included this time because the regime has to be proportionate, but the EP hopes to gain experience on how to create registers for other high value assets for which there is a lack of data.

A regulator stated that supervisors should be able to rely on each other's assessment. Once access has been granted to registers in one member state, it should be granted elsewhere. The legislative framework should provide certainty in this regard in order to foster unbureaucratic behaviour which is prerequisite for effective supervision and investigation. Money laundering crosses borders, so investigating funds requires checking registers across Europe. A European solution is certainly the way forward also when it comes to BO registers and transparency.

2.2 However, when pursuing money laundering, it is essential to consider data privacy and take account of possible reputational damage. Policymakers' judgement will be key in this respect

An industry representative remarked that caution is needed around extending access to the wider public. The recent ECJ decision on data privacy should be remembered, and the French data privacy authority was also sceptical. AML risk is of a different nature because of the potential reputational impact. Putting information into the media too quickly can trigger huge damage before the legitimacy of the information can be checked. Recently, the role of social media in the collapse of Silicon Valley Bank has been acknowledged. That type

1. On ultimate beneficial ownership (UBO), the EU's Fourth Anti-Money Laundering Directive states that holding more than 25% of the shares or interest of an entity or being a beneficiary of at least 25% of its capital gains gives individuals UBO status. Setting the threshold to 15% is debated. UBOs are natural persons who ultimately own or control a customer and/or natural persons on whose behalf a transaction is conducted. They include persons who exercise ultimate effective control over a legal person or arrangement.

of impact could be greater in an AML case. This is not to say that transparency is not needed, but a balance with data privacy must be found.

2.3 People with a legitimate interest should access data

A public representative observed that the ECJ decision on transparency was a surprise. The EP tried to work on the basis of the statement in the verdict that journalists have a legitimate interest to ensure quick and unbureaucratic access for journalists. The EP has come up with a way forward to ensure quick access while doing justice to the ECJ decision and will discuss this with the Council. This involves providing quick access based on a declaration of honour, with the possibility of revoking access if it becomes clear that someone is not a real journalist. Mutual recognition is also needed, because Luxembourg has restored access to the BO register only for the two journalists in Luxembourg, when Luxembourg is an investment hub with clients from across Europe and the world.

A regulator commented that the ECJ ruling shows that balancing transparency and privacy rights is difficult. The court contributed to finding a good solution by pointing out that there is a clear need for transparency and rapid access to registers to combat money laundering, and that journalists have a legitimate interest. The ECJ said that while transparency was highly important in fighting money laundering, unrestricted access to registers which legislators introduced with the fifth AML Directive (AMLD) following the Panama Papers would go too far, opening a Pandora's box of private information that could be disseminated to anyone. So, the question to answer is yet again how to give rapid access to all the right people. The decision on the way forward is a call for the legislator, but for supervisors it is important that the assessment of who has a legitimate interest in access to registers is granted as quickly and unbureaucratically as possible. The legislator should provide guidance in a level 1 or 2 text to give greater certainty around the definition of legitimate interest.

2.4 Conditions for improving data protection

A policymaker noted that a European Data Protection Board (EDPB) letter observed that the provisions on information exchange between private sector institutions do not give sufficient weight to data protection. A regulator commented that the reasons for the implementation of the regime must be considered. The two main innovations of the AML package are the AMLA and the shift from directive to regulation. These steps are more of the same. The first line must be strengthened in the fight against financial crime. The concern expressed by the EDPB must be acknowledged, but it lacks nuance and fails to recognise the importance of the AML regime. Co legislators should discuss introducing more safeguards into the rules, but the AML package must change how things are done today. A policymaker questioned whether the EDPB letter understood that the current EU draft provides for national legislation to set up the data protection requirements. The EDPB should have spoken to the AML community beforehand.

2.5 Effective transparency requires an appropriate trade off between information quality and quantity since data should feed into a meaningful risk based decision-making process

An industry representative stated that the key questions are whether more transparency is better and who connects the dots. One must question whether the system is ready to connect the dots and become more effective. Global standards are necessary to create a common understanding of how public and private sectors can combat money laundering because it is a cross border activity, but when a matter becomes sufficiently material to be considered further is a matter of judgement. It is necessary to determine whether taking action will result in a meaningful outcome and act on the basis of risk. There is a big difference between a local company and an offshore company, and the means of a company are important.

Reflection is needed on how much the focus should be on implementing more policies and procedures as opposed to adopting a risk based approach. All entities have the same interests, and it is necessary to ensure they can respond to changes in the geopolitical environment. The right balance is needed before the focus can shift to the outcome. The speaker's organisation urges that the beneficial ownership threshold should be kept at 25% in line with the Financial Action Task Force (FATF), the US, the UK and Switzerland. Application of a lower threshold should be determined on the basis of risk profiles. While increasing numbers of suspicious activity report (SAR) filings are made, their outcomes remain unclear. The speaker's organisation therefore promotes the new directive very strongly because it is fundamental that there is greater effectiveness across many countries.

3. Real synergies between AML and sanctions application arrangements should be sought, though significant specificities must be factored into the surveillance framework. Succeeding at implementing these arrangements may open the way for progress on tax evasion

A Financial Intelligence Unit official stated that, while the proposal on financial sanctions and related measures for "obliged entities" is certainly interesting and makes sense, it is necessary to determine who the obliged entities are. AML/CFT obliged entities cover a huge scope, but essentially everyone is obliged to enforce sanctions. It is necessary to clarify which group the rulebook addresses. Although there is a difference in nature and purpose between sanctions, which are rule based and deterministic, and CDD measures, which are more discretionary and risk based, there are some commonalities. A designated person can be a beneficial owner of a company, so a look-through approach is needed to identify the subject that has to be sanctioned.

This is very similar to the BO conundrum that arises in traditional CDD. The European Commission has also presented a proposal to criminalise sanction evasion, which is a more nuanced area. Progress is therefore being made towards merging the two frameworks, but some fine tuning is needed.

Although the idea of conferring sanction-related tasks to AMLA is appreciated, there are many concerns. It is not clear which obliged entities will fall under AMLA's remit around sanctions or how it would take decisions. Two configurations of the AMLA general board are proposed and neither includes sanctions competent authorities, with the exception of supervisors and FIUs that have competencies in that area. This governance issue must be addressed. There is also a question around feasibility with regard to the time and resources needed to implement this.

A regulator commented that there are clear supervisory synergies between AML/CFT and sanctions monitoring. Those responsible for AML in industry are increasingly also responsible for sanctions monitoring. National prudential supervisors also check the sanctions monitoring systems and controls of obliged entities and report inadequacies to sanctions monitoring boards. The EP's attempt to achieve convergence is positive, but there are concerns around the fragmentation of the list of sanctions competent authorities. It is also unclear whether AMLA will have the necessary resources to achieve its objectives, given the lack of trained supervisors. A European academy for training supervisors could address this and increase the consistency of approach. Centralisation using technology would allow resources to be pooled between AML and sanctions monitoring, producing better results.

A public representative noted that it is surprising that AML and tax avoidance remain separate, as the information on high value assets for AML could be used for tax purposes, but this is not on the table.

4. Expected challenges and priorities to implement the AML framework

4.1 Financial institutions as well as the public sector must make important technical and human investments to comply with the forthcoming AML framework and meet expectations

An industry representative stated that the whole AML package should be implemented, including less popular areas such as the one-stop shop. Financial institutions are making significant investments to be compliant, so it is important to see the real impacts of the regime.

An industry representative observed that the current system is inefficient despite costing banks significant sums, so there is a lot of expectation. The new system should be implemented efficiently, and AMLA should have significant powers. It needs to have enough people to supervise 40 entities and to have access the right information, because it will not start with its own information. A constructive dialogue with the industry is also needed, both because of the cost and because the industry is making a lot of SARs to protect itself, when the proportion that leads to action is small.

4.2 Many lessons will be learned around public private and NCA-AMLA cooperation from the application of a new risk based surveillance approach

An industry representative remarked that a constructive dialogue is needed to implement a risk based approach, because the existing lack of risk tolerance makes this impossible. Agreement on such an approach is necessary to have an efficient system that does not cost huge sums.

An industry representative commented that the directive should be implemented as soon and as cleanly as possible. A risk based directive will be a strong foundation to address new developments. The more open dialogue and intelligence sharing within public-private partnerships over the last 18 months has been very beneficial and encouraging. The directive also recognises that even the sanctions regime is no longer solely rule based because of the provisions around enablers, which are a key consideration for banks. The risk of the present system is that form is prioritised over substance and the bigger picture is missed, so a risk based approach is needed. Getting to the next level will require comprehensive cooperation between public authorities and the private sector.

A regulator stated that AMLA should start functioning in line with its AML obligations and, once these are functioning as planned, the European Commission should propose expanding its role. This is a good opportunity to establish a centralised European institution to supervise the financial market. If AMLA also cooperates closely with national authorities, it has the potential to be transformational.

A regulator wished to ensure that AMLA adds value and does not become another layer of complexity. AMLA's role in coordinating with national authorities will be much more difficult than the European Central Bank's (ECB) challenge regarding the Single Supervisory Mechanism (SSM), as this is a more difficult issue to supervise.

4.3 Defining clear, short term operational objectives and leveraging existing national expertise are key success factors for the upcoming AML framework implementation phase

A regulator commented that legislators should finalise the legislative package and supervisors must establish priorities and effectively prepare to avoid the endeavour failing, because the AML architecture is much more difficult than the SSM. It will be crucial for national authorities to understand AMLA's role, and vice-versa, in order to integrate it into their processes, to avoid both redundancies and supervisory gaps. There is a lot of expertise in national authorities that must be brought together to set it up. Sharing forces will be key. Finally, expectations from within and outside the EU around what can realistically be achieved should be managed. There is no doubt that the right intention is there. But realism about the delays and the deliverables is necessary. Contingencies should hence be put in place to anticipate and address them.

A Financial Intelligence Unit official stated that AMLA as an FIU mechanism acts as a multilateral accelerator of cooperation in the Commission and Council's approach. FIUs will remain in the same situation because there is no truly supranational level at which AMLA would sit and govern properly. FIUs are already free to start joint analysis and AMLA simply acts as a broker. In the EP's proposals, AMLA becomes a truly supranational director of joint analysis with the power to steer, promote and initiate joint analysis. This is helpful in giving FIUs the correct incentives to join and participate in a supranational approach. However, the EP should not embark on the FIU.net one stop shop proposal because it is neither feasible nor appropriate.

A regulator commented that AMLA should promote stronger cooperation between prudential and AML regulators, which is very important for the integrity of the European financial system.

Exchanges of Views

Stability and Growth Pact: possible way forward

Pierre Gramegna - Managing Director, European Stability Mechanism

Mindaugas Liutvinskas - Vice Minister of Finance of the Republic of Lithuania

Vincent Van Peteghem - Minister of Finance, Belgium

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

Jacques de Larosière - Honorary President, EUROFI

Pierre Gramegna

Good evening, ladies and gentlemen. Let me start by thanking Eurofi for putting together this impressive programme with more than 1,100 participants. I am glad to be back at Eurofi for the first time with a new hat as the Managing Director of the ESM.

Let me say on a serious note as an introduction, that we are very fortunate that we had Valdis Dombrovskis presenting in 20 minutes to us today what the Commission has in mind. In a nutshell what struck me in the presentation is that to improve the public debt compared to GDP, you have to act not only on the numerator, which means on the amount of debt, you also have to act on the denominator. In other words, it is not only about reducing debt or stabilising it, which is the numerator; it is also about the denominator, which means enhanced growth. Strengthening public debt sustainability and boosting sustainable and inclusive growth go hand in hand.

The first question out of the two that I will ask my friends the panellists to address is: how do we reduce the high and divergent public debt in the EU countries, as we have high heterogeneity, a different point of departure on the one hand? Do you think that having a realistic growth-friendly, but at the same time case-by-case approach, will be helpful? This is also one of the guidelines that Valdis has indicated to us. I will start by giving the floor to Vincent for that.

Vincent Van Peteghem

Thank you very much Pierre and good evening, everybody, I am very happy to be here in Stockholm and I am already looking forward to the session in Ghent in February next year. I am sure that you can also be a moderator of one of the sessions that will take place there, Pierre.

First, I think that it is a good thing that the Commission put the proposal on the table. We should be honest enough to say that the current rules did not really work, because we have very specific situations and very specific contexts in each and every member state. Every member state has a different debt level, different labour markets, different challenges, and we should take these specific contexts into account. It means that today I am also sure that the idea of having one rule to fit all does not work today.

We should consider the different challenges that each of us have. That is why I also believe that we need to differentiate between the different member states, look at the context of every member state. For example, if I look to my country, we have high debt and we also know that we have an ageing problem, which has an impact on healthcare and on our pensions. This can be completely different for other member states. At the moment that we take into account the debt reduction and then the sustainable debt that we need to have in the medium and the long-term, it is not only necessary to look to that debt evolution but also to the specific context of that member state.

That is the reason why I really believe in the proposal of the Commission. That it is indeed, as Pierre is indicating, not only focusing on the nominator but also focusing on the denominator, look at what kind of reforms and investments can be done, of course, specific for every and each member state, taking into account the goals and challenges that we all have. That does not mean that we also do not need to look to the general challenges that we have as a continent, including the climate goals. We need to be prepared for the future challenges of Europe, but at the same time we need to also look at the specific situations in each member state of Europe, but at the same time we need to also look at the specific situations in each member state.

Pierre Gramegna

Thank you, Vincent. Jacques de Larosière, what is your comment on the disparities and heterogeneity that we have in the Economic and Monetary Union?

Jacques de Larosière

Thank you very much for giving me the floor. I think that we should remind ourselves that a monetary union does not, by itself, create convergence, but it should not exacerbate the existing heterogeneities of our Union. However, since the establishment of the euro in 1999, we have observed that the divergence that existed amongst the member countries has increased. That I think should not be accepted. The existence of a Union should not exacerbate the divergencies. What we have seen in a little more than 23 years is that budgetary discrepancies have increased, structural deficiencies have increased, productivity gains have been distorted, and so the existence of the Union has been concomitant with a very serious aggravation of the heterogeneity.

Fiscal deterioration is something we have to look at very seriously because fiscal deterioration is developing in our Union. If we do not understand that then the discussion that we have this evening makes very little sense. Beyond a certain point, which is the mere point of non-sustainability of public debt, the deterioration of public finance is much more than the deterioration of public finance, because it pushes monetary policy towards the monetisation of the deficits. At one point, it is the fabric of the financial market that is jeopardised and unfortunately, we have reached that point. If we do not understand that the discussion on a stability pact is to no avail.

The Stability and Growth Pact has not worked well, and we have to admit that. It has not worked well, because of a fundamental reason which was a lack of will, a lack of political desire to cooperate and, perhaps more, that lack of will than the details of the pact itself.

The legislative proposal of the Commission, of which we have heard by Mr Dombrovskis presentation, is in my view a very useful set of recommendations, because it does not change the figures in themselves. I have nothing against 60% in terms of the maximum of debt that we have to search for. I am completely in favour of keeping the 3% deficit, which is rather benevolent. The idea of the Commission is good, because instead of putting these objectives, which are very difficult to obtain and which become a pretext for not doing anything, you start with each country's practical situation. Instead of saying, 'You should reach not more than 60% debt in terms of GDP', you say, 'Well, we are going to start with the facts. We are going to start with the present position, and we are going to determine together a trajectory that will make you gradually closer to these objectives'.

I think it is a better method than just setting the objectives, because you start from reality, and you forge a trajectory that hopefully would make sense.

Pierre Gramegna

Thank you, Jacques. Let me also ask Harald Waiglein how he sees the thrust of the proposal, but also in the sense of the question that I asked: on the one hand heterogeneity case-by-case. You could also phrase it reinforcement versus flexibility. How do you see that?

Harald Waiglein

Let me start with what I heard and probably what you heard, Pierre, in Washington two weeks ago. The message from the IMF was pretty clear: debt is back in focus and consultation is a must. Whatever rules we choose to adopt, I think we have to look at the results. If they achieve the results, then they are good rules. If they do not achieve the results, then they are obviously not so good. Against that background there are many good elements in the proposal by the Commission, there are some clever ones and there are some where there is at least a question mark, from our point of view, on whether they will achieve the goals in practice.

That is not because there is an inherent mistake in the rules themselves, but precisely because of what Jacques said: the old rules did not work because they were designed badly, but because there was not a will to apply them. That is the same for this proposal. If there is no will apply it in a way that actually reduces debt then the new rules will also not work. Just to go back to the question because I love these very European questions: how do we reduce the high and divergent debt in a sustainable and growth friendly, realistic manner? I love this language. I am so used to it. It is: how do I jump into a swimming pool without getting wet? Of course, if you want to consolidate at some point there has to be pain otherwise there is no consolidation. The only way to reduce debt and actually enhance growth happens in a situation where you are already in big trouble because your interest rates are so high that they themselves are an obstacle for growth.

I hope we do not get into that situation, but we have to accept that austerity, coming back from high debt levels, will be painful. There is no way this cannot be painful, and this is also one of the messages that came from the IMF and that is the benchmark against which we have to assess part of the proposals. It is a good idea to include investment in there and focus on the role of investments, but, then again, we have to be very careful about what these investments actually achieve, whether they actually reduce debt and increase growth. I have been in many discussions in the past where we had the investment questions and I am not going to say who, but one country said, 'An increase in pensions is an investment in social stability'. If that is the benchmark we are obviously not going to get very far. I will leave some more space for thoughts from Jacques.

Pierre Gramegna

Thank you, Harald, for showing that you can prepare a panel as much as you want, but if you have the Vice President of the Commission presenting the new plan just before it is difficult to stick to the agenda. I congratulate you for that, not only you, but all of us here, because the theme is well-known to the public here. What is more interesting is for this debate to get to the heart of the matter of what the four of you here think is key, so the public can understand the challenges that ministers face trying to find a compromise on this. Additionally, the challenges between what would be the most advisable economic solution and what is politically feasable. Let us give you the chance, Mindaugas, to give an initial view on this from your side.

Mindaugas Liutvinskas

This is indeed a very timely discussion having the fresh Commission proposal on the table. I am so glad to be here. Overall, I tend to see what has been proposed as a broadly balanced proposal. It could be a potential landing-zone going forward. A great deal of discussions at the Council went into what has been proposed.

Let me focus on one specific element at the heart of the proposal, which has to do with domestic ownership. I come from a country with relatively low debt levels, so we do not seem to have big problems with domestic ownership when it comes to fiscal discipline, but it is a big issue when it comes to the EU as a whole. I would say that the whole idea of having a risk-based framework with a country-specific approach, is the key pillar for enhancing domestic ownership. Individual plans that the member state negotiates with the Commission, and which is later approved with the Council, should ideally increase domestic buy-in. That is the whole idea, especially when we talk about the possibility of having a longer adjustment path. This creates space for investments, which is often quoted as an element for domestic ownership, investments that could enhance the growth potential. This should also be in favour of domestic ownership.

However, at the same time it might come at a cost to the multilateral nature of the framework. This is an important trade-off that we have been discussing and the answer that I came to myself in having this debate is that the only way forward to deal with this trade-off is to ensure maximum transparency. Maximum transparency in the criteria, in the way the member state deals with the Commission, otherwise we risk having a very bilateralised framework which then loses a key element of its character in terms of the multilateral element.

Going forward, on the domestic ownership element, it is important that whatever we construct has some inherent flexibilities. What I mean by this is that if a country agrees with the Commission on a fiscal adjustment path, the country itself, the authorities, should have a certain degree of flexibility in terms of proposing and implementing the specific design and instruments on both the revenue and expenditure side when it comes to fiscal as long as the agreed fiscal path is respected. Otherwise, we risk creating some rigidity that might harm domestic ownership. That is also an important element to keep in mind.

The third point, we have to reflect on the changed geopolitical realities surrounding us. This calls for some smart and flexible treatment of green and defence spending in the framework. I am not saying golden rules, I am saying some smart treatment within the rules, especially for countries that have the fiscal space and need to invest in the build-up of defence capacities. My final point is also on the external environment. When we think about domestic ownership, incentives to comply, we should not forget that the reality when it comes to monetary policy and the market situation is changing. The era of low interest rates seems to be behind us, which means that the market discipline is back. This is an element that could definitely increase compliance rate and domestic ownership to whatever you sign on as a government. I will stop here.

Pierre Gramegna

Thanks, Mindaugas for making explicit what ownership means. All of you touched upon it. It is a very important factor and what we can keep in mind is that ownership means that as a country you want also to have a dialogue on revenue and the expenditure side. On the denominator side you want a dialogue on the type of investments such as for the dual transition or defence expenditures. In a country like Lithuania, which neighbours Russia, this has even more prominence than in other countries. How would you rebound on that Vincent? How do you focus on the different data and variables that you can act on?

Vincent Van Peteghem

Again, it has already been mentioned by others, it will be important that we are responsible for what we put on the table and the goal of what we want to achieve, which for all of us is sustainable debt in the medium-term and long-term. The way that we are going to do that is based on a solid risk-based analysis, and that we know what our goal will be. It will be important that we look at the rules that we are going to have. Today we know that the rules are actually not as they should be. They are unachievable. For example, the 1/20 rule is not achievable.

It is clear that if we want to have new rules and we want to increase the ownership, as was mentioned before, it is important that we focus on a commitment-based approach (with more ex-ante flexibility, but also more ex-post enforcement). For me, it is important that we have that medium-term perspective, that we know what we want to achieve, that we know where we are heading to and that we take into account not only the debt reduction level that we want to obtain, but also look at how we are going to increase our investments and the reforms that are necessary.

Pierre Gramegna

Thank you, Vincent. Harald, maybe you could tell us how you see the dynamics between expenditures, on the one hand, revenues on the other hand, and the major change of focusing more on investment. How can that interplay be helpful? What pitfalls are there?

Harald Waiglein

Vincent made a very good point that it has to be based on some sort of risk analysis, which is part of the proposal. Quality of expenditure is a decisive factor, again, that is easier said than done, because I am sure that we disagree on what high quality expenditure is in different cases. I know for Mindaugas being in his place with the Russian border he has a different view of priorities in the budget than we might have, and that is perfectly understandable.

The expenditure benchmark as the anchor is a good idea because it simplifies things and that has to do both with expenditure and revenue, in a way. Having said that, a debt sustainability analysis is normally a risk management tool. If you want to assess the debt sustainability of a country and you want to be sure, you make very conservative assumptions. It is not normally a tool that you use to determine a potential budgetary path more than 10 years in the future, because there is a risk of retrofitting.

Even though these tools can be useful, we need a multilateral approach. Mindaugas has said it, when we started with the Stability and Growth Pact (SGP) the approach was bilateral and the experience with that was not very good, because countries were treated differently. That was not wanted at the time, so the multilateral character has to be there. It is not possible to reproduce all aspects of the Debt Sustainability Analysis (DSA), but part of that approach is a minimum common benchmark to maintain the multilateral character and ensure there is a minimum consolidation effort. That is why the rule is a good idea and the Commission is a fair basis for this discussion.

Pierre Gramegna

Mindaugas, maybe you can rebound what was said. I will pick up two things that maybe you, Jacques and Vincent would like to pick up too. I like your sentence: debt sustainability is a risk management tool, on the one hand, and the second point that we need minimum common benchmarks. How would you see that Mindaugas? For me, these two issues are at the heart. The importance of a debt sustainability assessment goes to the heart of the ESM's mandate of safeguarding financial stability and assessing the risks. We also want to ensure that the beneficiary countries will be able to pay back the funds that we lend to them. It is just common sense. That is why we need some benchmarks.

Mindaugas Liutvinskas

I will try to build on what Harald said. I see this issue as a broader trade-off between, on the one side the need to maintain or enhance the soundness of public finances, and on the other side all the investment needs that we have. There is defence, green, digital, Union-level goals, and that is the inherent tension on the table and on the DSA element. It is a complex theoretical exercise that is very sensitive to assumptions. Basing the whole new framework on this as a starting point raises questions of clarity, transparency, replicability. I fully agree with you here.

There is some welcome movement on the issue of whether there should be minimum common safeguards. It is important to ensure that there is a safeguard against the potential backloading of fiscal adjustment, especially in cases where there is an extended period of time, like seven years. Seven years is longer than a political cycle, so it is quite easy to push forward the adjustment and kick the can down the road. That leads to a framework that does not lead to the desired effect of reducing the debt level or keeping it at a sustainable level.

It is also important, when talking about green investment, digital investment or more broadly growth enhancing investment as a basis for extending the adjustment period, is to have ex ante criteria agreed on what is growth-enhancing or fiscal sustainability enhancing reform or a truly green reform for which a country would be given the ability to extend the period of adjustment.

One last point, the whole framework is now based on the risk-focused approach, which makes sense. At the same time, we have a group of lower debt member states. Lithuania is currently part of them, but with a few shocks this could change dramatically. We now have debt to GDP at 38%. If a big shock occurs, we could go closer to 60%. This then changes the whole situation quite dramatically. My asking to the Commission in the debates was always, 'Do not keep us under the radar. Give us something as indicative guidance that would work as an anchor in domestic political debates to help us maintain the fiscal discipline, because this is an important issue. Flexibility is good to some extent, but it should come with norms and limitations.

Pierre Gramegna

Thank you very much Mindaugas. I am now going to come back to Jacques de Larosière. By underlining what you have all said, debt sustainability assessment is important. We need minimum common benchmarks. We heard Valdis Dombrovskis indicate a few safeguards, which I will summarise quickly and then give you the floor. First, the 3% yearly deficit remains a key benchmark. Second the 60% of GDP public debt also remains a key benchmark. Third, a new one, if you are above the 3% annual deficit benchmark, there is a safeguard of 0.5% of GDP fiscal adjustment that you have to apply to your budget.

What one can hear from the presentation – which was said by Mindaugas – it is trying to find the right balance between doing a case-by-case exercise and having ownership. Then you immediately see the risk that it is a la carte and you do what you want. Those are the two extremes. How do you see that Jacques de Larosière.

Jacques de Larosière

Well, I am very much in agreement with what you have said, and I think the observations that the panellists have presented are valid. The amount of scepticism which is going to surround this experience can only be erased if it is matched by an equal amount of seriousness in the analysis. We have been tinkering with this stability pact for too long and people do not take it seriously. You need to have an economic analysis that is impeccable. I agree with my friend Waiglein on this. It is more than just using a few macro-economic figures to say that 'This is the recommendation'. You have to go more in depth. I have some experience on this, because when I was the head of the International Monetary Fund, we did exactly that. It was called the Article 4 examinations. The economists that used to practice this art were remarkable people. Their objectivity was unshakable. It was totally objective.

The amount of knowledge, practice, experience that they had gained in their careers made these examinations very powerful. I do not know one country that pushed aside those reports saying, 'It is of no value'. I never saw that. Often the recommendations were not observed, but they were never dismissed as not serious, not loyal. We have to give this effort a chance, but we also have to understand what the conditions are for success. I am going to tell you how I feel about it.

Firstly, the teams who will write these reports and discuss them with the interested countries have to be really impeccable in terms of their capabilities. It might be a good idea if the Commission were to recruit a few top economists in the IMF or the OECD to buttress the people at the Commission. Secondly, I think it would be a good idea to have a group of either academics or economists of high quality, that would do the 'le suivi 'that we say in France and unfortunately do not do it enough. They would follow the application, the enactment of the reports. If it is not a group of academics it could be the ESM, because the ESM, in my view – and I say that very modestly – has the potential and it has the conjunction of financing capabilities and analytical capabilities.

The ESM should be part of the procedure leading to the report, to follow the report and to check whether it is done and get to the nitty gritty. If a country like France is told not to have more than 60% public debt to GDP then there is not much value because it is too far away. But if they are told they have 60% of GDP in public expenditures with the average in Europe is 50%, and so these 10 points excess of GDP which kills competitiveness. That is going to be the centre of the report. It is going to be the lynchpin of the recommendations to follow them and accompany them on the trajectory that would lead them to a more sensible figure. That makes a lot of sense.

I think if you had a group of people like the ones you could have in your own institution, it would reinforce the Pact. Now, I know that ESM is for the euro zone, but we can solve that. The last point I wanted to say is about national ownership and equal treatment. A sensible minister, in the case for instance of France, could not be hostile to the idea that there is too much public expenditure and that we have to reach a more sensible level. No one would say that is wrong. You have to talk them into the process, and I am perhaps a bit naïve, because I still feel that people are rational and reasonable. I think it is a chance that we must not dismiss, and equal treatment is of the essence, because, for instance, if France gets away with the process it will have absolutely no credibility for the smaller countries.

The equal treatment is an imperative. I wish you well, Pierre, because you are our hope. I think we agree on most of it. I would agree with Harald on investment. I would be very sceptical to exempt investment from the figures because nothing is easier to baptise investment something that has nothing to do with investment in productive terms. I am a rather conservative guy, but I think that it is a chance, and we should try it.

Pierre Gramegna

Thank you. Coming from you, it is very encouraging. I would like to have your age and be as optimistic as you are. It is difficult to continue, but I would give all of you one more minute and then I would have two minutes to sum up, which is completely impossible. We start with you Vincent.

Vincent Van Peteghem

We were talking about the ownership and I actually think that all countries will agree with that more country-specific approach if the tools that we are going to use, for example the debt sustainability analysis, is clear and transparent and we know on which criteria and parameters that it is based, and do not need thousands of Monte Carlo simulations to come out and know what the plan will be. The same is true for the investments. If you look to the investments, it is already discussed. Pierre, I remember the first time we met we talked about the golden rule about investments. We started with infrastructure, and digital, and sustainable, and we ended with the wages of schoolteachers, because that is also something where you invest in the future. Harald already mentioned the pensions.

It will be important that we are able to label investments at a European level and put a quality stamp on these investments to say, 'Okay, we agree on the facts, based on some criteria, based on the fact that we also do it at a European level, that these kinds of investments are really helping our growth, are productive'. It also needs to be approved by other member states. Again, I believe that if you look to the goals we have with the proposal that is on the table, I am convinced that it can work, that it should work and that everybody can agree as long as it is transparent enough and everybody will also know how the rules and the plans of different member states will be set out.

Pierre Gramegna

Thank you, Vincent. Harald and then Mindaugas.

Harald Waiglein

I will be very brief. I will just highlight my favourite problem I have with the proposal, so that you get the picture. There is a common benchmark in there, but only in the corrective arm, as Mindaugas mentioned. We must not forget the preventative arm of the Pact as it was a lesson learned from the crisis. If it is abandoned there is no benchmark in the proposal for that part. Speaking from an Austrian perspective, if the 3% is the limit and there is no preventive arm and benchmark there, the message that Austrian policymakers will understand is that 3% is the new target, not the limit. The policymakers will think that as long as Austria is under 3% it is fine. That is a worry for Austria, but it might be the incentive structure in other countries as well.

Pierre Gramegna

Thank you for this political wisdom, Harald. Mindaugas?

Mindaugas Liutvinskas

I will repeat what I started from: I think that what has been proposed is a good basis for agreement with some possible tweaks in the future political discussions. There is the possibility and the potential to make the rules more realistic to implement and more effective in practice, and this opportunity should be taken. Together we still need to find the balance between some trade-offs including ownership versus equal treatment, which is a very important element. Secondly increasing fiscal sustainability on the one side and reducing debt levels in high debt countries, versus addressing the very immediate investment needs in many countries, which is also reflected at the Union level.

Pierre Gramegna

Thank you, Mindaugas. I would like to congratulate you all, because we covered a great deal of ground and you all tried to be quite brief and really focus on the essentials. This is not a summary; it is just an impression of the debate: we all agree that the existing system did not work well. This is an understatement but with time it has been learnt that it was not satisfactory and not reachable. For it to be reachable, there has to be change.

What is needed can be formulated in three elements, according to this panel discussion.

The system needs to be transparent; it needs to have reliable and observative data and it needs appropriate criteria. It seems that the expenditure benchmark is quite a good criterion for most, so issues are on the right track in that regard.

The second objective is credibility. This includes ownership that is serious; and enforcement with safeguards. If that is a good balance, we would reach the objective of credibility.

Lastly, everyone mentioned that the system must be even-handed or guarantee equal treatment as far as possible. Transparency, credibility, and equal treatment are success factors.

On a political note, let us not forget that for politicians, especially for the finance ministers, when they come back home, they can be alone against all their other ministers. They need the framework to have something at hand to guarantee sound public finances. I can tell you on a personal note, when I was asked 10 years ago by Xavier Bettel to become the finance minister, and I was not a politician, I said to him, 'I will eventually accept, but in the programme of the coalition we need a benchmark that is serious for Luxembourg, like we want to stay under 30% public debt to GDP. If that is in the coalition programme, I accept. If that is not in the programme you must find something else'. I was wise that day. I don't know which angel was above my head that day, or the Holy Spirit probably was.

Just to finish on this note, saying that you are all representatives of the public finance sector with long experience. They know how difficult it is to fight for sound public finances in council of government in their country. If the framework has a good ownership and fulfils the three criteria, there is hope. Thank you to all of you for being here. Thanks for listening. I look forward to meeting many of you next year.

Conversation with Bernie Mensah

Bernie Mensah - President of International, Bank of America
David Wright - President, EUROFI

David Wright

It is my pleasure to welcome for a discussion Bernie Mensah, who is the President of International, Chief Executive Officer of Merrill Lynch, Bank of America. Bernie has been with us a number of times and we greatly value your support of Eurofi.

He comes from a really distinguished career. He was an accountant, came from the University of Bristol and has been in Merrill Lynch and Bank of America for many years. Bernie, when you survey the scene in Europe in particular, are you seeing the capital markets develop in a way you would like? Are you worried about the lack of progression or how do you see things?

Bernie Mensah

Thanks, David. Thanks for having me and thanks everybody for being here. It is a terrific venue, by the way, and we have had all the seasons today, sun and snow. With respect to how we see it, I think it depends. There is so much work to do and that is why a lot of us do turn up at Eurofi to see if we can move the agenda along. Certainly, in Europe there is a lot of progress that can be made in capital markets. We have all had a great deal of discussions this week about bank resolution and, given some of what we have seen recently, what that might look like. Then we need to have the tools and be prepared for things like climate finance over the next period of time.

Overall, we should all be proud of pretty sophisticated, deep, well-run financial markets here and in the US, and a lot of good people do a lot of work every day trying to make that better, broadly speaking, so it serves the needs of corporates, asset managers and those that manage the savings of pensioners, but a lot more work could be done.

David Wright

You have to allocate your investments around the world. You are a huge bank. Can one say that Europe is becoming more attractive for you? Are you seeing the depth and liquidity, variety of trading and instruments that make European business more attractive for Bank of America?

Bernie Mensah

We have been investing in Europe seriously since Brexit, and that has gone well. In fact, I came a couple of days earlier because our Stockholm office has pretty much doubled in the last three or four years, so that is terrific. We are seeing that across Europe, so we are making that investment. Some of it was defensive, we needed to have access to our clients, but increasingly, it is certainly quite positive because, as I said, Sweden is a great example whereby having more of our people, we can be closer to clients and be involved in many terrific transactions. My colleague today was showing me we were in three or four of the pages of the local financial press on transactions that we have advised on over the last period of time, but we are allocating a lot more capital, a lot more balance sheet, to Europe and it is important. We have a $3 trillion balance sheet, and a lot of my job is to make sure that, as we allocate that globally, that we do that efficiently and well, taking Europe into mind, so that is good.

The other good thing is it is incredibly exciting seeing European companies that are doing exciting things at scale and we and our competitors are there looking to support them and provide finance and capital. I was in Singapore last week and when you compare and contrast, you have to be reminded about the depth and quality of European corporates and their ability to leverage the financial markets to do what they need to do. That is good. Could things be better? Yes. Could we make more progress towards Capital Markets Union so that it is more effective? Yes. Could we use European savings more efficiently? We absolutely could. The US does present a big challenge in terms of if you are a fast-growing company or if you are moving at scale, or if you are looking for different types of risk capital to help you grow, there is more ability to do that in the US.

David Wright

Bernie, we heard this morning from the president of the European Investment Fund, who said exactly that. She said above a certain level – I think she said something between 50 or100 million euro or pounds or whatever – there is a shortage of risk capital in Europe and therefore, as you say, a lot of good prospects head off across the Atlantic to the US. What can we do to ameliorate that situation?

Bernie Mensah

The thing there is that a lot of that capital in the US is European savings, right? Europe exports a huge amount of its savings to the US. Some of it stays there to drive those activities. Some of it comes back, by some of our best US asset managers, into Europe to invest in European markets for a small fee. A lot of the debate here is about is the ways in which we can deepen these markets, make them more sophisticated, and allow people with different risk appetites to participate in the market, so via a leveraged finance market, a high yield market, the securitisation market, the ability for pension funds and insurance savings pools to participate in different parts of the cap structure and across Europe more efficiently.

The elephant in the room is that we have a large amount of pooled capital still in the UK versus Europe. It is a lot less than it was, but it is still probably the majority. We do not want to get into all those conversations, but it means that it is slightly more cumbersome accessing that pool of capital.

The final thing I would say is the US and the UK and Europe is getting much better at being welcome to rest of the world capital. We must not forget that we have savings pools here, but there are huge amounts of savings that are building up in the Middle East, or in Southeast Asia and elsewhere, and those economies are not able to absorb the amounts of excess savings that are generated there, so they get exported around the world. Europe could play more of a part there.

David Wright

One area we have not talked very much about it at this Eurofi, but we have done before, was about securitisation. You just mentioned it. How important do you think it is for the European Union to have a vibrant securitisation market? I think that all the big banks here would agree with that. Why is it so important?

Bernie Mensah

Yes, we have talked about it at length. It is important because it allows you to manage risk better. It allows you to aggregate and disaggregate risk and get it into the right pockets. In doing that there is more risk appetite and there is more capital freed up on bank balance sheets. There have been synthetic securitisations to some extent, but that is not such an efficient way. If you have a cash securitisation market, you can package different types of asset classes more efficiently and, insofar as the rules allow it, then allow for more of those saving pools to get capital to that place.

Essentially, we are supposed to connect excess savings to those that need it in as efficient a way as possible. Today, under Solvency II and other regimes, much more capital is required for Triple A securitisation assets than single B or double B non-securitized assets, and mathematically at least that is not wise.

David Wright

We have seen reverberations, tremors, in financial markets, both in the US and in Switzerland, but not, touch wood, in Europe. Are you confident about European banks? Do you think our resolution and our regulatory framework is sound? We have made the right decisions post the great financial crisis and we are ensuring dividends. Are you optimistic about this?

Bernie Mensah

I guess that is the $6 million question that we have been debating a lot since everything. We are certainly not in a place where we can sleep at night without worrying. I think we have put a lot of security in place. We have the house and we have put alarms around it, we have put a double lock on the door, we have put some security grills in place, but things can still go wrong, and things probably will. The question is when they do, are we able to react to it?

I am not saying that there are any systemic issues in the European banking system or, frankly, in the US regional banking system. I think the backdrop that I have been sharing with some colleagues, is that we have had 10 years of dramatic interest rate reductions, quantitative easing, central bank balance sheets in aggregate have probably extended by, I do not know, $8-10 trillion over the last 10 years. When you stop that and you say you are going to put up rates and through quantitative tightening bring those balance sheets down, it is not free. It is a non-trivial exercise.

In that background, to my mind, we have seen Credit Suisse and Silicon Valley Bank and First Reserve is under pressure today, we will see, and others, and I suspect that if that carries on, seeing projections on targeted longer-term refinancing operations (TLTROs) and other liquidity coming out here and, in the US, then I think there will be more issues. Are we well placed to tackle that? Yes. Have we given it thought? Yes. I think that a lot of regulators, and I have spoken to some of them here today, are thinking through what the resolution mechanisms are like. Are they funded or not? How might they be applied in certain circumstances?

I am sure people can go through what we have just been through and think through whether a bridge bank sale versus bail-in-able, or how much additional loss-absorbing capital we should have, is the right route or not. Those debates are happening. I know they are happening here. Certainly Europe and the US are wealthy and rich enough to manage the contagion. The issue is how it is fixed. It is not that it can be managed, but if something goes wrong, how it is fixed. I think that is really the debate.

David Wright

Finally, give us your views of where you see the risks that worry you. Is it in leveraged commercial property loans? Is it in nonbank financial institutions, leveraged private equity? Where could we see the next pop?

Bernie Mensah

I could say, but I will keep that to myself. No, I do not know. People are debating a whole bunch of things. Some of the things that you mentioned, by the way, commercial real estate is a very broad definition. Is it retail? Is it hotels? Is it office? The classic offices.

David Wright

Is that more in America than European, do you think?

Bernie Mensah

Perhaps, but it could leak across here as well. The two markets are linked, and it is the same global flows of capital. I think the important thing is, as I said, we have had that backdrop of essentially quantitative tightening, because if you look at it, we had the LDI situation in the UK under the Truss government, the liability-driven investments. We have had Credit Suisse, and then we have had First Reserve. They are very disparate things, so issue number four might be somewhere else, so we will all in this room keep an eye out on that. I think the issue is making sure that when that does happen, we have the tools, and we can respond quickly and that I am pretty sure about.

David Wright

Bernie, I think our time is up, regrettably, but thank you and thank you for all your support for us. We look forward to seeing you in Santiago de Compostela and in Ghent after that. It is mandatory that we have a follow-up discussion. Thank you very much.

Conversation with Stephen Hester

Stephen Hester - Chair, Nordea
David Wright - President, EUROFI

David Wright

Ladies and gentlemen, joining me here is Stephen Hester. Stephen, I do not know whether trouble follows you around or you follow the trouble, but there cannot be many people who have had more experience and depth of dealing with very serious financial crises. In an early part of your career, you were advising Sweden on good bank and bad bank solutions. You were on the front row in the fallout of the Russian bond crisis in the 1990s and bank restructuring in the UK from dot-com failures in the equity markets. You were right at the helm of RBS during that huge crisis in 2008 and 2009, and then moved to Northern Rock in insurance, and now you are in the calm waters of Nordea. A very warm welcome to you and thank you very much for your support of Eurofi, which is greatly appreciated.

From all your experience, how do you see what has been going on with SVB, Signature, Republic and Credit Suisse? Is this systemic in your view or is it a one-off or idiosyncratic? Are we managing well?

Stephen Hester

Thank you for that introduction, David. I feel duty bound to explain that it is precisely because of that background that, when Nordea asked me to be its chairman last year, I said yes because I am fed up of fighting losing battles and I wanted to fight a winning battle. Today, coincidentally, we released our first quarter results at Nordea. On the safety front, we are in a small group of only three banks in Europe with an AA rating category, which says all that we need to say about safety. We are pleased to report a 17% return on equity in our first quarter, which says something about the business model. Hopefully, I can be here as a past expert rather than a present expert in challenges.

The first thing that we should not lose sight of is the inescapable fact that banks are, and always will be, a mirror of the societies and the customers they serve. Our health is inextricably entwined with our customers' health and the environment in which they operate. That is a good thing, and it would be rather sad if it were otherwise. Of course, that means that there is absolutely no surprise that some areas of the banking system are being tested in the current environment. We have the coming together of three extraordinary societal stresses, the first being a completely unprecedented, decade-long experiment in very low absolute and real interest rates, then the hopefully once-in-a-century event of Covid and the stresses and strains that came from that, and on top of the inevitable supply chain disruption that would come after that, the Ukraine war and the disruption in energy markets, and no less the political and human disruption that came with it.

For world society to be grappling with these three events and working through an adaptation, as Jean called it, but a big adaptation, that creates stress on our societies and their economies, of course, we should be surprised if it did not in the banking area. I am in no way surprised that there are some individual examples of when stress is applied, that some individual institutions have not been able to withstand that scrutiny.

I would say that the system has coped remarkably well so far with the stresses. That is a testimony in part to the huge reforms of the banking world that came after the 2008 financial crisis. However, we must not become too complacent. Despite huge stress in our world economy and in our societies, that stress has not yet resulted in widespread recession, and indeed, there is a very real possibility that we avoid widespread recession. Although our societies are under stress, they have not buckled from that stress. My only note of caution is that, before declaring that the financial system will not see more individual problems, we also need to have an eye on saying, 'Have we seen the stress that there is going to be, or could there be another leg?' I think not, but we must be cautious.

The system is coping well with stress. There are going to be some examples where stress finds people out, which I think is a good thing. If capitalism has taught us anything, it is that the dynamic reallocation of capital from losers to winners is a fundamental part of today's society. We must have losers to have winners, but because of the special role that financial institutions play in economies, we obviously need some arrangements for losers rather than letting the market completely free to deal with it. I think that we are in good shape, and these are isolated examples, but I cannot rule out that there could be other isolated examples.

David Wright

For those banks that have failed or are in serious distress, where do you think the major errors here were, Stephen? Use your experience to point our where the vulnerable points were.

Stephen Hester

Although each story of corporate failure, and indeed financial institution failure, has its own nuance and its own story, there definitely are common themes that I have seen across my business career. The most fundamental safeguard against risk hurting you is to have a strong business model. We have dozens of people who worry about liquidity, capital, risk management and so forth, but all of that is not very helpful if you do not fundamentally have a strong business model that is serving customers in a good way and producing good, safe, stable profits as a result of it on which your capital structure can be built, and your risk can be managed.

In the individual cases of failure so far, there have been significant business model questions and vulnerabilities, and when you have business model questions and vulnerabilities, it puts you on a watchlist. Of course, it is the first duty of management to deal with that, and not of supervisors and regulation, but it is a positive aspect of the last decade or so that regulators are also spending more time on business model issues in their interaction with banks. They could have been more forceful earlier on in some incidences than they have been.

Business model is a common theme. Another issue which is not a common theme, but is certainly true in the US, and we must not be complacent in Europe, and it has been true in past failures, is that whenever you let your books and records diverge a long way from reality, you have a big problem. In the United States, and in regional banks in particular, but we should not say that it does not happen in Europe, there was a problem of huge bond portfolios that were not marked to market and were not carrying capital in the same way to reflect the risk of the unhedged interest rate risk. Neither the capital regulation nor the accounting regulation was reflecting that divergence between reality, and those divergences were dangerous. We must be ever vigilant as managers and supervisors. It is never possible to mark every single asset to market every single day, and as Jean was saying, you can debate on the validity of a number of markets, but you cannot allow huge divergences, and both the regulation and the system of accounting must look at that.

There is a third aspect which I have put third because I think that the first duty of avoiding failure lies on management and boards, but of course, regulation has an impact. We can say that, at least in the case of the United States, that regional bank regulation is not good enough yet, which is why I think that the regional bank situation in the US has not yet stabilised, as we have been seeing in recent days in California. Two-tier regulation always carries danger with it, and two-tier regulation can appear in several different guises. It can either be baked into the rules, or it can be that some people, for political or other reasons, are given an easier ride in an existing set of regulations.

Business model, divergence of economic reality from books, records and regulation, and then divergent regulation are the three areas which have commonality and from which we should learn lessons. Why that matters in a connected world is that when things are stressed, people look for signals of weakness. The weakness may not have to be absolute weakness. It can be relative weakness. If you make it easy for institutions to be picked out from the crowd like the weak gazelle in the herd, even if that gazelle is not particularly weak but only relative to the herd, you are inviting trouble in a modern world with panic, information, and money that can move quickly. We all share some responsibility to learn a few lessons from that.

David Wright

Do you think that a lot of commentary has emerged saying that the speed of deposit withdrawal has important implications for access to the discount windows or liquidity provision by central banks, or does it touch more widely? Is there a speed issue here that we have to be worried about in terms of resolution and crisis management?

Stephen Hester

I think that the most important parts of the regulatory lessons that were learnt after 2008 have been shown in very good light, both in the United States and in Switzerland, in recent weeks. The system has not been perfect, but the system has been much better than it ever was. Regulators on both sides of the Atlantic have had the tools to move quickly. Perhaps the tools were not perfect and needed adjusting here and there, but fundamentally, they have had a tool set to move quickly. They have been empowered. They have been more practiced in it than they were. Vitally, the capital structure rules that were put in place post-2008 of bail-in-able capital have been shown to do the job. Taxpayers will not carry any cost from the bank rescues, and shareholders and bond holders and so on will carry it, and although controversial in some respects, the bail-in has worked. One of the most fundamental issues coming out of the 2008 financial crisis was that, although the banking system, because of its liquidity and maturity transformation role, can never be unregulated. It is vital to economic interests and cannot be left completely wild west. If you want to operate in a private sector manner, then you cannot have taxpayers taking the downside, and we have solved that.

The thing that we have not solved and can never solve is removing state involvement from liquidity provision in a crisis. A banking system cannot exist if 100% of your deposits have to be covered by liquid funds. It cannot because you will then have no money to lend to people. Especially in a modern world with the speed of information and people naturally wanting to react to fears, there will always be the possibility of liquidity run that you do not have enough liquidity for. There is no level of liquidity that you can say, 'It is impossible for me to run on liquid funds,' if you are still a bank. It is therefore impossible and not even desirable to remove public authorities, and in this case, central banks, from emergency provision of liquidity with a discount window, or more extensive things. What you can do, and what I think was done well in the recent crisis, is make sure that once that liquidity and emergency is over, the taxpayer is not out of pocket. There may be an initial guarantee, but the taxpayer is not out of pocket in the end, and that is what we have been tasked to achieve. To my mind, the system has worked well.

With each occurrence, you learn lessons, you find some areas of controversy and some things that you can tighten up, but my view of what has happened is that it was supposed to happen. In times of financial stress, there should be the ability to have losers as well as winners, but the overall system and the general public should be protected from extreme events, not at the expense of the taxpayer. I think we have achieved all of those things. I do not want to be complacent, and we must keep learning, but the lesson so far is our current structures, if applied well, are working well.

David Wright

That is a very optimistic statement, and you have cheered me up a lot. To make that statement from your experience is very reassuring to us. If you were in charge of resolution policy in Europe, are there one or two things that you would change, or one or two technical details that you think might help?

Stephen Hester

Having flattered the system of regulation, I can also flatter Europe to some extent because we have not fallen as clearly into the US regional banking difference two-tier trap. However, in Europe, we are operating two-tier regulation, and that is dangerous. Today, there is an unhealthy split between micro-prudential regulation and macro-prudential regulation. From the point of view of banks, the market and investors, they do not care what is one and what is the other. They care about the total. Today, if you take the top 20 banks in Europe, there is nearly a 50% difference in the capital that the lowest versus the highest is being asked to carry, not that they choose to carry. This is not because of differences in micro-prudential regulation, but of differences in application of macro-prudential regulation in a way that is not smoothed across Europe and is not using common principles and is not being applied in that way.

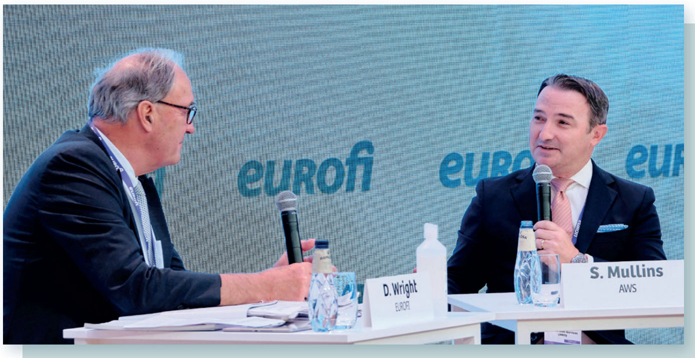
In some ways, Nordea is suffering from this at the high end, but we are on the safe side. We are suffering in terms of a lack of a level playing field but, if there is a future crisis and people are looking for weak players, it is unhealthy for the regulators of Europe to allow such a big gap in capital requirements, and to not bring macro-regulation under more control and consistency. There is an important issue here that is politically difficult because it lies in the relative powers of the central ECB and others, and country regulators, but it has to be grasped.

David Wright

Stephen, thank you so much for being with us, and thank you for your support of Eurofi. I am rather encouraged. We need that. I was involved in some of this work back in 2008 and 2009, and it is encouraging to hear that we did a few things right. Thank you very much for being with us.

Stephen Hester

Thank you very much.



Conversation with Scott Mullins

Scott Mullins - Managing Director & General Manager, Worldwide Financial Services, AWS
David Wright - President, EUROFI

David Wright

Good afternoon, everybody. I have the pleasure of having with me Scott Mullins, the Managing Director, General Manager, Worldwide Financial Services of Amazon Web Services (AWS) Worldwide. When you look at his CV, I think I am right in saying that what you find is not just an immense experience, having worked at many great firms – NASDAQ, J.P. Morgan, Merrill Lynch and so forth – but also somebody who has been at the frontier of financial services innovation. I think that is where your expertise lies.

For example, you are working today with the Federal Deposit Insurance Corporation (FDIC) subcommittee on supervision, but, Scott, you were right at the heart of some of the most recent developments in technology and particularly in the cloud and so forth. We are going to talk about how you see these developments. Where is Europe? Where are the risks? How do you see the future? With a great thank you for supporting Eurofi, let me ask you why is the cloud so important? Why are these developments so important? Are they really enhancing efficiency in capital markets?

Scott Mullins

David, it is nice to see you again. It is nice to be back at Eurofi and we are delighted to be supporters of Eurofi. It was interesting for you to repeat back to me my CV, because what you called expertise, I am just thinking back on as experience. It is very flattering of you and kind to say that I have been at the forefront of innovation in the industry. That is completely by accident, and I will explain why I am saying that. That is based on my career choices and timing in the industry. If you look for the common thread that runs through my career, it is technology. I started my career as a trader trading equities, and tried to do that for a good decade until I ran into something in the US called the Regulation National Market System, which changed the way that markets operated in the US at the time, specifically for equities. The fact that we went from trading in fractions in many securities at the time down to decimals completely changed the industry that I had decided I was going to devote my career to, which required a pivot into the world of regulatory compliance for me.

Along the course of my career I can track the different moves I have made, and it is all due to advances in technology and changes in the way the technology powers the industry. Specifically in capital markets, technology has always been at the forefront of making the industry work and as we look at the cloud today, cloud simply represents the next evolution of technology, not just for financial services but also for any enterprise organisation or any startup that is just beginning. It is a new tool set for a new era of builders and so I am very delighted to be a part of what is happening in the industry today. If you look at why cloud is important, it is simply that it is enabling us to build differently. That difference cuts across a number of different areas.

First and foremost, it allows us to build with modern technologies that are scalable. We heard about scalability in the last panel. This is a different kind of scalability from the standpoint of being able to provision infrastructure very quickly and scale it up, but then scale it down and not have to use capital expense. Another way that cloud is making a difference is in efficiency. When you can scale up and down, you can adjust your cost on what you are using. You do not have to put capital into building and maintaining your own infrastructure. There is also a great deal of improved resiliency that comes with using these services and the ability to architect in a way that we have not had available to us in the past unless we were willing to sink capital into building multiple redundancies across our infrastructure.

Last but certainly not least, as we look at what is happening across the planet from the standpoint of where we are with climate change, the opportunity to leverage infrastructure that, in the case of AWS, is nearly four times more efficient than an enterprise-grade data centre that anybody operates today is helpful not only to the institutions themselves but also to the entire planet. That is why I think cloud is something that should be at the forefront of everybody's decision making when it comes to new technology.

David Wright

We heard a very good example of that this morning. I do not know whether you heard that from the chair of NASDAQ. Adena was saying that moving some of her business to the cloud had enabled her to have double the number of data points and it was a tremendous efficiency measure. This is evidently good and efficient. Where is Europe in the race here?

I am using some of your figures from your article and you say, 'If you look across all sections of the economy, only 26% of European companies have taken up key technologies, such as the cloud, AI, and big data. This is a long way from the target of 75% of companies to adopt cloud, big data. AI, as set out in the European Commission's Digital Decade programme. In Europe, are you seeing a change here? Are you seeing an acceleration of interest and use of the cloud? Are these figures going to be very different in a few months or years' time?

Scott Mullins

I do not know that they will be different in months, but in a year's time, yes. You stole my metrics, by the way, so I do not get to drop my metrics on the audience, but if you look in general at cloud adoption across the globe, we are now in the second decade of cloud adoption by the financial services industry. In fact, we are in year 12 if you go back to 2012 when NASDAQ made the introduction to the industry in relation to being able to use cloud to support meaningful systems, systems that had sensitive information and that were providing mission critical applications and services to customers. In 2012, NASDAQ led the way in that, and they continue to lead the way. Obviously, Adena had some comments in relation to their leveraging of cloud services in AWS.

If you look particularly at Europe, some of the comments in the last panel are applicable to this conversation. I heard the gentleman speaking about, 'If I had a single', and that speaks to simplicity. Where we have seen more clarity and more simplification in relation to what is possible in relation to regulation and oversight, we see people moving forward with confidence and when you have confidence, you have comfort. In many parts of the world, you have regulatory regimes that are a bit less complex than you might have in Europe. Europe is a construct of many different member states, and so when you have that many different opinions and points of view and interests, that can be challenging for any builder. I happen to own a 126-year-old house where I live in New York and for me to get a building permit in the jurisdiction that I live in, I have the state, I have the local municipality and then I have my village and I have a historical review board. That is a number of different organisations that I have to go through to get things approved and to understand specifically the regulatory requirements for me to go and do something to my house. It can be similar for any organisation that is building in a complex regulatory regime.

If you look at where we are in Europe, there are instances where you see organisations that are moving forward with great confidence because of the regulatory regimes that they are in. You could look at the Spanish banks, for instance, who are looking at moving very quickly to more modern technology, and there are some instances where organisations and other member states are looking at what is possible, 'What is regulation going to permit me to do?' That is not to say that the interest is not there, it is not to say that there is no desire to be able to use more modern technologies, but that there is not yet a comfort or a confidence that they can do so without changing and evolving their regulatory regimes.

David Wright

Before we talk a little bit about Digital Operation Resilience Act (DORA), what do you say to critics who say, 'This is concentrating risk. There are not so many suppliers, competition issues or oligopolism'. You hear these criticisms. What do you say to those?

Scott Mullins

If you stood back and looked at the industry as a whole, this is not a new concept. In fact, on my way here from New York, I stopped over in London and when you land at Heathrow, you fly over a small town called Slough. Slough is interesting because that is where a good number of data centres that support financial institutions in the London area reside. The reason for that is because land around an airport is relatively inexpensive because nobody wants to build a house at the end of a runway that supports international flights, and so you can build data centres relatively inexpensively. I love this story that was relayed to me by an individual and he said, 'One day we went out to Slough and we stood on top of our data centre'. I do not know why they were standing on the roof of the data centre, but they were, and he said, 'We played a game. We were pointing out the roofs of the other data centres of all our peer financial institutions, and as we did it, we remarked how concentrated we were around the runways at Heathrow, as all these large transatlantic flights began to land in the direct path of our data centres'.

The same is true in New York. I live in the New York area. If you go across the Hudson River from Manhattan, there are three little towns, Carteret, Secaucus, and Mahwah, in New Jersey. Those are all within about a 25-mile radius of each other and they all house some of the most mission critical applications on the planet for some of the most mission critical financial institutions in the world, including our exchanges in the US. Concentration has existed in the industry since the beginning of the industry.

The conversation about risk is much more interesting when you begin to introduce modern technology like the cloud, and not just for AWS but our peers as well, because when you introduce this technology, it allows you to build in a different way, and so no longer are we thinking about having my primary and my backup. We are looking at the way that we architect applications, and we are thinking about resiliency within the application itself. It is not just business continuity planning. We are planning for making sure that, with the application itself, if something were to break – and things break all the time, from a technical perspective – how does that application continue to perform? If something does break to an extent that we need to failover, failover now becomes something completely modernised in that you can fail in our architecture into another part of an availability zone, or you can fail completely into another region.

In fact, in the US, we have worked with a number of our customers who have fully embraced AWS and the cloud to, during the course of a business day, in production, failover from one coast of the US to the west coast and back to the east coast in an entire day without any disruption to their customer base. What we are now able to do with modern technology is not just talk about disaster recovery but resiliency from disasters. The conversation around concentration risk is not one that I shy away from, because it enables us to look at this in a different way based on this technology.

David Wright

Tell us about how you see the European Union's DORA rules? Do you think this helps us get to a more unified view? Does it improve resilience? Give us your views, Scott.

Scott Mullins

At AWS we are very optimistic about DORA, because it goes back to what I said earlier. It is about simplicity, making it much simpler for institutions, for third-party providers like cloud providers, and other third-party providers who will be responsible under DORA as well, but also for regulatory agencies and overseers. The simpler we make things for organisations, the more confidence we will have moving forward together and the more confidence that we have, the greater comfort we will have in adopting new technologies and improving the industry, so, David, we see it as a very positive thing that Dora is here.

Level 1 is now complete, now we are on to level 2. Level 2 is where we will get into the details of what DORA will be in practice and so we are looking forward to continued dialogues and participating in those dialogues at level 2.

David Wright

Are you worried about fragmentation? Are you worried about different interpretations of various parts of the so-called level 2 rulebook? Is that something of concern to you?

Scott Mullins

We have had these conversations through the course of the day and when we think about interpretation, it is all about speaking a common language, and that is very important, and not just a language, whether it is English or German or French or Spanish or Italian, it is understanding fundamentally the same taxonomy and concepts. We have spent a lot of time speaking about that and making sure that first, as AWS, we seek to understand both the viewpoint of our customers, who are the financial institutions, as well as regulatory bodies themselves, so that we can then explain the technology itself and the application of the technology, and then hopefully inform what will be the regulation.

David Wright

How do you look at European open strategic autonomy thinking? Some people talk about localisation requirements. Presumably, this is an anathema to you.

Scott Mullins

No, it is not, because, if you look at AWS today, there are 31 different geographic areas in the world where we have infrastructure regions. We have seven of those in Europe today, another one in Ireland and another one in London as well. If you look specifically at the way that we build and operate our infrastructure, in the fullness of time, we will likely have infrastructure regions in every single major metropolitan area around the world. That is our viewpoint, and so we understand viewpoints on localisation, but we also believe that that can be limiting.

When you think about what was possible as the conflict and now the war in Ukraine kicked off – and we were at Eurofi in Paris when that began – if you had continued the policies in Ukraine about localisation, you would have found that the Ukrainian government and many of the financial institutions there would not have been able to continue operation. We were very fortunate to be in a position to help the Ukrainian government, number one, as well as some financial institutions in Ukraine, move their operations, their applications and their data out of Ukraine to continue operating. We do not have a local region in the Ukraine, so we were able to move that to a different region in Europe. That helped the government of Ukraine, and those financial institutions continue to serve their entire country. From our standpoint we understand the localisation interests, but we also understand the importance and the value of being able to leverage the value of Europe and being able to hopefully lead into a DORA to give us some clarity on how we can do that.

David Wright

Finally, Scott, we are one year away from the end of this political cycle. What advice would you give for the new Commission, which will come in with the new Parliament towards the end of next year? What sort of vectors would you be saying to them, 'Get this right over the next five years and European capital markets are going to be a lot stronger?' What would you be saying to them?

Scott Mullins

The financial industry by nature is about risk management, and I would encourage everyone to remember that we do not have to manage risks in the same way that we have in the past. As technology and the world changes, we now have an opportunity to also evolve the way that we manage and view risk. My encouragement would be to look at this technology not necessarily through the lens of risk but of opportunity, because it does allow you to build differently, it allows you to operate differently, and it allows you to address risk in a very different way.

My encouragement would be, if there is not an understanding of what that means, if the cloud is – pardon the pun – a little cloudy in relation to what it is and how it works and how it operates, AWS and our peers in the industry would be delighted to continue a dialogue in helping regulatory bodies and institutions understand what the technology is and how to leverage it for greater good.

David Wright

Sounds like very serious and sensible advice to me, Scott. We are out of time, unfortunately, and we always could go on for a long time. Again, thank you for your support. Come back and tell us how we are doing.

Scott Mullins

Delighted to.

David Wright

Please do that and we look forward to seeing you in Santiago or, following that, in Ghent in Belgium early next year, but keep encouraging us to get at the forefront of technology and apply it. Thank you very much.

Scott Mullins

Thank you, David.

Conversation with Jean Lemierre

Jean Lemierre - Chairman, BNP Paribas
David Wright - President, EUROFI

David Wright

Ladies and gentlemen, I have the pleasure of having with me Jean Lemierre, the chairman of BNP Paribas. Jean, welcome, and thank you very much for your continued support of Eurofi, which is greatly appreciated. Jean, we are seeing a world in which there appears to be more financial instability with a number of banks in trouble. How do you see things from a European perspective? Are you worried or are you reasonably confident?

Jean Lemierre

I am confident. I am not too sure it is a time of crisis. It is more a time of adaptation to a new monetary policy. We have inflation, higher interest rates and liquidity is being reduced by central banks. Over the past year, there were some tensions. The first one was in the commodity market a year ago because of the war in Ukraine. We have seen tensions in the pension funds, for reasons that we know well. Cryptocurrencies have created tensions. We also see tension in the American regional banks and in Switzerland.

These tensions that have been managed by the official sector.

I know that many, including myself, are willing to make lessons out of what is happening. Let us do it in a calm way, and we should not overreact. Decisions which were made after 2008 are good. The system is resilient. The global prudential regulatory framework should be implemented everywhere. The key lesson I can make is when regulation and supervision are not implemented, you will see difficulties. I would like to make sure that all of the regional banks do respect the MREL requirement.

David Wright

When you look at the European institutional structure, what you are saying here is that you have some confidence that it is working quite well, and that Europe has done a lot. Is that where you come from?

Jean Lemierre

Decisions were taken, and the implementation of the decisions had been made and should be fully respected. I have already expressed doubts in this forum about the notion of proportionality, it is not the best way to implement rules. We should avoid to endlessly reopen debates. The Eurozone is safe. The job has been done.

In times of adaptation, you cannot have a ratio for everything, because to some extent, we are in the unknown in the fight against inflation. We need to interact in a clever way to find, step-by-step, appropriate solutions. This is what has been done over the last month.

David Wright

When you look at Europe and some of the structural markets in Europe, do you feel that there are areas that need to be looked at, such as the CDS market? Do you worry about what we have seen in these banking failures and the tremendous speed and withdrawal of deposits? Does that change things?

Jean Lemierre

In times of tension, it is better to avoid opaque situations. Transparent behaviours and transparent markets are key. By the way, this is not new. We have had the same problem with the sovereign bonds in Europe a few years ago. One of the key risk we have today is contagion. It is difficult to use an opaque market as a measurement of the risk. The risk can be measured only if there is a decent transparency.

The withdrawal of liquidity has an impact. We need to have a sound review of the situations which are behind the question. I do not want to dwell on each of them, but there is a lot to say before making the conclusion that the rules should be modified. You know as well as I do that bank runs always have an origin ratios cannot address.

David Wright

There are some other areas of risk moving forward. Some people worry about the non-bank financial institutions, leveraged finance, and commercial property. Do you see any of these as issues that we need to be extremely worried about now?

Jean Lemierre

Regulation and supervision have a key role, which is to bring transparency and safety to investors and clients.

The risk is to not understand the nature of the tensions and to see the risk of contagion. This is why we need transparency.

David Wright

I think it is interesting that the Financial Stability Oversight Council (FSOC) in the United States has started a process to bring in some non-bank financial institutions under their wing.

Jean Lemierre

The American officials acknowledge the difficulties, and I am sure that they will make lessons. We wait for the report by Michael Barr which will be published in a few days at the beginning of May.

David Wright

Jean, thank you so much for being with us. Thank you again for your support, and we look forward to seeing you in Santiago de Compostela for sure.

Jean Lemierre

Thank you. By the way, David, you and this group are part of the mapping that I have in mind. It is by exchanging views and comparing notes that we have a better understanding of what we should do. This group is very key and thank you for organising it.

Conversation with Jérôme Grivet

Jérôme Grivet - Deputy Chief Executive Officer, Crédit Agricole S.A.
David Wright - President, EUROFI

David Wright

Ladies and gentlemen, I have the pleasure of welcoming Jérôme Grivet, who is the deputy chief executive officer of Crédit Agricole. Jerome, a very warm welcome to you, and many thanks from Eurofi for your support. You come from a very distinguished background in finance. You have been in Crédit Agricole for many years, taking on a range of important jobs as CEO of Crédit Agricole Assurances, director of strategy before that at Credit Lyonnais, and now as deputy chief executive officer. We have had a lot of talk about all the problems and challenges to European banking. I think you are going to tell us about why the universal banking model is still a very valuable model for Europe. Please give us your views.

Jérôme Grivet

Thanks for this opportunity to talk about this model because the universal banking model, the relationship-banking model, is probably a specificity of Europe as compared to the rest of the world, especially the Anglo-Saxon world. It is also a French specificity, and it is an area of excellence for my group, Crédit Agricole. This is a good opportunity to talk a bit about what it is in reality, how it works, and the benefits of this model for different stakeholders.

What is it? It is simple. It is a model in which we try to sell many financial products and services to our customers over time, through the same channel of a single branch, a single bank employee, and of course, a single app. We have to integrate all the new technologies in our model. It is a model based on relationship rather than on transactions that come one after the other over time. It is a model which is beneficial to customers. Indeed, it allows us to propose a very wide scope of products and services to our customers at a low cost, because we optimise the cost of our networks on the basis of a very wide series of products and services. An example to illustrate the cost-efficiency of this banking model for our customers over years, is that in the EU the price of a home loan is the cheapest in France. This is possible because the bank branch does not rely only on the selling of home loans, but it sells many more products.

It is also a guarantee of the quality of the service. If there is a miss on a specific product or on a specific service that we sell, the whole relationship is jeopardised. I know how difficult it was for Crédit Agricole group to launch the P&C insurance business 30 years ago. The main question was not that of success or moneymaking, but whether the business would jeopardise the banking relationship. It was: If we have a mismanagement of a motor insurance claim, is it going to jeopardise the entire relationship with the customer? This has shaped and framed the way that we have decided to launch this business in a specific manner and has led us to innovate in France: when there is a claim, we start by paying without asking questions. This universal banking model is good in terms of price and quality and proves to be very resilient and efficient for the strengthening of the financial sector.

Universal and relational banking model also means diversification and this is the base of good management practices as it clearly reduces risks.

David Wright

When you look at the economic and business climate today for Crédit Agricole, how do you see things? Do you see stability, or do you see some threats and risk building up which worry you?

Jérôme Grivet

I think it would be surprising if I answered, 'It is very stable. Nothing is happening.' We are in the midst of a major shift in the macro-financial regime. The drastic change of monetary and financial environment as we are experiencing nowadays is not benign. However, it illustrates the strength of European models, with the way we develop our activities and the way we are regulated and supervised. This has been proven in the turmoil of last weeks, showing that the banking sector in Europe is very stable and resilient.

David Wright

You effectively have a lifetime supply model for your clients and are very connected to local banks. I am sure Commissioner McGuinness will refer to the fact that the Commission is coming forward very shortly with a retail investment strategy to encourage retail investors into market. How do you see this? What are the things you like, and what are the things that you are worried about? What is on your mind?

Jérôme Grivet

In the past, we have had many discussions in several aspects of our universal banking models, because this model was accused of generating conflicts of interest for our customers, which is not the case. Indeed, if we were proposing products to our customers, which are in our own interest rather than in their interest, then we would jeopardise the entire relationship. We were also accused of distorting competition to the detriment of other less integrated players, in certain activities such as insurance. Nevertheless, this is not the case, because when we develop our insurance activities, we have exactly the same constraints and the same capital requirements as an insurance company.

I think that there have been many attempts over time to dismantle this universal banking model, and it has proven to be very resilient because it has been able to demonstrate the benefit that it was providing for the customers and for the economy. Of course, we must be cautious, and we know that in this retail investment strategy, there might be some elements that are going to challenge our model. We must make sure that what is decided will not result in decisions that penalise our customers. If we have to adapt by shutting down a large number of branches, it is not going to be positive for them.

David Wright

What are the areas specifically? Is that in all the inducements?

Jérôme Grivet

Yes. This is around the issue of banning inducements, which, by the way, is not a nice and positive word. Before jumping to this question, we need to assess its reality. Indeed most of the French customers do not consume financial products that bear inducements. However, banning those inducements would definitely jeopardise our model. It will not only be detrimental for us, but also for our customers.

David Wright

This is a political subject.

Jérôme Grivet

Regulations must respect all models and be neutral in this regard. The starting point for such a ban is incorrect. Customers are not locked into a captive relationship with their bank. They often have multiple banks, they can buy financial products on online platforms or from independent wealth-management advisers, and they do so. If they use their bank, it is by choice. Similarly, banks also offer financial products outside the group (open architecture).

We believe that all distribution models must co-exist to meet the needs of all investors. It is competition, and consumer freedom, that guarantee the best value for money.

But you are right David. This is a very political subject because the practical consequences are major:

- Without these commissions, the vast majority of customers will no longer have access to investment advice. We can see that in the United Kingdom and the Netherlands, which have prohibited retrocessions. Even the authorities in the UK are beginning to realize the negative effects on access to advice. Indeed, the FCA consultation in the UK published on 30 November 2022, based on studies on the impact of RDR (prohibition of inducements), clearly identified that (small) investors do not have the advice they need to invest. The reason is the cost of advice is too high (or advisors are not interested because the remuneration of their advice would be too low).
- The funding needs will be considerable in the coming years (transition to a sustainable economy, digitalisation, aging of the population, etc.). Private financing will therefore play a key role in meeting these new long-term investment needs and will largely come from household savings. They will need advice on how to direct their savings to their best interests and societal objectives.
- Without retrocessions, banking networks will shrink, even though they play a vital role in financing the local economy. Indeed, retrocessions represent a significant resource to distribute financial services and to provide advice. There is no free lunch, without this resource the number of advisers is going to dramatically dwindle, entailing the closing of a significant part of the network of local branches and ATMs. It is exactly what customers, customer organisations and municipalities do not want, in order to preserve proximity, and contact with responsible advisers when needed. A couple of figures: according of the ECB, between 2011 and 2021 the number of branches in the Eurozone diminished by 35%, but 73% in the Netherlands the only EU country which banned inducements, and only 7% in France. I can tell you that a dramatic closing of branches in France would trigger a fierce political opposition.

David Wright

In the bank, what do you see as the big challenges looking forward? I remember talking to Xavier Musca, and one of the things he said was, 'We need much more clarity about what we can give loans for and what we cannot on the whole green agenda.' Is that clarifying for you on the energy transition and so forth? Are you clear about what you can and cannot do, or should and should not do?

Jérôme Grivet

The way you have worded it is exactly what we should avoid going forward, because too often in Europe, the question is what you can do and what you cannot do. In addition to defining precisely what we should and should not do, there should be a concrete sustainable development strategy. In Europe in general, we end up with additional constraints and integrity paperwork, and in the US, you end up with incentive. We need a clear strategy on this issue of energy transition, which is the most important issue of the coming years. We need not only to have taxonomies, disclosures and rules, but we also need an energy strategy for Europe, and we need incentives to foster the sustainable projects that we are ready to finance massively.

David Wright

Jerome, thank you so much for being with us. I have learnt a lot. We look forward to seeing you in our future meetings. I wish you every success. Thank you very much for the support of Crédit Agricole for Eurofi.

Jérôme Grivet

Thank you, David.

Conversation with Adena Friedman

Adena Friedman - Chair & Chief Executive Officer, Nasdaq
David Wright - President, Eurofi

David Wright

Ladies and gentlemen, we have another very distinguished guest. I have the honour of talking to Adena Friedman, who is the chair and chief executive officer of Nasdaq. Adena, when I look at your CV, you originally joined Nasdaq way back in 1993 after distinguished academic achievement. You went on to do many things in the company. You then had a timeout, if I can put it like that, at the Carlyle Group for three years, but then you came back to Nasdaq again in 2014 as president, overseeing technology and information and so forth, and now you are chair and chief executive officer. The first question I would like to ask you is we now have a swirling world of digital change, but how do you see the exchange business changing in the United States and perhaps globally? What are the big drivers here?

Adena Friedman

It is great to be here again. It is great to see you. Change is inevitable in our industry and one of the great things about our industry is that change happens very quickly. As you said, I started at Nasdaq 30 years ago and I have never been bored, so that is pretty good.

David Wright

That is good.

Adena Friedman

When we look at the exchange industry today, we serve a very significant role across the financial system, and many of the exchanges have moved beyond just operating as exchanges, to provide technological solutions and capabilities that enhance the capabilities of the financial markets and the financial system. Within Nasdaq, we cover three key themes: liquidity, integrity, and transparency.

Starting with liquidity. Here, we focus on being an operator of markets and a provider of market technology to other markets. We provide technology to 130 other markets around the world, and so we focus on how we enhance the liquidity of the financial system through our technology and our capabilities.

The second is our theme around integrity. We have decided to become a very scaled player of anti-financial crime technology across the industry. Since 2010, we have had our surveillance technology that supports markets and regulators and trading firms, but we now have also expanded dramatically to have very scaled anti-fin crime technology for fraud and anti-money laundering (AML) detection across banks. We have 2,500 banks who use our services today across North America.

The third is in transparency which focuses on connecting corporates and investors better with data, indexes, analytics, workflow solutions to make sure that they can connect with each other, that they can communicate in the right way with each other, and also that they can navigate the complexities of markets better. That is where we focus on our ESG solutions, and it is a huge common and growing theme across corporates and investors.

David Wright

Talking about data, is this a major revenue earner for Nasdaq? You sell the data; you sell the analytics on top of the data. Is this a big driver for you?

Adena Friedman

The data business has always been a significant part of the Nasdaq story. I managed the data business for nine years earlier in my career and so market data as an asset of an exchange is certainly one of the three pillars of a securities exchange. You have listings, trading, and data, and those are the underpinnings of an exchange operator. Today, though, beyond our market data, we focus on how we provide tools that allow corporates to collect and communicate data related to ESG principles and other elements of their business, other KPIs and things that drive their business. How do we help them collect those and manage their workflows around those that then provides that information to investors in a consumable way?

Within the investment community, we provide very detailed analytics tools that help them allocate capital to the right funds. If you are an asset allocator, how do you allocate capital to the right strategies and the right funds, and then how do you have the right data available to you from the corporates to make smart asset allocation decisions? To us, that has become a very scaled business within Nasdaq.

David Wright

You are obviously using the cloud now and all sorts. Some people worry about all this and the dependencies. Is that something that worries you or not?

Adena Friedman

You have to recognise that the world's technology is moving into the cloud and cloud providers are among the most sophisticated technology providers in the world. They invest billions of dollars in protection and certainly in cybersecurity. They have ways to make sure that you can analyse your data in ways that are new and interesting that support your business. They also provide scalability and resiliency that are important pillars of the financial markets. As we have been taking our journey to the cloud, we started with architecting our solutions so that they can be cloud ready. That also makes them much nimbler. We started building our next generation trade lifecycle technology about seven years ago, when I came back to Nasdaq and right as I became CEO. It is a microservice architected solution, with pre-trade risk management, trading, clearing, settlements, post-trade risk management, and surveillance all now provided in a cloud-ready solution.

In the US, we have deployed our first options market using the AWS Edge cloud, so not full cloud deployment, but we have brought AWS and their stack into our data centre. We get the benefit of all the infrastructure that they have invested in, but still within the confines of our data centre. We did that because of the latency requirements within the US. In moving our system to the next gen system and then moving it into the AWS cloud, we were able to have a 10% improvement in our latency for that options market. We now are moving to our second one at the end of this year, and we are going to continue to roll that out. As we work with markets around the world, not every market is ready to dive right into the cloud, but they recognise that their future is likely in the cloud. Let us start with the technology architecture and all the infrastructure around it to make sure it is cloud ready, and then as the cloud continues to mature, help them navigate them into the cloud.

Any new market we work with that is launching for the first time, including our carbon removal marketplace and other new markets that we are building, is all cloud first. You go straight into the public cloud because the latency obligations are not the same, but the resiliency and the scalability of the cloud is remarkable. I would point out between 27 February 2020 and 28 February 2020, our message traffic doubled. We went from 30 billion messages in a day to 64 billion messages in a day, and that that required an enormous amount of scaling, but all our surrounding systems, other than our matching engine, were all in the cloud so that scaled instantly. On the matching engine, we have certain regulatory obligations that allowed us to scale up, but then we were instantly buying servers and flying them in to make sure that we were staying ahead of our regulatory obligations. I would say had we been in the cloud at that point, the scalability would have been even more instantaneous, so there are good reasons for markets to go into the cloud.

David Wright

Adena, do you see any role for blockchain technology in the way you are going to operate in the future?

Adena Friedman

Yes, certainly, for new markets, again, for instance, we are deploying blockchain technology into our carbon removal marketplace, because, if you think about carbon removal credits, what are they? They are capturing air, so having a trackable, traceable measurement of that air capture and that carbon removal is a very important thing for you to do. We think the carbon removal market is a perfect use case for blockchain in terms of having a registry that is intractable and that is completely traceable. If we look at the established markets and certainly at the high-speed, high-throughput securities and how they are traded today, the blockchain technology is not ready to handle the scale of the established markets that are already very high-throughput markets. There are a lot of very illiquid assets that exist, like repos and other fixed income securities, that also would benefit a lot from having the trackability and the traceability, the immutability of the blockchain.

David Wright

If I may, tell me a little bit more about financial crime. I find it very interesting that you are setting up a whole division of work for tackling financial crime, not just for financial clients, as I understand it, it could be much wider; any industry or whatever. What is involved here?

Adena Friedman

Yes, sure. We have three divisions within Nasdaq, so Market Platforms, our Capital Access Platforms and Anti-Fin Crime, so we have definitely decided that that is a big part of our future. What that entails is right now we are focused on the financial system, the banking system, payments, fintech players, certainly digital assets of banks, as well as Virtual Asset Service Providers (VASPs). All of them have the need to root out criminals, and it is a big data problem. The unique element of our solution is that we have a cloud solution. In the United States, the Patriot Act allows for data sharing across banks. They are not allowed to share the data with each other, but they can put it into a third-party tool that allows us to look at data across the banks and root out criminal behaviour. Criminals do not bank at one bank. They tend to use the banking system, but they leave little data breadcrumbs as they work the banking system to either commit fraud, to launder money, or to even manipulate markets and other things. They tend move around the system to do that.

The great thing about our solution is, by pooling the data across 2,500 banks, we are able to see everything, and we are able to see different patterns of behaviour and take those data breadcrumbs and piece them together into a story. As a result of that, when we now have gone up market in bringing the largest banks into our platform, we are able to reduce false positives by 25-50% and increase the fraud or money laundering found by 25-50% because of the effectiveness of the cloud, coupled with AI that we have within the system.

David Wright

Are you tackling cybercrime through this as well?

Adena Friedman

This is just looking at fraud and AML.

David Wright

Okay.

Adena Friedman

Yes, it is such a big problem. It is about a $4 trillion problem across the world in terms of how much money is laundered across the financial system, and right now, the estimate by the UN is only 1% is found. In the US, we have seen better stats than that, and I believe that the consortium data approach is a reason for that. As we have been here in Europe talking to European regulators, a big part of the conversation we are having is there is a new regulation that is coming that would allow for some level of data sharing for the purpose of anti-fin crime and I believe the ability to start to use more sophisticated technology like AI in terms of solving this problem.

The criminals do not have laws. They certainly do not follow the laws and they do not follow the regulations. They are going to use the most sophisticated technology available to them. If the banks and providers like us are not able to use those same technologies and are not able to pool the data to be able to find those criminals, we basically are tying a hand behind our back in trying to solve this problem, so we are letting the criminals win on that point. That is a big part of our discussions here in Europe this week.

David Wright

We look forward to hearing more about this, as you know. When we met in Helsinki, Adena, I asked you to tell me one thing Europe should do which would improve the markets and you said, 'Build an EU Electronic Data Gathering, Analysis, and Retrieval system (EDGAR), or a form of it'. Well, I took that to heart and, following your instruction, that is exactly what Europe is doing and it is quite close to agreeing something along those lines. It will be good for international investors to have one repository. I am asking you the same question. What should we do now?

Adena Friedman

We should focus on how we bring more participation into markets and how we make the markets more accessible to companies who are looking to raise capital. That is the whole purpose of why we are here. We have looked at the European landscape; we operate markets here in the Nordics. In fact, Sweden is the home to our largest office in the world, so I come here, and I feel like this is my second home. The great benefit that the Nordics have in Europe is the fact they have so much retail participation in the market. They have anywhere from about 20-30% of the population within Finland and Sweden actively participating in equity markets and that brings a richness into the marketplace. It allows smaller companies to raise capital.

If you had a common place for every investor to look at every company that is available to be invested in and if you made so it is more uniform in terms of what the obligations are for companies to come and raise capital, again, bringing more participation into the market is the ultimate goal, and our view is to be pragmatic with regulation. Think about the outcome that you are trying to achieve and stay true to that outcome, even as all the interests start to creep into the regulatory process. Focus on how we make the markets more accessible to the everyday investor, how we make the markets more accessible to smaller companies who want to raise capital and that will drive an entrepreneurship ecosystem. Over time, when you look at the compounding returns that investors enjoy, particularly over decades, they will have great wealth creation if they have more access to markets.

David Wright

I very much agree with you, and I think that in Europe we have to do more for the small company. What is happening here in Sweden with Nasdaq is highly impressive, with a lot of factors that need to be replicated. You do not worry about 'the equity culture is dying, and companies are going to private equity' folks, and you do not buy that.

Adena Friedman

I look at the lifecycle of a company and private and public capital as being a continuum. When you are early stage, you need those angel investors, those risk takers, those professionals, to come in and help understand what the potential of this company is. It is probably better for a professional investor to focus on that, as well as friends and family and things like that, but that is a closed private market. As those companies mature, they want to be able to provide their employees and early investors some liquidity. We have the Nasdaq private market that allows them to sell their private shares, but as they mature even further, they need to determine do they seek out the public market or do they sell themselves to a larger private equity firm or things like that.

Private equity firms are not permanent capital vehicles. They invest for five or seven years and then they either bring it back out into the market or they sell it to someone else. The markets are permanent capital vehicles. Depending on the maturity of the company and what they are doing to grow their business, the public markets become this amazing source of capital for them and an amazing source of wealth creation for their employees. We provide equity to almost every employee in Nasdaq, and it is a big part of our culture. It also makes it so that you can use that currency to grow and expand your business. There are times in a company's life where the public markets are a great experience and there are times in a company's life that maybe private money is a better option for them. It is all there. What we want is a vibrant economy. That is what we are looking for.

David Wright

That is true, and the right implementing rules which avoid complexity, especially for smaller companies, to simplify as much as possible. Adena, very nice to see you here and thank you for the support of Nasdaq to EUROFI, it is greatly appreciated. I will try and come back when we next meet and say that your latest instruction has been carried out to simplify and encourage retail investors. That is a good reason to come back and thank you very much for being with us.

Adena Friedman

Thank you, David.

Speeches

Elisabeth Svantesson

Minister for Finance, Sweden

Speech at the Eurofi Gala Dinner

Thank you. I am happy to be here, it is so great to welcome you to Stockholm and to this beautiful building. Is it not beautiful? I just heard that Rihanna, Frank Sinatra, and Louis Armstrong have stood on this stage. I feel a little pressure, but I can assure you I will neither dance nor sing, so you can feel calm.

I will just say a few words. A couple of weeks ago, some of us were in Washington at the G20 and IMF spring meeting. I represented the Swedish government, of course, but was also there as the chair of ECOFIN. We had a lot of meetings, from early morning to late at night, and also some media interviews, of course. I gave an interview to CNN. I was prepping with my staff the day before and I had these quite complex technical talking points. Then one of my staff said, 'Elisabeth, scrap the talking points. We are in the US now. Here they want easy one-liners. I think that you should say "Inflation is too high, and it has to come down" and then you just repeat it over and over'.

It sounds a bit silly, but actually it is just as easy, and as complicated, as that. The phrase 'inflation is too high, and it needs to come down', really captures the reality that governments, central banks and financial institutions are struggling with right now, every day. This is our collective job description and, as I see it, there is no room for failure. We must bring inflation down to ease the burden on households, to see that we have lower interest rates and, of course, to bring back stability to financial markets. The central bank Governor of Sweden is here, Erik Thedéen, and I know it is primarily the Riksbank's task to fight inflation. But as Minister for Finance in Sweden, responsible for fiscal policy, I know we have a much broader responsibility. My priority right now here in Sweden is to bring inflation down and, at the same time, support vulnerable households and restore economic growth to Sweden and to all of Europe.

Let me highlight one other topic that has been on my mind for the last couple of months, and that we have been discussing at ECOFIN, the economic governance review. Have you heard of it? Yes, good. I just wanted to see if anyone was listening. The EU needs a solid fiscal framework that will guarantee sustainable growth, sustainable finances, public finances, sustainable debts, and economic growth. To make it possible, we have been focusing these past months on trying to build consensus among the 27 EU Member States. That was not an easy task, with 27 countries. I do not need to tell you that we are not at exactly the same page when it comes to fiscal framework. But I guess, in the end, when we tried to find agreement, the Swedish cinnamon buns that we served when finalising the negotiation may have helped me, and us, to get across the finishing line. Have you tried our cinnamon bun? No? Yes? Some of you. Good. Tomorrow, I can recommend that you who have not should ask for a Kanelbulle. Those of you who do not know what it is can ask a Swedish mate at the table.

I know I am the last person standing between you and the main course, which I think will be delicious, but I will just finally say a few words about Ukraine. Just a two and a half hour flight from here, Ukrainian soldiers are fighting and sacrificing their lives to protect us all from Russian tyranny. They do not just fight for themselves. They fight for the freedom of all of us. That is why I am very honoured to be joined this weekend by Ukraine's Finance Minister, Sergii Marchenko, and the Canadian Deputy Prime Minister, Chrystia Freeland. They will share their views on the support and reconstruction of Ukraine. I have a message to all of you. We all need to stay united in showing strong support for Ukraine. We do it with financial backing and weapons, but in addition, all of us, in our different roles, must act to show support and cut some – all – business with Russia. That was not ending on a happy note, I know, but it is an important note for me to say to you. With that, I would like to thank you and I will let you enjoy good food, good company, and good discussions. I have never been to a dinner with so many enthusiastic talking dinner guests and I love it. Thank you and have a nice evening!

Niklas Wykman

Minister for Financial Markets, Sweden

Opening Speech

Dear colleagues, ladies and gentlemen,

thank you for the invitation. I am happy to see so many of you gathered here in Stockholm this morning – and may I on behalf of the Swedish government and the Swedish presidency extend our warmest welcome to Sweden.

We are meeting in troubling times.

Russia's unacceptable invasion of Ukraine has brought war back to Europe. The scale of human suffering is enormous. So many lives that will not be lived. So much love that will be lost. We must stand firm with the people of Ukraine, in their fight for our values and democracies.

As economists or actors in the financial markets we see the war's implications for global welfare. At the same time, and to some extent because of the war, once again, inflation is haunting our economies.

Times are indeed troubling. Decision-making must be based on the long-term benefits of cooperation, the value of the market economy, the need for well-functioning markets, the absolute necessity of financial stability and a never-ending search for best practice and insights from research. But none of us are economic machines, and as Tolkien puts it down in words, as Frodo says to Gandalf, "I wish it had happened in my time."

Now, in the light of recent events, let me first touch upon the issue of financial stability and the current shape of our financial institutions.

The recent turmoil we experienced back in March was a stark reminder of what is the essence of banking: to uphold trust and to manage risk properly. Over the past years we have seen exceptionally low interest rates, which seemed to yet again have had many actors believe that this time was indeed different. But as Reinhart and Rogoff have taught us, they seldom are.

Therefore, it is crucial to remain persistent in our efforts to safeguard financial stability. If banks and other financial institutions are not strong and stable enough, they will pose risks to our economies. Sweden in the 1990s was one example in this regard and we all remember the Irish experience where public debt to GDP increased from 20 to 120 per cent during the Great Financial Crisis (GFC). Whatever other reforms to foster growth you seek to undertake under such circumstances, it will be rather hopeless.

Thanks to our efforts since the GFC, European banks today have stronger capital and liquidity positions. That has served us well. Banks' share prices and funding costs have recovered somewhat since the March turmoil, but the new economic environment is challenging for firms and households. Risks remain elevated. We need to stay alert.

In our endeavor to strengthen the European economy we must not compromise with financial instability. It must come first and foremost. I would therefore like to stress the importance of the banking package and the Commission's proposal on revising the "crisis management and deposit insurance framework". We aim to reach a political agreement with the Parliament on the banking package during our presidency and on the crisis management proposal we will start negotiations in the Council.

Stable and efficient financial markets are key building blocks for increased competitiveness. International competition is intensifying for many European businesses. Emerging markets are increasingly competing with knowledge and technology, Asia's share of the global market has grown rapidly, and US productivity growth in recent years has outperformed that of the EU with almost 60 per cent annually. We Europeans need to up our game.

At a general level, this means enacting structural reforms which make our economies more productive. We must have the best incentives, and the best conditions, for work, entrepreneurship, learning math, adopting to new technologies. We need to invest in research and development. And we need to strengthen the internal market, which at some point also means extending it to services. And as we are all aware, a lot of the international debate currently focuses on various forms of state support and subsidies. While a certain amount of this might be reasonable for some specific purposes, this is not how we build our competitiveness and prosperity long-term.

When it comes to further development of European capital markets, we can gladly note that we have seen quite some progress over recent years. For example, market depth has increased by some 30 per cent since the launch of the Capital Markets Union initiative. However, despite the many CMU reforms, we still lag our most important peers. The British capital market is nearly twice as deep as ours, and the American is four times deeper. EU capital markets also remain highly fragmented, with large differences in size to GDP in different countries. Most venture capital investments, for example, are concentrated in a few Member States.

While we as policy makers set the framework and conditions, it is entrepreneurs and innovators that drive real development. We need to continue our efforts to make sure the EU's capital markets can serve these businesses in a good way. And this will be one of the key topics for discussion when Ministers gather for our informal meeting on Friday.

To deepen the CMU, the Commission has proposed reforms in several areas that could still be finalised under this mandate. This includes measures to facilitate access to financial and non-financial information, to strengthen financial market infrastructure, harmonize insolvency frameworks and to promote listings on public markets. Further proposals which are yet to be presented include reforms to achieve an EU-wide system for withholding tax, and measures to increase the participation of retail investors in capital markets. Here it is a key priority of the Swedish presidency to ensure as much progress as possible.

Beyond the reforms undertaken under the CMU umbrella, there are other important issues which will also strengthen the competitiveness of European financial services. For example, with the banking package the last part of the internationally agreed Basel III standard will be implemented in the EU. Apart from strengthening our banks, it will also contribute to a level playing field both internationally and within the Union. This will enhance our competitiveness. In the EU we also have the habit of implementing international standards for all banks and not only the largest ones. As we have seen, there are good reasons for doing so. But to ensure that banks of all sizes and business models can provide services to firms and households, we must also cater for unique European characteristics when implementing international standards.

Further files that we are currently negotiating and which will enhance our competitive potential is the regulation on instant payments, which will make it easier to interact commercially cross border. And upcoming initiatives regarding PSD II and open finance should help harness the potential of digital development in financial services.

In all work, we must strive for a balance between fostering competitiveness and regulation, where the latter shall be firmly upheld where it is essential in safeguarding financial stability but thoroughly scrutinized where it only creates red tape.

As Minister for Financial Markets, the stability and efficiency of the financial services industry is my core commitment. But finance also has important roles to fulfill in many other respects. One of them is the fight against organized crime, another is climate transition. Let me briefly comment on both.

Organized crime is an issue in all of our Member States and it certainly has become an acute problem in this country. The creativity of criminals in devising new schemes and ways to commit fraud and money laundering is in some sense impressive. We must make sure we do our outmost to make life as difficult as possible for these people.

In July 2021, the Commission presented a package of legislative acts to strengthen the EU's rules on anti-money laundering. The package includes a regulation and a directive, "the rulebook", a proposal for the creation of a new EU authority to fight money laundering, and a revision of the Regulation on Transfers of Funds. The aim is to improve the detection of suspicious transactions and activities, and close loopholes used by criminals to launder illicit proceeds through the financial system.

The co-legislators have reached an agreement on the Regulation on Transfer of Funds. We are now looking forward to starting trilogues on both the rule book and the authority in the coming weeks. We aim to get as far as possible but given the size of the package it is rather obvious that negotiations will have to continue under the leadership of our Spanish colleagues.

Turning then to the issue of climate transition, financial markets have an important role to play also in this aspect. They are key in delivering on the policy objectives under the European green deal as well as the EU's international commitments such as the Paris Agreement and the new biodiversity framework.

Subsidies and various support measures are often promoted as essential tools for climate action. But I think we tend to forget that well-functioning financial markets that enable a sound supply of capital are a crucial basis for the green transition. Europe must lead by example, by delivering on ambitious climate goals while boosting growth and competitiveness. For this reason, I was very happy to see that we recently could find an agreement on the standard for European green bonds. It is yet another important step for the green transition.

So, it is natural to begin our conversation about finance in the spectrum of financial stability and competitiveness of the broader economy, but this a complex area where other perspectives also need to be considered.

We have entered a new period of increased financial uncertainty as we leave the days of near-zero inflation and ultra-loose monetary policy behind us. Risks are elevated and new unexpected problems like the gilt market episode last autumn and that of the American mid-sized banks in March are likely to occur also going forward. We must be ready to deal with all of this in the short-term.

That said, we must not lose track of the long-term perspective. Unstable banks might put the economy in peril in a matter of days and weeks, but if banks are to be stable over the longer time horizon, then the underlying economy which they serve must also be healthy. The financial and real economies are intertwined, and we must make sure to increase the competitiveness of both.

Or as Gandalf answered Frodo, when he wished that such troubling times would never had come to him. "So do I, and so do all who live to see such times. But all we have to decide is what to do with the time that is given us".

And let me, from the Swedish presidency say, that we will do our best, for a safer, greener and more competitive Europe.

Thank you for your time and once again, welcome to Stockholm.

Valdis Dombrovskis

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

Speech

Ladies and gentlemen: it is a pleasure to be with you today in Stockholm. Thank you to Eurofi for inviting me again to speak.

Dealing with the events of the last few years has been an uphill struggle. First, the COVID-19 pandemic. Now, Russia's relentless and illegal aggression against Ukraine.

Throughout the many shocks and geopolitical shifts, Europe's economy has shown remarkable resilience and agility.

Co-ordination, solidarity, quick focused responses, have all helped a lot.

Our economic output returned to pre-pandemic levels fairly quickly. Inflation is cooling off after hitting record highs last autumn.

For the euro area, we expect annual inflation to fall to 6.9% in March, down from 8.5% in February.

We have also made a substantial shift away from Russia as an energy supplier, especially for gas.

However, while there are now more promising signs for our economy, there is no doubt that 2023 will continue to be a tough year.

And not only in Europe.

We are not out of the woods yet. As the IMF put it recently in its Global Financial Stability report, the world is looking at a 'rocky recovery'.

There are longer-term structural challenges to tackle too: our energy dependence, the green and digital transitions and, more broadly, the need to strengthen our competitiveness.

All this is taking place in a context of high uncertainty.

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.

It applies not only to reducing our energy dependence, which we are already doing with the REPowerEU initiative.

It also applies to the vital inputs and technologies that we need to advance with the green and digital transitions: batteries, semiconductors, critical raw materials, hydrogen.

For the next few years, we have the Recovery and Resilience Facility, to help Member States become more sustainable, prepare them for new challenges and shore up their ability to withstand future shocks.

This should be done in close partnership with the private sector, including financial institutions.

Member States are firmly into the implementation phase of their RRF investment and reform agendas.

We now see a steady flow of RRF funding, with total disbursements standing at more than €150 billion.

Since more than half of RRF milestones and targets will be due by the end of this year, all Member States should get their reforms and investments into place as soon as possible.

I cannot stress enough the importance of more investment for stimulating growth, also for keeping up with global competition.

Here, what matters is for Member States to prioritise their RRF projects so that they are focused and realistically achievable and mobilise further investments from the private sector.

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. We also need growthenhancing reforms and investments.

The SGP paper co-authored by Jacques de Larosière and Didier Cahen also emphasises these two aspects: sound public finances and investment are essential for growing out of debt.

Each Member State should also have enough fiscal space to make the sizeable investments required for the green and digital transitions.

However, we are now living in a high-debt environment. Some EU countries have public debt ratios that are far above 100% of their GDP.

This is why we need reformed fiscal

rules to effectively reduce debt as well as promote reforms and investments.

Our aim is to strengthen public debt sustainability via gradual, realistic fiscal consolidation – and to boost sustainable and inclusive growth through ambitious reforms and investments.

These are the main priorities of European Commission's proposal for revising the EU's system of economic governance, which we presented yesterday in Brussels.

They are designed around four key areas: simplicity, ownership, safeguards and enforcement.

To simplify the rules, fiscal policy coordination will be based on a single observable indicator: government net expenditure. Our proposals also promote greater national ownership by giving more leeway to take a country's specific situation into account.

Each Member State should commit to a medium-term fiscal structural plan. As a rule, it would apply for four years.

It should contain clear fiscal targets to achieve a gradual and sustained reduction in public debt ratios, or to maintain debt at prudent levels for low-debt countries.

If a country wants to extend this period, it must commit to structural reforms and investments that meet certain criteria: they must boost growth, improve fiscal sustainability and contribute to EU priorities. Each plan must be approved by both the European Commission and Council.

Greater national ownership should lead to greater compliance.

However, if that is not enough, we have provided for safeguards as well as stronger enforcement.

On safeguards: the added leeway for Member States is constrained by a set of common EU rules to ensure transparency and equal treatment.

The Treaty reference values remain in place: 3% of GDP for the public deficit and 60% of GDP for public debt.

For Member States that exceed either value, the Commission will issue technical trajectories to be used as the basis of each plan. The ratio of public debt to GDP must be lower at the end of the period covered by the plan than at its start.

If a country's public deficit remains above 3% of GDP, it will have to carry out a minimum fiscal adjustment of 0.5% of GDP per year, to apply as a common benchmark.

And no heel-dragging, no ackloading: Member States will not be allowed to push back fiscal

adjustments to a later date. This also applies to carrying out required reforms and investments.

Lastly, rules are only fully effective if they go with credible enforcement.

The excessive deficit procedure would be opened by default, if countries with substantial debt challenges do not comply with the rules. They would also face tighter fiscal requirements if they do not carry out the reforms and investments to which they have committed.

In addition, the Commission would be able to impose financial sanctions in the event of noncompliance.

These would be made more effectively enforceable by applying lower amounts.

Now, it is essential to reach political agreement quickly on new fiscal rules so that we can get them in place as soon as possible.

This is to provide certainty to Member States on the way forward.

Ladies and gentlemen

Private and public investment are two sides of the same coin. We need both. On the public side, channelling funds into the economy will crowd in private investment at a time when it is most needed.

However, the public purse has its limits. It simply cannot pay for the vast amounts needed to meet urgent and demanding challenges such as the green and digital transitions.

We will clearly have to rely heavily on the private sector.

For this, rolling out the Capital Markets Union to drive forward investment is the most cost-effective step we can take.

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 save and invest safely.

With deeper and more integrated capital markets, we can provide more sources of finance for EU companies to grow and thrive – and stay in Europe.

This is why we need to press ahead with creating the Capital Markets Union. We have made a lot of progress with this project in recent years.

Now we need to use the time before the next European Parliament elections to get all Commission proposals adopted.

This also includes reforms to structural obstacles for the further integration of capital markets, such as corporate insolvency.

It would go a long way to unlocking the private investment that we need to generate growth.

To sum up, Europe is coping well with the many short-term challenges that we are facing. Despite the current high-risk environment, our economy is holding up well.

For the longer term, our focus must be to maintain and strengthen financial and economic resilience, as well as creating lasting and sustainable growth.

Our policies are designed to achieve this goal, with: a globally attractive business environment targeted and productive investments based on sound public finances strong, resilient economic and financial architecture.

Thank you, and I wish you a productive and successful seminar.

Mairead McGuinness

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

The financial sector's contribution to the EU's competitiveness agenda

So, very good afternoon, it's great to be here.

It's a good job I was in the room for the end of that last conversation, which was an excellent conversation. And what really pleased me is that we can say as Europeans that our banks have been resilient.

On the Retail Investment Strategy, you are going to have to listen very carefully because there are items I will discuss before I get to the all-important Retail Investment Strategy. But maybe a few points in response.

In terms of the idea of the universal banking model, the issue of dismantling models – I'm in the business of creating, rather than dismantling.

I'm in the business of ensuring that the European system, the European financial system, continues to be strong, resilient and working for people and the economy. And I'll elaborate more on that as time goes on.

It's great to see so many in the room, and indeed many standing. It shows the vibrancy of this event.

And when we met in Prague just six months ago, we were taking stock again of a rapidly changing landscape around the world. And indeed, the pace of change has not slowed at all since then.

Quite the contrary.

Today I want to reflect on the current outlook for the economy and the financial sector. And talk about the EU's policy response to maintain our competitiveness.

And that includes work on Capital Markets Union – such as our efforts to support retail investment and consumer protection in the European Union.

The global financial environment has become more challenging.

We have seen banks failing in the United States and Switzerland. And again our banking system in the EU has proven resilient.

It reinforces our approach to bank regulation – applying Basel standards to all banks. But we're not complacent.

The shift in interest rates creates a new environment.

Higher inflation and rising interest rates present different challenges than the past decade or more of very low interest rates.

All of us – regulators, supervisors and the financial sector – have to stay alert. We have broader changes happening, too.

Technology and innovation are transforming how our financial system works.

We have seen the development of artificial intelligence accelerate.

And I would be really curious to know how you are already using this technology, and I've had good discussions with colleagues on this topic already.

Now sadly Russia's war in Ukraine continues.

Trade patterns and associated financial flows are changing.

Some call it fragmentation – the more I think about this, I would prefer to use the word reconfiguration.

We're ending our reliance on Russian fossil fuels at incredible speed.

The heating season is over – with our gas storage still more than half full.

And Gazprom is considering raising prices in Russia to compensate for the loss of export revenues in Europe.

So our work to break our reliance on Russia is working.

Now we're addressing our over-reliance on certain providers of critical raw materials.

We won't repeat the errors of the fossil fuel era in the net-zero economy.

EU trade around the world is booming – diversifying who we trade with and strengthening relations with our partners.

For example, trade between the EU and Japan increased by more than 13 percent last year.

The climate crisis continues to put pressure on everyone to join the transition to a low-carbon economy.

And indeed in the conversation David you referenced what we are doing around sustainable finance.

And we're going in the right direction, and it is a challenge, but it is a challenge we all have to face, and face up to.

And here we need to take the right action – decisive and bold, but also calm and considered.

It is my absolute view that Europe is capable of strong leadership.

We lead on the response to climate change – particularly on sustainable finance.

This work started three years ago with the European Green Deal. We plan to cut emissions by 55% by 2030. And aim to be climate neutral by 2050.

Half the emissions we need to cut by 2050 depend on technologies not yet ready for the market, or technologies that don't yet exist.

Now this is a challenge, but it is also a huge opportunity.

The EU's net-zero start-ups were worth over €100 billion in 2021, twice as much as the year before.

These industries make the clean technologies we need for the transition to a net-zero economy.

Europe's economic competitiveness – and our continued leadership – depends on embracing and financing this transition. And that's the thinking behind the new Green Deal Industrial Plan, which President Ursula von der Leyen announced in February.

We've been moving quickly to put that plan into action.

We adopted the Net Zero Industry Act in March to scale up the manufacturing of clean technologies.

Alongside this, we adopted the Critical Raw Materials Act to support raw material supply chains in the European Union. And then of course we need more investment.

The bulk of the money to fund green techs and clean techs will not come from the public purse, but from private investors.

So we need thriving capital markets in the European Union to secure our competitiveness.

The Capital Markets Union is about allowing businesses to access more sources of funding as they start out.

It's about making sure that start-ups born in Europe can scale up in Europe.

It's about giving investors more opportunities to invest in different projects and companies, including green tech and clean tech.

For instance, we recently proposed a new Listing Act.

And this is about making listings on public markets easier and more accessible, especially for smaller companies.

The revised rules on European Long-Term Investment Funds were adopted in March.

These changes will make it easier and more attractive for fund managers to offer these funds, and for investors to access them.

And this will help provide more long-term capital for projects in areas like sustainable energy, transport and social infrastructure.

And we are not shying away from tackling the more difficult, structural issues that are currently preventing integration.

In December we put forward a proposal on insolvency to make the process more consistent, no matter where you are in the European Union.

Alongside capital markets, European banks will continue to play an important role in supporting the European economy.

We want banks to continue to be a reliable and sustainable source of finance for European companies.

Our banking sector has become much more resilient in recent years thanks to the Banking Union.

We have strong common rules for banks. And we have fully operational central authorities to supervise banks and, when required, to handle their failure.

But as you know Banking Union is still a work in progress.

Last week, we made some more progress – by adopting a proposal to strengthen the EU's bank crisis management and deposit insurance framework. Our goal here is to ensure a more consistent approach to resolution, so that any bank can leave the market smoothly.

And this will bring greater financial stability, protect taxpayers and improve the confidence of depositors.

And now I take a drink of water before we go to retail investment.

That's in case you weren't fully attentive. Now you are.

It's true that we're great savers. Europeans are great savers. And I think in Covid we all saw the reality of that.

But there's another truth: we don't have the confident or dynamic retail investment culture that you see in other places like the United States.

And indeed I was there recently and I spoke to Rohit Chopra, Director of the Consumer Financial Protection Bureau.

His organisation is dedicated to making sure that consumers in the US get a fair deal in financial services.

And he had three interesting points which I absolutely concur with that are of importance to consumers.

Having, first, access to objective sources of information, being able to raise their hand to get help, and having regulators that defend their rights.

Here in the European Union, we need to recognise that without retail investors, there will be no Capital Markets Union.

And that's why we're looking to address this with the upcoming Retail Investment Strategy.

Now I cannot pre-empt decisions to be taken by the College of Commissioners.

But I do want to speak about some of the key issues the upcoming proposal should address.

Because the Strategy will look at all the different rules and practices in the EU on investment products for retail investors.

One key point is around advice.

Without trustworthy advice, retail investors will not invest more in capital markets.

So earlier this year, I said I wanted to have a conversation around consumer advice.

At the moment, financial advisors often receive benefits or commissions from third parties, typically the manufacturer, for selling their specific products.

And these are what we call inducements.

They mean that financial advisors often have a direct personal financial or in-kind interest in selling these 'induced' products to a client.

Research shows that retail investors are often advised to buy more expensive products and/or products not always suited for their needs.

Retail investors are rarely offered the least expensive products, though these can often perform as well as the more expensive ones.

Costs are passed on to consumers through high and often opaque charges which they pay to financial advisors for investment products.

Consumers very often don't realise how much they are paying for financial products, or how to compare products available on the market.

This area, more than any other in financial services, is one where I really believe that we need to address conflicts of interest around investment advice.

Now I think we all need to acknowledge that we are talking about retail investors – we should not expect them, or us, to be experts in financial services.

And so that makes it all the more important to avoid conflicts of interest in this area.

Consumers deserve decent advice that they can trust, at a decent price.

But biased advice doesn't serve them either.

There are strong, even polarised, dare I say it, views on the question of banning inducements – from very strong opposition to very strong support.

I will be very kind and not ask for a show of hands as to how this room would vote. I think I have three supported on that side.

Anyway – but whether you agree or disagree, it is important that we have this conversation.

It's important that we talk about retail investors, and how important they are for the completion and the success of capital markets.

What I do want to say, regardless of what side you come down on, even if you're neutral if that's possible in this very divisive debate, is a thank you to the many in this room who have actually contributed to that debate.

It's been extremely helpful.

From a very early age I was a strong debater and I believe that strong debates are healthy.

Member States, consumer organisations, Members of the European Parliament, industry representatives – you've all expressed very clearly your views.

I think that there is agreement that there is a problem – that the status quo does not best serve the consumer.

But views diverge strongly on how to address this.

We won't solve this problem overnight, but I think we still should be ambitious.

On balance, we have listened to those who tell us that a full ban on inducements could be too disruptive at this stage.

But we are also listening to those who tell us that consumers are not getting the best advice for their needs, and at a fair price.

And that is why we are also considering other measures, including transparency obligations.

But I would stress that increased transparency by itself is not enough.

Because we know that retail investors – who we cannot expect to be experts – will continue to rely on the experts in the financial sector when they make decisions.

And that gap in knowledge and understanding won't be addressed just by increasing transparency.

So we do need to go beyond transparency obligations.

We're looking at tightening the conditions under which inducements are allowed.

We're also looking at how we can ensure better value for money in investment products.

And we're looking at how we can make suitable, reasonably priced, easily understood advice available to everyone.

There should be a better breakdown of costs to make it easier for a consumer to compare different options.

And this will also increase scrutiny, including from supervisors.

There should also be a targeted ban on inducements for execution-only transactions.

Because it's not right that inducements are paid even when there is no advice relationship at all with a client.

And there should also be strengthened safeguards around when inducements may be paid – and when they must not be.

Together, these measures will strengthen the rules around advice to ensure that advisors act in the best interests of their clients.

I want to be clear: even if we do not propose a ban on all inducements now, it does not mean a free pass for the financial sector.

Those of you that are in this sector may have to rethink some of your business models and practices, so that consumers get a fairer deal.

In the coming months, I will organise a roundtable with all stakeholders, including industry and consumer associations.

I will challenge you to show me what you are doing on the ground to solve the problems that we've identified, and the timelines to address them.

And I will follow this closely.

And we will have a strong review clause in the proposed legislation.

And that will allow us to bring in a full inducement ban at a later stage if necessary.

I think I'll take another drink of water. That you can absorb.

And I do want to stress the point about the debate.

Because I do want European citizens to be more involved in the financial system, rather than feeling that they are outside takers of information.

So then in closing, just to say that it is – I don't even need to say it – that these are decisive times.

We are taking very strong action to support a resilient and competitive Europe. Your sector is absolutely crucial to that resilience.

It goes across from innovative industries, particularly those in the net-zero transition; from banks and capital markets; from consumers and retail investors.

Thank you.

Klaas Knot

Chair, FSB & President, De Nederlandsche Bank

Mamma Mia, here we go again? Lessons from SVB and Credit Suisse

Hello everyone.

Yesterday was King's Day in the Netherlands. The day we celebrate the birthday of our king. Having a monarchy is one of the great many things the Dutch and the Swedes have in common.

Our King's Day is a national holiday with flea markets on every square, music and beer in the high streets, and the entire country dressed up in orange to celebrate.

And every year I think to myself: "Mamma Mia, here we go again."

This thought also crossed my mind a few weeks ago, when the most recent episode of market turmoil started – with the failure of Silicon Valley Bank and the fall of Credit Suisse.

But are we actually 'going again'?

Alfred Nobel provides some wisdom to answer this question. He said: "One can state, without exaggeration, that the observation of and the search for similarities and differences are the basis of all human knowledge."

In saying this, he captured exactly what we need to do in case of turmoil, in case of a new shock to our financial system.

Of course, every shock is unique. But often, there are similarities. And often, there are differences with previous shocks. And it is up to us to distinguish between them. To draw on lessons learned for what is similar. And to look for new lessons for what is different.

We have learned a lot from previous shocks. They allowed us to identify vulnerabilities in our financial system. And we have been able to strengthen our resilience and stability as a result.

So far, no shock has been the Waterloo of our global financial system. But we need to remain vigilant. We need to remain diligent, in mapping, measuring and monitoring vulnerabilities. Old and new.

So let's put the super trouper on the most recent episode of market turmoil, and take a closer look at what happened, what vulnerabilities were exposed, and what lessons we can learn from similarities and differences with the past.

Roughly a month ago, on the other side of the Atlantic, Silicon Valley Bank failed. The reason for this was a classic bank run. Similar to bank runs in the past. Different in that this bank run was a direct consequence of SVB's specific business model. One that created a maturity mismatch: the interest rate on assets was fixed for longer than the interest rate on liabilities. On top of that, SVB made little use of interest rate derivatives to hedge this risk. The name of the game was serious risk mismanagement.

However, this only became apparent once interest rates started rising. When this happened, SVB's interest expenditure rose faster than its interest income. As a result, net interest income fell and continued to fall. This was reinforced by the migration from non-interest bearing deposits – on current accounts – to interest bearing deposits – on the savings accounts and fixed-term deposits.

When account holders got wind of the bank's weaker position, and the gimme, gimme, gimme... chant went viral on social media, a rapid outflow of savings followed. But due to the higher interest rates, the assets SVB had to sell to absorb this outflow of liquidity, mostly bonds, had lost value. Eventually, failure became inevitable.

Most of you know this, of course. But why didn't we see it coming?

The short answer is: money, money, money... it's so funny. The longer answer has to do with risk mismanagement.

SVB's 2021 annual report shows that a 2 percent interest rate hike would have led to a 35.3 percent decrease in capital by the end of 2021. If the Basel interest rate risk standards had been in place, this would have set off a series of alarm bells. Because, according to these risk standards, this position should not exceed 15 percent of capital. And if it were to exceed 15 percent, the financial supervisor should intervene.

But the Basel interest rate risk standards were not in place. So, it's not the case that the supervisor didn't hear the alarm bells. It's not that the alarm bells were quiet. It's that the alarm bells simply weren't ring, ring, ringing.

So what can we learn from this?

First and foremost – this case reaffirms that strong regulation makes for strong banks.

The failure of SVB was a shock to the financial system. And shocks are, by nature, hard to predict. We can't change that. So we need to deal with it. And to deal with it, we need strong and consistent regulatory frameworks. Frameworks that strengthen capital ratios and risk management. Frameworks that mitigate the potential impact of vulnerabilities.

We learned this from the Global Financial Crisis in 2008. And today, we can reaffirm the importance of the Basel Committee reform package. But there is a difference between designing the necessary tools to address vulnerabilities and implementing those tools.

So, once again, I call for a quick and faithful implementation of the final Basel III standards, with minimal and restricted transitional arrangements or exceptions. This is needed in order to strengthen the stability of the global financial system.

What else can we learn from the SVB failure?

SVB was a relatively small bank in the US, working mainly with tech companies. But when it comes to buffers, the size of the institution is irrelevant. Every bank, whatever the size, whatever the scope, whatever the geographic location, should maintain strong buffers.

Because a second lesson we have now learned, is that even a bank that was not considered to be a systemic bank, could still cause a lot of stress in the financial markets. Stress that could possibly have been avoided with sufficient buffers. Stress that, knowing me, knowing you, surely got us thinking about what we can do to improve our current policies further.

And this brings me to my third reflection in the aftermath of SVB – or rather a few questions that might serve as food for thought.

For starters, we need to make sure that our policies are up to date – and I mean that quite literally. Are our policies in sync with today's society? A society that, for a large part, is characterised by digitalisation and social media. A society in which, precisely because of this, liquidity risk seems to have become more acute.

Indeed, it cannot be denied that the speed at which deposits were withdrawn from SVB was much faster than expected – much faster than LCR calculations take into account. And so, should LCR be calibrated differently? And/or do we need to better stress test it?

Also - are there shortcomings in the way we look at interest rate risk? Should supervisors consider more frequently, and for each individual bank, whether additional Pillar 2 requirements are necessary, based on the bank's risk profile?

And finally, should unrealised losses – that is the difference between market and book value for bonds which are held to maturity on banks' balance sheets – should those unrealised losses be better reflected in the capitalisation of banks? And should we look at how instruments, that are not marked to market daily, are reflected in liquidity buffers?

I don't have an answer to these questions. But I do think they should be addressed. So that we can learn everything there is to learn from what happened at SVB.

And of course, not only what happened at SVB. Because the problems at SVB soon led the financial market to look at other banks – banks with the same combination of vulnerabilities, like First Republic.

These market concerns also found their way across the Atlantic, to this side, to Credit Suisse, a bank that has suffered from a series of mismanagement problems in recent years, and that experienced previous outflows of deposits at the end of 2022.

Here, too, we witnessed a rapid succession of events. It took, almost literally, only one tweet to lead to the downfall of Credit Suisse. Because, once an alleged S.O.S. was on the wire, additional deposit outflows quickly followed, Credit Suisse's share price fell, and its CDS spread spiked. In the end, the Swiss National Bank provided additional liquidity assistance, and Credit Suisse was sold to UBS.

FINMA, the Swiss supervisor, used a supervisory, and not a resolution power, to enable this sale – and it came with a write-down of Credit Suisse's AT1 securities.

Although the possibility of such a principal write-down was included in the relevant AT1 prospectuses and mentioned on the bank's Investor Relations page, although investors were clearly informed that extraordinary public support could lead to such a write-down, and that AT1 holders may suffer losses before equity holders, and although the coupons paid on the AT1-security well exceeded the RoE-target Credit Suisse had communicated to its investors, FINMA's decision still took investors by surprise.

This should encourage regulators to reflect on the role and functioning of AT1 instruments in determining the capital position of banks.

But let's go back a step, and ask: why not use resolution? Or, with Alfred Nobel in mind, what similarities or differences with previous cases led to this strategy?

In the aftermath of the Global Financial Crisis, resolution frameworks, based on the FSB's Key Attributes, were established. Just like cross-border cooperation between national regulators.

The past has witnessed several cases where such a resolution framework has proven to be an effective safeguard for both depositors and financial stability. But at the same time, we haven't had many bank failures since the Attributes were published. Which, in a sense, makes every new case all the more different. And so, it makes it all the more important to draw lessons from this specific case.

One lesson for sure is that it is essential to prepare more than one resolution strategy. Different circumstances require different strategies. So we need flexibility. This becomes all the more important in case of a liquidity crisis – when a bail-in can help to restore investor and depositor confidence by strengthening the solvency of the bank, but can't generate additional liquidity.

What Credit Suisse has taught us, is that we need to further explore resolution strategies that are better able to stabilise a bank's liquidity position.

Taking Alfred Nobel's advice, and observing and searching for differences and similarities, I can say that, today, we are in a very different situation compared to 2008. European banks have improved their capital positions and there is a structural change in the interest rate environment. And this is, in principle, good news for a bank's business model. The challenges of an artificially flat yield curve, negative interest rates, and fierce yield competition, have finally eased.

But there are also similarities. Today, too, risks are lurking around the corner and there are numerous vulnerabilities. Risks related to funding costs and interest rate sensitivity, or credit-related risks. And vulnerabilities related to high levels of debt in many corners of our economy, or hidden leverage along with liquidity mismatches in the non-bank sector.

This means that we need to remain vigilant. Supervisors, obviously. But also the banking sector itself – making sure their capital positions, risk management and governance strengthen their resilience in sentiment-driven markets.

So, yesterday was the Dutch King's birthday. And if I am not mistaken, two days from now, on April 30th, His Majesty King Carl Gustaf will celebrate his birthday. I'm sure that in between there must be some room for a Dancing Queen. Congratulations in advance to all Swedes here today.

Walpurgis Night is also celebrated in Sweden on April 30th. The night of the bonfire. A celebration of spring, new life and a brighter future.

Well, if we keep learning from the past, from our experiences with shocks and challenges – if we, like Alfred Nobel said, keep searching for similarities and differences to expand our knowledge, then I am sure we are heading, indeed, towards a brighter future.

Thank you.

Pablo Hernández de Cos

Chair, Basel Committee on Banking Supervision
& Governor, Banco de España

Where next for the Basel Committee?

Introduction

Good morning, and thank you for inviting me to speak at this High-level Seminar.

In many ways, the recent banking turmoil was the first "real" stress test of the banking system (or at least parts of it) since the Great Financial Crisis; as the banking system benefited from the huge scale of public support measures during the Covid-19 pandemic. We can take some comfort that the significant increase in financial resilience, due in large part to the Basel III reforms, has served to safeguard the stability of the global banking system. But we should also recognise that, once again, significant public sector intervention was needed to avoid potentially adverse spillovers to other banks, non-bank financial intermediation (NBFI) entities, and ultimately the real economy. With that in mind, we need to remain focused on assessing and mitigating the risks and vulnerabilities affecting the global banking system. These include elevated debt levels and stretched asset valuations, geopolitical developments, complex and opaque bank interconnections with NBFI entities, and continued uncertainty with regard to economic growth, inflation and interest rate dynamics.

Against that backdrop, I will be take a step back today and review the work programme and strategic priorities of the Basel Committee for 2023–24.[1] There are five broad themes that I will cover today – all of which have a bearing, directly or indirectly, on the recent banking turmoil and the short- to medium-term risks for the global banking system. But let me give you the headline messages upfront:

- there is a wide range of both short-term risks and medium-term structural changes that are testing and will continue to test the resilience of the global banking system;
- now is not the time for complacency or regulatory rollbacks; and
- safeguarding financial stability requires global cooperation more than ever.

Emerging risks and horizon-scanning

The first theme of the Committee's work programme relates to emerging risks. The Committee will continue to pursue a forward-looking approach to identifying and analysing risks and vulnerabilities to the banking system. This includes the impact of ongoing geopolitical developments, stagflationary dynamics, scarring effects from recent crises and cross-border spillovers to banking systems.

The Committee is also reviewing the recent banking turmoil and will take stock of the regulatory and supervisory implications from recent events, with a view to learning lessons. I recently set out my initial reflections about implications of these events for banks, supervisors and regulators.[2] I don't plan on repeating these remarks today, but I will sum them up in three points.

First, even in 2023, we continue to see cases of banks that fail to meet basic risk management and governance practices. The boards and management of banks should be the first port of call in managing and overseeing risks; these functions cannot be outsourced to supervisors. Second, it is crucial that we work collectively in preserving the strength and robustness of supervision over time. Supervisors must be able to exercise their judgment and tell banks, for example, that their leverage or maturity transformation are too elevated, and that they should promptly and substantively remedy risk management and governance failings. Third, we must remain acutely aware of the dangers of the "regulatory cycle", where memories of banking crises fade over time and vested interests call for regulatory rollbacks, all of which risk a weakening of the financial system. To that end, it is important to keep an open mind at this stage about whether any potential revisions to the global regulatory and supervisory framework are needed. And of course, the implementation of agreed global reforms remains of paramount importance.

In addition to reviewing the recent banking turmoil, the Committee is also conducting a series of horizon-scanning exercises related to other emerging risks and vulnerabilities. This includes work on the bank and supervisory implications of risks related to inflation, as well as risks specific to emerging market economies and cross-border booking models. The Committee will also continue to assess the robustness and suitability of banks' credit risk models, drawing on the lessons learnt from the pandemic and the evolving macro-financial outlook.

Digitalisation of finance

Moving on, the Committee will also be pursuing a wide range of initiatives related to the digitalisation of finance, which include analytical, policy and supervisory-related elements.

Over the coming two years, the Committee will publish an analytical report on the bank and supervisory implications of the ongoing digitalisation of finance. The report will review and synthesise a wide range of technological developments, including the emergence of new entrants/suppliers in the banking system, the use of artificial intelligence and machine learning, big data and governance arrangements. It will also draw on a deep dive analysis under way on the supervisory implications of banking as a service.

The Committee will continue its work related to cryptoassets, following the finalisation of our prudential standard on banks' cryptoasset exposures last year.[3] This involves two strands of work. First, the Committee will continue to closely monitor and assess bank-related developments in cryptoasset markets, including the role of banks as potential stablecoin issuers or custodians of cryptoassets, and it will also look at the broader potential channels of interconnections with the cryptoasset ecosystem. Second, it will monitor the implementation of its prudential treatment of banks' cryptoasset exposures. As part of this monitoring, the Committee will review by the end of this year the treatment of permissionless blockchains with additional safeguards and the criteria to identify stablecoins eligible for the "Group 1b" prudential treatment, including the appropriate composition of reserve assets and the effectiveness of statistical tests.

Climate-related financial risks

The third theme of the Committee's work programme is climate-related financial risks, which, together with the digitalisation of finance, are perhaps the most existential medium-term threats to the global banking system. The Committee will continue to pursue a holistic approach in this area. This will include work across all three pillars of regulation, supervision and disclosure.

On regulation, the Committee is undertaking ongoing analytical work to assess the materiality of gaps in the existing Basel framework. This follows the publication last year of responses to frequently asked questions that clarify how climate-related financial risks may be captured in the existing Basel framework.[4] Building on this work, the Committee will consider whether potential regulatory measures to address climate-related financial risks are needed.

On supervision, the Committee will monitor the implementation of its *Principles for the effective management and supervision of climate-related financial risks*, as published last year.[5]

Building on ongoing work by other global forums (most notably the Financial Stability Board (FSB) and the Network for Greening the Financial System), the Committee will also discuss potential complementary work related to banks' transition planning and the use of climate scenario analyses.

On disclosure, the Committee will continue to coordinate with the International Sustainability Standards Board, and, building on this work, will consult on a Pillar 3 framework by the end of this year.

Monitoring and review of existing standards and guidance

Another theme of our work relates to monitoring and reviewing existing standards and guidance. Let me be clear: this work is not about reopening Basel III. We are instead focused on other aspects of our existing supervisory guidelines and regulatory standards that may require review in the light of recent developments.

I will mention three examples of work in this area. First, the Committee is reviewing its *Core principles for effective banking supervision*. The Core Principles are the de facto minimum standard for the sound prudential regulation and supervision of banks and banking systems. They are used by countries as a benchmark for assessing the quality of their supervisory systems, and are also used by the International Monetary Fund and the World Bank in the context of the Financial Sector Assessment Program. The Committee is reviewing the supervisory insights and structural changes since the previous update to the Core Principles in 2012, and will consult on revisions by mid-2023.

Second, the Committee is reviewing its supervisory guidance and principles with regard to banks' interconnections with NBFI entities. The past few years have seen several episodes of NBFI distress, which in turn revealed a wide range of direct and indirect interconnections with the banking system. The Committee will update its previous *Sound practices for banks' interactions with highly leveraged institutions*, building on its guidelines on step-in risk and drawing on the lessons learnt from recent NBFI-related stress events.[6]

Third, the Committee will develop updated supervisory principles on banks' outsourcing practices and their reliance on third- and fourth-party service providers. The principles will supersede previous principles by the Committee on outsourcing, and will complement, and build on, similar work by the FSB under way on outsourcing and third-party risk.[7]

Implementation and evaluation

The last, but certainly not the least, theme of our work is the full, timely and consistent implementation of Basel III.

The recent banking turmoil has again reminded us of the critical importance of prudent and robust regulatory standards for bank capital and liquidity. The implemented Basel III reforms

have greatly enhanced the resilience of the global banking system, with total leverage in the banking system halving from about 30x to 15x since 2011. Banks' holdings of liquid assets have more than doubled during this period and now stand at €12.5 trillion. These reforms have helped contain the fallout of the recent banking stress events.

But these events have also highlighted areas of "unfinished business", including as it pertains to the robustness and credibility of banks' reported risk-weighted capital ratios. The Basel III reforms finalised in 2017 seek to address these and other fault lines, which remain as material today as they did six years ago. Therefore, implementing the outstanding Basel III standards in a full and consistent manner in all jurisdictions is a critical step towards safeguarding the resilience or our banking system.

Conclusion

In conclusion, there are no shortages of risks and vulnerabilities affecting the global banking system. Medium-term structural changes raise fundamental questions and challenges for banks and supervisors. The Committee has a wide-ranging and comprehensive work programme in place to address these challenges over the next two years. And, as we have seen with the recent episodes of banking stress, cross-border supervisory cooperation is more important than ever.

References

Basel Committee on Banking Supervision (1999): "Banks' interactions with highly leveraged

institutions", January.

(2005): "The Joint Forum: Outsourcing in Financial Services", February.

(2012): "Core principles for effective banking supervision", September.

(2017): "Identification and management of step-in risk", October.

(2022a): "Basel Committee work programme and strategic priorities for 2023/24", December.

(2022b): "Prudential treatment of cryptoasset exposures", December.

(2022c): "Frequently asked questions on climate-related financial risks", December.

Hernández de Cos, P (2023): "Banking starts with banks: initial reflections on recent market stress episodes", keynote speech at the Institute of International Finance Roundtable on the Shifting Risk Landscape, Washington DC, April.

1. BCBS (2022a).
2. Hernández de Cos (2023).
3. BCBS (2022b).
4. BCBS (2022c).
5. BCBS (2012).
6. BCBS (1999) and BCBS (2017).
7. BCBS (2005).

François Villeroy de Galhau

Governor, Banque de France

Banking turmoil: three blessings and a funeral

Ladies and Gentlemen,

I am delighted to address you at this Eurofi seminar in Stockholm, and I would like to extend my warmest thanks to David Wright and Didier Cahen. This speech, as the two previous ones, seems like a perfect opportunity to take a first look at the lessons to be learnt from the banking turmoil of 2023. As I have the privilege to speak after my friends Pablo Hernández de Cos and Klaas Knot, my task is made simpler: they have already covered a lot of ground, and hence I will be able to speak still more freely, and to call my speech "Three blessings and a funeral".

Let me start with the funeral, at least the one that we can welcome, but which, unfortunately, is not final. It should be the condemnation and the funeral of mismanagement. Indeed, blatant mismanagement of the risks and of the business model in some banks explains first and foremost the recent turmoil. As Pablo said in Washington, "jumping straight to discussions about the regulatory and supervisory implications of recent events is akin to forgiving banks for not fulfilling their primary responsibilities".[1] To put it even more bluntly, when some people act like reckless drivers on the road, they are the ones who are guilty, not the police. After the (temporary, alas) funeral, let me return to the three blessings. This word is a bit self-centered, I confess, since I am referring to public policies, and each of them today raises questions: (I) regulation, (II) supervision, (III) resolution. Therefore, how could we revisit each of them?

I. Regulation: a plea for an effective implementation

Allegedly, if regulation had been more effective, it could have prevented the banking turmoil. For its critics, Basel III was too focused on liquidity and counterparty risks, and not enough on interest rate risk. Well... let me call into question those ideas.

Such criticism is ironic: didn't anyone notice that the first blast of turbulence came from a bank not subject to the full set of Basel standards? While the Basel framework applies in its entirety to every single European bank – several thousands of them – , it applies to only 13 banks in the United States, leaving a myriad of regional but sometimes significant banks, including SVB, with much lighter requirements. According to our estimates, and in line with a study carried out by Yale University, SVB's short-term liquidity ratio (LCR) would have fallen short of the Basel requirement of 100%.

Another point concerns the allegedly inadequate treatment of latent but not recognised losses in the current prudential framework. First off, we should all bear in mind that all liquid assets included in the LCR are factored in at their fair value. In addition, unrealised losses have to be disclosed in financial statements ensuring transparency. Therefore, there is no issue here. On the capital side, we have to be very mindful of the risk of increasing the volatility of banks' own funds if unrealised gains and losses were to be fully reflected in capital for securities held at amortised cost. That said, and according to the IMF, the impact for EU banks would be 5 times smaller than for US banks.

SVB's failure argues for an effective and broader implementation of the Basel III requirements, rather than an eternal effort to refine them – and thus delay their application. In short, more Basel III now – whatever the reluctance of some European banks has been -, rather than a hypothetical and delayed Basel IV.

Speaking of regulation, let me add a word on two potential points of attention, and first the single name credit default swap (CDS) market. At the end of March, the lack of liquidity of this market and its opaqueness caused an undue episode of financial distress affecting Deutsche Bank. We should not accept that such a dysfunctional market entails such systemic risks: as a first step, we need to establish a better understanding of the transactions, the participants and the risk of correlation with other financial instruments like AT1 and deposits.

Second, we must acknowledge that the increased speed of deposit outflows – due to technology, combined with the power of social networks – raises new challenges: should we improve deposits insurance, and/or adjust some liquidity ratios? None of these changes is obvious, to say the least, but none should be taboo.

II. Supervision: lessons from an active euro area model

Fair enough about implementing Basel III; but then comes the next suspicion: Credit Suisse failed despite being Basel III compliant. The answer is clear: good regulation is necessary; it's never sufficient. The risks generated by specific business models such as the asset-liability mismatch at SVB or the weak profitability and weak internal controls that dogged Credit Suisse should typically have led to higher supervisory requirements. Supervision should not be seen as a static business; it must be active and tailored to banks characteristics. This is precisely the spirit of the "Pillar 2" in the Basel framework, with the annual Supervisory Review Process. I sometimes hear doubts about supervision, which some believe should be treated as a legal dialogue, cautious in its form, and slow in its effects. No: supervision can and must be intrusive – including on-site –, exercised by highly skilled practitioners, quick in its reaction, strong in its powers. This is not wishful thinking: it has been our experience for decades in the French ACPR, and now for years in the European SSM.

Active supervision is indeed one of the great successes of our European Banking Union. In light of the recent reality test, I believe there are two lessons to be learnt from our model. First, the experience of the Single Supervisory Mechanism shows the advantages of all the players being subject to one leading authority in an integrated banking space, with clearly defined responsibilities and coordination. This single supervision allows for comparisons across a vast sample of comparable institutions, and thematic campaigns of on-site missions.

Second, our active supervision features regular and comprehensive stress testing including on interest rate risks, which is also applied to less significant institutions. The European Banking Authority (EBA) conducts an EU-wide banking stress test every two years, taking into account the latest macrofinancial developments: in 2023, stress test scenarios are typically based on a sharp rise in short-term and long-term interest rates. Moreover, following the EBA guidelines on Interest Rate Risk of the Banking Book (IRRBB) – as part of the rigorous application of the Pillar 2 process – , published in 2018 and enhanced in 2022, European banks are required to perform regular supervisory tests to measure the impact of interest rate movements on their interest margins and economic value of equity; US regional banks such as SVB are not.

III. Resolution: how to make it work

Now for our last blessing. Since the global financial crisis, banks and authorities have strengthened their ability to deal with crisis events by developing a resolution framework. However, in the case of Credit Suisse, the Swiss authorities chose the option of a merger. It thus raised renewed questions on how to make resolution more operational and more trustworthy, facing as said the risk of faster bank runs. We should take this question very seriously, without jumping yet to its conclusions. Let me only share two thoughts at this stage.

The first one relates to the resolution of large and even systemic banks. The recent events showed, among other question marks, that the provision of potentially significant amounts of liquidity in crisis time is a key issue to address. We should collectively reflect on how to ensure a credible backstop to existing sources of funding. The framework allowing the ECB to provide a "Eurosystem Resolution Liquidity" remains to be built.

The other priority, on the other end of the spectrum, is to shift from resolution "for the few" – really for the too few: two cases in the last 9 years– to resolution "for the many", including small and medium-sized banks. The European Commission proposal on the revised Crisis Management and Deposit Insurance framework is a step in the right direction in this respect: enlarging the use of resolution for smaller banks is an opportunity to further operationalise transfer tools and ensure consistent and smooth market exit of non-viable banks. However, an increased mutualisation between the Resolution Fund and the

Deposit Guaranty Schemes is questionable, as having big corporates benefit

from the same protection than smaller retail deposits.

***

Let me sum up the three first lessons: an intrusive and effective supervision; a regulation implemented everywhere; and some soul-searching on resolution. But as the master of detective novels, Agatha Christie said: *"The truth, however ugly, is always curious and beautiful to seekers after it"*. We will continue to investigate and learn. But this should not obscure the elephant in the room. One of the most important potential source of vulnerabilities nowadays remains nonbank financial intermediaries, which are not regulated appropriately. This is here the liquidity mismatch is the highest and this is why I strongly concur with Klaas' determined commitment to deliver on the FSB agenda there. I thank you for your attention.

1. Pablo Hernández de Cos, Banking starts with banks: initial reflections on recent market stress episodes, Speech, 12 April 2023.

Monique Goyens

Director General,
The European Consumers' Organisation

What consumers really need from the financial services industry – some provocative thoughts

Thank you. Good evening, ladies and gentlemen. My name is Monique Goyens. I am indeed the Director of the umbrella organisation for European consumer organisations. I will only keep you a few minutes because I have been told I have five to seven minutes. I know it is late and you have had a long day. I have the impression of still being a little bit of an exotic animal in this crowd because I am here to give you a customer flavour of financial markets. I am very thankful to have been given that opportunity to give you a little bit of a market pulse check of what is going on in the market, what your customers are thinking about the financial service industry.

These may be some provocative thoughts. If I can convince one of you to at least ask yourself some questions, my day will be made. I only have a few minutes to share with you, but I am happy to elaborate in the hotel or in Brussels or online. I also have my colleague here, Agustin Reyna, who is the director in charge of financial services. Of course, he will also be able to engage.

First, let us go back to the basics. The terminology that we are using, and you also use, is financial services industry. Services, what does that mean? Service is serving a person with something that they request. I really need to be very honest with you. My members are in daily contact with the people, with the consumers, with the bank customers, with the insurance customers, with the retail investors, and what we hear from them is frustration and resignation. It takes 10 days to get an appointment with somebody called an advisor. This is not normal. What we see is that there is some sort of a dehumanisation of the relationship between the customer and the financial institution. We are not feeling that we are clients anymore. We are a bunch of data that is going to be exploited.

I am really quite provocative here, but just think about the change of attitude of the employees in the banking sector towards their customers. Of course, this is a frustration. It does not only happen in the financial market, by the way. People are fed up being treated as they are being treated, so just be aware that that could be a bomb that is ticking. You can quote me on that, and even my organisation can be quoted on that.

That is why we call for a re humanisation of the relationships between the professional and the customer. Personally, I bet that those financial institutions that reinvest in human relationships, in having somebody at the end of the phone when you call, will be the ones that will be the most sustainable. I do not want to go backwards. We know that digitalisation is certainly there to stay, but give it a personal touch and you will win out at the end of the day.

There are three topics I would like to share with you. The issue of inclusiveness. Of course, we know that digitalisation of finance has brought a lot of innovation, but it has not always brought progress. You have progress when you leave no one on the side of the road. We are in Sweden here. Sweden is the first country to go cashless. They are stepping back because there has now been a government intervention so that you can pay cash in pharmacies and with doctors. My Swedish member told me this afternoon that there is now some lobbying going on so that you can also buy food with cash.

Norway is quite a digitalised country, and the Norwegian Consumer Council made a report a few months ago mentioning that 25% of consumers indicate that they struggle with digital payments quite regularly. 43% of them, that is quite a lot, say that they need help when making payments in the digital world. That means it is not so obvious as it seems to be. Of course, there are many reasons which can explain that people have difficulties with digitalisation. First of all, because many of the digital tools are not complying with the Accessibility Act. It is about font sizes. It is about accessibility for people with reduced motricity skills. It is also about closure of branches. You really have difficulty in having somebody to talk to.

There I insist this is not a question of generation. I very often hear people telling me, 'Digital natives, that will be all fine for them.' Of course, yes, it will be easier when you have more people being used to paying with smartphones, but it is not only a question of generation. It is a question of age, because your smartphone might be digital, but your brains are still biology. With age, cognitive skills and motricity skills go down, meaning that when you are older – I do not know what age, it depends on each person, of course – but surely when you are 80, 85, 90, you cannot adapt so easily to new interfaces. You cannot adapt to new software as easily as a person who is 20. This is a very important point for tomorrow when we speak about digital euro, because one of the conditions that needs to be met by the digital euro is this inclusiveness.

A second point I would like to make is financial advice. This is another word where I would like to check the terminology, because advice means you stand with the consumer to take them by the hand and you provide them with the information that they need in the specific case and which is in their best interest. What we see too often is that the use of the term financial advice is in fact a misrepresentation because the person who advises you is in fact selling you something. For example, if you go to the butcher, they sell you something. You do not say, 'It is my steak advisor.'

More seriously, what we see is that financial markets, like many other markets, become more and more complex. In order to keep up with the complexity of those markets, consumers should not have to spend the whole day. It should not become a full time job to be the consumer of financial services. However, it is now more and more important for consumers to take the right financial decision. For example, the pension gap. This is something that is now on the shoulders of consumers to fill by taking out pension products on their own. They better make the right decision and take out the product or service that is the most suited to their profile. Consumers also need to be part of the green transition, meaning that their money should go to the sustainable investments, but there also there is a lot of support that needs to be given to the consumers so that they really undertake the true green choice.

That means that we need access to independent trustworthy advice. For the moment, this is not the case most of the time because most of the advice that consumers are being exposed to when taking financial decisions is biased. It is biased by a conflict of interest because there is an inducement linked to that advice, meaning that the person who is going to advise you – in other words, sell you a product – is in fact being pushed because of an inducement, because of a commission, because of a kickback, to sell the product that has the most interest for that institution rather than for the consumer. This is corrupted advice. Let us call a spade a spade.

We have been asking for a ban on inducement in retail investment cases. It already exists in the Netherlands and in the UK, and all the evidence that we get back from consumer organisations is that it works quite well. In fact, the evidence is mounting that inducements do not deliver the products that consumers deserve. The solutions – the alternatives exist, but despite that, we really are very concerned that there will still not be a protection – a prevention of biased advice for consumers in the new retail investment strategy that we hope the commission is going to publish soon. That is something that we are very worried about, and we know that the industry has been working very hard to not have a ban. I can tell you that we could debunk every argument that the industry has provided to us in two minutes. We have the evidence, and we can really provide this quite clearly. Can I say from a consumer perspective that these delays in having people get value for money and unbiased independent advice are a disgrace towards your clients?

The last point I would like to make is sustainable finance. As I already mentioned, there also it is very important to help people take the right investment decision if they want to make sustainable investments. There again we have an emergency. We have no time to waste. Can I say there will be no high level Eurofi seminar on a dead planet? It is really important not to just play with time, and the least you can do is to inform consumers properly that the investment they would like to make is not sustainable. Of course, then being even stronger and stricter on what can be considered as sustainable is the most important thing. There is a lot of green washing going on and we really need much more robust and ambitious regulation when it comes to disclosure on sustainability and reporting standards, and this should be done sooner rather than later.

This is only about disclosure, but we think that people should stop being misled, because when they see an investment labelled as sustainable, they really think that they are doing something good for the planet. Currently, this is too rarely the case and they go on investing in, for example, fossil fuel companies without knowing it. That should certainly stop if they don't want to do that. I do not keep you longer. Thank you very much for your time.

Tomoko Amaya

Vice Minister for International Affairs,
Financial Services Agency, Japan

Four lessons learned from recent events: Do not miss the real issues

Thank you, David, for your kind introduction. It is my great pleasure to give a speech here. What can and should bankers and authorities learn from recent events? Let me take this opportunity to share with you my preliminary thoughts. Preliminary because further consideration is needed as more information becomes available, including the US authorities report expected in a week.

Depositors connected through social media and acted all together to withdraw their deposits. As a result, Silicon Valley Bank suffered a huge outflow of deposits in less than 24 hours. Many people, including me, were shocked by the speed. Existing liquidity risk management practices cannot address such rapid outflow in the digital era. What should we do? We need to differentiate market driven liquidity stress from stress due to the loss of confidence in a specific bank.

As we saw in the global financial crisis, in the case of market driven liquidity stress, higher liquidity in normal periods would have helped, as it enables banks to withstand the stress until markets start functioning again.

However, in the case of liquidity stress due to the loss of confidence in a specific bank, once a deposit run has started, it will continue until very decisive measures such as full public support or backup by strong big banks are announced. Outflow tends to accelerate, and, in the recent cases, social media and the high proportion of uninsured deposits exacerbated the speed. More liquidity in normal periods could buy some time but would not make a bank viable. It only provides a few more hours of survival, which is too short to take remedial actions.

Banks need to monitor various qualitative and quantitative indicators and take appropriate measures before a devastating run starts. In the good old days, late at night, when people were asleep in bed, bankers sat in the meeting room discussing the measures to be announced the next morning. These days, late at night, people are in their beds disseminating the information and withdrawing their deposit with smartphones. Therefore, agility is required. Thorough review is needed on the adequacy of the operational aspects of liquidity risk management, i.e., whether a banks' contingency and action plans, and the monitoring points, are fit for the challenges of the digital era, and whether they are well prepared to carry out the plans when necessary. The same applies to the crisis management practices of financial authorities as well.

Next, let me turn to the interest rate risk and its interaction with depositors' behaviours. Due to rapid increases in interest rates, the levels of unrealised loss on available for sale and held to maturity securities have risen significantly. At the same time, on the liability side, higher interest rates have brought an end to the influx of cheap funds to venture firms and the total amount of deposits started to decline as the firms made their operational payments. Therefore, banks needed to sell bonds to accommodate liquidity needs and the unrealised losses had to be realised.

Interest rate risk and unrealised losses should not be ignored, but they should be managed in the context of comprehensive asset liability management. If Silicon Valley Bank has had illiquid assets like loans, instead of held to maturity government bonds, they could have avoided unrealised loss, but when facing a liquidity shortage as venture firms made their operational payments. Effective and dynamic asset and liability management (ALM) integrating interest rate risk and liquidity risk, taking into account the concentration of deposits in terms of the business model, was indispensable.

In asset liability management practices, on the liability side, the stickiness of the deposit is usually analysed by attributes such as "corporate" and "small retail", as well as by experiences. However, in the recent cases, the concentration of the depositors combined with the nature of the funds concerned was the source of volatility. Actually, there has been other cases where banks need to pay enough attention to the nature of funds with respect to deposits. For example, regional banks in agricultural areas may experience seasonal fluctuation of total deposit amount, or after natural disasters, local banks may experience a temporary increase of deposits during the period between insurance payments and reconstruction.

Banks are required to carefully analyse possible depositors' behaviour and manage their assets accordingly, reflecting their business models. Furthermore, the categorisation of risk such as liquidity and interest rate risk is convenient, but does not represent the full picture of risks. If we focus on those risks individually, we would lose sight of the real vulnerability of the bank. We should look at the banks, not the risks.

This brings me to my third point, business models and outliers. The vulnerabilities I have mentioned so far are derived from banks' unique business models. In addition, Credit Suisse ran into crisis even with its high capital and liquidity ratios as the market lost confidence in its business model.

It has long been long stressed that regulatory and supervisory approaches should reflect the features of each bank's business model. The uniqueness of business models sometimes appears as outliers of the key indicators; rapid growth of balance sheets, high proportion of uninsured deposits and long duration in bond portfolios. Uniqueness can be identified through both more qualitative and sometimes rather simple quantitative analysis, such as the concentrated composition of customers.

Regulatory metrics are there for all banks and are good for banks with somewhat standard business models. However, regulatory metrics could not and should not address all the unique features of different business models. We may pretend they can, but we will end up creating a false sense of security. Regulatory requirements would become overly complex or conservative if we try to address the risks in all the possible business models. Tailored approaches are needed to regulate and supervise banks with unique business models, and discretion is necessary.

In addition, the case of Credit Suisse clearly shows us that a high level of capital may absorb financial losses, but not the loss of confidence in business models. The viability of business model needs to be a key perspective of supervision and to be expeditiously addressed by management.

The Silicon Valley Bank case raises various issues in supervision. Because it was a mid sized bank, it was not subject to stringent supervisory and regulatory standards, and after it crossed the threshold, transition took time. Furthermore, even where deficiencies were identified and communicated to the bank, they remain unfixed. This tells us that reliance on banks' size may overlook the risk of banks, especially those with non traditional business models, and that we need to pay attention to banks that have rapidly expanding balance sheets, and which often change business models as well.

It is the responsibility of bank management to develop effective risk management and sustainable business models, but it is the supervisors' responsibility to protect public and financial systems from the consequences of poor bank management. There should be no blind spot. The problems identified should be followed up. Material deficiencies need to be fixed promptly. Regulators and supervisors have tools to constrain banks, but I have to confess that compelling banks to do something is not an easy task, especially when bank managers are unwilling to do so or incapable of understanding the problem and taking corrective measures. One of the key tasks and skills for supervisors is to engage with bank management, persuade them tenaciously and sometimes cultivate them.

The post global financial crash (GFC) reforms have made the banking system resilient, and the implementation of the finalised Basel III will further enhance the resilience. At the same time, the recent events revealed new challenges calling for new perspectives. If we look at challenges through the lenses we are used to, we may miss the real issues.

Today, I focused on lessons learned from recent events. However, they have also shown us that the landscape of banking business has been evolving. We need to understand more broadly and deeply the evolving nature of banking business due to social media, digital banking and other technological developments, and their implications for financial stability.

Now let me finish with a regular disclaimer. All the views and opinions expressed here are my own and not attributable to JFSA. Thank you very much for your attention.

Kristin Johnson

Commissioner, Commodity Futures Trading Commission

Speech

Hello. Good evening. I want to thank David and Didier and the professional staff at Eurofi for inviting me to join you today. I also have to say that the views I will share today are my own. They do not reflect the views of the other CFTC Commissioners or the CFTC Commission staff.

Events over the last several years 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 – the onset of the COVID-19 pandemic – monetary and fiscal policies endeavour to effectively address a confluence of 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, further exacerbated many of these issues, creating further price volatility affecting key markets that we oversee and simultaneously impacting trading volumes on global platforms.

During this same period, we have witnessed the continuing development and adoption of innovative technologies. This includes an explosive growth in the integration of artificial intelligence, marked by expanding use cases for supervised and unsupervised machine learning, natural language processing, neural networks, the conceptualisation of web 3.0, a decentralised technological application that enables peer-to-peer engagement and empowers content generators not only to read and write but to also own their contributions to the internet. Coders are carefully developing public and private-permissioned and permissionless internet-based architecture. Integrating cloud computing is an increasingly important conversation among market participants as well as financial market and prudential regulators. Increasingly, quantum computing appears less like science fiction.

Over the last decade, a growing number of digital start-ups launched an impressive bid to disrupt one of the most exclusive sectors of the economy. Armed with a nascent technology that harvests vast quantities of data and algorithmic platforms capable of interpreting the data, a host of insurgent developers have revived historic debates regarding the architectural design and regulatory framework of the financial markets industry. Leveraging successful disruptions in payments systems and securities markets, a cadre of start-up financial services firms or fintech firms and storied, legacy financial institutions have engaged in notable competition.

Two weeks ago, I had the opportunity to travel to Kenya to meet with the Governor of the Central Bank, the Chief Executive Officer (CEO) of the Nairobi Securities Exchange, and the CEO and President of MPESA.

For those who are not familiar, M-Pesa is a mobile money services platform. MPESA's story illustrates the promise of innovation and the potential of innovation to achieve financial inclusion. Launched in 2007 by Vodafone and Safaricom, M-Pesa is the largest mobile network operator in Kenya. Today, M-Pesa hosts 51 million customers and facilitates over $315 billion in transactions per year. M-Pesa allows users to deposit money into an account, store it on their cell phones, send balances using PINs secured by SMS text messages to other users, and enables buyers and sellers of goods and services to redeem and access purchases. Users are charged a small fee for sending and withdrawing money using the platform. M-Pesa represents the potential to develop platforms that give customers access to banking services, reduce transaction costs, and otherwise overcome the endemic frictions that have challenged access to financial services for millions.

As fintech payment and investment platforms proliferate, we are witnessing a shift in a demographic interested in engaging with financial markets. I noted earlier on our panel that markets have witnessed an uptick in retail market participation. While the class of retail market participants should not be viewed as a monolith, it should be presumed that foundational protections long-established to protect institutional investors, and to safeguard market integrity more broadly, are very much needed when retail investors enter markets.

Careful study of crypto market crises and recent events reveals important observations regarding two classes of market participants. A recent Bank of International Settlements study carefully evaluating losses during the crypto crisis illustrates that market participants who invested small amounts of capital in crypto spot markets, typically buying a fraction of a cryptocurrency coin or token, often purchased during periods when prices were the highest and when sophisticated investors were selling off. According to the study, one might describe the sophisticated investors, those who own one to 1,000 crypto units, as whales, and the retail investors as krill. The authors observed that when the seas are stormy, the whales eat the krill. Further, the study details increased retail market participation or exposure as even more pronounced in emerging economies, such as Brazil, India, Pakistan, Thailand and Turkey.

Beyond retail customers engaged in spot market transactions, it is also important to recognize a point of inflection in the engagement of certain institutional investors in crypto markets Immediately after FTX's collapse, two Canadian pension funds acknowledged their investments in FTX affiliates. In 2019, the Ontario Teachers' Pension Plan (OTPP) launched the Teachers' Venture Growth Platform. In October of 2021, the Ontario Teachers' Pension Plan invested $75 million in FTX International and its US entities. Later, the Ontario Teachers' Pension Fund doubled down on that investment, adding another $20 million into FTX US. On 11 November 2022, when FTX filed for bankruptcy, the Ontario Teachers' Pension Fund had to write down the Fund's investment of $95 million zero dollars.

Similarly, Caisse de dépôt et placement du Québec (CDPQ) experienced significant losses on its investment in Celsius Network. CDPQ had invested $150 million in crypto lending platform Celsius Network.

At the CFTC, I have raised alarms and called for the Commission to carefully and thoughtfully engage our fellow market regulators in a collaborative process to build a cryptomarkets regulatory framework. I am also mindful that a number of initiatives have been launched here in Europe, also in the UK and in the United States to begin to bring order to this market. A number of initiatives seek to outline a regulatory reform. As the panels today have described in great detail, detail that I will not repeat here, MiCA and the trilogue process of the European Commission, Council, and Parliament appears to be moving rapidly in the direction of implementing a regulatory design. The FSB has initiated work on a framework. IOSCO launched workstreams on crypto assets and DeFi. CPMI IOSCO published guidance on the application of principles of financial markets infrastructure to stablecoins. In the UK, the Financial Services and Markets Bill is on track to make progress.

I would argue that in many ways, the macroeconomic challenges in financial markets have demonstrated the effectiveness of post-financial crisis reforms designed to enhance governance, (specifically risk management policies and in particular, with regard to systemically important intermediaries). These reforms have minimised single points of failures. They have strengthened resilience by requiring appropriate allocation of financial reserves and other default-centred reforms. Perhaps most importantly, the post-financial crisis reforms have encouraged cooperative regulatory responses that are global in nature. I believe that the governance risk management recovery and resilience reforms that we have adopted in the wake of the post-financial crisis offer a pathway for understanding the critical components that we must include in any crypto asset regulation.

Today, I would like to take just a couple of minutes to talk about the importance of adopting, implementing and enforcing risk management governance reforms. Specifically, in talking to the Commission, in meeting with Congress, in meeting with industry participants, traditional financial market industry participants and crypto market industry participants as well, I have specifically suggested that each crypto asset intermediary would benefit by adopting well-established risk management practices. These include internal risk governance practices that have long been part of traditional financial market businesses. Firms should begin to assess compliance with these principles and inculcate a culture of compliance. I would further posit that the industry would benefit from a robust dialogue that advances a set of blue-ribbon risk management principles. This is critical because, in the context of the crypto crises and contagion, we saw that counter party risk is present in every market for all asset classes. It is not unique to traditional financial markets and crypto markets are not exempt from being exposed.

Finally, in the absence of imminent final legislation that articulates a regulatory framework — I am hopeful that historic commitments to harmonisation and coordination in developing and adopting international regulatory standards, equivalency determinations and cooperation in enforcement will continue to serve as guiding principles for the international regulatory community.

I am hopeful that through dialogues here today, tomorrow and Friday, and ongoing conversations with many of you, I can help to refine, enhance and make progress on many of the rules that we are considering at the CFTC and more broadly across financial market regulators in the United States. Thank you so much for giving me your time and attention today. Thanks so much for being here. I really am grateful. Thanks so much.

Hester M. Peirce

Commissioner, U.S. Securities and Exchange Commission

Tow Truck Taxonomies: Remarks before Eurofi

Thank you for the chance to address you this morning. I particularly appreciate your welcoming me to address environmental, social, andgovernance ("ESG") issues despite my heterodox – some might say heretical – views. You will be happy to know, therefore, that I speak only for myself, and not necessarily for the US Securities and Exchange Commission ("SEC") or my fellow commissioners.

Let me state those views briefly. First, I am concerned that ESG standards, intentionally or not, drive private capital to uses that check the right officially sanctioned ESG box, not where it will best meet human needs and solve societal problems. Second, ESG rulemaking, by concentrating capital in favored assets, could become a source of systemic instability. The third concern, which exacerbates the first two, is the considerable international pressure to converge on a single set of ESG standards. If every jurisdiction directs capital using a single set of standards, poor choices will reverberate through the global economy.

ESG is an ambiguous term, the depths of which I do not have time to plumb.[1] Companies, asset managers, and investors always have considered a wide range of factors in deciding how to spend or invest their money. Some of those factors might today get an ESG label, but we do not need ESG-specific standards to serve investors' needs; materiality-based disclosure standards already do this.

Today's ESG-specific standards too often have a different purpose. These standards cannot help but direct the allocation of private capital, especially when they are combined with sustainable finance initiatives designed to encourage financing of favored activities and the defunding of disfavored activities.[2] Indeed, they appear intended to do exactly this: to direct private capital flows. As such, they are meant not primarily to serve investors' needs but rather to direct the allocation of private capital to further government ends. This objective, and not concerns about consistency or comparability, is what distinguishes voluntary ESG standards, which have been around for many years, from the mandatory standards that we are increasingly rushing to adopt. The parallel, though not identical, standards the United States,[3]the European Union,[4] and the International Sustainability Standards Board ("ISSB")[5] are developing are more ambitious, complicated, and costly than anything we have seen before in the corporate reporting realm.

This commandeering of private capital in the name of ESG causes me grave concerns. To illustrate why I think this sustainability-themed centralized allocation of capital is a bad development, let me tell you a story.

Several months ago, I found myself waiting for a long time by the side of the road for a tow truck. A first tow truck arrived relatively early in the evening, but the driver, mumbling that "This job is impossible!" drove off after looking at the car's severely damaged wheel. Many hours later, after a dark chill had set in, a second truck arrived. This driver pulled up, got out, and quickly and without saying much, assessed the situation. He then calmly set to work by the light of his cellphone. With remarkable skill, alacrity, and precision, he removed the wheel of the car, inspected the considerable extent of the damage, provided an estimate for its repair, lifted the car, and gradually and methodically worked it onto the back of his truck. He was an expert doing a difficult job in uncomfortable circumstances with confidence, meticulousness, and ease. After about fifteen minutes, he was on his way with the car in tow. The driver's skill, deep knowledge of his craft – a knowledge that involved so many disciplines such as math, physics, mechanical skill, technical ability, a bit of psychology, and spatial relations – is a miracle that repeats itself billions of times each day; each person possesses a unique set of talents, interests, skills, and experiences.[6]

Why am I going on about tow-truck drivers? That incident helped me to put my finger on my concerns around current ESG standard-setting efforts. First, that encounter renewed my appreciation for the depth and diversity of human activity and correspondingly underscored the futility of the technocratic effort to use elaborate ESG disclosure standards and taxonomies to classify the full range of human economic activity in an effort to reroute capital to human activities that we regulators favor.

It may sound like I am exaggerating the scope required to make these disclosure standards work, but let us be clear about this: This effort – if undertaken to starve unsustainable activities of capital and flood sustainable activities with capital – necessarily entails understanding and classifying all of economic activity in terms of its effect on an increasing number of complex, sometimes mutually contradictory, metrics. This task is impossible. Even brilliant people in tidy conference rooms far removed from the nitty-gritty complexity of the world (or these days behind screens in their cozy living rooms) cannot accurately label swathes of human activity as categorically positive or negative. Collecting bushels of data to measure the unmeasurable and quantify the unquantifiable is an unreliable basis for deciding where to send capital, even if all these data create the illusion that we understand the world and how humans live and work in it.

As little as standard setters can hope to know about the world as it currently exists, the future remains an even greater enigma. Yes, scientists can help regulators estimate how the climate is changing, technologists can help regulators predict which solutions for mitigating and adapting to these changes look most promising, and economists can advise about the viability of those solutions. But nobody – not even the most capable regulators advised by the most qualified experts – can prophesy where, when, and how the most important innovations will arise. A regulator trying today to drive capital flows toward green technologies might be doing the opposite inadvertently.[7] Solutions to our greatest problems will come – in ways we could never have imagined – from people, many of whom are just now being born and educated. In a fully taxonomized world would these people with truly original ideas be able to access capital? Inflexible taxonomies, updated through the slow political process, are static solutions to dynamic problems like food insecurity, water shortages, educational needs, air pollution, access to medical care, climate change, and many other problems we have not yet seen. A principles-based regulatory framework designed to elicit financially material information about companies will not guarantee that these innovators are funded, but it will not foreclose their access to capital by prejudging the who, what, where, and when of innovation.

Second, ESG taxonomies, built on misplaced confidence in how accurately they capture reality, and the sustainable finance behemoth resting on top of these taxonomies will concentrate capital in ways that could create systemic instability. Past financial crises have taught us that regulatory inducements to invest in particular sectors or in particular ways can harm investors, financial institutions, the financial system, and the broader economy. Leading up to the great financial crisis, for example, policies designed to favor certain asset classes injected dangerous instability into the financial system.[8] As unique as each person is, humans nevertheless sometimes behave like sheep[9] and follow others uncritically into investing fads. Government regulation can exacerbate these trends by distorting incentives.

Moving capital to government-designated sustainable activities could create a green bubble within the financial system as investors pour money uncritically into green assets, as defined in the relevant taxonomy. We already see tell-tale signs of a problem: investors are complaining about the lack of investable assets, and, as we have seen many times before, the search for investable assets may cause them to forgo standard risk management precautions. Asset bubbles always pop, no matter how noble the intentions of those who established the incentives that helped create them. We have no reason to expect that the distorted incentives created by ESG disclosure standards and related policies will produce a different result. And because the herding that created the bubble also likely will lead to the underfunding of activities that could produce real change but that do not fit within our taxonomies, the messy economic aftermath may not even be softened by the consolation that these standards brought us closer to solutions to any of the problems these taxonomies were designed to address.

We could mitigate the risk created by fallible regulators and herd-prone investors by allowing for diversity across jurisdictions. But increasing calls for regulatory convergence threaten diversity in ESG standards, which brings me to my third concern. While I appreciate the difficulty companies and investors face with multiple competing standards, we need to be more specific about what we mean by convergence. If convergence allows for mutual recognition of different approaches – including a US approach to ESG disclosures truly rooted in financial materiality – then it would be a positive development. For example, the world has managed to operate with multiple sets of accounting standards.

If, by contrast, convergence means that every jurisdiction has to implement substantially identical standards, then convergence raises several serious concerns. First, if all jurisdictions use the same standard, the distortion of private capital flows will be more pronounced. Any problems in the taxonomy – favoring harmful activities or disfavoring socially useful activities – will reverberate through the whole world, rather than being confined to a particular jurisdiction. Second, and related, if my systemic concerns are well-founded, a consistent set of ESG standards could exacerbate them by creating a global asset bubble. Third, as the tow-truck driver reminds us, regulators will have a difficult time writing standards that apply equally well everywhere. Global standards could miss important nuances about the physical, legal, social, and cultural environment in which an activity occurs. Finally, achieving convergence by applying standards extraterritorially, would undermine national sovereignty and the rule of law. A jurisdiction that has a set of procedures for adopting new disclosure standards cannot simply delegate the task to a supra-national body, such as the ISSB,[10] or another jurisdiction, such as the EU.[11]

I shared with you the wonder that I have when I see human talent in action. I also am awed by the talent of the people in this room who are devising and implementing complex sustainability regulatory frameworks – the sheer ambition of the projects you are undertaking, your passionate devotion, and your deep knowledge are impressive. But I fear the impossible scale and scope of your undertaking. I do not believe even the most talented taxonomist could capture the full range of skills a tow-truck driver might bring to bear on any particular accident he might encounter where I live in the Washington, DC area. But even if you could, imagine the sheer complexity of attempting to generate a taxonomy of skills that would be accurate for every tow truck driver operating across the globe, from the icy roads of northern Canada to the deserts of North Africa to the rain forests of Southeast Asia. Even an accomplished taxonomist would be humbled by this task and would have to confront the reality that producing a taxonomy for this one profession that was actually useful – and not so general as to be utterly useless – would require years of fieldwork and analysis. Now imagine the same undertaking for every economic activity in every jurisdiction and in every form that it takes place. We do not – and cannot no matter how hard we try – know it all. Thank you for your time this morning.

---

1. For an interesting and nuanced discussion of ESG,seeAlex Edmans, Applying Economics – Not Gut Feel – To ESG (Mar. 16, 2023), https://ssrn.com/abstract=4346646.

2. See, e.g.,See Regulation (EU) 2020/852 of the European Parliament and of the Council of 18 June 2020 on the establishment of a framework to facilitate sustainable investment, and amending Regulation (EU) 2019/2088 at para. 16, https://eur-lex.europa.eu/legal-content/EN/TXT/?uri=CELEX:32020R0852 (hereinafter, "Regulation (EU) 2020/852") ("A classification of environmentally sustainable economic activities at Union level should enable the development of future Union policies in support of sustainable finance, including Union-wide standards for environmentally sustainable financial products and the eventual establishment of labels that formally recognise compliance with those standards across the Union."). The EU's taxonomy feeds into the design of green bonds and similar products, the classification of investment funds, and the calculation of financial firms' Green Asset Ratios. See, e.g.,Sanne Wass, Bank disclosures reveal limitations of green asset ratio as a comparable metric, S&P Global Market Intelligence (Jun. 8, 2022), https://www.spglobal.com/marketintelligence/en/news-insights/latest-news-headlines/bank-disclosures-reveal-limitations-of-green-asset-ratio-as-a-comparable-metric-70544636("The European Banking Authority will require around 150 lenders to publish a so-called green asset ratio, or GAR, from 2024. The ratio is slated as a comparable and harmonized metric showing environmentally sustainable assets as a percentage of lenders' banking books. Banks will follow a common classification system, the EU's taxonomy, to define a 'green' asset."). The EU explained that a "common language and a clear definition of what is 'sustainable' is needed . . . to meet the EU's climate and energy targets for 2030 and reach the objectives of the European green deal, [for which] it is vital that we direct investments towards sustainable projects and activities."European Commission, EU taxonomy for sustainable activities, https://finance.ec.europa.eu/sustainable-finance/tools-and-standards/eu-taxonomy-sustainable-activities_en (last visited, Apr. 27, 2023). Sustainable finance lowers the capital costs for activities favored by the government and likely raises capital costs for disfavored activities.See, e.g.,Council of the EU, Sustainable finance: Provisional agreement reached on European green bonds (Feb. 23, 2023), https://www.consilium.europa.eu/en/press/press-releases/2023/02/28/sustainable-finance-provisional-agreement-reached-on-european-green-bonds/ ("Under the provisional agreement, all proceeds of [EU green bonds] will need to be invested in economic activities that are aligned with the EU taxonomy, provided the sectors concerned are already covered by it. For those sectors not yet covered by the EU taxonomy and for certain very specific activities there will be a flexibility pocket of 15%. This is to ensure the usability of the European green bond standard from the start of its existence. The use and the need for this flexibility pocket will be re-evaluated as Europe's transition towards climate neutrality progresses and with the ever increasing number of attractive and green investment opportunities that are expected to become available in the coming years."). Whether sustainable finance will change behavior as hoped is unclear.See, e.g.,Jitendra Aswani and Shivaram Rajgopal, Rethinking the Value and Emission Implications of Green Bonds at 6 (Sept. 11, 2022), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=4215882 (finding that although emissions fall in the first year after issuance of green bonds, "when that time window is expanded, emissions of green bond issuers do not fall after four years following the issuance.").

3. In the United States, a little over a year ago, the SEC proposed to require public companies to disclose, among other things, their climate-related risks, the governance of those risks, granular greenhouse gas emissions, a number of climate-related financial statement metrics, any climate-related targets and goals, and any transition plan.See The Enhancement and Standardization of Climate-Related Disclosures for Investors87 FR 21334 (Apr. 11, 2022),https://www.federalregister.gov/*documents/2022/04/11/2022-06342/the-enhancement-and-standardization-of-climate-related-disclosures-for-investors. Congress did not authorize the SEC to direct capital flows, but the SEC's climate proposal would likely have that effect. It departs repeatedly from a common understanding of financial materiality, and its unusual granularity will serve as a checklist for companies, which will dull their creativity as they respond to regulatory cues, rather than market cues.*

4. For a description of the European "action plan on financing sustainable growth," see European Commission, Renewed sustainable finance strategy and implementation of the action plan on financing sustainable growth, https://finance.ec.europa.eu/publications/renewed-sustainable-finance-strategy-and-implementation-action-plan-financing-sustainable-growth_en (last visited Apr. 27, 2023). The Europe Union ("EU"), as part of the European Green Deal to reach carbon neutrality by 2050, has taken a number of steps. Pursuant to its Corporate Sustainability Reporting Directive, the European Financial Standards Advisory Group developed twelve European Sustainability Reporting Standards ("ESRS") for adoption by the European Commission. See European Commission, Corporate sustainability reporting, https://finance.ec.europa.eu/capital-markets-union-and-financial-markets/company-reporting-and-auditing/company-reporting/corporate-sustainability-reporting_en (last visited, Apr. 27, 2023) ("On 5 January 2023, the Corporate Sustainability Reporting Directive (CSRD) entered into force. This new directive modernises and strengthens the rules concerning the social and environmental information that companies have to report. A broader set of large companies, as well as listed SMEs, will now be required to report on sustainability – approximately 50 000 companies in total."); European Financial Reporting Advisory Group, Draft European Sustainability Reporting Standards: Cover Letter (Nov. 22, 2022), https://www.efrag.org/Assets/d?assetUrl=%2Fsites%2Fwebpublishing%2FSiteAssets%2F01%2520EFRAG%2527s%2520Cover%2520Letter%2520to%2520the%2520first%2520set%2520of%2520ESRS%252022%2520November%25202022.pdf. These standards, which cover a range of topics from climate to biodiversity to workforce, are more expansive and apply more broadly than the Non-Financial Reporting Directive they replace. In addition, the EU is developing a taxonomy to classify environmentally sustainable economic activities.See Regulation (EU) 2020/852 at para. 6 ("In its communication of 8 March 2018, the Commission published its action plan on financing sustainable growth, launching an ambitious and comprehensive strategy on sustainable finance. One of the objectives set out in that action plan is to reorient capital flows towards sustainable investment in order to achieve sustainable and inclusive growth. The establishment of a unified classification system for sustainable activities is the most important and urgent action envisaged by the action plan. The action plan recognises that the shift of capital flows towards more sustainable activities has to be underpinned by a shared, holistic understanding of the environmental sustainability of activities and investments. As a first step, clear guidance on activities that qualify as contributing to environmental

objectives would help inform investors about the investments that fund environmentally sustainable economic activities. Further guidance on activities that contribute to other sustainability objectives, including social objectives, might be developed at a later stage."). For an overview of the taxonomy,see Frequently Asked Questions about the work of the European Commission and the Technical Expert Group on Sustainable Finance on EU Taxonomy & EU Green Bond Standard, https://finance.ec.europa.eu/system/files/2021-01/200610-sustainable-finance-teg-taxonomy-green-bond-standard-faq_en.pdf (last visited, Apr. 27, 2023); see also Nigel Howorth, et al., EU Finalises Sustainable Finance Taxonomy: New Obligations for Financial Market Participants and Large Public-Interest Entities, Clifford Chance (Jan. 2020), https://www.cliffordchance.com/content/dam/cliffordchance/briefings/2020/01/eu-finalises-sustainable-finance-taxonomy.pdf; Vanessa Havard-Williams, EU Taxonomy Regulation: what does it do and what happens next? Linklaters (Sept. 22, 2020), https://sustainablefutures.linklaters.com/post/102h1rz/eu-taxonomy-regulation-what-does-it-do-and-what-happens-next. Environmentally sustainable economic activities are activities that "make a substantial contribution to at least one of the EU's climate and environmental objectives, while at the same time not significantly harming any of these objectives and meeting minimum safeguards." European Commission, EU Taxonomy Navigator, https://ec.europa.eu/sustainable-finance-taxonomy/ (last visited Apr. 27, 2023). The double materiality approach that is embedded within the EU standards is intended "to provide a long-term incentive to direct financial flows towards environmentally sustainable activities."Frédéric Louis et al., One More Step Towards Sustainable Finance in the European Union, WilmerHale (Dec. 17, 2021), https://www.wilmerhale.com/insights/client-alerts/20211217-one-more-step-towards-sustainable-finance-in-the-european-union. See also European Commission, Sustainable finance: Political agreement on Corporate Sustainability Reporting Directive will improve the way firms report sustainability information (Jul. 26, 2022), https://ec.europa.eu/newsroom/fisma/items/754701/en ("The CSRD incorporates the concept of 'double materiality'. This means that companies have to report not only on how sustainability issues might create financial risks for the company (financial materiality), but also on the company's own impacts on people and the environment (impact materiality).").

5. The International Sustainability Standards Board ("ISSB") has prepared two sustainability standards which will soon be ready for adoption by jurisdictions across the world, including a standard focused on climate. See IFRS, Climate-related disclosures, https://www.ifrs.org/projects/work-plan/climate-related-disclosures/ (last visited, Apr. 27, 2023) and IFRS, General Sustainability-related Disclosures, https://www.ifrs.org/projects/work-plan/general-sustainability-related-disclosures/ (last visited, Apr. 27, 2023). The ISSB has taken a granular approach that wanders from traditional conceptions of materiality.

6. For additional examples of skill, talent, and expertise, see Mike Rowe, Dirty Jobs, https://mikerowe.com/videos/dirty-jobs/ (last visited Apr. 27, 2023); see also Greg Morabito, 'Chef's Table' Recap: Magnus Nilsson Created a New Cuisine by Embracing His Homeland (Sept. 28, 2018), https://www.eater.com/2018/9/28/17267784/chefs-table-magnus-nilsson-recap-season-1-episode-6.

7. Innovation, for example, coming out of industries that do not qualify as green may be key in carbon reduction. See, e.g., S&P Global, ESG Insider Podcast (Mar. 17, 2023), https://www.spglobal.com/esg/podcasts/on-the-ground-at-ceraweek-where-the-energy-world-stands-on-the-low-carbon-transition (David Victor, professor of innovation and public policy at the School of Global Policy and Strategy at UC San Diego in California explained that the oil-and-gas companies "that went off and did the obvious things . . . solar and wind, they're frankly scaling back those plans because those plans don't generate the kinds of returns and don't rely on the kinds of risk management, chemical engineering skills that these firms are really good at doing and petroleum engineering skills. And so what we're seeing is more companies trying to figure out what are we going to do on hydrogen. It's potentially an area where they have a lot of skills. What are we going to do with the carbon capture and storage, downhole activities? It's another area where they have potentially large skills.").

8. See, e.g., Stephen Matteo Miller, The Recourse Rule: How Regulatory Capture Gave Rise to the Financial Crisis, Mercatus Center (Jan. 15, 2019), https://www.mercatus.org/research/policy-briefs/recourse-rule-how-regulatory-capture-gave-rise-financial-crisis ("Well-intentioned regulations can have harmful unintended consequences. The 2007–2009 financial crisis revealed such a possibility for a particular regulation: the so-called Recourse Rule. After that rule reduced bank capital requirements for a narrow class of financial products, including those at the heart of the crisis, some bank holding companies (BHCs)—the legal structure within which many banks operate—increased their holdings of those financial products. The result was damaging to the BHCs that exposed themselves.").

9. No offense to Shaun the Sustainable Sheep intended.See European Commission, Sustainable Shaun online game https://ec.europa.eu/environment/sustainableshaun/game_en.htm (last visited, Apr. 27, 2023).

10. The ISSB, with the assistance of IOSCO and other allies, is conducting a campaign for widespread adoption of its standards.

11. The EU has adopted a framework that would apply to many companies and company activities outside of the EU. Even companies that do not directly serve European customers may be part of a European company's value chain or a European asset manager's portfolio, which would require them to collect the data required by European standards. The EU could exercise mutual recognition based on financially material standards in other jurisdictions to address this concern.The EU's Sustainability Reporting Standards, which will apply to European subsidiaries and, after several years, to their parent companies outside the EU. Europe has taken an aggressively extraterritorial approach in applying its European Sustainability Reporting Standards, which will apply to European subsidiaries and, after several years, to their parent companies outside the EU. See, e.g, EY, Think ESG: a view of the EU Taxonomy – The Better Finance Podcast, (Feb. 20, 2023), https://podcasts.apple.com/us/podcast/think-esg-a-view-of-the-eu-taxonomy/id1251517753?i=1000600690038 (discussing magnitude of the effects on US companies); Paul Kiernan, SEC Climate Rules Could Decide Whether U.S. Firms Face Tough EU Law, Wall Street Journal (Apr. 26, 2023), https://www.wsj.com/articles/sec-climate-rules-could-decide-whether-u-s-companies-face-tough-eu-law-6ccd4c83 ("More than 3,000 U.S. companies are expected to have to gather and disclose data on their greenhouse-gas emissions and those of their suppliers and customers under a European Union law passed in 2022."); Sarah Katz and Torben Kulasingam, Here's how the EU Taxonomy could influence US businesses, Ramboll (May 11, 2022), https://ramboll.com/ingenuity/heres-how-the-eu-taxonomy-could-influence-us-businesses ("A new research partnership . . . recently evaluated the extent to which large US financial institutions and real estate firms are prepared to comply with [the EU's] ambitious sustainable reporting requirements. The main takeaway . . . is that these firms need more and better data to assess whether their assets meet the definition of sustainability, as outlined by the EU Taxonomy."); Andy Marks, New EU Sustainability Reporting Rules: How Impacted US Companies Can Prepare, WSJ Pro (Feb. 1, 2023), https://deloitte.wsj.com/articles/new-eu-sustainability-reporting-rules-how-impacted-us-companies-can-prepare-01675110236?st=mlnfb14is7jr83b&reflink=desktopwebshare_permalink ("The new sustainability reporting requirements will affect not only EU-based companies, but all companies with significant operations in EU jurisdictions, including U.S.-based companies with as little as one subsidiary or branch in the European Union."); Emma Bichet, Jack Eastwood, and Michael Mencher, EU's New ESG Reporting Rules Will Apply to Many US Issuers, Harvard Law Forum on Corporate Governance, https://corpgov.law.harvard.edu/2022/11/23/eus-new-esg-reporting-rules-will-apply-to-many-us-issuers/ ("New environmental, social and governance (ESG) reporting requirements in the European Union and the US are set to fundamentally change the nonfinancial reporting landscape. The new EU rules will require ESG reporting on a level never seen before, and will capture a whole host of companies that previously were not subject to mandatory nonfinancial reporting requirements, including public and private non-EU companies that meet certain EU-presence thresholds. For US issuers, the new EU rules will result in mandatory reporting on a broader set of ESG topics than those required under current and proposed Securities and Exchange Commission (SEC) rules.").

Jean-Paul Servais

Chair, IOSCO Board and Chairman, FSMA

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

Key IOSCO priorities 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.

Priorities and actions to mitigate greenwashing and protect investors

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.

Crypto-assets, stablecoin and DeFi

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 cryptoassets, 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.

Carmine Di Noia

Director for Financial and Enterprise Affairs,
Organisation for Economic Cooperation and Development

The challenges and role for EU capital markets in the context of the green and digital transitions

Let me start by thanking Eurofi, Jacques, Didier, and especially David, for this invitation. Thanks also for what all of you have done to improve EU capital markets, and also for the terrific discussions we have had throughout the years in our different roles.

In the spirit of unity, let me begin my remarks today with a statement we can all agree on. The European Union needs to grow its capital markets.

That statement begs at least two big questions, and on these there may be less agreement. Firstly, how should we grow EU capital markets? And secondly, why have they not grown more already? The coming three days will be packed, as usual, with very interesting discussions between experts, regulators and market participants seeking to address these questions through the lens of specific areas within EU capital market policy. This is incredibly valuable – successful financial systems are not built solely on overarching ambitions, but through a multitude of small technical successes. Overcoming barriers on everything from clearing systems and sustainability disclosure to retail investment and insolvency regimes, is naturally important to capital market development. Well functioning capital markets require a sound and logical institutional architecture, appropriate regulation and robust supervision. But since I have been given the honour of saying a few opening remarks this morning, let me pose a more general, and possibly more controversial, barrier to EU capital market development.

Capital markets like growth, and the EU does not have enough of it. Since 2008 the EU economy has grown at a pedestrian pace of just above 1% per year. That means it is about 15% bigger today than at the onset of the global financial crisis. For comparison, the US economy grew by about 28% during the same period. Out of the world's twenty most valuable technology companies, only two are listed in the EU. Fifteen are in the US and the remaining three are in Asia.

This relative lack of economic growth is not exactly an engine for growing capital markets, and we should recognise that. Admittedly, the direction of causality is not clear cut here. For example, the reason the US has grown more than Europe may well be, in part, because of its much stronger capital markets. But while it is surely true that good ideas go where there is money to finance them, money also follows good ideas and growth, to paraphrase Joan Robinson. Therefore, the growth of capital markets and real economies go hand in hand.

The case for larger and more developed capital markets, then, is clear. Financialisaton is not an end in itself. Rather, capital markets are important because they are well suited to financing long term uncertain ventures, and mobilising such funds is more important than ever.

For example, the EU's ambition of less resource intensive and more sustainable growth will necessarily require enormous investments in nascent technologies. As you know, the European Commission's own estimate is that annual investment needs to increase by €645 billion annually over the next decade compared to the previous one in order to realise the green and digital transitions. For reference, that is an annual increase larger than the total Swedish GDP.
And do not forget that another project which will require massive investment is the reconstruction of Ukraine.

Clearly, amounts of this magnitude necessitate a mobilisation of private capital, which is most effectively done through capital markets.
We know this from previous large scale transitions in history, like the expansion of railway and telecommunication networks. EU capital markets are not currently offering this mobilisation to the extent that the transition and the size of its economy demand.
This is visible in a range of capital markets indicators: for initial public offerings, secondary public offerings, stock market capitalisation and corporate bond issuance, the EU's share in the global total is smaller than its GDP share. Policymaking should proceed with this in mind.

The second thing we should keep in mind is that capital markets are global, and it is this global flow of capital which has enabled resources to be put to productive use on a historically unprecedented scale, to the benefit of people all over the world. Simply, the global economy depends on the effective functioning of capital markets.

This has real word impacts. For example, we see it in action in the development of clean technology and new medicines. It is imperative to our continued prosperity that we maintain this global functioning.

This global coherence is an important aspect to consider when designing regional policies. Currently, around 10% of the world's market capitalisation is on EU exchanges. It is good to have an ambitious agenda for regulation of local markets, but when 90% of global public equity sits outside the EU, it is neither realistic nor desirable for European regulation to be unaligned with the rest of the world. It is important to have leaders, but to be a leader you need to have followers.

A fragmentation of global capital market regulation would result in inefficiencies and cost increases for companies seeking to raise capital. This is true not just for firms operating in multiple jurisdictions, but also for small and medium sized companies which will have less financing available to invest and grow. Capital markets must work for all – governments, citizens, and businesses of all sizes.

Fragmentation also runs the risk of lowering diversification on the EU investor side, exacerbating the impact of local downturns on the stability of the financial system and the economy. Different rules and standards would also increase opacity in the markets at a time when global challenges like climate change more than ever require transparency and accurate pricing, including of externalities.

Ultimately, global problems cannot be solved locally.

Instead, policymaking must proceed based on a platform of global consensus to the extent possible. A well functioning world economy is one guided by common principles and shared values. That includes capital markets. At the OECD that is our guiding principle and the basis from which we proceed to develop our international standards.

The G20/OECD Principles of Corporate Governance – which is also one of the Financial Stability Board's (FSB) Key Standards for Sound Financial Systems – and the G20/OECD High Level Principles on Financial Consumer Protection are two important examples of international standards including not just OECD countries, but also heavyweight emerging markets like China and India. Promoting international standards does not mean relying on a one-size-fits-all approach, but rather ensuring that there is a baseline on which there is broad agreement, which can then be adjusted according to national circumstances.

These are the two main messages I would like to leave you with today. Capital seeks growth opportunities, and it moves globally. These two general facts should guide and feed into our more technical discussions over the course of the next three days, but also in policy debates in Brussels, Paris and individual member states.

Finally, let me finish by saying that there is reason to be optimistic. The EU has steered clear of a systemic financial crisis, even in the face of significant stress tests like the pandemic, the ongoing war in Ukraine and the recent banking turmoil. The European Union has set out an ambitious and sensible strategy for its capital market development, and progress is being made on implementing it. As David was reminding us, at the same time the Capital Markets Union urgently needs to be accelerated in the short timeframe before the institutional break due to the renewal of EU institutions. We should not wait for the next financial crisis to advance the CMU agenda. Through our capital market reviews at the OECD, we are supporting the EU and its member states on all sides of capital markets developments; supply, demand and the institutional framework.

In the end, perhaps the greatest reason for optimism is the amount of brain power that is going into boosting EU capital markets, and Eurofi is an excellent example. In other words, we are in capable hands. With those words, I thank you very much for your attention. I wish you all a productive conference, as usual, and I am very much looking forward to following the discussions in the coming days. Thank you.

Axel A. Weber

President, Center for Financial Studies

Concluding Remarks

Thank you, Didier. I am very conscious that I am not just standing between you and lunch, but also between you and your flights, so I will be brief.

First of all, I really want to thank Didier and David, and in particular Jacques, for continuously putting together these meetings of market participants with policymakers on the side line of the informal meetings of finance ministers and governors. I was on both sides of these tables in my professional live. When I was a governor, I always found it very useful to have the exchange with the market participants on the side line of these events. I think the informal Ecofin Council was a very important invention at the time when it started, because it allowed governors and ministers to talk about more fundamental issues without the pressure of taking a decision or having a press conference. It really was a brainstorming session and I vividly remember, both during the financial crisis and also before, that these were actually the events where everyone got to know each other better.

Knowing each other well in good times is a key ingredient to working together well in difficult times. I do remember that both the informal Ecofin meeting itself, but in particular also the ability of the private sector to exchange views with the official sector in a closed-door environment like this, was very useful. It was useful for me in the public sector, but it was even more useful for me in the private sector. Running a global bank in Switzerland – and I was Chairman of the Board of Directors of UBS for ten years – required regular access to European policymakers and regulators, who often look at Switzerland as that small point on the European map where the Europeans usually put the European flag or the Euro coin when they show the EU or the euro area, so you do not see this red spot with a white cross that is not part of the European Union, nor part of the monetary union, nor in my experience – over the 10 years I have lived there – has any desire to to joining the Union or adopting the Euro.

I moved back from Switzerland to Germany and the European Union in the month I left my job at UBS. I lived in Switzerland to work for UBS. I did not work for UBS to live in Switzerland. There is a subtle nuance between these two statements. I'm a true European. I believe that a united Europe has a great future. When I look at where we stand, having been 10 years outside the European Union, there is a lot of potential that Europe still needs to deliver on and can deliver on.

If I just look at the current problems, I must say I find it surprising that we are back in a financial crisis. And all the relevant and important good regulatory and supervisory progress we made over the last decade appears to have had little impact. Mark Twain once famously said, that 'history never repeats, but it rhymes.' The current situation rhymes with the situation more than a decade ago when I left the EU for Switzerland. Back then Switzerland had stepped in to rescue UBS. With all the new rules and regulations of capital, liquidity, governance, resolution and stress testing I was pretty sure that global banks today were in a much better place. But then Silicon Valley Bank, Silvergate Bank and Signature Bank happened in the United States and Credit Suisse had to be rescued in Switzerland. And all of that new banking stress has happened in spite of all the good work that has been done by banks, regulators, supervisors and policymakers over the past decade, which has put global financial institutions on a much sounder footing.

I can definitely assure you that UBS today is much more stable and financially sound than a decade ago. I recently had several interactions with Swiss authorities who told me that 'the UBS of ten years ago could not have played the vital role it took on in rescuing Credit Suisse.' One of the reasons the Credit Suisse problems were solved so quickly was that UBS could bring management capabilities – in particular risk management capabilities – into the merger. UBS, the bank that we rebuilt over the last decade after it had to be rescued last time around, had strong capital and liquidity ratios, a profitable and sustainable business model and it did not go into some of the risks that plagued the books of its main competitor. Like during the pandemic, this enabled UBS to become part of the solution instead of being part of the problem.

Gandhi once famously recommended 'not to look at the problems, look at the solutions.' The important issue when looking for solutions is that they are rarely obvious. Very often, solutions need to be found as the largest common denominator of everyone involved. They are often compromises between people getting together and working on a solution that is not obvious to them at the time they get together. Let me share a sense of déjà vu with you that I have about the current financial market situation in Europe. I remember when I was frequently in an emergency room full of bankers as the central bank governor during the last financial crisis. I was a trained academic by profession. I was neither a traditional central banker, nor a traditional commercial banker. And I felt that whenever we were in such an emergency a room during the great financial crisis, the public sector had a role to play that was not well recognised by the private sector, but that was very important. The role the public sector had to play was defining the common good. I such meetings , if every individual representative of financial institutions from the private sector would have done what was best for their own institution, the collective outcome of these rational individual decisions would have been disastrous. It was the role of the public sector to define what the common denominator for a good solution would be that was in everyone's interest, rather than looking at individual interests. Deep down, the purpose of the public sector is to be that common denominator. It can provide that public good, because the public sector has the mandate to speak for everyone, as opposed to representing singular interests.

I think we are back in such a situation, not just with the re-occurrence of financial instabilities, but rather because we are facing a multitude of crises. We are back in a situation where Europe is again at a crossroads. The crossroads are defined by external events. The biggest challenge that the European Union faces today is that there is again a war in Europe, bordering on the borders of the European Union. This war is the result of an aggression of Russia, which has used military force to move into a peaceful neighbouring country and is now trying to use military force to move the borders within Europe. That is something we had hoped we had left behind after Europe emerged from the ruins of the First World War and the Second World War. The country in which I was born, Germany, has throughout the entire post-war era felt a very deep moral obligation to ensure that the human suffering caused by such devastating wars would never again re-occur in Europe. The European Union project was the political and economic response of the founding members of the EU to emerge from the ruins of war in a stronger and more united way. This may have been less in focus over recent years when the peace dividend in post-war Europe allowed European policymakers to focus more on the economic dividend of creating a Single European Market and a Single European Currency. The new war in Europe has fundamentally changed all this. The European Union now needs to re-focus and move to the next level to overcome the current challenges.

What would that next level be? Like during the aftermath of the great financial crisis, we are today back in discussions about the Stability and Growth Pact. The Stability and Growth Pact was a set of economic and fiscal conditions under which Germany was willing to accept a common currency in exchange for a prudent common European fiscal framework. These rules focussed on what I usually call 'below the line' coordination. 'Below the line' here means that the fiscal rules did not focus on fiscal revenues or fiscal expenditure separately, the focus was solely on the residual of expenditure and revenue decisions, that is, fiscal deficits and public debt. The rational behind this was that countries within the monetary union retained fiscal sovereignty. Economic and monetary union was explicitly not a fiscal union, the no-bailout clause was a constituting element of EMU. At the time, Europe was not ready for truly European decisions on the expenditure or revenues.

To date within the Economic and Monetary Union, every government still insists on its sovereignty and independence to determine its revenues and expenditures.

The only conditionality that EMU imposes is 'below the line', after adding it all up, member countries should not have more than a 3% deficit/GDP ratio in a cyclically adjusted sense, and not more than a 60% debt/GDP ratio. This minimalist coordination pressure embedded in the Stability and Growth Pact has failed consistently - since the onset of EMU - to deliver fiscal stability and prudent budgetary behaviour. Wherever one looks within EMU, governments failed to deliver responsible long-term stability-oriented budgetary policies that would allow them to act decisively on the challenges of today, rather than being caught up in discussions of past problems, or rather, facing problems that should have been addressed and solved in the past. Just look at the Italian election campaign for a 15 percent flat-rate tax for everyone in face of a debt/GDP ratio that entails no room for fiscal manoeuvre. Or look at the French pension debate in face of a retirement age and entitlement levels that fail to reflect a century of progress in life expectancy and current adverse population dynamics. Or look at Germany, where the last 25 years of standstill in embarking on any eye-catching reforms has left the country deeply cemented with a level of bureaucracy and entitlements that is suffocating innovation and incentives to work or produce in German, something an industrial country like Germany can simply not afford. I could go on, but I guess you get the picture.

If you work in the private sector and something has consistently failed for 25 years, you would think about changing it. The problem is that there is no confidence among the European policymakers that if they were to open the Stability and Growth Pact or the European Constitution now, that they would end up with something that would resemble progress on fiscal rules or any form of budgetary stability going forward. I actually share that sentiment. So, why do I still think that Europe nevertheless needs to move forward in changing the fiscal and budgetary framework of EMU?

The war in Ukraine has taught Europeans two things. The first lesson is, that it was a historic mistake that Germany did not contribute more than 2% of GDP to funding NATO. It was a dire mistake, it needed US President Trump to undiplomatically put it on the agenda, but it needed a war in the Ukraine to change it. This is what I call notorious learning. The German government learned from past mistakes, corrected them and as a result has become more Transatlantic/European under the pressure of external events. If Europe continues to only improve as a result of a series of accidents, I can tell you we are likely to have many more accidents. But if Europe moves to the next level of integation because it finds a new destination – and the war in Ukraine can be a catalyst for that – Europe can revive its original purpose of moving closer to a political union, not just a single market with a single currency, but a multi-faceted union, and last not least, a union of cultural and humanitarian values.

The second lesson goes beyond NATO. Europe now needs its own mechanism for coordinating foreign and defence policies including a single mechanism for securing the perimeters of the European Union. I often joke that the biggest success of German diplomacy was the Dublin Agreement. The Dublin Agreement made securing the perimeters of the European Union a task for the countries which have an external common border. Germany has no common border outside the European Union except with Switzerland, and that is a pretty secure border. Actually, Switzerland is part of the Schengen Agreement, so this boarder does not actually count. The other external boarder of Germany is the Nordic Sea. The biggest immigration risk we have is Norwegians going by boat to Hamburg. That is a low risk and correspondingly Germany's cost of securing the perimeters of the European Union was low. You compare that with the costs of monitoring, policing and defending the wide-open border of the European Union in the south, which countries like Portugal, Spain, France, Italy and in particular Greece, had to secure. Today, the war in Ukraine has is simply invalidated the view that border security is not a common task. Securing the perimeters of the European Union has become a common task. It requires a European mandate, it requires European coordination, it requires European expenditure for monitoring, policing and defending the common external boarder and it ultimately requires a European budget and European revenues to do so. It requires what I referred to as moving fiscal coordination from 'below the line' to 'above the line'.

The same is true for European military defense as part of NATO. We already have a joint Franco-German Brigade stationed in Mülheim on in the Rhine. European countries have a long history of jointly serving within NATO. It is an important next step to move to a joint European Army. Europe needs a crisis intervention capability to be able to act fast on rapidly evolving geopolitical risks and military conflicts at the perimeters of Europe, such as the war in Ukraine. Again, I could go on but I think you got the picture. In a poly-crises world the European Union needs poly-crises intervention capabilities and it needs to resist the reflex of continuing to define European Union as the sum of its parts. Europe needs a common denominator, common policies and common expenditures and common revenues in key areas of common interest. In my view, quarrelling about 'below the line' coordination on the residual fiscal outcomes of budgetary action taken independently by 'above the line' national policies is an outdated way of moving forward in the European Union.

Policymakers need to get together and define what the common interest in Europe is. European policymakers need to have the willingness and courage to face that responsibility and execute these powers. European national policymakers need to have the courage to delegate those key crisis intervention responsibilities from their own budgets and sphere of influence to the European level. Only if Europe comes together in this way, it will move to the next level.

We have tried this in some areas before, and we can learn from the attempts that have failed and from the attempts that have worked. In my view, the concept that has worked is getting together on a voluntary basis with those member countries that want to move to the next level. If you get a coalition of the willing that coordinates in key strategic areas beyond what is now a common European task, you will get – like Schengen, which is a contractual arrangement – a new European reality of moving ahead. If a few core countries move ahead, the rest will follow soon. They will follow quickly because they will understand that if they follow instead of leading, they will not be part of the rulemaking in the new framework. So there is a big incentive for them to join early and maybe even to be there from the start.

At this point in time the war in Ukraine has raged for more than a year, with no end in sight. It has moved European sentiment very decisively towards needing a more united, open Europe. We need to reset the clock on Europe. More European Union is needed to secure peace and prosperity in Europe. Policymakers need to face that responsibility and take Europe to the next level of European integration.

Let me close by thanking you for the invitation to speak at this conference. I found it very fascinating to be here and I want to thank you for your attention.

Index of Speakers

Public Authorities

Austrian Financial Market Authority
Helmut Ettl
Executive Director
Andreas Schirk
Head of Division, Prevention of Money Laundering and Terrorism Financing

Autorité de Contrôle Prudentiel et de Résolution
Geoffroy Goffinet
Director, Authorisations
François Haas
Deputy Director General, Financial Stability & Deputy Secretary General

Autorité des Marchés Financiers
Benoît de Juvigny
Secretary General
Jérôme Reboul
Head of the Regulatory Policy and International Affairs Directorate

Banca d'Italia
Paolo Costanzo
Manager, Financial Intelligence Unit (UIF)
Giuseppe Grande
Deputy Head of Market and Payment Systems Oversight
Giuseppe Siani
Head of the Directorate General for Financial Supervision and Regulation

Banco de España
Margarita Delgado
Deputy Governor
Pablo Hernández de Cos
Chair, Basel Committee on Banking Supervision (BCBS) & Governor
Mercedes Olano
Director General, Banking Supervision

Bank for International Settlements
Luiz Awazu Pereira da Silva
Deputy General Manager
Cecilia Skingsley
Head, Innovation Hub

Bank of England
David Bailey
Executive Director of UK Banks
Jon Cunliffe
Deputy Governor, Financial Stability and Chair of the CPMI
Philip Evans
Director, Banking Policy
Lee Foulger
Director, Financial Stability Strategy and Risk
Sasha Mills
Executive Director, Financial Market Infrastructure

Bank of Greece
Christina Papaconstantinou
Deputy Governor

Bank of Latvia
Mārtiņš Kazāks
Governor and Member of the Governing Council of the ECB

Bank of Lithuania
Simonas Krėpšta
Member of the Board of the Bank of Lithuania

Banque de France
Claudine Hurman
Director of Innovation and Financial Marketing Infrastructures
François Villeroy de Galhau
Governor, Banque de France & Chair, Bank for International Settlements (BIS)

Central Bank of Ireland
Gerry Cross
Director Financial Regulation – Policy and Risk
Derville Rowland
Deputy Governor Consumer and Investor Protection

Commission de Surveillance du Secteur Financier
Marco Zwick
Director

Commissione Nazionale per le Società e la Borsa
Carlo Comporti
Commissioner

Committee on Payments and Market Infrastructures
Takeshi Shirakami
Deputy Head of Secretariat

Council of the European Union
Tuomas Saarenheimo
President of the Eurogroup Working Group and the Economic and Financial Committee

Croatian Financial Services Supervisory Agency
Ante Žigman
President

Croatian National Bank
Vedran Šošić
Chief Economist

Danish Financial Supervisory Authority
Tobias Thygesen
Director, FinTech, Payment Services and Governance Department

Danmarks Nationalbank
Per Callesen
Governor

De Nederlandsche Bank
Klaas Knot
President, DNB & Chair, FSB
Olaf Sleijpen
Member of the Board, Executive Director of Monetary Affairs

Department of Finance, Ireland
Michael McGrath
Assistant Secretary, Financial Services Division

Deutsche Bundesbank
Burkhard Balz
Member of the Executive Board
Julian Reischle
Director General Payments and Settlement Systems
Joachim Wuermeling
Member of the Executive Board

Dutch Authority for the Financial Markets
Barbara Antonides
Manager Public and International Affairs
Jos Heuvelman
Member of the Executive Board

Estonian Financial Supervision Authority
Kilvar Kessler
Chairman of the Management Board

European Bank for Reconstruction and Development
Odile Renaud-Basso
President

European Banking Authority
José Manuel Campa
Chairperson
François-Louis Michaud
Executive Director

European Central Bank
Evelien Witlox
Programme Manager, Digital Euro Project

European Commission
John Berrigan
Director General, DG FISMA
Niall Bohan
Director, Asset, Debt and Financial Risk Management, DG Budget
Declan Costello
Deputy Director-General, Coordination of Economic Policies of Member States, DG ECFIN
Paulina Dejmek-Hack
Director for General Affairs, DG FISMA
Valdis Dombrovskis
Executive Vice-President for an Economy that Works for People, with responsibility for Trade
Alexandra Jour-Schroeder
Deputy Director-General, DG FISMA
Mairead McGuinness
Commissioner for Financial Services, Financial Stability and Capital Markets Union

European Economic and Social Committee
Kęstutis Kupšys
Member

European Insurance and Occupational Pensions Authority
Petra Hielkema
Chairperson
Fausto Parente
Executive Director

European Investment Bank
Debora Revoltella
Chief Economist
Gelsomina Vigliotti
Vice-President

European Parliament
Marek Belka
MEP, Committee on Economic and Monetary Affairs, former Polish Prime Minister, Minister of Finance and the Governor of the Polish National Bank
Jonás Fernández Álvarez
MEP, Committee on Economic and Monetary Affairs
Danuta Hübner
MEP, Committee on Economic and Monetary Affairs
Ondřej Kovařík
MEP, Committee on Economic and Monetary Affairs
Ludek Niedermayer
Vice-Chair & MEP, Committee on Economic and Monetary Affairs
Tsvetelina Penkova
MEP, Committee on Industry, Research and Energy
Paul Tang
MEP, Committee on Economic and Monetary Affairs
Irene Tinagli
Chair & MEP, Committee on Economic and Monetary Affairs
Johan Van Overtveldt
Chair & MEP, Committee on Economic and Monetary Affairs
Stéphanie Yon-Courtin
MEP & Vice-Chair, Committee on Economic and Monetary Affairs

European Securities and Markets Authority
Natasha Cazenave
Executive Director
Klaus Löber
Chair, Central Counterparties Supervisory Committee
Verena Ross
Chair

European Stability Mechanism
Pierre Gramegna
Managing Director
Rolf Strauch
Chief Economist and Member of the Management Board

European Systemic Risk Board
Francesco Mazzaferro
Head of ESRB Secretariat

Federal Department of Finance, Switzerland
Daniela Stoffel
State Secretary for International Financial

Federal Financial Supervisory Authority, Germany
Mark Branson
President
Thorsten Pötzsch
Chief Executive Director of Securities Supervision

Federal Ministry of Finance, Austria
Harald Waiglein
Director General for Economic Policy, Financial Markets and Customs Duties & Member of the Board of Directors, ESM

Federal Ministry of Finance, Germany
Marcus Pleyer
Deputy Director General, International Financial Markets, Digitization, Anti-Money Laundering & Counter Terrorist Financing
Eva Wimmer
Director General

Financial Conduct Authority
Sheldon Mills
Executive Director for Consumers and Competition
Nikhil Rathi
Chief Executive Officer

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

Financial Services and Markets Authority, Belgium
Jean-Paul Servais
President & Chair of the Board, IOSCO

Financial Stability Board
Eva Hüpkes
Head of Regulatory and Supervisory Policies

Financial Stability Institute
Fernando Restoy
Chair

Finnish Financial Supervisory Authority
Samu Kurri
Director, Digitalisation and Analysis

HM Treasury
Richard Knox
Director, Financial Services International

International Association of Insurance Supervisors
Romain Paserot
Deputy Secretary General

International Monetary Fund
Ashok Bhatia
Director, Offices in Europe; Senior Resident Representative to the European Union
Alfred Kammer
Director, European Department

International Organization of Securities Commissions
Martin Moloney
Secretary General

International Sustainability Standards Board
Suzanne Lloyd
Vice-Chair

Italian Insurance Supervisory Authority
Alberto Corinti
Member of the Board of Directors

Malta Financial Services Authority
Christopher P. Buttigieg
Chief Officer Supervision, Chief Executive Officer ad-interim

Ministry of Economy and Digitalization, Spain
Carlos Cuerpo Caballero
Secretary General of the Treasury and International Financing

Ministry of Economy and Finance, Italy
Stefano Cappiello
Director General of Regulation and Supervision

Ministry of Finance of the Republic of Latvia
Līga Kļaviņa
Deputy State Secretary on Financial Policy Issues

Ministry of Finance of the Republic of Lithuania
Mindaugas Liutvinskas
Vice Minister

Ministry of Finance, Belgium
Vincent Van Peteghem
Deputy Prime Minister and Minister of Finance

Ministry of Finance, Czech Republic
Alex Ivančo
Director, Financial Markets III Department

Ministry of Finance, Finland
Leena Mörttinen
Permanent Under-Secretary

Ministry of Finance, Sweden
Johan Almenberg
State Secretary to Minister for Financial Markets
Nils Friberg
Deputy Director
Elisabeth Svantesson
Minister for Finance
Niklas Wykman
Minister for Financial Markets

Ministry of the Economy, Finance and Industrial and Digital Sovereignty, France
Pierre Chabrol
Head of the Savings and Financial Market Office
Martin Landais
Director, Insurance division, French Treasury
Emmanuel Moulin
Director General of the Treasury

National Bank of Belgium
Tim Hermans
Executive Director

Oesterreichische Nationalbank
Robert Holzmann
Governor and Member of the Governing Council of the ECB

Organisation for Economic Co-operation and Development
Carmine Di Noia
Director of Financial and Enterprise Affairs Directorate
Carl Magnus Magnusson
Policy Analyst, Capital Markets
Robert Patalano
Head of Financial Markets Division

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

Portuguese Securities Market Commission
Luís Laginha de Sousa
Chair

Single Resolution Board
Dominique Laboureix
Chair

Single Supervisory Mechanism
Kerstin af Jochnick
Member of the Supervisory Board, ECB Representative
Sofia Toscano Rico
Deputy Director General, DG Horizontal Line Supervision

Spanish Securities and Exchange Commission
Rodrigo Buenaventura
Chairman

Sveriges Riksbank
Anna Breman
First Deputy Governor
Per Jansson
Deputy Governor
Erik Thedéen
Governor

Swedish Financial Supervisory Authority
Henrik Braconier
Chief Economist
Åsa Larson
Executive Director Insurance
Karin Lundberg
Executive Director, Banking

Swiss Financial Market Supervisory Authority
Léonard Bôle
Member of the Executive Board & Head, Markets Division

U.S. Commodity Futures Trading Commission
Kristin Johnson
Commissioner
Suyash Paliwal
Director, Office of International Affairs
Caroline D. Pham
Commissioner

U.S. Department of Treasury
Steven Seitz
Director, Federal Insurance Office
Nicholas Tabor
Deputy Assistant Secretary for International Financial Markets

U.S. Securities and Exchange Commission
Hester M. Peirce
Commissioner

Industry Representatives

Allianz SE
Andreas Wimmer
Member of Board of Management, Head of Asset Management Division & Allianz Life in the U.S.

American Express
Juan Orti
Country Manager Spain & Head of International Card Services Spain and Benelux

Amundi
Simon Janin
Head of Group Public Affairs

Amazon Pay
Megan Bramlette
Director North America and EU Payment Acceptance, Amazon.com Services LLC

AWS
Scott Mullins
Managing Director & General Manager, Worldwide Financial Services
Maria Tsani
Head of Financial Services Public Policy and Regulatory Affairs EMEA

AXA Group
Stéphane Janin
Head of Global Regulatory Developments and Public Affairs, AXA Investment Managers
Alexander Vollert
Chief Operating Officer & Chief Executive Officer of AXA Group Operations

Banco Bilbao Vizcaya Argentaria
Santiago Fernández de Lis
Head of Regulation

Banco Santander
Barbara Navarro
Head of Research and Public Policy

Bank of America
Bernie Mensah
President of International & and Chief Executive Officer, Merrill Lynch International
Fernando Vicario
Chief Executive Officer, Bank of America Europe DAC & Country Head, Ireland

Bank of China (Europe) S.A.
Wang Lei
Deputy Chief Executive Officer

Barclays Europe
Francesco Ceccato
Chief Executive Officer

Binance
Richard Teng
Regional Head of Europe and MENA

BlackRock
Joanna Cound
Managing Director, Global Public Policy
Elisabeth Sterner
Head of Nordic Region

Bloomberg Trading Facility BV
Nicholas Bean
Chief Executive Officer

BNP Paribas
Philippe Bordenave
Senior Executive Advisor to General Management and the Chair of the Board
Haroun Boucheta
Head of Public Affairs for Securities Services, BNP Paribas Securities Services
Laurence Caron-Habib
Head of Public Affairs, BNP Paribas Asset Management
Christophe Delafontaine
Head of Global Markets Regulatory
Jean Lemierre
Chairman

BNY Mellon
 Isabel Schmidt
 Co-Head of Global Payment Products

BVR
 Marija Kolak
 President

CACEIS
 Arnaud Misset
 Chief Digital Officer

Caisse des Dépôts
 Philippe Blanchot
 Director Institutional, International and European Affairs

CaixaBank
 Christian Castro
 Head of Public Affairs

Citadel
 Stephen Berger
 Managing Director, Global Head of Government & Regulatory Policy

Citi
 Kristine Braden
 Europe Cluster Head and Chief Executive Officer of Citigroup Global Markets Europe
 Erik Savola
 Head, Nordic Cluster & Country Officer

CLS Bank International
 Marc Bayle de Jessé
 Chief Executive Officer
 Dino Kos
 Special Advisor to Chief Executive Officer

CNP Assurances
 Thomas Béhar
 Chief Financial Officer

Coinbase
 Faryar Shirzad
 Chief Policy Officer

Covéa
 Mireille Aubry
 Director of Prudential Regulation Standards & Foresight

Crédit Agricole S.A.
 Alban Aucoin
 Head of Public Affairs
 Jérôme Grivet
 Deputy Chief Executive Officer
 Bruno Lepoivre
 Head of ESG for non life branch & NZIA representative, Crédit Agricole Assurances

Dai-ichi Life Holdings, Inc.
 Hidehiko Sogano
 Managing Executive Officer

DekaBank Deutsche Girozentrale
 Daniel Kapffer
 Chief Financial Officer & Chief Operating Officer

Deloitte
 Laurence Rivat
 EU Corporate Reporting Policy Leader

Deutsche Bank AG
 Olivier Vigneron
 Member of the Management Board and Chief Risk Officer

Deutsche Börse Group
 Niels Brab
 Head of Group Regulatory Strategy & Chief Regulatory Officer
 Erik Tim Müller
 Chief Executive Officer, Eurex Clearing AG

Deutscher Sparkassen- und Giroverband
 Joachim Schmalzl
 Executive Member of the Board
 Karolin Schriever
 Executive Member of the Board

Erste Group
 Sergiu Cristian Manea
 Chief Executive Officer & Chairman of Management Board, Romanian Commercial Bank

Euroclear S.A.
 Philippe Laurensy
 Managing Director, Head of Strategy, Innovation, Product Developments and M&A
 Roger Storm
 Chief Executive Officer, Euroclear Sweden AB

Euronext
 Stéphane Boujnah
 Chief Executive Officer and Chairman of the Managing Board

Federated Hermes (UK) LLP
 Gemma Corrigan
 Head of Policy and ESG Integration

Fidelity International
 Christian Staub
 Managing Director Europe

Generali
 Gerardo Di Filippo
 Head of Group Risk Management Processes and Operations

Google Cloud
 Georgina Bulkeley
 Director, EMEA Financial Services Solutions

Groupama
 Cyril Roux
 Deputy Chief Executive Officer

Groupe BPCE
 Jacques Beyssade
 Secretary General
 Benoit de La Chapelle Bizot
 Head of Public Affairs

HSBC Holdings plc
 Ash Booth
 Head of Artificial Intelligence

ING Group
 Tanate Phutrakul
 Chief Financial Officer & Member of the Executive Board

Invesco
 Matthew Tagliani
 Head of Product and Sales Strategy, EMEA ETFs

J.P. Morgan
Anna Dunn
Chief Financial Officer, EMEA
Vittorio Grilli
Chairman of Italy & CIB EMEA
Patrick Thomson
Chief Executive Officer, EMEA, J.P. Morgan Asset Management

Klarna
Niclas Neglen
Chief Financial Officer

KPMG LLP
Kay Swinburne
Vice Chair Financial Services

Kraken Digital Asset Exchange
Marco Santori
Chief Legal Officer

La Banque Postale
Perrine Kaltwasser
Deputy General Manager of Risk, Compliance and Conglomerate Supervision & Member of the Executive Committee

London Stock Exchange Group
Cornelia Andersson
Group Head of Sustainable Finance and Investing
Daniel Maguire
Group Head, Post Trade & CEO, LCH Group

Mastercard Europe
Sherry Madera
Senior Vice President, Public Policy and Government Affairs

Mazars
Sylvie Matherat
Senior Advisor

MetLife
Gino Del Sesto
Head of Government Relations, Europe

Microsoft
Tomas Jakimavicius
Director, European Government Affairs

Mizuho Financial Group, Inc.
Shinichi Tsunoda
General Manager, Sustainable Business Promotion Dpt., Mizuho Financial Group, Inc. / Mizuho Bank, Ltd.

Moody's Investors Service
Colin Ellis
Global Credit Strategist
Michael West
President

Morgan Stanley
Jamie Martin
Head of EMEA Sustainability Office

MUFG Bank, Ltd.
Takanori Sazaki
Regional Chief Executive Officer for Europe, Middle East and Africa

Nasdaq
Roland Chai
Executive Vice Pressident
Adena Friedman
Chair and Chief Executive Officer
James McKeone
Vice President, Head of European Market Data
Bjørn Sibbern
President European Trading Services, Executive Vice President

Nordea
Stephen Hester
Chair of the Board and Board Member
Sara Mella
Head of Personal Banking, Group Leadership Team, Nordea Bank Abp
Martin Persson
Head of Large Corporates & Institutions, Branch Manager Sweden, Group Leadership Team, Nordea Bank Abp
Frank Vang-Jensen
Group Chief Executive Officer

Oliver Wyman
Christian Edelmann
Managing Partner Europe

Optiver
Jan Boomaars
Global Chief Executive Officer

Poste Italiane
Matteo Del Fante
Chief Executive Officer

PwC Germany
Martin Neisen
Partner

Raiffeisen Bank International AG
Hannes Mösenbacher
Chief Risk Officer

S&P Global
David Henry Doyle
Vice President, Head of Government Affairs & Public Policy EMEA

SEB Large Corporates & Financial Institutions
Johan Torgeby
President & Chief Executive Officer

SIX Group
Jochen Durr
Chief Risk Officer & Member of the Executive Board

SMBC Bank International plc
Melissa Ocampo
Head of Sustainability Strategy in EMEA

Société Générale
Stéphane Giordano
Deputy Head of Public Affairs, Société Générale & Chairman, AMAFI
Michala Marcussen
Group Chief Economist

Standard Chartered Bank
Lawrence Low
Global Head of Regulatory Affairs

State Street Bank
Joseph J. Barry
Senior Vice President and Global Head of Regulatory, Industry and Government Affairs

Suade Labs
Diana Paredes
Chief Executive Officer & Co-founder

Swedbank
Jens Henriksson
Chief Executive Officer

SWIFT
Marianne Demarchi
Head of European Strategic Accounts

Swiss Re
Tarun Kohli
Managing Director & Head, Group Delivery Services, Swiss Re and Chairman, Swiss Re Solutions AG

The Depository Trust & Clearing Corporation
Jason Harrell
Managing Director and Head of External Engagements
Jennifer Peve
Managing Director, Head of Strategy and Business Development

The Norinchukin Bank
Hirotaka Hideshima
Counsellor on Global Srategy to President and the Board of Directors

Tradition
Vincent Remay
Advisor to the Chairman

UBS Group AG
Markus Ronner
Group Chief Compliance and Governance Officer

UniCredit S.p.A.
Pier Carlo Padoan
Chairman of the Board of Directors

Visa Europe
Charlotte Hogg
Executive Vice President and Chief Executive Officer

Western Union
Bryant Gofstein
Deputy Chief Compliance Officer and Head of Financial Crimes Compliance

Zurich Insurance
Anna Green
Chief Executive Officer, Sweden

Other Stakeholders

Better Finance
Guillaume Prache
Managing Director

EPI Interim Company SE
Martina Weimert
Chief Executive Officer

EUROFI
Jean-Marie Andrès
Senior Fellow
Jean-Jacques Bonnaud
Treasurer Eurofi
Didier Cahen
Secretary General
Jacques de Larosière
Honorary President
Marc Truchet
Senior Fellow
David Wright
President

European Financial Reporting Advisory Group
Patrick de Cambourg
Chair of the Sustainability Reporting Board

European Investors' Association
Gerben Everts
Executive Director

Experts
Alexander Batchvarov
Structured Finance Expert
Sylvie Goulard

Robert Ophèle
Former Chair, AMF

Finance Watch
Julia Symon
Head of Research and Advocacy

Goethe University Frankfurt
Axel A. Weber
President, Center for Financial Studies

The European Consumers' Organisation
Monique Goyens
Director General
Agustin Reyna
Director, Legal and Economic Affairs

This document was drafted by Eurofi and does not engage in any way the Swedish EU Council Presidency or the Swedish EU public authorities.

The views expressed in this report are the personal opinions of speakers and do not necessarily reflect the views of Eurofi or of its members or partners. Several chapters of this report are reported under Chatham House rules.

Authors: Jean-Marie Andrès & Marc Truchet

Publisher: Didier Cahen

Design & Production: Daniela Craciun, Virginie Denis & Initial Production

ABOUT EUROFI

The European think tank dedicated to financial services

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

OUR OBJECTIVES

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

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

OUR APPROACH

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

Our work is organised mainly around two yearly international events gathering the main stakeholders concerned by policy work in the financial sector and macro-economic developments impacting the sector for informal debates. Research conducted by the Eurofi team and contributions from a wide range of private and public sector participants are provided as input to the debates and allow an effective structuring of discussions. The output of these discussions and assessments provides a comprehensive account of the latest thinking on trends and issues affecting the financial sector and the policy actions needed for addressing them.

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

OUR ORGANISATION AND MEMBERSHIP

Eurofi works on a membership basis and comprises a diverse range of more than 80 European and international firms, covering all sectors of the financial services industry and all steps of the value chain: banks, insurance companies, asset managers, market infrastructures, payment platforms, technology firms, service providers... The members support the activities of Eurofi both financially and in terms of content.

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

OUR EVENTS AND MEETINGS

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

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

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

OUR RESEARCH ACTIVITIES AND PUBLICATIONS

Eurofi conducts extensive research on the macro-economic and monetary developments affecting financial services, vulnerabilities in the financial sector, key industry trends (digitalisation, sustainable finance...) and on-going financial and digital policy initiatives. This research allows an effective preparation of the debates during the annual meetings and provides input for the discussions. Four main documents are published twice a year on the occasion of the annual events. These documents are widely distributed in the market and to the public authorities and are also publicly available on our website www.eurofi.net:

- **Regulatory Update:** policy notes and background papers on the latest developments in financial policy and on macro-economic and market trends affecting the EU financial sector
- **Scoreboards:** key facts and statistics on the economic performance of EU countries and the impacts of fiscal and monetary policies
- **Views Magazine:** over 190 contributions on current regulatory topics and trends from a wide and diversified group of European and international public and private sector representatives
- **Summary of discussions:** report providing a detailed and structured account of the different views expressed by public and private sector representatives during the sessions of each conference on on-going trends, regulatory initiatives underway and how to improve the functioning of the EU financial market.

eurofi

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

EUROFI MEMBERS

Allianz
amazon pay
AMERICAN EXPRESS
Amundi ASSET MANAGEMENT
aws
AXA
BANK OF AMERICA

中国银行 BANK OF CHINA
BARCLAYS
BBVA
BINANCE
BlackRock
Bloomberg
BNP PARIBAS

BNY MELLON
GROUPE BPCE
BVR
caceis INVESTOR SERVICES
GROUPE Caisse des Dépôts
CaixaBank
CITADEL
citi
CLS trusted market solutions

CNP ASSURANCES
coinbase
COVEA
CRÉDIT AGRICOLE S.A.
Crédit Mutuel
CREDIT SUISSE
DAI-ICHI LIFE

Deka
Deutsche Bank
DEUTSCHE BÖRSE GROUP
Deloitte.
DNB
DTCC
ERSTE Group
euroclear

EURONEXT
European Bank for Reconstruction and Development
European Investment Bank The EU bank
Federated Hermes
Fidelity INTERNATIONAL
Finanzgruppe
GENERALI

Goldman Sachs
Google Cloud
LE GROUPE Groupama
HSBC
ice
ING
Invesco
J.P.Morgan
KPMG

kraken
LA BANQUE POSTALE
LSEG
mazars
Mastercard
MetLife
Microsoft
MIZUHO

MOODY'S
Morgan Stanley
MUFG
Nasdaq
Nordea
NORINCHUKIN
OliverWyman

Optiver
Posteitaliane
pwc
Rabobank
Raiffeisen
Santander
SIX

SMBC
SOCIETE GENERALE
Standard Chartered
S&P Global
STATE STREET
Swift
Swiss Re

Tradition
UniCredit
UBS
VISA
WesternUnion WU
ZURICH

eurofi

www.eurofi.net