

VIEWS

THE EUROFI MAGAZINE

SEPTEMBER 2023

NADIA CALVIÑO

First Vice President and Minister
for Economy and Digitalization, Spain

Spanish priorities for
a more integrated,
competitive and open
European economy



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The integration of the EU banking
sector and the challenges of
global competition



V. VAN PETEGHEM

Reform of the EU budget rules:
towards a new generational deal



A. TÚRI

The holistic view on open
strategic autonomy and
competitiveness



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EUROFI REGULATORY UPDATE

EUROFI VIEWS MAGAZINE

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SEPTEMBER 2023

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

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This new edition of the Eurofi Views Magazine is published on the occasion of the Financial Forum organized in Santiago de Compostela in association with the Spanish EU Council Presidency.

The macro-economic challenges facing Europe and the main regulatory and supervisory developments in the financial sector at the European and global levels will be discussed during this Forum, as well as the key vulnerabilities in the financial sector and the EU policy initiatives aiming to support the digitalisation of financial services and the development of sustainable finance. With the European elections due to take place in June 2024, we are also initiating during this Forum a discussion about the priorities for the incoming European Commission in the financial area, which will be pursued by Eurofi throughout the next year.

In the following pages, you will find more than 200 contributions and articles drafted by the public and private sector and civil society representatives participating in this event on the themes that will be addressed. We are very grateful to the contributors for this significant input, providing a comprehensive overview of the latest thinking on trends and issues affecting the financial sector and the policy actions needed to address them. We are sure that you will read their thoughts and proposals with great interest.

The Eurofi Secretariat has also published several papers on these topics in the latest edition of the Eurofi Regulatory Update, which we invite you to read. The Eurofi economic and monetary scoreboards have also been updated, providing a detailed perspective on the European macro environment.



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DAVID WRIGHT

President, Eurofi

A very warm welcome to all distinguished speakers and delegates to EUROFI, Santiago de Compostela. We are truly honoured that this magnificent historical city has agreed to host the 36th edition of EUROFI under the auspices of the Spanish Presidency of the European Union whom we thank most sincerely for supporting this event so effectively and efficiently.

We read very often that the EU or indeed other major countries around the world are at tipping points, critical moments, pivotal times etc. Reflecting, the reality is the EU will always be in such situations. By this I mean the EU will always be evolving institutionally, politically, economically and socially. It cannot be any other way with 27 countries forming this Union of countries and no less than 8 potential new accession countries, including Ukraine, waiting, wanting to become members. As post-war European history demonstrates, demand for the EU, for Europe is far bigger than supply, which I have always interpreted and believed to be a positive signal demonstrating the long-term benefits of European integration.

The extremist Brexiters hoped the EU would fall apart if the U.K left the EU. They have been 100% wrong. It has not, it will not. In fact the contrary is true - European integration in many areas since Brexit has accelerated and deepened and there are many examples - the €800 billion post-Pandemic New Generation Economic Programme with common EU bond issuance; the impressive European cooperation on vaccine production and distribution during the pandemic; European global environmental leadership on global warming; sophisticated EU digital rule making; the immense EU Horizon Research programme (which U.K scientists are so keen to join...)

This said there should be no complacency whatsoever because the fact is that the EU and Member State economies are still lagging the economic growth rates and productivity increases of the United States, in fact the gaps are getting wider. The U.K as well. So in spite of the deployment of great European political skill and effort to navigate through

COVID and its economic aftermath plus supporting, on its doorstep, Ukraine in its tragic and devastating war against Russia which has resulted in damaging energy shortages and inflationary price hikes, the EU's economic fundamentals and perspectives are just not good enough.

Banking Union is stalled; Capital Markets Union maybe approaching a mid-stream point at best, with time running out in this European political cycle; renovating the Stability and Growth Pact is unfinished.

I strongly believe that delivering all of these major, interlinked European financial projects really matters. They are vital for a renaissance of European finance, they will spread risk and are essential for delivering the EU's laudable political priorities. Together they will greatly enhance the dynamism of the EU; international investors will be attracted to wider, deeper, barrier-free, predictable integrated financial markets; fast-growing small and medium sized innovative European companies will be far more tempted to raise capital in deep EU capital markets and not take the first plane to New York and Wall Street - so crucial because these companies are the future of Europe. In my view it is essential to help these companies far more to raise the capital they need inside the EU so that their HQ and locus of economic activity remain firmly inside European borders.

All these issues are resolvable with political will, determination and leadership. The history of the EU illustrates this time and time again. Indeed, where EU institutions have evolved to assume new responsibilities, to implement new EU policies they have become very successful - the ECB, SSM, ESA's, EIB, the EU Pharmaceutical Agency, the European Commission's trade and competition policies all being prime examples and there are countless others.

The point I am making here is that when the Member States and European Parliament converge and agree on key directives and regulations to develop European integration with rational institutional structures to support them, it works. Collectively, EU wide, it is Pareto optimal.

Pan-EU trading costs are reduced with one set of rules to export and import and with one set of product standards, customs rules, tax and insolvency procedures etc. The key importance of these Single Market intangibles can be witnessed today by reading about the daily exasperation of U.K traders who face numerous, complex, economically expensive barriers by being outside the EU Single Market and Customs Union.

Looking back on Banking Union and Capital Markets Union, perhaps we have not made sufficient intellectual effort to demonstrate the collective benefits that would accrue to all EU Member States of delivering these projects. Perhaps we did not draw enough conclusions from “la méthode Delors” by which I mean rigorous ex-ante economic and cost-benefit analysis to underpin major European economic projects. Like the Checcini report, a swathe of detailed macro and micro-analyses which supported the 1992 Single Market programme. I think this has proven to be an important lacunae. And if these major EU financial projects are going to continue stalling in the slow lane, detailed supportive economic analysis should commence now to prepare the next EU political cycle.

My message here is the urgent need to prepare and to accelerate. The EU surely cannot afford to rumble on discussing, endlessly, mind-boggling technicalities which are not delivering the dynamic capital markets the EU badly needs to become much more economically successful in the medium term.

Co-decision time remaining in this EU political cycle is now very short, around just 7 months to go before the political shutters come down for months next year. This will result in outstanding dossiers being shifted into 2025 with implementation, maybe, in 2027 earliest. Too slow by more than half. We, Europeans, should not work at this pace anymore. Ambitious political agreements have to be struck and urgently.

The really good news is that delivering deep EU financial integration will accelerate economic growth, help lower

public debt levels, stimulate innovation and investment (eg environmental, infrastructure, digital etc), encourage inward investment into a more dynamic EU and help to resolve the huge, medium-term challenges of resourcing the future EU budget needed, inter alia, to accommodate the costs of new Member States joining and Ukrainian reconstruction.

The bad news is that continuing financial stasis means the EU will fall further and further behind in relative economic terms and will face serious constraints to deal with the huge forward European agenda - geopolitical, environmental, security and defence, trade, immigration and ageing.....

With these personal remarks let me wish everyone a very thoughtful, interesting and dynamic EUROFI Santiago de Compostela, I am sure it will be. As usual I count on everyone to contribute their practical and constructive ideas to leading European decision-makers to help accelerate, decisively, European financial integration. For the good of all.



Q&A

NADIA CALVIÑO

First Vice President and Minister
for Economy and Digitalization, Spain

Spanish priorities for a more integrated, competitive and open European economy

What are the priorities of the Spanish Presidency in the economic and financial area?

This is the fifth time Spain takes over this responsibility, and we do it with the same commitment, the same pro-European enthusiasm we had when we joined the Union in 1986.

There are many important files on our plate. We are the last full-semester presidency before the European elections and time is of the essence. We have a very ambitious agenda and there are high expectations from our fellow Member States. Our aim is to make as much progress as possible, closing as many files as we can, contributing to a stronger, more prosperous and fairer Europe.

From the economic and financial point of view, our Presidency hinges on three main priorities. First, we must deepen our economic and monetary union, with fiscal rules that are fit for current and future needs, a fully functioning Banking Union, a deeper Capital Markets Union and robust protection against money laundering and terrorism financing. Our unwavering support for Ukraine needs a stable and predictable framework, which is being discussed in the context of the mid-term review of the Multiannual Financial Framework, together with new own resources. Green finance, the digital euro, and adapting our tax system to the digital economy will also be important files in the coming months.

The second priority of the Spanish Presidency is strengthening European competitiveness and strategic autonomy, with the reform of electricity markets and the deployment of projects linked to the new hydrogen economy, net-zero technology, manufacturing, a secure and stable supply of critical raw material supplies... All those key elements for our strategic autonomy with an open approach, so that Europe continues to be a trade powerhouse.

Finally, we aim at strengthening the role of the EU as a global actor, building on Spain's position as a gateway

between Europe and Latin America and the Caribbean. The leader's Summit held in Brussels spearheaded two main initiatives. On the one hand, the set-up of an ambitious global gateway investment agenda, with more than 100 projects and over 45 billion euros committed. On the other hand, a renewed impulse of trade and investment agreements. The informal ECOFIN meeting, to be held in September in Santiago de Compostela, will bring together finance ministers from both sides of the Atlantic, gathering more than one third of the IMF's constituency. Together with all relevant stakeholders, including multilateral development banks, we will discuss the future of the international financial system and present some concrete examples of strategic investment projects for the region.

What are the main building blocks of a review of the Stability and Growth Pact?

We already had a very productive Ecofin in July, where finance ministers welcomed unanimously the work programme of the Spanish presidency, identifying four building blocks on which we will focus in the following weeks:

First, institutional balance with clear roles and the room of manoeuvre for each institution, combining a rules based multilateral approach with sufficient flexibility to adapt to new challenges. Second, basic parameters to guarantee debt reduction paths that are credible and lead to fiscal sustainability, while being compatible with economic growth and job creation. Thirdly, how to ensure that the new fiscal framework finances the necessary investments and European public goods. Finally, how to ensure effective enforcement.

The first discussion gave us a very clear mandate to intensify the technical work and the political negotiation in order to reach a balanced agreement in the autumn.

How “autonomous” is the EU in terms of financing? What are the main areas of improvement in this regard and what impact is expected on economic growth?

During the last decade, the European Union has made significant progress in building more solid, efficient, and integrated financial markets. But there is still a long way to go. The impact of Covid-19 pandemic, bottlenecks in global value chains and Russia’s military aggression against Ukraine underscore how important it is for the EU to reinforce economic security by improving our short and long-term financing and meeting public and private investment needs. It is actually one of the topics we will discuss in Santiago.

A well-functioning financial sector is key for sustainable economic growth, better quality jobs and prosperity for European citizens. Going forward, it will also be an important lever for the EU’s long-term growth strategy and the twin digital and green transitions.

Green finance will certainly be one of the areas for development in coming years. And the EU can lead at international level with a strong legal and institutional framework, providing certainty and a sense of direction in this transition. I hope we can make progress under our presidency also in this area.

How to accelerate progress in the integration of the euro area banking sector?

The completion of the Banking Union is key for a more efficient allocation of savings and investment, improving financing conditions for households and companies and fostering economic growth. The first two pillars of the Banking Union – the Single Supervisory Mechanism and the Single Resolution Mechanism – have been in place and fully operational for several years, substantially contributing to the overall good

shape of the EU banking sector. Within this framework, banks have greatly reinforced their resilience while they are closely supervised by national and European authorities.

However, more remains to be done. A complete Banking Union does require a European Deposit Insurance Scheme, the so called “third pillar”.

In the short term, we are finalizing the translation of Basel III requirements into EU legislation and work is underway to reinforce the framework for crisis management and liquidity provision.



Q&A

VALDIS DOMBROVSKIS

Executive Vice-President for an Economy that Works for People and Commissioner for Trade - European Commission

Boosting growth and investment, building a more inclusive and resilient economy

What are the policy priorities for coping with persistent inflation and the reduction of growth in Europe?

Along with the ECB's policies to reduce inflation, it is vital to ensure an overall coherent macroeconomic policy mix. So fiscal policy should move to a clearly contractionary stance in 2024, after a slight contraction in 2023 and the sizeable expansionary policies seen between 2020 and 2022.

Our advice to EU governments is to achieve this primarily by winding down energy support measures – or, if energy prices rise again, to focus them on protecting vulnerable households and companies. Governments should help to prevent fuelling inflation and increasing inflation expectations.

This is not only because high inflation hurts people's purchasing power and our companies' competitiveness. It is also because public finances will suffer from an extended period of high inflation, leading to a higher cost of debt and lower economic growth. In addition, high-debt countries need to achieve a sustained and gradual reduction of their debt-to-GDP ratio in the medium term to reduce fiscal sustainability risks. At the same time, governments should support economic growth potential by preserving investments and absorbing financing from the Recovery and Resilience Facility (RRF).

Sustaining and stimulating the green and digital transitions is vital for Europe's longer-term growth. With interest costs rising, prioritisation and quality of expenditure will become more important.

Winding down energy support measures and implementing Recovery and Resilience Plans will help to improve the composition of expenditure next year, minimise the impact on economic growth in the short run and create a solid base for balanced growth in the future.

What are the stumbling blocks, possible solutions and key success factors in reaching a rapid agreement on revising the Stability and Growth Pact? What are the main objectives of this revision?

In April 2023, the Commission presented its legal proposals for a comprehensive reform of the EU's economic governance. Their main aim is to strengthen debt sustainability and promote sustainable and inclusive growth in all Member States.

This will be achieved through more gradual but steadier debt reduction, supported by high-quality public investment and reforms, including those on the supply side. Enforcement will be stronger, in exchange for more leeway for Member States.

Unsurprisingly, Member States have expressed different positions on the proposals. However, they represent a balanced approach that takes into account the various views expressed during wide consultations.

On timing: at such a critical moment for the EU economy, we need to reach agreement on the economic governance review as soon as possible. The European Council has called for legislative work to be concluded by the end of 2023. I fully subscribe to this timeline.

The new rules would allow Member States to better balance investment needs with ensuring debt sustainability. They will be able to benefit from a more gradual fiscal adjustment path by committing to reforms and investments to boost growth, support debt sustainability and respond to common EU priorities, not least the green and digital transitions.

It is easy to see the relevance of these proposed changes at the current juncture. While the new rules are being discussed, the current ones continue to exist – so we will not enter a vacuum. In spring, we provided clear guidance for 2024.

We announced that the Commission will open excessive deficit procedures in spring 2024 for countries that do not respect the 3% of GDP deficit criterion in 2023.

Is Next Generation EU a gamechanger for providing the investment needed for the green transition? What impact has been observed 4 years after its creation?

So far, Next Generation EU (NGEU) has catalysed significant investments across Member States for the green transition. It sends a clear message to private investors that Europe means business with the green transition and is a good place to invest.

National recovery plans under the NGEU go even beyond the required 37% allocation for climate financing. This confirms countries' recognition of the urgent need to address climate change and the economic potential of the green transition. And it shows the significant impact that common EU resources can have on these goals.

Green bonds are playing a pivotal role in financing climate-related reforms and investments outlined in the national plans. With €44.2 billion issued to date, the strong investor interest in these bonds and favourable pricing conditions have been very encouraging.

Introducing REPowerEU chapters into national plans adds another layer of effectiveness to NGEU by encouraging more investments to reduce our reliance on fossil fuels and strengthen our energy independence, especially given Russia's war of aggression against Ukraine.

While funding from the RRF will not be enough to fill the entire investment gap for the green transition, it plays a key role in getting the recovery on the right track. The RRF is fast-tracking the implementation of much needed reforms and sets the right conditions to facilitate future investments.

So it has certainly been a gamechanger: in its magnitude, and in the nature of its impact. It shows the EU's commitment to leading the way in combating climate change.

Since we cannot rely on public funds alone, we clearly need private capital – and that means making our regulatory environment conducive to private investment. This has been a constant objective in the revision of climate and energy legislation under the 'Fit for 55' package that the European Union is about to finalise.

What are the priorities for developing capital markets in Europe and equity financing in particular? How are these being implemented in the context of the CMU initiative?

Public funding alone cannot provide the large amount of investment required to achieve all key economic policy objectives such as the green and digital transitions, increased competitiveness and open strategic autonomy.

For these, the EU economy needs vast amounts of private financing, and banks will continue to play a key role in channelling it. Investments raised through capital markets from large institutional investors and from retail investors will be important as well.

This is why we embarked on the flagship Capital Markets Union (CMU) project so that our financial system can provide the finance needed. Several initiatives in the 2020 CMU action plan are particularly relevant for developing equity financing:

For example, in May, EU co-legislators reached an agreement on the European Single Access Point. This will be a one-stop shop for investors and make it easier for them to find information to invest across borders.

It will give companies more visibility and open up more sources of financing.

Several other proposals are still under discussion with the European Parliament and EU Member States. The Commission is ready to work with them to conclude all the outstanding CMU legislative proposals.

The Commission has proposed an EU-wide Debt-Equity Bias Reduction Allowance to address the tax bias that disadvantages equity financing. At the moment, the interest that companies pay on debt is tax deductible, whereas their costs on equity are not.

The Listing Act aims to make it easier and cheaper for companies, particularly smaller ones, to access public markets. It will simplify and ease initial and ongoing listing requirements to reduce costs and increase legal certainty for issuers.

The Retail Investment Strategy will empower retail investors to take full advantage of EU capital markets, making Europe an attractive, safe place for people to invest. Retail investment, including in equity, is vital for funding the EU economy.

We proposed to make withholding tax procedures simpler and faster, and to help tackle related tax fraud. Our open finance proposal aims at making data flows more efficient as a way to promote more effective competition between financial service providers.

By deepening the CMU, the Commission has taken significant steps to make sure that European companies – SMEs especially – can access the type and amount of funding that best correspond to their needs, at all stages of their development.

And by giving people opportunities to save and invest for the long term, the CMU contributes to a more inclusive and resilient economy and society.



Q&A

MAIREAD MCGUINNESS

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

Helping the financial sector support growth, innovation and competitiveness in Europe

How is the EU sustainable finance framework contributing to the objectives of the Green Deal and what progress has been made so far in this area?

The European Green Deal is Europe’s growth strategy for a climate neutral economy. Public finance alone is not enough to meet the needs of the transition. Private investment is key. That’s why sustainable finance is one of the pillars of the European Green Deal. The EU sustainable finance framework is amongst the most advanced globally. The European Commission has developed an EU Taxonomy that classifies economic activities based on performance criteria that show commitment to six climate and environmental goals. We have also finalised new European sustainability reporting standards that will allow companies to report on their sustainability performance systematically and in a comparable manner.

The Taxonomy is the flagship initiative of the sustainable finance agenda. How is it succeeding in mobilising the private sector and supporting the transition?

The EU Taxonomy serves as a compass to guide investors and companies towards an effective sustainable transition. It offers new opportunities to finance the decarbonisation of industry and attract capital and investments towards technologies that will significantly reduce emissions over time. It includes activities that are already low-carbon, as well as activities where significant emission reductions can be achieved. The Taxonomy also recognises investments in economic activities that will become Taxonomy-aligned within five (or exceptionally ten) years. These investments can be disclosed as Taxonomy-aligned capital expenditures and financed through European green bonds.

There are already good signals in the market. First indications of corporate reporting from this year are encouraging, with

companies in a number of sectors making use of the EU Taxonomy as part of their sustainability efforts. By May, 63% of STOXX Europe 600 undertakings had already disclosed their taxonomy eligibility and alignment.

What are the main tools that are being developed to allow an adequate financing of the transition? Are there major issues remain to address?

As we want to promote greater sustainability in the EU economy, the Commission’s main priority is to ensure that the sustainable finance framework is as effective and usable as possible. Our expert advisory group, the Platform on Sustainable Finance, is working on this. We will provide FAQs to support firms to implement our framework. In our June sustainable finance package, we explained how companies, banks, investors and financial intermediaries can use the Taxonomy and other sustainable finance instruments on a voluntary basis. There are other tools that companies can use to finance their transition, especially where the Taxonomy does not yet cover their activities. The EU Taxonomy focuses on activities with a significant potential to improve climate and environmental impact. The fact that a company has no Taxonomy-aligned activities is not sufficient to draw conclusions on its impact on the environment or its ability to access finance.

Are technologies such as cloud, AI and DLT expected to fundamentally change the financial industry structure and value chains in the coming years? What are the related opportunities and risks?

Digital technologies, such as cloud computing, the Internet of Things (IoT), Artificial Intelligence (AI), blockchain and Distributed Ledger Technologies (DLTs), are at the

core of the digital transition. These technologies could fundamentally alter the financial services value chain and user experience because they can quickly scale up, collect and process real-time data, without human intervention. As with all technologies, we should embrace the benefits while mitigating the risks. For the financial sector, the pressure is on to embrace new technologies, rather than invest in legacy infrastructures. For example, greater use of AI and IoT could provide cost savings through automation, enable predictive analytics for better product offerings, create more effective risk and fraud management processes, and facilitate regulatory compliance. DLT could also lead to greater efficiency by enabling financial intermediaries to share a view of events on a DLT platform. This could be a paradigm shift for the financial sector, which currently relies heavily on proprietary accounts and ledgers. But the use of digital technologies entails security, privacy, liability, societal, economic, and ethical risks. Another key concern is that technology is not always easy to explain and predict. So it can be hard to control its use and anticipate its risks.

What is being done by the Commission to maximise the benefits and mitigate the potential risks from the digital transformation?

To incentivise the scale-up of these technologies in the financial sector while mitigating the risks, we have put forward policies to build trust, ensure safety, and address regulatory gaps and market failures. We adopted a Digital Finance Strategy, a framework to increase cyber-security resilience, and created two bespoke regimes – one for the market in crypto-assets (MiCA) and another to experiment with DLT in more traditional financial markets (the DLT pilot regime). We also published a new Regulation proposal on a framework for financial data access (FIDA) to enable data sharing in financial services that fully complies with GDPR. And we are on the verge of adopting the first major legislation in the world to regulate the use of AI.

How to accelerate progress in the integration of the Euro area banking sector? What are some important challenges in this context going forward?

In recent years, we have taken significant steps towards integrating the European banking system to strengthen the EU's financial stability. We set up the pillars of a common supervision and resolution framework and built on the foundations of a single rulebook. Our recent proposals on the crisis management and deposit insurance (CMDI) framework are the latest step in this ongoing process.

Integrating the banking system is not an abstract goal, but an opportunity for the sector to become stronger and better equipped to face current and future environmental, digital and geopolitical challenges. There is room to expand well-supervised and regulated transnational banking activity in the EU. The challenge is to balance financial stability concerns at national level with the need for a more integrated and efficient single market. One important issue, debated in the context of the recently agreed Banking Package, is the requirement for banks to meet prudential requirements at all levels of the banking group. Another important issue is finalising the third pillar of the Banking Union, the European deposit insurance scheme, which is long overdue. I hope that progress on CMDI will pave the way towards further progress on completing the Banking Union.

Banking groups could already take steps to make full use of the Single Market. Banks could reflect on their cross-border organisational structure and, for example, rely more extensively on branches or make use of the benefits of *Societas Europaea* (which is a type of limited-liability company that allows for a business to be run across the EU using a single set of rules). Financial integration is the best way to achieve robust economic growth and will improve financial stability at national and EU level. Given banks' unparalleled role in financing the EU economy, everyone should continue to do everything they can toward a truly single market for banking.



Q&A

ALFRED KAMMERDirector, European Department -
International Monetary Fund (IMF)

Achieving higher sustainable growth in Europe requires debt policy management

What are the consequences of lasting high inflation on investment and growth? What further steps should European central banks take to address above target inflation?

High and lasting inflation would be costly in terms of output and investment. First, it dampens useful signals from relative price changes that typically help allocate workers and funding efficiently across the economy. As you can imagine, this can be particularly costly at a time of rapid structural change due to higher energy prices or the changing trade patterns following Russia's invasion of Ukraine and geoeconomic fragmentation. Second, high inflation is also more likely to be accompanied by higher volatility of inflation and thus higher uncertainty, which hurts private investment. The longer inflation stays away from target, the higher the uncertainty effect will become. Moreover, high inflation has distributional consequences, hurting the poorer segments of society most.

For the euro area, inflation is projected to converge back to target by mid-2025, conditional on an interest rate path that is projected at the time of our July World Economic Outlook Update to peak at 3.75 percent and stay at that level until mid-2024, before easing gradually. But uncertainty remains highly elevated with risks, on balance, to the upside. When inflation persistence is uncertain, the economic losses from reacting too little and too late are larger than those from reacting too forcefully early on. This is because underestimating the persistence of inflation could entrench higher inflation expectations and force central banks to ultimately tighten more and for longer to bring inflation back to target, resulting in a sharper downturn. There is therefore merit in further hikes of the key policy rates and to maintain a tightening bias, with stronger responses to upside than downside surprises on inflation. This would limit the risks of a meaningful overshoot of inflation above the baseline projection and a potential upward shift in inflation expectations. That said, the ECB should keep its flexible meeting-by-meeting approach to making policy decisions because this rightly

allows it to set rates based on the evolving inflation outlook, the drivers of underlying inflation, and the strength of monetary policy transmission.

In most advanced economies around Europe, the policy rate is yet to reach the terminal rate while in several emerging economies the peak rate was reached earlier this year. So, the question for now remains whether to hold or to further raise rates. However, depending on country-specific developments and conditions, at some point in the future, most central banks will have reached their terminal rates and start to assess whether it is time to pivot towards a gradual easing cycle. Indeed, our current WEO forecast assumes that for many European central banks this moment could come around mid-2024—but, in the end, this will have to depend on how the economic situation evolves. And, given the uncertainty around persistence, guarding against premature easing should be a priority for all.

What are the challenges and concerns raised by excess liquidity (e.g. source of inflation and financial instability) and how to address them? What should be the features of the ECB's Quantitative Tightening (in terms of pace of asset sales, timing etc.)?

When inflation was below target for a prolonged period, several central banks in advanced economies, including the ECB, engaged in asset purchases. The proceeds of these purchases were kept as bank reserves (or deposits with the central bank) beyond what was strictly needed for banks to meet their reserve requirements (hence the term excess reserves or liquidity). The way these purchases created inflation and stimulated the economy was by lowering risk premia and, thus, creating the incentive for households and firms to borrow more.

So far, in this tightening cycle, financial indicators have responded more or less as expected to interest rate hikes. Banks have reduced their loan volumes, increased their lending rates

to the private sector, and increased their term deposits rates. This speaks to a broadly effective transmission of monetary policy. One welcome feature of this tightening cycle is that the increases in banks' lending rates and term deposit rates are more uniform across euro area members compared to previous years. This will reduce the risk of fragmentation in monetary policy transmission in the euro area. European banks have however been slower in raising overnight deposit rates.

With the hike in interest rates, there is no longer a case to provide accommodation through quantitative easing. This is thus a good opportunity for the ECB to reduce its footprint in the financial markets by gradually reducing its balance sheet. Starting from early 2022, the ECB reduced asset purchases before terminating net purchases under both the Asset Purchase Programs and the Pandemic Emergency Purchase Program. The market's smooth absorption of this reduction has allowed the ECB to fully terminate all reinvestments of securities purchased under the Asset Purchase Program in July 2023.

Interest rates should, however, remain the primary monetary policy instrument. They are the better understood tool relative to quantitative tightening (QT) and easier communicated to the public. We are still trying to fully understand the impact of quantitative easing (QE), and QT may not be simply QE in reverse. Using the policy rate more actively also makes a return to the effective lower bound—which can constrain policy in a downside scenario—less likely.

Consistent with a learning-by-doing approach, QT should thus for the time being remain gradual and cautious. A predictable path for QT allows market participants to adjust their expectations for the additional supply of bonds that need to be absorbed, thereby facilitating a smooth adjustment in bond prices and minimizing adverse impacts on financial stability. A state-contingent approach to QT would formally provide the flexibility to adjust course if financial conditions change sharply.

Are we on the right track in Europe for achieving higher sustainable growth? What is the adequate mix of fiscal and monetary policies?

Fiscal policy and monetary policy will both restrict demand in 2023 according to our assessment, and appropriately so. A tight fiscal policy stance in 2024 will help avoid additional inflation pressures and rebuild fiscal space. In particular, country authorities should allow temporary energy support programs to expire and avoid extending or replacing these with other spending programs. This will require that any new expansionary policy measures introduced during the

preparation of the 2024 budget are offset by other discretionary policy changes. Temporary revenue windfalls from higher-than-expected inflation should be saved.

At the same time, it is indeed imperative that fiscal policy contribute to an improvement in the economy's supply side. The current outlook for long-term growth in Europe is disappointingly low, reflecting both a trend of diminishing productivity growth and decreasing labor supply, including from worsening demographics. The more recent energy price shock has worsened the situation further, with an estimated permanent output loss of over 1 percent of GDP, albeit with large differences across countries.

To remedy this situation, bold structural reforms are needed. These range from reskilling the labor force—focusing on digital skills—and integrating immigrants, to improving labor market flexibility and promoting innovation. Investments are also needed, in particular, to facilitate the transition to renewable energy and green technology. Next Generation EU is expected to play an important role, both in providing funding for investment, and through the structural reforms that form the basis for the release of funds. According to Fund estimates, a full implementation of the Next Generation EU could increase potential growth in the EU by as much as 1.5 percent by the end of the program in 2026. This highlights the need to accelerate implementation by addressing delays and bottlenecks.

Achieving higher sustainable growth in Europe requires deft policy management. The Commission's proposed reform of Europe's economic governance framework recognizes the importance of not sacrificing investment when consolidating public finances, and the positive effect that higher growth—which depends, among other things, on investment—has on public debt dynamics. The Commission therefore proposes that countries that undertake ambitious investment and structural reforms can extend fiscal adjustment periods. This can help create incentives for growth-enhancing policies. At the same time, backloading of adjustment and overly optimistic growth estimates must be avoided.



Q&A

JEAN-PAUL SERVAIS

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

IOSCO pushes forward its initiatives in sustainable finance, FinTech and financial stability

What have been the main achievements of IOSCO’s climate change and energy transition activities since the beginning of the year?

In a major step towards consistent, comparable and reliable sustainability information, in July 2023 IOSCO endorsed the first set of sustainability-related disclosure standards, issued by the International Sustainability Standards Board (ISSB). Investors are demanding better information about sustainability risks and opportunities, and the G20, the G7, and the Financial Stability Board (FSB) rely on IOSCO to assess whether the ISSB Standards are fit for purpose for capital markets. IOSCO’s unanimous and unconditional endorsement was the final step in the extensive engagement between IOSCO and the ISSB over the last two years, culminating in a comprehensive and independent review of the ISSB Standards on climate and on general requirements.

Based on this review, IOSCO has concluded that these ISSB Standards serve as an effective and proportionate global framework for investor-focused disclosures on climate-related matters specifically (IFRS S2), and, more generally, sustainability-related information (IFRS S1). IOSCO has concluded that these ISSB Standards are appropriate for the purpose of helping globally integrated financial markets accurately assess relevant sustainability risks and opportunities. It has also determined that they form an appropriate basis for the development of a robust assurance framework to apply to such disclosures.

IOSCO now calls on its 130 member jurisdictions, which together regulate more than 95% of the world’s financial markets, to consider ways in which they might adopt, apply or otherwise be informed by the ISSB Standards within the context of their jurisdictional arrangements, in a way that promotes consistent and comparable climate-related and other sustainability-related disclosures for investors.

What are the remaining priorities of IOSCO in those areas?

IOSCO will help its members with the implementation or use of the ISSB standards through a program of capacity building. Furthermore, I welcome the ISSB’s commitment to assisting jurisdictions in their transition towards adoption, taking into account the initial challenges faced by preparers and the varying levels of readiness across different jurisdictions, while also ensuring delivery of the consistency and comparability necessary for capital markets.

Progress in the uptake of the standards will be monitored under the political aegis of the FSB and the G20. The FSB has asked the ISSB to deliver a report in 2024, liaising with IOSCO as appropriate, on progress in firms’ disclosures, including on early uptake of the ISSB standard on climate-related disclosures and on progress in achieving interoperability.

To attain global comparability of climate-related disclosures, establishing interoperability between the ISSB’s global framework for climate-related disclosures and the specific requirements of national and regional jurisdictions becomes a key factor. As an example of progress in this area, coming just after the endorsement of the ISSB standards by IOSCO, the European Commission, in its European Sustainability Reporting Standards (ESRS), has taken significant steps towards integrating the ISSB disclosure requirements, bringing all 27 Member States of the European Union (which is such an important part of the global financial markets) into the global wave of support for the ISSB standards around the world.

IOSCO also welcomes the fact that the International Auditing and Assurance Standards Board (IAASB) is consulting on the exposure draft of their International Standard on Sustainability Assurance (ISSA) 5000, General Requirements for Sustainability Assurance Engagements. Corporate reporting, including sustainability-related disclosures, is indeed more trusted when it receives external and independent assurance based upon globally accepted standards that have been independently developed in the public interest.

IOSCO will review the draft IAASB standard from the perspective of global capital markets, considering the issues of market integrity and investor protection. IOSCO will do the same for the expected new proposed ethical and independence Standards developed by the International Ethics Standards Board for Accountants (IESBA). Once the relevant audit standards have been set, the necessary global arrangements will be in place for the issuance of consistently prepared and independently assured sustainability disclosures by companies across the globe, starting with their end 2024 accounts.

Finally, by the end of the year IOSCO will publish further policy considerations regarding voluntary carbon markets, complementing IOSCO's report on well-functioning compliance carbon markets issued in June 2023.

What are the main risks and vulnerabilities of the financial sector in the current macroeconomic context? What are the actions undertaken by IOSCO to address those risks?

During the global pandemic, retail investors encountered new and bigger risks; some of these risks may continue into the future or evolve. In response, IOSCO will continue taking initiatives aimed at combating retail market misconduct and fraud, promoting investor confidence and financial inclusion, and protecting the investor interests.

The events of the past year have highlighted the intrinsic volatility and structural vulnerabilities of crypto-assets and related actors. They have also illustrated that the failure of a key service provider in the crypto-asset ecosystem can quickly transmit risks to other parts of that ecosystem. Significant risks in the crypto-asset market include fraud, money laundering, misappropriation of funds and market manipulation. To mitigate the risk that crypto-assets can pose in term of retail investor harm, IOSCO recently launched a consultation on detailed recommendations to jurisdictions worldwide on how to regulate crypto-assets and adequately address the risks they pose.

The recommendations stem from the principle "same activity, same risk, same regulatory outcome" and propose to address, amongst other things, issues such as conflicts of interest and the safe custody of client assets.

Our actions contribute to the building of an international framework for crypto-assets by the FSB and the standard-setting bodies such as IOSCO, as envisaged by the G20. Virtual activities are truly global by nature and operate on a cross-border basis, which makes international consistency

in the application of regulatory and supervisory frameworks crucial. The collaborative efforts between IOSCO and the FSB guarantee that the ongoing work on the monitoring and regulation of crypto-asset activities and markets is well coordinated and mutually reinforcing.

Jurisdictions are encouraged to ensure the timely and faithful implementation of the IOSCO recommendations once the report is finalized at the end of the year, so as to mitigate the risk of regulatory arbitrage. Implementation of these recommendations will be monitored appropriately.

In the coming weeks, IOSCO is set to launch a consultation on policy recommendations regarding Decentralized Finance (DeFi), intended to be finalized by the end of 2023. These recommendations are aimed at tackling market integrity and investor protection concerns stemming from DeFi and at following a 'lifecycle' approach to addressing the key risks relating to DeFi by applying IOSCO's widely accepted global standards for the regulation of securities markets.

On the financial stability front, recent market developments have led various international bodies such as the FSB and the Basel Committee, as well as IOSCO, to assess the priorities of their work programme. In this respect, IOSCO will strengthen its efforts to address structural vulnerabilities in non-bank financial intermediation (NBFi), in partnership with the FSB. This will include monitoring the effectiveness of the 2021 policy proposals for money market funds, updating measures on liquidity mismatches in open-ended funds, and conducting work on margining practices and hidden leverage in NBFi.

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ECONOMIC CHALLENGES AND POLICY PRIORITIES FOR THE EU

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REFORMING THE STABILITY AND GROWTH PACT



VINCENT VAN PETEGHEM

Deputy Prime Minister and Minister of Finance, Belgium

Reform of the EU budget rules: towards a new generational deal

The European budgetary rules are still out of order. Due to the severe energy and purchasing power crises, the General Escape Clause has put the rules temporarily on hold. But starting in 2024, we again fall under this framework. As those budgetary rules are clearly outdated, we are currently discussing a much-needed reform.

Of course, 2024 is getting there rapidly. Therefore we need to reach a swift agreement on this reform. We need to create predictability. Especially at a moment when economic forecasts are surrounded by uncertainties, we as politicians should provide clarity and prepare the long term. Our citizens and companies, but also the financial markets need a long-term perspective on where we are heading to.

When it comes to the political discussions, the main division lines are clear now: we need to find an agreement that combines a more country-specific based approach with certain minimum quantitative benchmarks.

According to me, it will be a matter of political courage to reach a compromise. This is not about pitting countries against each other, but about creating a new deal with our future generations. There can be no taboos, no red lines, for no single actor involved. We need to find an agreement with all 27 Member States, and with the European Parliament. Therefore, each of us will need to jump over its own hurdles.

Finding a new balance, a new deal with our future generations, is of utmost importance because the existing European budgetary rules did not work in the past and would not do so in the future. These rules do not take into account the different foundations on which our economies are built. They do not recognize the heterogeneity of economic performance between euro area countries. One-size clearly does not fit all, when it comes to debt reduction trajectories. Moreover, the budgetary rules are not adapted to the current macro-economic environment. The European fiscal framework sets the pace (1/20th rule) at which Member States must reduce their debt levels to the 60% benchmark (the average when the rules were created in 1992). For many Member States, that pace is far too high, making compliance unachievable. In order for the rules to be applied, they should at least be realistic.

Therefore, more than ever, a thorough reform is needed. Of course, the starting point of the European fiscal rules remains

unchanged: we need sustainable debt ratios in the medium and long term. Nonetheless, the current focus has shown to be too one-sided. In addition to a healthy budget, we also need a strong economy. Productivity and future economic growth - through investments and reforms - must also have their place. Because those too have a positive effect on future debt levels.

Over the past years, I have been highlighting the importance of structural reforms, the need to structurally tackle the deficiencies of our labour markets, of our pension systems, and tax systems. A reform of our budgetary rules should not solely focus on reducing debt, but should encourage Member States to improve the supply side of their economy in order to achieve higher sustainable growth.

In order to incorporate reforms and investments into the European fiscal framework, I have been pleading for a more commitment-based approach. Member States should set up a package of investments and reforms according to their country-specific needs, allowing them to extend their debt reduction trajectory. This could create more ex-ante flexibility. But ex-post, this mechanism will also enhance compliance and an effective commitment of a member state to its fiscal path, due to strict control of this package.

Of course, the eligible investments allowing for a prolonged debt trajectory need to be growth-enhancing. This requires a clear labelling of investment, and those 'labelled' investments would need approval by the Member States. This more country-specific approach will not only create more ownership for Member States, it will also encourage Member States to see debt reduction, investments, and reforms as one package for increasing the resilience of their economies.

Therefore our future budgetary framework should shift away from the one-sided focus on debt reduction, towards a tripartite European budgetary framework with a focus on and debt reduction and investments and reforms. Only this way, we will be able to align debt reduction with strengthening our future economy, towards a new intergenerational deal.



GINTARĖ SKAISTĖ

Minister of Finance of
the Republic of Lithuania

The new fiscal rules must be realistic and account for fundamental challenges

In recent years, the EU has grappled with a series of significant shocks, ranging from the global pandemic to Russia's war against Ukraine and the energy price shock. While the EU has demonstrated remarkable agility and resilience in the face of these unprecedented challenges, it has come at the cost of elevated public deficits and mounting debt levels across member states.

The deterioration of public finance came at the time of significant shifts in the macroeconomic environment. With the inflation rate surging to levels unseen in decades, central banks were prompted to raise interest rates in an expeditious manner. Consequently, the era of low interest rates has gone to the past, and debt accumulation is becoming increasingly costly. Though the rise in public debt does not pose immediate debt sustainability risks, vulnerabilities in fiscal positions may grow as member states will have to refinance debt at much higher interest rates in the future.

Against this backdrop, the reform of the EU fiscal rules takes on paramount importance, particularly as the general escape clause will be deactivated next year. We are faced with a looming risk that a return to the old rules, which require annual debt cuts by 1/20 in excess of 60% of GDP, may impose overly burdensome consolidation paths on high-debt countries, leading to economic hardship that could weaken these member states and the entire euro area.

The EU economic governance review presents a significant opportunity to enhance the fiscal framework and address the shortcomings of the current rules. There is a broad consensus that a one-size-fits-all approach has not yielded satisfactory results over the last decade, especially considering that public debt levels in the EU have increased. We have substantial heterogeneity among member states in terms of economic performance and the state of public finance and the revised fiscal rules must duly take the existing reality into account.

The Commission's proposal rightly aims to introduce a forward-looking and differentiated approach that would reflect country-specific circumstances. The new approach should lead to realistic and achievable fiscal objectives tailored to ensure sustainable reduction of debt in high debt countries and it should be effective in preventing excessive debt accumulation in countries with currently low debt levels. Granting member states with enough room for political manoeuvre in shaping their reforms and investment policies within the agreed fiscal adjustment path will be vital to foster the sense of national ownership.

The introduction of a forward-looking perspective and differentiated fiscal targets should go hand in hand with strengthening the multilateral nature of the fiscal framework and ensuring equal treatment of all member states. The credibility of the framework should be supported by maximum

transparency at every stage of the fiscal cycle as well as a strengthened role of the EFB and IFIs. All together this should provide a robust accountability mechanism to ensure member states adhere to the agreed-upon rules and targets.

Security challenges caused by Russia's war against Ukraine require adequate attention in the review. A sensible treatment of the defence spending should be upheld, though not in the form of a "golden rule", but rather smart and targeted flexibility that would allow bolstering expenditure aimed at preserving the territorial integrity of the EU and security of the member states, especially for countries with an external EU border and ample fiscal room. For instance, such spending could be regarded as a relevant factor when assessing breaches of the 3% deficit limit.

Security challenges require a sensible treatment of the defense spending.

The renewed fiscal framework must aptly account for the challenges and opportunities presented by the green and digital transformation era. The proposed flexibility to extend the adjustment period for countries committed to growth-enhancing reforms and investments is a welcomed feature, but it must be complemented by a rigorous ex-ante and ex-post assessment of the quality and efficacy of intended reforms and investments.

Sufficient safeguards must also be put in place to prevent backloading of fiscal adjustment and ensure a sustainable decline in debt levels, which remains the overarching objective of the economic governance review.

In conclusion, the ongoing review of the fiscal framework holds immense significance for the future economic trajectory of the continent. Drawing on the lessons of the past and taking into account the broader economic, technological, and geopolitical context, the EU can strengthen its economic governance foundation to ensure prosperity and resilience for member states and the Union.

OPEN STRATEGIC AUTONOMY AND EU ECONOMIC SECURITY



JOHN BERRIGAN

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

An open and resilient EU economy and financial system

Over the past years, the Commission has been pursuing a policy of “open strategic autonomy” in financial services to benefit from financial integration while defending the interests of the Union and strengthening its role on the world stage. The objective is to avoid excessive reliance on non-EU service providers or jurisdictions and increase the EU’s preparedness in a world of growing uncertainty, while remaining integrated in an increasingly multi-polar world.

The EU’s vision of open strategic autonomy is to ensure that our global interdependencies are sufficiently diversified and based on long-term, trusted partnerships that uphold high regulatory standards and reinforce international cooperation through cross-border investments and exchanges. In finance, open strategic

autonomy can reinforce Economic and Monetary Union, foster a stronger international role of the euro, and deliver more developed and resilient financial market infrastructures. The Commission issued a Communication on this topic in January 2021, to foster openness, strength, and resilience with the goal of strengthening the European economic and financial system.

The EU financial system is considered one of the most open in the world, building on the implementation of strong international standards and supervisory arrangements. Currently, in some areas, such as investment banking, the EU relies heavily on large foreign players for specific financial services. This reflects our globalised world, where competitive specialisation based on comparative advantages goes hand in hand with interdependence. While remaining open, the EU financial sector has also increased its resilience over the last decade.

The euro has consolidated its place as the second most used currency internationally. Moreover, the uniform enforcement of high regulatory and supervisory standards has strengthened the banking sector, which remained resilient against the turbulence in the US and Switzerland last spring.

That said, much work remains to be done to reinforce the resilience of the EU financial system. For example, the EU banking sector remains fragmented due in part to a sometimes suboptimal capital and liquidity allocation between parents and subsidiaries, low profitability levels, different legal systems etc. In addition, while two pillars of the Banking Union are already in place, the third pillar, a common deposit insurance scheme, is still missing.

A key challenge going forward will be to balance financial stability concerns at national level with the need for a more integrated and efficient internal market for banking, within a well-regulated prudential and resolution framework with single supervision and resolution in the Banking Union.

Several policy responses can be envisaged to foster market integration, such as a more efficient and fungible allocation of capital and liquidity within cross-border groups and the operationalisation of single-point-of-entry resolution strategies, while taking account of

financial stability concerns. Promoting the establishment of a European deposit insurance scheme would also enhance the allocation of capital, make liquidity management more efficient, ensure the same protection to all depositors, foster mutualisation of risks within the Banking Union and alleviate concerns that banks are European in life but national in death.

Building a Capital Markets Union is another top priority going forward. EU citizens are amongst the world’s best savers and during the pandemic saved almost €1 trillion, topping up already historically high savings. There is untapped potential to activate these largely passive savings so that they get a better return for consumers and better support the EU’s capital markets and business financing needs.

An open and resilient economy and financial system bolsters the EU’s role on the world stage.

The Commission recently adopted the Retail Investment Strategy which seeks to support this goal and aims to empower retail investors to make investment decisions that are better aligned with their needs and preferences, ensuring that they are treated fairly and duly protected. With this, the proposal seeks to enhance retail investors’ trust and confidence to safely invest in their future and take full advantage of the EU’s capital markets union.



MAGDALENA RZECZKOWSKA

Minister of Finance, Poland

Open strategic autonomy of the European Union and the Capital Markets Union

The phrase “autonomy” has been at the very centre of the European debate in recent years. Autonomy often erroneously evokes negative connotations, associated with its former understanding, however in our view, it should no longer. Autonomy does not have to mean protectionism or separatism, but quite the opposite. Autonomy is about making own decisions, own alliances and working together with partners to defend common ideals.

Obviously, threats to EU’s autonomy usually result from external challenges. An ongoing test to EU solidarity and resilience is Russia’s aggression against Ukraine. And this is not the only challenge - growing economic protectionism in the world is becoming another. Today, we are confronted with a world in which we either preserve autonomy or risk becoming superfluous. Strategic autonomy should provide the Union with the means to independently engage in constructive dialogues with any of our partners. Also, the EU should provide a supportive environment for growth-enhancing investments, green

and digital transitions and building defence capabilities of its Member States. However, we must never forget to strengthen the single market, which is absolutely the basis of our autonomy. And finally, the EU needs to become more self-sufficient by reducing existing dependencies on fossil fuels and critical raw materials.

But the concept of autonomy refers also to internal challenges. And those may be well illustrated by all the pressures resulting from the Covid-19 crisis. Pressures on healthcare systems, economy and the organization of the market, that depicted the vulnerabilities when it comes to global supply chains and the inextricable ties to major Union’s economic partners. Therefore, the European Union’s open strategic autonomy must be understood in this highly dynamic and complex context of global trade flows, resource dependency and ongoing environmental crisis, as well as the future challenges of green and digital transitions.

And what about “financial” autonomy and its relationship to “strategic” autonomy? First of all, there is general agreement, that the financial sector is a key area in which open strategic autonomy can be ensured. And it was Brexit that raised the question of the EU’s financial autonomy, as it has highlighted the key dilemma in whether the Union’s economy should remain merely an importer of financial services delivered by third countries or should it build some form of strategic autonomy in finance.

**The diversity of EU
Member States should
not be perceived as
an obstacle, but as an
opportunity.**

The question remains on how to achieve the EU’s autonomy in the field of finance? While there are various answers to the question, we believe that accelerating the implementation of the Capital Markets Union is critical for creating a more resilient, inclusive and green economy. But in order to fully understand our position one should realize that CMU is not merely a sectorial policy – it underpins the health of the entire European economy. And we believe the main opportunity of the CMU is not centralization, but rather its diversity. Let’s repeat it once again – the diversity of EU Member States should not be perceived as an obstacle,

but as an opportunity. The motto of the Union, “United in diversity”, should thus become the guiding principle for designing a multi-centred CMU that will work to the benefit of citizens and companies in all Member States.

And in order to accelerate the implementation of the CMU, there are several priority areas to be addressed. We think we must consider best practices from regions that have successfully developed their markets; rebuild local ecosystems through regulation that is better adapted to the size of companies and markets; develop private capital markets and alternative ways of financing; build an equity culture in Europe; and last but not least – review prudential regulation to prevent it from handicapping the sector’s capacity to finance the economy.

With regard to possible regulatory initiatives, it should be noted that while the traditional investment services market appears to be sufficiently regulated, several emerging investment activities remain outside the system. Many far-reaching requirements for traditional investment companies can be contrasted with the almost complete lack of regulations regarding the phenomena emerging in the investment area resulting from the technological revolution - such as artificial intelligence, social media and influencers providing investment advisory, as well as the phenomenon of “copy trading”. It seems that the regulatory environment is not keeping up with the rapidly changing technological reality.

In general, we believe that at the current stage of deepening of the CMU, efforts should be made not to create new regulations, but rather to review the existing ones and eliminate barriers, including those at the individual Member States’ level. An example of such activities may be the Capital Market Development Strategy adopted in Poland with the support of the European Commission and currently being implemented.



ANIKÓ TÚRI

Permanent Secretary of State -
Ministry for Economic
Development of Hungary

The holistic view on open strategic autonomy and competitiveness

As we all know the financial services is based on prudential approach, the preparedness for the unexpected crises. In the last decade we could experience the results of vulnerabilities and the benefits of resilience. Open strategic autonomy is the realisation that EU should look at the specific risks of its open economy in European perspective, which has the broader context in the EU economic security.

The current geopolitical environment has put even more pressure on the EU to look the effectiveness and competitiveness of its regulatory system on a global scale. The double transition of digitalisation and sustainable finance also entails several issues linked to strategic autonomy, like critical service providers, central banks digital currency, the treatment of critical raw materials and sustainable energy supply. For example, in line with the communication of 2021 the legislative work on digital euro has started, the EU Green Bond standard has been approved, and the next step is the practical implementation through taxonomy and ESG ratings, which are underway.

An important goal of the open strategic autonomy is the greater self-respect of EU interest, an open economy which is capable of self-sustainment.

An autonomous economy welcomes investments working in the interest of EU's economic success.

There is a need of holistic approach to identify vulnerabilities of the EU and of its Member States. When we map these risks we should focus on long term competitiveness, and the ability of the financial sector to finance the sustainable growth of the real economy. While upholding our European values, like the open economy, we should increase our room for manoeuvre globally dealing with various partners by strengthening our competitiveness and resilience.

If we turn to the question on how to achieve financial autonomy and competitiveness the priority area should be effective crises management in banking, and moving forward on Capital Market Union, where accelerating digital and green transition can play a key role.

Open strategic autonomy is also about the use of our own resources, like domestic funding of economy by EU savings through equity financing. A good way forward to enhance the involvement of European savings in the domestic funding of economy in relation to bonds and equities is clearly the public and private partnership, for example in the field of green finance, but also in general to finance the real economy.

**An autonomous economy
welcomes investments
working in the interest of
EU's economic success.**

The regulatory regime should enable efficient and proportionate approaches. Strong cross-border financial institutions emerge from efficient companies, mergers and acquisitions happen if there is a business case for them. The role of the prudential regulation is to ensure stability in all institutions, and not to distort the level playing field by preferential treatment. EU should deepen the single market, but also uphold a level playing field.

In the banking sector the EU has achieved a high level of resilience and integration. The foundation for further integration is trust among regulators, supervisors and consumers.

We should avoid fragmentation of the EU banking sector by making sure that consumers can be confident in the resilience of local subsidiaries of banking groups. The supervisors knowing best the local entity and its environment, with sensitivity to local and regional trends, can act quickly and efficiently. Banking groups are strong if they do not have a weakest link, and supervisors can cooperate effectively if they have trust among themselves, this way can transnational banking groups stay integrated. Concerning regulation we should aim to reach the common goals by taking into account local specificities.

In these objectives the focus should not only be on financial stability, but the safety of supply in case of financial services also an issue of consumer protection, which in our digitalised world includes financial education. Meanwhile it should be highlighted that the openness in our strategic autonomy is important for competition to strengthen competitiveness and for consumer experience.

The new institutional cycle starting from next year is a good opportunity to make the second step in strategic autonomy, including a possible new approach to Banking Union with a focus of efficiency and the new Capital Market Union action plan, which could be a flagship for the next institutional cycle starting in a year's time. Deepening the capital markets in all EU Member States would obviously help to strengthen the open strategic autonomy.



EMMANUEL MOULIN

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

Moving forward on strategic autonomy: how can the EU become more sovereign

Strategic autonomy has become a central topic in the last two years in policy thinking in response to the numerous geopolitical and economic crises Europe is facing. The French presidency of the Council took a major step forward in these debates with the adoption of ambitious conclusions in April 2022. Moving forward on strategic autonomy remains more than ever a necessity as Europe is still confronted with a challenging economic context resulting from the war in Ukraine, the energy crisis and the global economic competition after the launch of the Inflation Reduction Act (IRA) in the United States.

As with any policy decision, achieving strategic autonomy will require to balance between opening the financial sector to new players, technologies and practices, in order to achieve the digital and sustainable transition our economy needs and foster innovation, while ensuring a financing of our economies that respects our values and policy goals.

To achieve this objective, we have to keep working collectively on all levers we have at our disposal in order to work on an economic and financial legislative framework that supports strategic autonomy. For that, we need to make our capital markets more attractive and integrated, our banking sector more competitive and resilient and our economy less dependent to external shocks.

First, we need to ensure a proper functioning of our Economic and Monetary Union. The digital euro appears to be one of the tools to foster strategic autonomy in the field of payments, while adapting the euro to the digital age. Proposals brought forward by the Commission on the digital euro and the legal tender of euro banknotes and coins are important steps forward to structure the debate on the project, with far-reaching implications on the payments landscape. Beyond the digital euro, the revision of the payment services directive should also be the way to comfort the emergence of innovative pan-European payment champions.

Second, we need to complete both the Capital Markets Union and Banking Union. On the Capital Markets Union, to address the current shortage of long-term capital, some efforts are required both at the European and national levels. At the national level, in order to boost the level of savings available for the financing of the green transition in France, we have recently adopted a “green industry law” which will lead to better channel savings towards the funding of the green transition. At the European level, we have entirely revamped the European alternative fund structure, in order to offer European savers a common vehicle to channel their savings towards the real economy.

It is time to accelerate to make strategic autonomy the key driver of the construction of a stronger European financial system.

Regarding the other files being discussed as part of the CMU action plan, our key priorities should be to (i) revitalize securitization, (ii) enhance transparency in capital markets and (iii) simplifying our firms’ access to capital markets, with specific attention to small and medium-sized enterprises.

On the Banking Union, I support the recent agreement on the Banking Package to transpose the Basel agreement as it will increase further its resilience while ensuring its capacity to provide sufficient financing to the European economy. The agreement also places the EU in a leading position to implement its international commitments on time. This is complemented by the recent Commission’s proposal on the crisis management framework for which protection of deposits and a proper financing of the resolution scheme will be essential. Progress is also on the way on the insurance side with the recent adoption of the Parliament’s position after the agreement in Council in June 2022 under the French Presidency.

Third, we need to preserve and build on our EU specificities in a more globalized and competitive world. The European Union has put forward a powerful response to the IRA with the Green Industrial Plan in order to make Europe a more attractive place for green industrial projects. Europe should keep playing a leading role in the development of sustainable finance in order to mobilize the private capital required for the green transition.

The current development of European sustainability reporting standards to streamline the sustainability information provided by companies is, after the Taxonomy, a good example of how the EU can position itself as a front-runner in standard making. Europe is also taking the lead on providing the means and conditions for an orderly digitalization of the financial sector with the recently published initiatives on the review of the PSD2 and open finance together with the ongoing discussions on the Artificial Intelligence Act and following the agreement on the Data Act.

Strategic autonomy should therefore remain a guiding principle in the different reforms we undergo to shape the financial system according to our needs and challenges. Europe has taken significant steps forward in front of the crisis it has been confronted with. Now, despite the challenging context and the upcoming reshuffle of the European institutions, it is time to accelerate to make strategic autonomy the key driver of the construction of a stronger European financial system.



PEDRO CASTRO E ALMEIDA

Regional Head of Europe -
Banco Santander

A competitive Europe requires competitive banks

The war in Ukraine, the COVID pandemic, and the increasingly fragmented global economy have sharpened the focus of EU policymakers on the need for strategic autonomy and economic security. That will translate into new ways to set priorities and make choices for the next several years.

The key to success in this new paradigm will be growth, driven by competitiveness. Only growth and competitiveness can provide the security, social equity and sustainable transition we seek.

That need for growth has become urgent. In the last decade, Europe's global competitive position has deteriorated. As Jeremy Shapiro and Jana Puglierin of the European Council on Foreign Relations have pointed out, the EU economy was larger than the U.S.'s in 2008, \$16.2 trillion versus \$14.7 trillion. By last year, the US economy had grown to \$25 trillion, while the EU plus the UK were at \$19.8 trillion. The U.S. economy is now a third larger than the EU plus UK and 50% larger than just the EU. If this trend continues, the EU's leadership as a setter of global rules for trade, standards and sustainability – its projection of soft power – will not be tenable.

Banks, which provide 70% of financing to Europe's businesses, large and small, have a key role to play in recovering competitiveness and growth. After building capital buffers during the 15 years since the Great Financial Crisis, Europe's banks are resilient, as their support during the pandemic and the war in Ukraine show. But the current regulatory framework remains tilted toward financial stability, affecting banks' competitiveness and capacity to finance sustainable growth.

Despite its resilience, EU banks are just starting to earn their cost of capital, while US competitors have returned some time ago to pre-crisis profitability. The lower returns have been driven by comparably poor eurozone growth, fragmented markets, lack of scale and the long period of negative interest rates.

Meanwhile, banks still face obstacles to consolidation across the eurozone. Banking Union is incomplete, while political and regulatory restrictions prevent the emergence of universal banks across borders. Divergent national regimes on insolvency, consumer protection, product disclosure, data housing and other areas fragment what is supposed to be a single market.

Furthermore, the EU's capital market union is underdeveloped, limiting financing choices for large companies and SMEs. A weak securitization market and market fragmentation hampers investment within the EU and also dampens funding from outside. SMEs and retail investors lack access to capital markets. Yet more financing, including equity, is needed to build strategic autonomy and sustainable, economic security.

Europe's competitiveness and growth needs competitive banks.

Banks are ready to do their part in meeting these challenges. Estimates vary, but only a slight recalibration of capital requirements towards growth could unlock trillions in lending across Europe.

Finishing unfinished policy projects can play their part as well. As we look to the new five-year Commission and parliamentary period, growth and competitiveness should guide choices as Europe seeks autonomy and security. In banking, this would mean:

Completing the Banking Union: The lack of a banking union one of Europe's biggest missed opportunities – the

European Parliament has estimated the completed economic and monetary union could add €321 billion a year to the economy by 2032. Without a European Deposit Insurance Scheme (EDIS), the missing third pillar of the banking union, we face impediments to intra-EU transfers and do not have a level playing field to offer retail banking across borders.

Developing the Capital Markets Union (CMU). Together with the banking union, this is essential to finance the green and digital transitions, enhance the global role of the euro and reduce excessive dependence on banks from other jurisdictions. The priority should be on strengthening the securitization market as the best way to connect capital markets to the real economy. Europe's securitization market (including the UK) is about 6% the size of the US', representing about 1% of GDP compared to 18% in the US, according to a recent study by Oliver Wyman.

Policy-makers should also support EU businesses operating in third countries, a crucial element of strategic autonomy and economic security. The next Commission should ensure that the EU rules do not penalize European businesses operating abroad.

Santander's purpose is to help people and businesses prosper. We are a driver of the green transition and the digital transformation of our society. We have 164 million customers and work with more than four million SMEs.

For Santander, Europe is not only our home, but our future. We stand ready to work with all stakeholders to build a better Europe for all.



VITTORIO GRILLI

EMEA Chairman -
JP Morgan

Open strategic autonomy and the completion of CMU: what's next

The COVID experience and recent geopolitical issues have shown Europe's vulnerabilities in some of its external dependences. Open strategic autonomy should be seen as increasing the EU's resilience in these strategic sectors, where trade flows should no longer be the main determinant for openness. However, applying the EU's strategic autonomy objectives in the financial sector should be handled with care.

By their nature, banking and financial markets increase their resilience and quality through the strength and breadth of their network. The more national they are, the less resilient they are. The transatlantic nature of financial markets is a sign of strength.

The involvement US banks in EU capital markets supports the EU's aspiration of capital market financing for the EU economy. US banks have beefed-up operations in the EU, including by moving or creating new highly paid roles inside the EU.

Part of a concern about "reliance" on US banks relates to the incorrect perception that non-EU banks retreat to their home markets in times of crisis. However, the

opposite has happened. If we take the example of the COVID crisis, (I've quoted these figures before), JPMorgan increased lending by >20% during COVID in 2020.

Rather than retreating, the participation of global firms in the EU system adds competition and market depth, to the benefit of EU clients. The EU should remain open to international financial markets, which fortifies its resilience.

Policymakers should keep this in mind when looking at the next EU mandate. The objectives of the Capital Markets Union (CMU) should be taken forward with even greater ambition. Recent events have shown how more diversified sources of financing in the EU and relatively less dependence on bank funding increase resilience.

Good progress has been made since the 2015 CMU Green Paper, including on covered bonds, private pensions, long-term investment vehicles and listing rules. Going forward, fundamental securitisation reform should be a key part of these efforts to reduce pressure on banks and open up lending to help support the economy.

Re-launching and scaling up securitisation is an essential component of the CMU, and can bring considerable benefits to the European financial system by reducing over-reliance on bank funding while encouraging cross border investments. When developed in such a way as to be responsible, prudentially sound and transparent, securitisation seemed to us to be an important vehicle to increase the capacity of banks to lend and also for investors to have access to European credit products.

Re-launching and scaling up securitisation is an essential component of the CMU.

For example, there should be a clearer role for Competent Authorities in Significant Risk Transfer assessments. For the sake of a global level playing field, the EU prudential rulebook and the Basel framework should to be amended when it comes to recalibrating capital charges for senior securitisation tranches (both for banking and insurance) and when reassessing criteria under the Liquidity Coverage Ratio (LCR). In considering these changes, it goes to the ability of banks to support clients with securitisation exposure and market making, rather than primarily as investors.

The potential funding that a truly functioning securitisation market could unlock is considerable. Some international comparisons give an idea about the potential. For example, securitisation has represented 12.5% of GDP in the US (excluding GSEs) and 12% in the UK vs. 3% in the EU-27. This suggests the enormous potential securitisation has in the EU to advance capital markets union and green finance, but it does not mean that the same levels should be replicated in the EU.

For the next Commission, it would also be important to facilitate disclosure and due diligence requirements, both in the context of public and private and third country securitisation to ensure a more proportionate approach to disclosure requirements. We also ask for the facilitation of the securitisation of legacy portfolios and allow the development of an active market for buying and selling pool of assets in Europe, notably by explicitly allowing the practice of re-underwriting the loans in cases where an entity acquires legacy and NPE pools.

At the same time, we need to ensure that the EU is stronger when it comes to the flow of capital across its members. This brings me to the Banking Union (BU). We have seen good progress achieved, especially the creation of the single supervisory and resolution mechanisms. The recent proposal to strengthen rules for bank crisis management and deposit insurance (CMDI) is a very welcome one. Although it is a highly political issue, EU policymakers should continue to work to find a common position before the end of this Commission's mandate.

CMU and BU are the fundamental drivers of financial resilience in the EU. The next Commission will be a great opportunity to continue the work, balancing the open strategic autonomy while increasing EU's financial resilience and allowing for cross-border market financing.



STÉPHANE BOUJNAH

Chief Executive Officer and
Chairman of the Managing
Board - Euronext

Aligning supervision, levelling the playing-field and facilitating consolidation

The European Union is a major power centre. With approximately 450m inhabitants, the EU is the third bloc on the planet, behind India and China. With more than \$16,000 billion economic output, the EU trails only the United States and China. With \$1,450 billion net inflows between 2019 and 2022, the EU is the largest destination for Foreign Direct Investments.

In recent years, the EU has achieved impressive results to deliver prosperity, health and security. In 2020, the European Parliament and Member States agreed to launch the €750 billion Next Generation EU recovery and investment package, which is financed by the issuance of bonds by the European Commission. This unprecedented move demonstrates the EU commitment to European cohesion. In 2021, in the context of an EU-coordinated effort, no other region in the world has vaccinated so many people, so quickly, for such a small cost. By December 2021, 2 billion

doses had been ordered by the EU-coordinated program. More recently, the EU has been massively supporting Ukraine to resist the Russian aggression. EU Member States have channelled close to €61 billion to Ukraine.

These achievements have been attained each time the EU recognized that, even if Europeans have friends and allies, Europeans must ultimately control their future with their own resources. European strategic autonomy is necessary to maintain our European way of life and protect our European values. Making the European strategic autonomy real is the only way to mitigate the possible impact of trade decisions made by China today and uncertain decisions regarding Taiwan tomorrow, or the consequences in Europe of the Inflation Reduction Act today and the unpredictable decisions of voters in certain States of the US tomorrow.

To progress towards strategic autonomy, the EU must nurture critical industrial capabilities. Connecting European investors and global markets with European companies efficiently is a core component of any European strategic ambition. The EU must rely on strong EU-based finance makers to power European markets and to finance European economies. Otherwise, Europeans will be renouncing financial autonomy and Europe will become a continent of finance-takers.

Strong and competitive EU financial companies are therefore a condition to European strategic autonomy. Euronext continues to champion a competitiveness test in order to assess systematically unwanted consequences of any new piece of EU regulation. This competitiveness test should assess whether any policy adjustments hurt the level-playing field between EU-based players and global firms that operate on our continent through their "Europe, Middle-East and Africa" divisions.

**The EU must rely on
strong EU-based finance
makers to power
markets and finance
European economies.**

Empowering EU-based financial players requires moving from similar but different rules towards a single set of rules. Since its IPO in 2014, Euronext has been building the backbone of the Capital Markets Union. Regulated markets in Amsterdam, Brussels, Dublin,

Lisbon, Milan, Oslo and Paris are now operated by a common pan-European organisation and offer a single European liquidity pool, enabled by a single order book, empowered by a single technology platform. Euronext also operates a post-trade platform in Copenhagen, as well as commercial and technology platforms in Bergen, Berlin, Espoo, London, Madrid, Munich, Porto, Rotterdam, Stockholm, Tallinn and Vilnius. Still, Euronext faces divergent applications of EU rules across its markets. This complexity, however, does not affect branches of competing global financial firms, which operate from a single country.

The Listing Act is a step in the right direction with a further standardization approach to the prospectus for primary issuances. We welcome the proposals to improve supervisory convergence by setting out a harmonized framework for national authorities to follow in relation to additional information requests.

But this is not enough. The EU must streamline and harmonize rules, phase out national exemptions and prevent domestic 'goldplating' of EU law to deliver one Single European Rulebook. This simplification requires an empowered ESMA, which must be able to ensure close cooperation and alignment between national supervisors in order to directly and decisively act when national supervisors diverge. Single Supervision in Europe must be the ultimate goal of legislative changes after the 2024 European elections cycle.

Europe is as strong as its Single Market is, because the rest of the world respects the EU because of the strength of its Single Market. In finance, a true Single Market requires an ecosystem of strong EU-based players to ensure our strategic autonomy.

Empowering European finance-makers, aligning divergent supervision to eliminate undue complexity, levelling the playing field with foreign third-parties and facilitating European consolidation must be the core objectives of the next Commission's agenda. Only with this condition met will a Capital Markets Union emerge to contribute to the strategic autonomy of Europe.



The Eurofi Financial Forum
September 2023

is organised in association with
the Spanish Presidency of the EU Council

FIGHTING INFLATION AND ADDRESSING LOW GROWTH



ROLF STRAUCH

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Fiscal policy and long-term growth: challenges in a new normal

Ample fiscal support at the national and European levels and accommodative monetary policy helped the euro area overcome the recession stemming from the Covid-19 crisis. Still, the pandemic severely impacted supply chains, generating substantive inflationary pressures. The war in Ukraine, a tragedy itself, also exacerbated these pressures and knocked economic growth back down.

Energy-related support measures have helped shield citizens from excessive energy prices. But these measures also have been adding to fiscal stimulus as the European Central Bank (ECB) has been tightening monetary policy to meet its price stability objective.

The euro area now faces a difficult trilemma: containing inflation, improving public finances, and generating sustainable higher growth.

Tackling inflation is imperative. Persistent high inflation would prolong uncertainty, undermine business confidence, and thereby hamper investment and growth. The sooner inflation and inflation expectations stabilise in line with the ECB's objective, the better it is for investment and long-term growth.

Beyond the temporary fiscal windfall from higher revenues, lasting high inflation also poses significant risks to fiscal policy. This is particularly true when inflation is driven by an external supply shock. To avoid fuelling inflation further, governments will need to carefully calibrate how they support the economy. A better alignment between fiscal policy and monetary policy is needed.

Fiscal consolidation is required to support monetary policy in its quest to curb inflation. Thus, in the short-term, energy-related support measures need to be phased out. The Eurogroup statement on the euro area fiscal stance for 2024 reflects that commitment.

But fiscal consolidation is also necessary to enhance resilience. Reducing economic vulnerabilities, not only to domestic but also to external shocks, has become crucial, as these shocks could become more severe in the future. While a coordinated approach at the EU level is crucial, it also requires solidarity across Member States to enhance the ability to overcome common shocks. Creating fiscal space is vital for the longer-term challenges to increase potential growth, face population ageing, and make our economies greener and more digital.

Next Generation EU (NGEU) plays an important role in addressing these challenges: it has an element of risk sharing, sets incentives for broader structural reforms, provides inter-regional transfers to the areas where financing is most badly needed, and supports investments in digital and green transitions.

However, NGEU is a temporary instrument that will phase out in 2026.

Against this backdrop, reducing public debt over the medium-term is essential. The increase in public debt was needed during the pandemic to help citizens and businesses. Such additional flexibility to respond to the crisis was possible because of the activation of the general escape clause that is embedded in the Stability and Growth Pact. However, this clause will be deactivated at the end of this year.

Hence, coming to an agreement on the Economic Governance Reform, i.e. the reformed Stability and Growth Pact, sooner rather than later is key. The reformed framework should be transparent, credible, and ensure equal treatment across Member States. The framework should also put more emphasis on sustainable growth, which requires making enough room for productive investment. To boost potential growth, securing high quality investments will be essential.

On average, potential growth in the euro area has been close to one percentage point lower than in the US since 2000. Around 40% of this difference is explained by a lower investment ratio in Europe and 30% is due to lower technological progress. The remaining 30% are explained by a less dynamic growth of the labour force. This means that we not only need to invest more, but also invest better.

The role of the public sector as a catalyst for private investment should become more prominent. This means attracting private investors, both domestic and foreign, to invest in innovation to boost potential growth. And here reforms, rather than investments, are the key factor.

The role of the public sector as a catalyst for private investment should become more prominent.

Working on establishing a genuine European capital markets union (CMU) would be also helpful in supporting investment. It would facilitate more market-based financing and complement bank lending. An integrated market for capital would be conducive to a better allocation of capital and attract international investors as well. A deep, liquid capital market is key to the equity financing of innovation the EU needs. CMU would also make the euro area more resilient by complementing public risk sharing with private risk sharing.

So far, progress has remained disappointing. Let us hope that the Euro Summit's recent decision to enhance CMU will provide new and decisive momentum.



MARIO NAVA

Director General for
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European Commission

The Technical Support Instrument: reviving sustainable growth through support to reforms

Since its emergence from the last sovereign crisis, the European Union has set a clear vision for the future of its financial system and wider economy. Avoiding the mistakes of the past, the complete transformation of the economy, rooted in the green and digital transitions, has proven to be a persistent feature of European policymaking throughout subsequent years. Surely, this clarity of purpose has contributed to the resilience of the euro area at the outset of the COVID pandemic, with the financial sector acting as part of the solution. The response of financial markets to the Commission issuance of bonds confirms the right path taken by the EU in response to the recent crisis and in particular the right choice to tackle recovery and resilience at the same time. This resilience broadly persists today, in the current challenging environment.

Nonetheless, despite this resilience, the sudden onset of Russia's war against Ukraine exposed the depth of significant vulnerabilities, such as persistently low growth levels and declining productivity

that ought to be tackled with appropriate reforms and investments.

Governments face pressure to consolidate their debts while at the same time to create the fiscal space for better investments in the green and digital transitions. This is a key challenge facing the Union. To respond to such challenges, Member States need to prioritise structural reforms to boost the supply side of the economy, leading to higher productivity and sustainable growth, while being buoyed by the right fiscal and macroeconomic policies. NGEU, and more specifically, the Recovery and Resilience Facility (RRF), is at the forefront of orienting Member States' policies.

The performance-based nature of the RRF requires that Member States put in place reforms and investments, as well as reach corresponding milestones, in order to access funding. The RRF's combination of reforms and investments has proven a now widely accepted axiom: investments alone are not enough to trigger sustainable growth. Member States must undertake the necessary reforms that will underpin well-functioning, resilient institutions – in particular, the efficiency of their public administrations. Capital markets, recognising the credibility of this approach, routinely oversubscribe to the bond issuance, including green bonds, that underpin the NGEU and RRF.

**With its “flagships”,
the Technical Support
Instrument contributes
to orient Member
States's efforts.**

By identifying key areas for reforms in line with EU priorities with its “flagships”, the Technical Support Instrument contributes to orient Member States' efforts to improve the supply side of the economy. Flagships reforms are defined on a yearly basis by identifying the most pressing reforms needs at EU level and proposed to Member States as possible areas for support via the Technical Support Instrument (TSI). The high number of requests for support in the Flagships areas (more than 40% of all requests) confirms the convergence of Member States' reform objectives throughout the EU.

Overall, the TSI, and the SRSP its predecessor, has supported more than 1500 technical support projects in all 27 Member States since 2017. Digital

transformation, sustainable growth and business environment, labour market, health, education, social services, revenue administration and public financial management or reforms relating to the financial sector are also covered by the TSI. Furthermore, the TSI is an agile and flexible instrument. For example, following Russia's invasion of Ukraine, DG REFORM supported 17 Member States to phase out their dependence on Russian fossil fuel imports, contributing to REPowerEU objectives and the long-term, sustainable development of Europe's energy systems. In the context of mounting public debt, DG REFORM has also responded to requests from Member States to strengthen their public finances.

Specifically, DG REFORM has supported 15 Member States to conduct high-quality spending reviews, which would allow them to identify and prioritise reforms and investments needed to reach debt consolidation. In addition, starting in late 2023, DG REFORM will further support Member States in the area through a flagship technical support project, facilitating knowledge exchanges and good practice sharing in spending reviews. Depending on the agreement reached by the co-legislators, this support could facilitate the implementation of a revised economic governance framework.

Over the last 3 years, the Commission has also stepped up its efforts to help Member States modernizing and making their public administration more efficient, conscious that the success of any reform and investments is strongly linked to the quality and efficiency of public administration.

Among other initiatives, it launched the first Public Administration Cooperation Exchange (PACE), an exchange of civil servants across Member States to foster exchange of expertise and good practices. In autumn, the Commission will propose a package of initiatives (so called “ComPact”) to further enhance the functioning and performance of public administrations in Europe.



REINHARD FELKE

Director of Policy Coordination,
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After the shocks: challenges for the European economy

Over the last three years, the European Union has grappled with not one, but two black swan events: the Covid-19 pandemic and Russia's full-scale invasion of Ukraine. The pandemic triggered the deepest recession in EU history, while last year's surge in energy prices caused inflation levels in the euro area to reach double-digits, amid concerns over possible gas shortages in winter and the competitiveness of Europe's industry.

Yet the European economy has managed to withstand these shocks better than many believed possible. It recovered more quickly than was the case during previous crises. GDP had returned to pre-pandemic levels already at the end of 2021. Last year, the economy recorded higher growth rates than both the United States and China. This year inflation remains above the ECB's target but has fallen considerably from its peak of 10.6% in October 2022. Unemployment rates are at historically low levels, while labour market participation and the employment rate have climbed to all-time highs.

This remarkable resilience of the European economy can be traced back to three distinct factors. The first is the strong and coordinated policy response at national and European level. During the pandemic, fiscal and monetary policy worked in tandem to shore up confidence and support businesses and households, helped by unprecedented decisions such as the activation of the 'General Escape Clause' of the Stability and Growth Pact and the launch of the SURE mechanism and NextGenerationEU, with its Recovery and Resilience Facility (RRF). The second key element are the reforms that many Member States have carried out in response to previous crises, whose positive effects are being felt years later when Europe's economy was again put to the test. Finally, the European corporate sector has shown an extraordinary adaptability, from diversifying input sourcing to embracing new working practices and greening their production methods.

These factors have helped the European economy ward off the risk of a deep recession in 2023. Nevertheless, growth is likely to remain subdued this year and to pick up only slightly in 2024, as tighter financing conditions weigh on demand and uncertainty around the global economic outlook remains high.

Looking ahead, Europe faces a number of structural challenges that will determine its long-term growth prospects. These include high investment needs for the green and digital transitions, and for economic security and defence; lingering trade tensions amid changing patterns of globalisation; population ageing, low productivity trends and high levels of debt.

**Member States should
maintain the momentum
of reforms and
investments.**

In this context, one key policy challenge going forward will be to find the right balance and policy mix between the fiscal and monetary levers.

As our economies continue to wrestle with still high inflation, high public debt levels and higher interest rates, a more restrictive fiscal stance is warranted. This was also agreed by the Eurogroup, as reflected in its July statement on the euro area fiscal stance for 2024.

This shift will ensure greater consistency with the ECB's efforts to reduce inflation,

while remaining mindful of the downside risks to the economy. Moving to a more restrictive fiscal policy will also avoid the need of even larger increases in interest rates, which in turn would affect investment and growth as well as the sustainability of public debts and macro-financial stability in the EU.

Ensuring a predictable conduct and close coordination of fiscal policy will be crucial. Reaching an agreement on a reformed framework of fiscal rules by the end of the year would be key in this respect.

Finally, the appropriate response to the structural challenges of the European economy is to continue to put in place growth-enhancing reforms and investments.

The implementation of the RRF is spurring a wave of ambitious reforms across Europe, encouraging Member States to make progress on many of the long-standing bottlenecks to growth identified in the country-specific recommendations.

The RRF has already helped to lift Europe's public investment-to-GDP ratio to its highest level in years, in a markedly welcome difference to the trend observed over much of the previous decade. REPowerEU is accelerating the clean energy transition and reducing Europe's dependency on Russian fossil fuels. With a bulk of RRF milestones and targets earmarked for this year and in 2024, and as Europe gets ready for the upcoming Winter season, continuing to deliver on this investment and reform agenda remains essential.

Still today, pilgrims making the *camino* to Santiago de Compostela can be heard greeting each other with the Latin words of encouragement *Ultreia et suseia* – onwards and upwards. As EU Finance Ministers gather in Santiago, it is in this spirit that work to build a more resilient and sustainable economy should continue.



TIBOR TÓTH

State Secretary -
Ministry of Finance, Hungary

Fighting inflation and addressing low growth in Europe

Lasting high inflation creates unfavourable environment for investments and economic growth: it disrupts the stability needed for investment decisions and long-term planning. Economic growth is often lower when inflation is high. Steeply rising prices restrain consumption because real wages cannot keep pace with the price level while businesses tend to be more cautious and reduce their investment activity.

Significant steps have been taken since the surge in the European inflation last year. The raise of interest rates and the cut back on money supply were the two main pillars of this policy. The communication of European Central Banks suggests that they are ready for further monetary policy tightening in order to approach inflation targets. However, these steps come with economic and growth trade-offs, so decision-makers will undoubtedly carefully weigh their application.

Most European countries are very determined to keep their finances under control and to maintain discipline regarding their fiscal deficit and continuous public debt reduction. There may have been several non-monetary or fiscal policy related reasons for the unusually high inflation rate, such as the increased demand following the course

of the COVID-19 pandemic, significant supply chain disruptions, shortages of certain products and raw materials, and labour market challenges, particularly the emerging shortage of skilled labour. Alongside credible and prudent monetary policy, addressing these combined factors also requires handling the longer-term structural challenges facing the European economy like the climate change induced green and digital transition ahead of us. The European productivity and competitiveness should also be substantially improved on the global marketplace.

Challenges like the green transition and the response to the COVID crisis made us all concentrate more on the supply-side of the economy. In Hungary, the government have been engaged for years in industry policy to make sure that the transition to the green economy is orchestrated in a way which is economically and socially sustainable. Economic policy is incentivising the creation of new capacities in battery manufacturing and electro-mobility, investments in solar power production capacities to make sure that Hungary is ready for the economy of tomorrow.

**The European
productivity and
competitiveness
should be substantially
improved.**

The NGEU has been a one-off experiment in a challenging situation, an experimental response to counteract the economic damage of the pandemic. The lessons of the NGEU still needs to be drawn, but at this stage the least one can say that experience with the NGEU are so far mixed and controversial. It turned out to be an extremely bureaucratic tool putting heavy burden on national administrations, the implementation requirements of the national recovery plans remained rigid, furthermore substantial delays in transferring payments to every Member States did not ensure level playing field in this area. Today still 5 MS have got no access at all to those funds more than 2 years after the pandemic! How this can be called “recovery supporting” fund for them at the end of 2023? In addition against the background of the high interest rate environment it has become much more costly for the MS then originally foreseen. In that sense I do not see any reason for the EU to repeat of taking up loans and making the EU even more indebted for decades. As regards the

economic governance reform, the basis for financing investments and reforms is rooted in sustainable economic growth. The review of the Stability and Growth Pact (SGP) is expected to result in a framework that places greater emphasis on the implementation and promotion of investments and reforms. However, it must be acknowledged that this in itself does not offer a solution for promoting desirable structural supply side-oriented reforms and investments. Achieving high quality investment performance and implementing growth-friendly reforms could still be accomplished within the existing fiscal rules. This requires crucial commitment and discipline from Member States and making appropriate choices regarding policy priorities.

The purpose of reviewing the Stability and Growth Pact (SGP) has to be the simplification of fiscal rules enhancement of the enforcement and the clarity of the regulatory framework. The economic governance framework is needed to strike a proper balance between the sustainability of public finances, fiscal discipline, and the financing of investments and reforms with a medium-term perspective. Fulfilling commitments and ensuring equal treatment among Member States are best guaranteed by a rule-based fiscal framework. It is crucial that future regulations include specific numerical provisions for debt reduction commitments.

Our efforts are directed towards establishing a future framework that better promotes national ownership, supports forward-looking public investments and reforms, and ensures sustainable and ratcheted reduction of the government debt ratio compared to the previous framework.



CARMINE DI NOIA

Director for Financial and Enterprise Affairs - Organisation for Economic Co-operation and Development (OECD)

Walking the tightrope between price stability and financial stability

Macroeconomically speaking, Europe is caught between a rock and a hard place. Inflation remains far above target, and even though headline figures have begun to fall as the energy price shock – fuelled by the war in Ukraine – has subsided, core inflation remains stubbornly high. Getting this situation under control is rightly a priority for central banks. However, this is taking place in an environment of unprecedented peacetime indebtedness for both sovereigns and corporates, as OECD work has highlighted. EU government debt is substantially higher today than it was in 2008. Non-financial corporate bond debt has increased by about three-quarters.

This borrowing spree has happened during the extended period of ultra-low interest rates following the 2008 financial crisis and was boosted further by fiscal and monetary expansion in the face of the COVID crisis. Thanks to near-zero interest rates and QE, this debt has not been a great burden so far – government interest expenditure as a share of GDP in the EU is still

less than 60% of what it was in 2008. However, the main tool central banks have at their disposal to fight inflation – raising interest rates – serves to increase borrowing costs throughout the economy. In a high-debt environment, this creates a possible tension between ensuring price stability and financial stability, posing a significant challenge to central banks.

Monetary policy is a blunt instrument that impacts all parts of the system, and the higher the debt burden, the more sensitive the response. Changes in interest rates are like tectonic shifts in global markets. The fastest tightening on record, which we are currently going through, is therefore bound to have widespread effects on financial markets. We have already seen some of these risks unearthed around the world, with the recent banking turmoil as a salient example. In other areas, notably commercial real estate, risks have not fully materialised, but we know they are there. But the risks we should worry about most are those we are yet to discover; the structure of global markets has changed radically since 2008 with the expansion of new segments, notably within non-bank financial intermediation, and we still do not fully know how these are interconnected with the rest of the market, nor how they will fare under stress.

Significant economic uncertainty and volatility also make it difficult to estimate the connection and timing between monetary policy and (dis)inflation movements. In the face of this uncertainty, the logic has been that it is easier to undo a strict tightening than to get a wage-price spiral, for example, under control. However, in a fragile financial context, sharp increases in interest rates could have non-linear effects on financial markets, and thereby also on inflation.

The price of price stability should not be a rupturing of our mechanism for capital allocation.

A debt crisis is not a desirable way of getting inflation back to target. Even outside of an outright collapse, it is difficult to estimate the magnitude of the disinflationary effect of a sharp and widespread deleveraging, and a possible balance sheet recession. Triggering a sharp economic downturn may also call for fiscal stimulus, which would in

turn confuse the messaging between monetary and fiscal policy.

None of this is to say that getting inflation back to target should not be a priority. On the contrary, doing so is a prerequisite for investment and sustainable economic growth – both much needed in Europe, which has been falling behind the US since 2008. But while it is imperative to get inflation down, the process must be orderly, because another prerequisite for investment and growth is well-functioning capital markets. The price of price stability should not be a rupturing of our mechanism for capital allocation. Against this challenging background, what should be done about the inflationary situation in Europe? Central banks should carefully monitor financial stability risks and their impact on inflation as part of their decision making, including the impact of quantitative tightening on market functioning. There should be recognition that we are uncertain about the lags with – and sometimes channels through – which monetary policy operates.

Importantly, sound prudential policies, including the corporate governance of financial institutions, can give monetary policy more freedom to focus on price levels, to ensure we can charter the path to low inflation while steering clear of financial instability.

This is a great challenge indeed, and as the BIS has noted in its annual economic report, one which stems from having leaned too much on what is supposed to be stabilisation mechanisms (monetary and fiscal policy) as engines of growth in recent years. It is an error to think that they can ever substitute for structural reform. But while reversing that model is crucial, it must be done with caution. Monetary policy cannot be an engine of growth, but if not carefully calibrated it can certainly be an engine of instability.



DIDIER BOROWSKI

Head of Macro Policy
Research - Amundi

In search of the right policy mix

Over the last three years, the ECB and European governments have deployed far-reaching measures to stem the effects of the pandemic and then the energy crisis. With the return of inflation and the economic slowdown taking shape on both sides of the Atlantic, the tensions between fiscal policy and monetary policy are becoming glaring: the policy mix can no longer mitigate both simultaneously.

These tensions are all the more acute as core inflation is struggling to slow down. The fall in energy prices since the start of the year is not enough to stem the pressure on service prices. Admittedly, the recent work presented in Sintra¹ shows that the fiscal policy implemented in Europe to limit the rise in energy prices helped to contain inflation last year and limit the shock to economic activity. But with falling energy prices, these measures should have been withdrawn much sooner. In the absence of fiscal consolidation, the ECB could be led to raise its key rates further. This “non-cooperative game” between fiscal and monetary policy results in an unbalanced policy mix which, by placing the burden of adjustment disproportionately on the central bank, poses a threat to macrofinancial stability.

Key interest rates are now above their neutral level. Has monetary policy

overstepped? It is impossible to give a clear-cut answer. Recent work on neutral rates suggests that they have hardly changed over the last three years. The main factors that have caused real interest rates to fall over the last few decades are well known (ageing population, slowing productivity gains, growing demand for safe assets), and none of them seem set to reverse. However, it remains to be seen what impact the energy transition will have on the global balance between savings and investment: the huge investment needs alone could lead to a sustained rise in global real interest rates.

At the end of the day, as Obstfeld² so rightly notes: as unsatisfying as it may be, we largely remain in the situation described in the 1930s by John Williams (1931): “*The natural rate is an abstraction; like faith, it is seen by its works. One can only say that if the bank policy succeeds in stabilizing prices, the bank rate must have been brought in line with the natural rate, but if it does not, it must not have been.*”

Why are inflationary pressures so persistent? Rising corporate margins and unit labour costs have played a key role. Inflationary pressures are the result of a combination of supply and demand factors. Goods inflation is falling, while services inflation remains high. To put it simple, it appears that goods inflation is driven by supply-side factors, while services inflation is increasingly driven by demand-side factors.

**Fiscal consolidation
should do more than
monetary policy to
reduce pressure on
demand and inflation.**

Policymakers must now consider the financial risks posed by rising interest rates. For the first time since WWII, very high levels of private and public debt coincide with high inflation. The highly accommodative monetary policy of the 2010s encouraged risk-taking on the financial markets and the accumulation of debt. The resulting risk of financial instability increases the challenges facing central banks.

The real reason for persistent inflation is fiscal policy, not monetary policy. If monetary policy is taking longer than expected to take effect, it is precisely because budgetary support has been “too generous”. Governments no longer have much room for manoeuvre. They can no longer mobilise their policies

to promote growth without fuelling inflation. The increase in public debt therefore requires a rebalancing of the policy mix. The emphasis should now be on fiscal consolidation. This would help to reduce the pressure on aggregate demand and inflation more effectively than continued monetary tightening. All the more so as rising interest rates will make fiscal consolidation more difficult.

And governments should not be afraid of the economic slowdown. Weaker growth is inevitable. Economic players overestimate the extent to which macroeconomic policies can be used to smooth the economic cycle. The nature of the economic cycle is changing. Globalisation can no longer be relied upon to contain inflation. On the contrary, geopolitical and climatic risks can materialise at any time. The policy mix will no longer be able to absorb as easily as in the past the new shocks we are likely to experience over the coming decade.

Budgetary consolidation (apart from the investment expenditure needed to increase supply and the energy transition) is a necessary condition for re-establishing a “cooperative game” between monetary policy and fiscal policy, for limiting macrofinancial risks and for being able to redeploy supportive policies effectively when the time comes.

1. Gourinchas, Pierre-Olivier. “Unconventional Fiscal Policy in Times of High Inflation.” *ECB Forum on Central Banking, Sintra, 25-26 June 2023.*
2. Obstfeld, Maurice. “Natural and Neutral Real Interest Rates: Past and Future.” *10th Asian Monetary Policy Forum, Singapore, 25-26 May 2023.*

SUPPORTING THE GREEN TRANSITION



SYLVIE
GOULARD

Insufficient climate / nature policies explain the lack of good projects

Since the Paris agreements, and even more since COP 26 in Glasgow and the biodiversity COP 15 in Montreal, finance is seen as part of the solution to accompany transition to net zero and safeguard nature. Numerous reports and studies from the IEA, the UN, OECD as well as the Stern-Songwe report for example rightly underline the need to scale up finance for climate and development. We nevertheless make as if money would follow the needs, which is simply not true. Financial flows are indispensable, but they cannot be a substitute to appropriate government action, multiplying the strength of the markets.

Though facing a vital threat for mankind, governments still refuse to ban coal and to introduce carbon prices worldwide, as the last Environment G 20 showed again. Should finance alone solve the problem if the pricing of externalities (in agriculture, in industry, in housing etc) remains limited? Why should we be surprised that transition and preservation of nature are not encouraged as

long as polluting activities (such as deforestation, intensive agriculture or air transportation) continue at a rapid pace, often legally? Nature positive and climate neutral projects can only flourish in an environment clearly penalizing polluting activities. It would require more stringent measures from governments, central banks, and supervisors. “Light touch” supervision, legislation, and blind tax policies, not to mention the perpetuation of public subsidies to polluting activities are unfortunately giving the wrong signal.

Secondly, there is no global mandatory disclosure of climate and nature-related data yet. Though TCFD (and soon TNFD) provide frameworks helping companies to act in a responsible way, many of them will not publish data spontaneously (for business or for capacity reasons). Time has come to move from voluntary recommendations to compulsory disclosure. The European Union adopted by law ESG standards that will soon enter into force and will cover impacts and dependencies (double materiality).

The ISSB global standards published last June are a first attempt to create a global base line for climate, but they are optional. It will take some time before they are used at a large scale. In the US, ESG issues became highly politicized. Elsewhere push backs are observed as well, including in countries that were at the fore front of fighting against climate change or promoting biodiversity (such as the NL or the UK). For developing countries and emerging market economies extra-financial disclosure can still be seen as too complex and costly. In this context, initiatives such as the Bloomberg-Macron creation of free repository (NZDPU) or GFANZ are particularly important.

Thirdly the international regulatory framework for finance was mainly put in place in the aftermath of the great financial crisis. It was not aiming at encouraging risk-taking to safeguard the planet. Unintended consequences occurred. For example, penalization in Basel III-IV and Solvency II of extra-border and non-OECD financing is a reality: the capital charge for infrastructure projects for European insurers is 25% for an OECD project, 49% outside OECD. Blended finance projects with public guarantees are seen as complex securitized products and therefore less attractive in Solvency II in the standard model. Currently, less

than 5% of the assets of European banks and insurers are exposed to non-OECD/non-G20 countries, and only 2% for US players. Capital market actors (pension funds, sovereign wealth funds, asset managers, etc.) depend on the practices of listed markets (equities and bonds) and on the mandates given by their clients and investors. They face very restrictive fiduciary responsibility.

The need for a reset of these rules to allow financing of sustainable projects in the South was underscored during the Summit for a New financing pact last June in Paris. Several speakers from private and public sectors mentioned the hurdles they face to finance development and climate-oriented policies. Some large western asset managers simply do not finance any project in the global South. The cost of capital is still linked to the rating of the countries where projects are based which makes it more expensive (3 to 4 times higher in Africa for a solar panel compared to Europe).

Insufficient climate / nature policies explain the lack of good projects.

Exchange risk remains an issue for financing sustainable sources of energy as well, while financing of fossil fuels extraction usually guarantees future flows of revenues in USD. Financial institutions fear loss of control over image and reputation, they try to evaluate political, security and geostrategic risk even more since the war in Ukraine. There is also a competition between Europe (or US based) projects and financing of development, even more since governments distribute state aids on both shores of the Atlantic.

In a nutshell, we cannot complain that sustainable projects are too rare when public policies still don't take climate change and biodiversity loss seriously enough, when the global dimension is underestimated. In democracies, demagoguery seems to be the worst enemy of nature, in authoritarian regimes, “Machtpolitik”. The best way to let finance play its roles is to have the right rules and incentives in place.



CARLOS CUERPO CABALLERO

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Deepening EU integration to respond to the needs of the green transition

The EU has an opportunity to remain at the forefront of the fight against climate change as a global public good, laying the foundations for a sustainable growth path.

There is no doubt that climate change is the single most outstanding challenge we share globally. Beyond more immediate threats that result from geopolitical tensions, inflation, bouts of financial stability and even the necessary digitalisation process our societies are undergoing, slowing the rise in temperatures, and preserving the quality of our environment is critical for the economy and for livelihoods of current and future generations.

Future growth will need to be green to be sustainable. Addressing such a vast challenge will be demanding for our citizens and productive structures and thus requires a profound political commitment, accompanied by transparency, proper communication, and anticipation.

An orderly transition towards greening our economies is undoubtedly the optimal path forward and requires taking early action. An increasing number of countries have committed to “net zero” emissions targets under the Paris Agreement. According to the IMF, achieving its objectives requires cutting global carbon dioxide emissions, along with other greenhouse gases by a quarter to a half in this decade.

This will inevitably come at a cost, requiring sizeable investments that, quite simply, cannot be postponed. The European Commission estimates that EUR 600 billion annually until 2030 will be needed for the EU’s green transition.

The EU should remain at the forefront of the preservation of this global public good. Over the next few months, it has the opportunity to activate the necessary policy levers to do so, to provide the necessary incentives for both public and private investment to revamp and consolidate the green transition, setting the basis for a stronger, more sustainable growth path and a more competitive industry.

On the one hand, as regards public resources, we must ensure that our economic governance framework is defined by a deep understanding of the trade-offs we incur as a society, and that it aims at striking the right balance going forward between ensuring fiscal sustainability and locking investments in areas that are key for long-term growth. The upcoming reform of the EU fiscal rules should bring about this much needed change of paradigm. The new framework should generate the necessary fiscal space to accommodate the unprecedented investment and reform needs over the next decade, to make the most of their potential to transform the real economy and, in turn, contribute towards enhanced debt sustainability.

Of course, the non-rivalrous and non-excludable nature of a clean environment means that these investments cannot be left up to national fiscal capacities alone. Hence the importance of Next Generation EU, that has brought approximately EUR 750 billion of funding for the green and digital transitions, that add to another EUR 300 billion from RePower EU. Once these expire, however, we must avoid discontinuing our efforts and further action is required to set the EU economy firmly on its path to climate neutrality by 2050.

Beyond these initiatives, we are moving forward with the design of additional own resources, to complement the EU budget’s ability to address our climate goals. This is already a reality with the Carbon Border Adjustment Mechanism,

that will start operating in October 2023 and is aimed at adjusting for carbon leakages, as the EU raises its climate ambition vis à vis other countries.

On the other hand, given the magnitude of the financing gap, public resources will not suffice. Decisive action is needed in the banking sector, on which EU companies heavily rely, as well as in capital markets, to mobilise private financing.

- Completing the Banking Union continues to be the path to more integrated and efficient banking markets in Europe, enhanced risk-sharing and cross-border lending to fund the European economy and its needs. Although much has been achieved, further steps are of the essence, such as an improved Crisis Management and Deposit Insurance Framework and, ultimately, a European Deposit Insurance Scheme, the lacking pillar of the Banking Union.
- Significant progress has also been made towards the integration of capital markets. However, EU capital markets remain underdeveloped in size when compared to those of other major jurisdictions. Legislative initiatives, such as the Retail Investment Strategy and the Listing Act will be addressing critical issues that tend to hamper access to non-bank finance.

The EU has an opportunity to remain at the forefront of the fight against climate change as a global public good, laying the foundations for a sustainable growth path.

Ultimately, these initiatives will help mobilise savings and encourage private investment directed towards easing the green transition in our economies.

Avoiding conflict in the aftermath of World War II was at the core of the motivation for the European integration project. Once again, an overwhelming intergenerational challenge ahead should bring us together and provide the momentum to push EU integration forward, towards a successful green transition and a more sustainable growth path over the next decades.



HARALD WAIGLEIN

Director General - Federal
Ministry of Finance, Austria

Green transition and fiscal sustainability

Since the establishment of the current European Commission in late 2019, the green transition was put into the focus of European politics, and well so. It is time to take a short breath to see what we did and where we stand.

On the side of the policy initiatives we have been confronted by a plethora of proposals in all policy fields. While the intention was to use all policy fields to one end, the transparency and knowledge about those new regulations is fairly limited. Civil servants in the Member States are struggling to get the legal texts alright, in particular to cope with interactions of legal texts. But even more so are those struggling, who have to implement those regulations, mainly the enterprises. But resistance in the general public is also on the rise.

Too many habits have to be changed in a too short period of time. In early 2022, the public reaction to the sharp energy price increase in the aftermath of the Russian war of aggression showed that the ability of policymakers for sharp and significant increases of CO₂-taxes is fairly limited. This also adds to political polarisation. It is not fair to blame the people for this. It is the political sphere which is acting pretty late and thus needs more drastic measures than if we had started in the early 1990s.

One example might be the taxonomy for green financing. Hundreds of pages of rules were created, but the intended effect to channel money towards green projects remains to be seen and the frustration over “bad” compromises limits the credibility of the instrument.

At the same time, the headline indicators move only slowly towards climate neutrality. The combination of both seems to suggest that we need more money to achieve the targets. The currently rising interest rates come on top of the debate for “green” debt.

I am convinced that money is not the problem. If you take the normal capital scrapping rate, you can finance a big chunk of the transition. If you add savings in costs on fossil fuels, the bill towards climate neutrality becomes even smaller. Further headroom is created by “brown” subsidies. However, business models and consumer habits are based on brown subsidies. Abolishing brown subsidies is politically not a free lunch.

NGEU was meant to reduce the local financing further. In that respect, the relatively low share of green projects in the plans of the Member States was surprisingly disappointing. Moreover, the rolling-out becomes increasingly cumbersome, as increased scrutiny and new reporting requirements slow down implementation. Its noteworthy that the intention that NGEU would also be a forceful counter-cyclical instrument has not proven right. It has turned out being pretty pro-cyclical and adds to supply-bottlenecks and inflation due to extra-demand.

The green transition can be achieved without diluting fiscal rules.

What really has to rest on public budgets is to make the green transition socially affordable. Social spending in the Member States amounts to around 30 % of GDP annually. Better targeting of social spending should create the room for manoeuvre there.

The financing possibilities are pretty similar in all EU-Member States. Thus, there is no need for extra-funds. There is also no reason to depart from the EU fiscal rules. “Green debt” is also debt and has to be borrowed from the markets and financed by the people. If there is a credible greening strategy, there is no need for extra green debt, as people understand the costs and benefits.

“Green” debt on top of existing debt is thus in itself signalling a problem.

So money is less of an issue than the co-ordination of all markets to deliver goods and services needed for the green transition. There, I doubt that the government has a role to play. The Government could overcome the co-ordination problem of markets, but erring on the qualifications needed could make things even worse. An example for that was the re-skilling of persons working in the tourism sector before the COVID-19 pandemic in Austria. As the tourism sector recovered more quickly and better than expected, there is now labour shortage in the tourism sector, while unemployment in the health sector has gone up.

High on the agenda is an enabling environment to foster green investment. This is not about money, but about permits and regulations and proper pricing signals.

Where the government also has a role is the formation of expectations so as to allow citizens and enterprises to do their calculations. Governments still shy away to do that, as shifts in lifestyle seem unattractive and enterprises see the costs but not the chances. This vacuum could be filled by the next European Commission.



GERASSIMOS THOMAS

Director General for
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European Commission

International cooperation on carbon pricing can help accelerate global efforts

If our climate change mitigation efforts in the EU are not to be in vain, we must find an alternative way to fight carbon leakage – whereby production simply moves to other regions with lower environmental standards. Enter the Carbon Border Adjustment Mechanism (CBAM): an innovative and world-leading initiative which will start implementation in October this year in its transitional phase.

When designing the EU Green Deal plan to fulfil our legally binding commitment to reduce carbon emissions to zero by 2050, we decided that the so-called ‘polluter pays’ principle must be an integral part of the jigsaw puzzle. As its name suggests, the polluter pays doctrine implies that those who cause the most harm to our environment and contribute most to climate change should pay a commensurate price for their actions. This will in turn incentivise cleaner production and greener habits.

This idea has already been borne out in the EU, in the form of a carbon price

on manufacturing and energy sector emissions. The Emissions Trading System (ETS), in place since 2005, has led to a 35% emissions reduction in industrial sites under its scope between 2005 and 2021. To build on that success, the EU has now agreed to extend the ETS to even more sectors and to gradually reduce the current provisions which allow some sectors to reduce their liability under the system. Once those ‘free allowances’ dry up, the CBAM kicks in.

By confirming that a price has also been paid for the embedded carbon emissions generated in the production of certain goods imported into the EU, we can ultimately ensure the carbon price of imports is equivalent to the carbon price of domestic production, and that the EU’s climate objectives are not undermined. CBAM’s transitional phase will last until end-2025, and full implementation will be gradual and phased-in to help both importers and producers adjust.

Contrary to some conjecture, the CBAM is fully WTO compatible and addressed at companies, not countries. It is an environmental measure which simply treats imported goods as if they had been produced in the EU. That means that once fully implemented, a meaningful monetary cost will become attached to the actual emissions expended during their production.

Our push for carbon pricing as a climate change mitigation tool is not happening in a vacuum. Recent trends point to strong international appetite for global action in this area. This can help us come to a mutual standard of carbon content measurement, price setting methodologies and – why not? – a global carbon price floor for energy intensive industries. By singing from the same hymn sheet, we can show global intent and spur action towards worldwide industrial decarbonisation that drives innovation, investment in clean energy and competitiveness.

The CBAM is already a major breakthrough for global climate diplomacy.

With our experience in designing and implementing the CBAM and ETS, the EU is uniquely placed to help develop this ground-breaking work. We are engaging with the OECD under the Inclusive Framework for Climate Mitigation Approaches (IFMCA), as well as the G7 Climate Club, to share our experience and enhance mutual learning. Because

the more international cooperation we have, the more effective our common tools will be.

The CBAM is a major breakthrough for global climate diplomacy and is already seeing results with our international partners. Türkiye, for example, – the EU’s second largest source of iron and steel with an 11% share of imports – plans to introduce, with significant support from the EBRD, a carbon pricing scheme as a direct result of CBAM. Similarly, Ukraine has committed to introducing an ETS, while South Korea has recently announced important reforms to its system. This is a policy choice strongly advocated by the EU. And it is an inherent design feature of CBAM that any effective decarbonisation effort – including carbon pricing initiatives – will reduce charges on import.

When designing carbon pricing schemes, policy-makers of course need to make sure that it is not the most vulnerable or the final consumer of goods that are hardest hit. This is particularly true during energy price spikes, the most recent of which thankfully shows signs of abating. To soften any unintentional blow for those at risk when designing national carbon pricing schemes, governments could consider for example recycling revenues through lump sum transfers, which have been shown to boost disposable income in poorer households.

What holds true in any carbon pricing regime is that fossil fuel energy costs include appropriate price signals to encourage consumers and businesses to act with their feet, disincentivise their use and encourage investment in greener fuels further up the production line.



JAVIER RODRIGUEZ SOLER

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Enabling clean-tech investment for a greener, more inclusive and secure Europe

The transition to a greener and more inclusive economy is a huge opportunity for Europe. The deep transformation needed means a tectonic shift in sectors, business models and activities, and will require a massive investment. According to BNEF, the region invested around €200 billion in the low-carbon energy transition in 2022. To stay on track, average annual investments into clean energy in Europe need to run at more than three times this level for the rest of this decade, and more than four times in the 2030s.

And we need to channel investment not only in green activities and projects but also in those areas more difficult to abate. If we want to succeed in our climate goals we have to help the whole economy to transition. In this journey, the financial sector plays a key role which is to bring the age of these opportunities to everyone. This is why it is so important to have the holistic approach recently adopted by the

European Commission setting not only green finance, but transition finance at the core of its strategy.

The paramount capital reallocation needed happens only when it has economic sense. Companies, investors, banks, citizens... They are not going to change their financial decisions and behaviors massively and at scale unless we dramatically reduce the green cost premium thanks to technology and the right enabling policy framework. In this sense, the green transition is reshaping the global competitiveness landscape, with the different regions in the world competing to win the race to net zero. Europe is already making relevant steps with relevant proposals such as the Net Zero Industry Act but we need to do more.

How to create the best enabling policy framework to support the green transition? I propose to frame this question using technology maturity which, at the end, define the basic elements of any financial decision: the traditional risk and return, and the increasingly relevant impact.

At a first level we have those technologies without a green cost premium and that are ready to be massively deployed such as renewable energy, energy efficiency, or electric mobility. In this area, the improvements in the policy framework should be focused on facilitating a faster permitting and simplifying industrial projects for climate- neutrality. The latest estimates show that build time for utility-scale solar and wind projects ranges from four to ten or more years, depending on the geography. According to the IEA Renewables report 2022, Europe's renewable capacity expansion during 2022-2027 could be 30% higher if accelerated-case conditions were met.

The paramount capital reallocation needed happens only when it has economic sense.

The second level includes those technologies that are in the early stages and need to move to an economically viable phase to reach a point where the conditions to scale up are met. Here we have those sectors difficult to abate where we still have relevant green cost premiums: how to produce green steel or cement, how to produce sustainable aviation fuels, how to solve heavy transportation or shipping, how to make carbon capture and many more. All

those technologies may suffer a “valley of death”, and consequently public resources are critical to incentivize additional private investment.

In this sense, we welcome the Net-Zero Industry Act proposed by the Commission where they are qualified as strategic net-zero technologies such as battery/storage, electrolysers and fuel cells, sustainable biogas/biomethane or carbon capture and storage (CCS). A good reference is the innovative mechanism such as the carbon credit for difference (CCfD).

And finally, we have the third level of technologies that are still in the research phase but need to be accelerated such as nuclear fusion, electric or H2 planes or truly smart grids. Here we need long-term investment, with public-private partnerships and industry alliances to share the high risks but also to build on the different capabilities of the different stakeholders (governments, companies, universities and other civil organizations). The right policy framework for the EU also means to invest in human capital development such as education or talent attraction through immigration and retention.

To conclude, investment in technology will be a game changer in the race to zero. Having the right policy framework and working in partnership is critical to promote the financial flows required. In all of this, we as the financial industry have to play our role: contribute to achieving more sustainable and inclusive societies without leaving no one behind. A better Europe for all.

Time is running out, but the solution is on us. Therefore, I am optimistic. We have to respond to the demands of the new generations.

Let's put our children and grandchildren ahead of everything and make it happen.



HANI KABLAWI

Chairman of International -
The Bank of New York Mellon

Aligning capital markets policy in support of the green transition

Post-Covid, and in the midst of the Russian war against the Ukraine, the EU alongside other jurisdictions is embarking on meeting the challenge of re-building the economy and energy supplies, whilst tackling the twin challenge of succeeding with a green transition and broad digital enablement. Banks and indeed all financial market participants have a core role to play in supporting the efforts to meet those challenges.

When it comes to policy making, the EU has taken a leadership role in developing a policy framework since the European Commission published its Sustainable Finance Action Plan 5 years ago. In the context of the green transition, the EU has focused on increasing transparency for financial products (e.g., through the Sustainable Finance Disclosure Regulation), defining sustainability parameters (e.g., through the EU Taxonomy Regulation), and most recently enhancing corporate disclosures (through the Corporate Sustainability Reporting Directive).

We are also witnessing efforts to ensure greater scrutiny of supply chains (through the proposed Corporate Sustainability

Due Diligence Directive). Many of these rules have been developed over the last few years and it is important to allow these initiatives time to fully implement before assessing whether they have achieved their desired objectives.

And whilst these developments have clearly put the EU at the forefront of policy making, international investors will look for global alignment of standards across these initiatives to ensure comparability and give comfort that there is no regulatory arbitrage between different rule sets. In that context, the advent of the International Sustainability Standards Board (ISSB) and the publication of their first set of disclosure standards is clearly a significant and positive development. The EU can continue its leadership role by supporting these international standards and thus ensuring that the policy framework introduced in Europe has a global footing.

And whilst disclosure and transparency are important, the actual success of delivering on the green transition will be dependent on numerous other factors such as investor appetite and availability of investable assets, not just on establishing an effective sustainable finance framework. Over recent years, we have witnessed the investor community increasingly demanding more detail about the sustainability credentials of any particular investment, rather than focusing solely on an overall ESG rating or classification. Whilst this underlines the continued and growing investor appetite for seeking out investments with sustainability objectives, a remaining challenge is whether there will be sufficient long-term projects or companies to finance that are accessible through capital markets.

**Ensure that citizens
(both in the EU &
abroad) as investors, can
participate and support
the transition.**

Returning to the EU policy perspective, one possible solution is to create a conducive environment that allows the public to find ways to channel their savings into these longer-term investment opportunities. This can take many forms, but I want to highlight those that are, in my view, crucial to that end:

1. Bridging the gap between EU infrastructure investments and investable products. Today much

of the financing in Europe still relies either on an already stretched public purse or bank financing. Whilst securitisation has a role to play in freeing up bank balance sheets and thus allowing greater bank participation in supporting financing, other capital markets instruments are yet to reach their full potential. The revised ELTIF framework can play a key role in channelling those private savings to long term funding of infrastructure investments.

2. Supporting greater funding through invested pension schemes. EU pension schemes vary significantly in structure and investment profile. Ensuring EU member states reform pension systems to allow more significant proportions to be invested through capital markets will support both green transition and infrastructure financing. The EU's Pan-European Pension Product (PEPP) already provides a policy framework for a harmonised pension product available to citizens that can be rolled across all Member States.
3. Allowing effective cross-border investments, including from third countries, to access financing opportunities in the EU. To that end, ensuring the EU harmonises core investment processes (from aligned withholding tax procedures, to enabling pan-European depositary servicing, to corporate action processes) is key to attracting foreign investments. The CMU initiative is an opportunity to address these issues and should remain a key priority for the EU.

Overall, the policy framework in the EU has made great strides to effectively support the green transition. Nevertheless, we should ensure that citizens (both in the EU and abroad), as investors, can participate and support the transition through their own pension savings, effective investment vehicles, and a truly unified EU capital market.



JOHN MURTON

Senior Sustainability Advisor -
Standard Chartered Bank

Transition finance: the importance of bridging divergence

Momentous falls in the costs of low-carbon technology such as solar PV, wind power and battery storage over the last decade mean the transition to a climate-neutral world is well underway. However, if we are to meet our climate goals, we need to accelerate this transition. This requires mobilisation of private capital at a huge scale and with great urgency.

Mobilising private capital for the low carbon economy can be supported through financial sector regulation. In recent years, policy frameworks have progressed substantially. We now have a sophisticated set of rules that define what makes an economic activity 'sustainable', as well as international standards on sustainability disclosures to help companies identify and manage ESG risks. But we still need better frameworks to help banks support companies transitioning from carbon-intensive activity to "green", and to provide market confidence in this burgeoning asset class. In the face of climate activism, markets need frameworks that encourage engagement with polluting sectors to help them transition (rather than simple disinvestment).

In this context, transition finance can be defined as a financing pathway with the core purpose of facilitating clients'

decarbonization strategies to assist the real economy meet global climate objectives. Transition finance will only be credible in the context of science-based transition pathways for individual sectors that are in line with climate goals and commitments. Such pathways allow companies to prepare effective transition plans at an entity level and allow banks and investors to assess these plans against clear benchmarks. Clear pathways are crucial to shifting and scaling investment towards a climate neutral economy.

The challenge within such a framework is that transition finance will have to be context-specific given the policy and socio-economic realities of transitions across jurisdictions and industries. In practice, this means that activities and sectors considered as 'supporting the transition' will vary geographically, as well as over time i.e. what may be eligible for transition finance in an emerging market may not be eligible in Europe; what is eligible today may not be appropriate in the future. The differing foci of the four 'Just Energy Transition Partnerships' is a useful case in point.

Such necessary variegation cannot become a free-for-all. There are some concerns, especially among financial market participants, about a lack of coordination and comparability of transition finance initiatives across jurisdictions. Significant divergences may undermine the credibility of the transition finance concept and hinder the flow of finance: bridging these cross-jurisdictional divergences will be crucial. Efforts to that end will need to balance the value of standardisation with the varying capacities and priorities of different countries and regions.

**To succeed, transition
finance must
recognise geography
whilst supporting
common goals.**

To improve coordination, transnational initiatives will play a key role. We are already starting to see efforts to develop better coordinated, high-level principles that can help guide the different national or regional initiatives: the International Platform on Sustainable Finance's (IPSF) Transition Finance Working Group and the G20 Sustainable Finance Working Group's Framework for Transition Finance are two examples. We need to connect domestic sectoral corporate

transition plans and pathways - where those have been developed - with global sectoral pathways.

Some regulators have started to codify standards related to transition plans. For instance, the EU is in the process of finalizing several requirements relating to transition plans, including the Capital Requirements Directive (CDR), and the Corporate Sustainability Due Diligence Directive (CSDDD). Similarly, the UK's Transition Plan Taskforce (TPT) is finalizing mandatory standards.

In this context, it is crucial that local requirements are consistent and interoperable with global initiatives, such as the ISSB's standards, to facilitate an internationally aligned approach. This is key for investors and financiers who compare plans across jurisdictions. Regulators should focus on this and on ensuring that local frameworks provide sufficient flexibility to accommodate evolving practice in developing credible transition plans.

Here at Standard Chartered, transition finance will be increasingly core to what we do as we seek to deliver on our 2050 Net Zero financed emissions goal. Our strong transition finance team brings together technical experts from key industrial sectors and experienced bankers to advise clients on transition.

Regulated in the UK, but with our major presence in a large number of diverse emerging and frontier markets, we cannot shy away from the challenges of transition finance if we are to meet both our climate goals and our desire to help grow the economies of the countries in which we work.

We thank **the partner institutions**
for their support to the organisation
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PRIORITIES FOR THE INCOMING COMMISSION



MARKUS FERBER

MEP, Committee on Economic and Monetary Affairs - European Parliament

The EU has to focus on competitiveness

The United States have decided to make a big play to become the number one player in clean technology. The vehicle to achieve this objective is the Inflation Reduction Act (IRA), which in essence is a big subsidy package aimed at bolstering the US industry and attracting foreign direct investments. With the IRA, the US opened the battle to attract clean tech business, which is why the IRA has also become infamous in European capitals. It threatens to widen the economic gap between Europe and some of its fiercest international competitors.

The IRA is a big problem for the EU and its Member States, which already suffer from economic headwinds such as persistently high prices and disrupted supply chains following Russia's war of aggression in Ukraine. One thing is abundantly clear though: it would be a fool's errand to enter into a costly subsidy race with the US. Lacking sufficient firepower, particularly on European level, the EU would be bound to lose.

However, there is at least one good attribute to the US Inflation Reduction Act from the European perspective: It sharpens the focus towards what really matters - competitiveness. After all, the reason why business move away from Europe to the US or decide to make their next investment across the pond, is hardly ever a one-off subsidy programme. On the contrary, what matters to European businesses and where they have been disappointed in the past is a general environment that is business friendly. To put it simply: the EU has to become more competitive, and the IRA has made that very obvious.

Becoming more competitive does not necessarily mean to spend a lot of money. You can maintain a high level of competitiveness, while being fiscally responsible. There is no obvious trade-off between these goals, which is why it would be a misconception to believe that the EU's economic governance regime would stand in the way of a more growth-friendly policy outlook.

While there is certainly a limited need for public investments in areas such as infrastructure, the bulk of the investments for green and digital projects has to come from the private sector. As we cannot rely on national expenditure or European projects such as NGEU alone, we need to put the private sector into a position to actually make those investments.

They key policy objective for the years to come therefore has to be to restore the EU's competitiveness. The first step would be a regulatory moratorium. In this mandate, the European Commission has adopted a plethora of policy proposal, most notably under the "Green Deal" umbrella, that all have in common that they substantially increase the regulatory burden for European companies starting with excessive reporting requirements and ranging to more substantial provisions. Those policy proposals all had their justifications, but they also had their respective undesired side-effects and they are a considerable burden to implement. That is why it would be the right moment to leave some time for the private sector to digest and properly implement the body of proposals that were adopted over the past few years.

A second step would be not only to stop introducing new requirements, but to start getting rid of the most burdensome

old ones. The European Commission once had a high level group on administrative burdens, which had the task to simplify existing EU legislation and identify particular burdensome pieces of European legislation. It would be high time to reinstate this group and provide it with a broad mandate.

Another element to make Europe a more attractive place to do business would be to complete the Single Market, but not by harmonising each and every detailed rule, but by tackling the big issues such as divergences in taxation and insolvency law that stand in the way of companies making the maximum use of the Single Market. The Single Market also needs to be made easier to navigate for small companies, which often shy away from the complexities of doing cross-border business. One-stop shops as a central contact point for all Single Market issues could be a useful invention in this regard.

They key policy objective has to be to restore the EU's competitiveness.

There is of course also a case for a new smart industrial policy that actually serves European interests. That does not necessarily mean more state intervention, but limited and targeted involvement to provide the right incentive at the right moment. The best example where this might be needed is competition policy where the Commission as the EU's ultimate competition watchdog often stood in the way of outcomes that would have been beneficial from a pan-European standpoint.

The US Inflation Reduction Act is regarded by many as a curse, but if we draw the right lessons and refocus on competitiveness, it can turn out to be a blessing in disguise.



PROF. MAREK BELKA

MEP, Committee on Economic
and Monetary Affairs -
European Parliament

How can Brussels catch up with Uncle Sam?

The unprovoked war that Putin is currently carrying on in Ukraine might have reinvigorated the transatlantic cooperation. However, the economic differences between the EU and the USA have been growing already for a longer time. As J. Shapiro and J. Puglierin from the European Council on Foreign Relations note, in 2008 the EU's economy was somewhat larger than the United States'. In the last 15 years, however, the US economy had reached 25 trillion dollars, while the economy of the EU and UK combined had grown to less than 20 trillion.

The EU lags behind the USA economically and technologically (not to mention the military perspective) so the question remains if the new or ongoing initiatives can help the European Union in catching up with Uncle Sam.

Firstly, indeed, the UK is worse off without the EU than the EU is without the UK. However, the Capital Market in the European Union without the United Kingdom is almost non-existent compared to the United States. We lack the financial know-how and the

institutions of the City of London. Despite the CMU initiative commenced in 2015, our financial sector is still fragmented, overbanked and does not give retail investors enough motivation and reasons to really invest. At the same time, there is still hope, since the topics on the European agenda, such as the Listing Act or the Retail Investment Strategy, can potentially address some of these problems.

Secondly, while one can perceive the Green Deal as a great EU project, which does not only serve to be environmentally crucial, but also unhamper European R&D, the Americans seem to do it better. The recent, election-fueled, negative connotation of the Green Deal connected to some European legislative acts, have only shown that many Europeans are unfortunately tired of the 'green dream'. In the meantime, the US agreed on the Inflation Reduction Act, supporting green investment on the North American continent which may have a negative spill-over effect on the European economy (in some EU countries bigger than in others).

Thirdly, for the EU to get closer to the US again (which would be of great benefit to the Western civilization) it needs investment and a pro-investment climate. In the meantime, technologically significant start-ups seem to be mesmerized by the 'American dream'. We rely on large American technological enterprises and have a problem with agreeing on the EU budget. For the US, investment is 'a credit card swipe' away, while the EU only recently agreed on a common debt through the Next Generation EU initiative.

**In the EU, we need to lay
a common foundation
- a Europe-oriented
foundation.**

Lastly, the concept of a 'strategic autonomy' has been a music to the ears of many Europeans in the post-pandemic times. One cannot perceive that autonomy only as a military (as we are still dependent on the US in that matter) or trade concept. It has to embrace various spheres of the European way of life. However, it is difficult to walk the talk on various fronts. Let us take one topic, which seems to be a no-brainer, but on which I have been working on recently - payments. It is an open secret that the biggest credit card companies in the world are American.

The recent initiative on instant payments of the European Commission - if implemented ambitiously - could be a potential impulse to overcome the American monopoly on this matter; the first step in the direction of an 'open strategic autonomy' in the payments sector in the EU. Little did I know - an ambitious view of the Parliament was quickly torpedoed by many member states and financial institutions.

Still, the European way of life, with far less inequalities than in the US and with a market economy based also on social progress, is still something that is attractive for many. Moreover, one has to emphasize that the EU can be perceived as a certain 'rule maker', pushing multinational enterprises to adopt to European regulations (thus, spreading them worldwide). However, there is a huge difference between creating wealth and regulating it.

Behind all of these challenges, despite the great encouragement and significant projects presented by the European Commission, lays the most crucial, and yet obvious, difference between the European Union and the United States - the EU is not a single country. Dissimilarities and various priorities presented by EU member states, the national egos, interests and selfishness play a crucial role in the - already difficult - political process.

In order not to sound pessimistic, one should understand that for the EU to come back to being something more than a group of wealthy countries, it first needs to put aside national egos. Even the best legislative proposal or strategic idea can be watered down in the European legislative process in order to simply be accepted. Many pandemics-related challenges were solved as we thought like Europeans. Why not do it now? While focusing on building a true Banking Union, Capital Markets Union and emphasizing our 'open strategic autonomy', we need to lay a common foundation; a European-oriented foundation.



ONDŘEJ
KOVÁŘÍK

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EU should aim to enhance innovation and foster global cooperation

Global competitiveness is shaped by various factors, including global trade, human capital, infrastructure, the business environment, sustainability, and technological advancements. Jurisdictions that invest in research and development, foster innovation, and adopt cutting-edge technology can gain a distinct advantage in the global market.

In Europe, the ageing workforce poses significant challenges, raising concerns about labour shortages and decreased productivity. As a considerable portion of the workforce nears retirement, the importance of EU policy measures such as NGEU and other initiatives cannot be understated. This demographic shift coincides with the EU's struggle in strategically important production, where the outsourcing of vital products and services could lead to an dependency on certain third country suppliers.

This not only jeopardizes the EU's economic autonomy but also exposes it to supply chain disruptions and geopolitical uncertainties. To address these complexities and enhance global competitiveness, the EU needs to

continue setting out in long-term policy measures and funding programmes which could help reduce the shortfall. The EU also faces specific challenges in promoting a strong start-up culture, lagging behind the US and China in digital innovation, and contending with strict labour market regulations.

Moreover, the lack of a coordinated industrial policy hinders support for crucial industries. Addressing these issues is vital to bolstering the EU's global competitiveness and securing its position as a leader in the increasingly competitive international arena. When considering the question of competitiveness of the EU vis-a-vis global partners, it's important to take into consideration the different legal frameworks and how they may impact the ability of firms to compete at home and abroad.

We can say with a relatively large degree of confidence that Europe is leading the way when it comes to legislation addressing emerging challenges in the financial and technological sectors. Europe tends to have clear rules which firms are expected to adhere to, and given the sophistication and purchasing power in European markets, most companies will work to ensure they meet European requirements. Specifically in the financial sector, and with the emergence of digital finance firms, which by definition work less to geographical borders, we see that the EU can often have the first-mover advantage, with other jurisdictions following in our footsteps to develop rules based on those we have conceived.

**We must be consistent
in our sectoral policies in
order to give regulatory
clarity to businesses.**

This is clear for example in drawing up rules for operational resilience and crypto markets. However, there is also the risk that if in Europe we continue to devise prescriptive rules with very strict provisions when it comes to third countries, we could see a loss of competitiveness in Europe, and also for our own businesses if they want to compete on price beyond the EU. Going forward it is important that we act consistently in devising legislation, and that those rules are flexible enough for firms based in third countries, especially likeminded partners across the globe.

That applies also for horizontal sectoral policies, such as the AI act and Data Act. To take the example of AI, it can help businesses to automate tasks, improve efficiency, and make better decisions. It could also be useful for financial market entities by providing the ability to predict and respond to risk.

Given the horizontal legislation relating to various areas, it's then important that in our decision making on legislation in Europe we avoid conflicting requirements and duplicative measures which lead to overburdening companies and potentially discouraging them from investing in European businesses. We must be consistent in our sectoral policies in order to give regulatory clarity to businesses.

This is important when it comes to closing the economic gap between the EU and other jurisdictions such as the US, where regulation tends to come only after innovation. In Europe the concept of open strategic autonomy has been gaining traction. In my view it is important to avoid closing Europe off from the world by virtue of our legal framework, especially to likeminded countries. It is a fine line between protecting our interests and becoming a version of 'Fortress Europe'.

Our growth potential becomes more limited the more we shut our financial sector off from the rest of the world. We have some excellent policy measures which have the potential to help the European economy, and particularly our SMEs, including Next Generation EU and InvestEU.

These programmes help supplement capital to the businesses that need it the most. Nevertheless, while conceptually strong, ultimately their success depends on implementation. We see that the long term viability of funding through these programmes can make or break businesses. If the guarantees offered are only over a short period of time, it makes it difficult for private investors to commit to a long term project.



PAUL TANG

MEP, Committee on Economic and Monetary Affairs - European Parliament

The return of industrial policy without demise of the single market

The European Union's single market has been a remarkable success over the past three decades, establishing itself as the world's largest integrated market area while being one of the most open economies in the world. It played a major role in the upward economic convergence in the EU. However, successive crises and increasing geopolitical tensions have underlined the need for strategic autonomy - or better strategic (in)dependencies. This puts Europe's lagging competitiveness in a different light. The economic gap between the EU and its major economic counterparts is widening every year. Average productivity growth is weaker than other large economies. R&D investment intensity in the EU falls behind the US with 2,3% of GDP compared to 3,5% respectively.

Based on current the trend, the EU will not reach its 3% target in 2030. Besides, the European idea of rule-based, open economies has been crushed between the Chinese state-directed developments and the American private monopolistic tendencies. To restore the position of Europe in the world economy a coordinated approach with permanent funding is

needed, while pursuing a more effective anti-trust policy.

Indeed, recent successive events have changed Europe, and industrial policy has returned centre stage. The Covid pandemic demanded a bold response and led to common borrowing, strategic investment and easing of state-aid measures. The war in Ukraine and its subsequent energy crises and period of high inflation, required strong interventions to mitigate market outcomes. Biden's US Inflation Reduction Act ruffled many feathers and fueled further state-aid competition.

Member State aspiration to compete at the global stage threatens to undercut the competitiveness of the single market as a whole. Germany and France called for further easing of state-aid rules. Most other Member States were wary, rightfully so. The European industrial powerhouse, Germany, accounted for more than half of European state aid under the temporary crises framework. Combined with France they were responsible for 77% of approved state aid. Instead of Germany or France, the European Union should be the main character. Therefore, it needs to be equipped with credible financial powers.

Size matters and unfortunately, the EU institutions are not blessed with large budgetary powers. A budget of a mere 1% of GDP is unable to absorb shocks. Moreover, the budget, set for 7 years, is too rigid to protect against the unforeseen. Consequently, the only tool left at the Commissions disposal seems to be the unfortunate easing of state-aid rules. This leaves Member States with fewer financial resources are left in the cold while fragmentation sets in.

A permanent fund is necessary to reignite the Unions competitive flame.

Accepting economic divergence and indebting Member States is a choice that will lead to Europe's own demise. Instead, focus on fostering fair competition in the single market, while keeping industries globally competitive. This focus necessitates a sizable budget. One that can deploy financial support in a direct, fast and flexible manner, bolstering the Union's competitiveness.

Reinforcing competition policy while at the same time pursuing a European industrial policy that selectively

supports green production and strategic sectors and is backed with a permanent fund, is the way back up. Only with a coordinated response can the power of our single market be unleashed. We need to kick-start investment and avoid the traps of duplication. A permanent fund serves this common goal.

The twin transition requires major public and private investments, that will boost GDP growth in the long run and, even more importantly, with the aim of sustainability with reach. Indeed, the metric of GDP growth is clearly insufficient to measure the aim of the transition.

New funds need to be unleashed. If necessary through common borrowing, but common borrowing requires credible methods of repayment. So, new own resources like a single market levy need to be introduced. A permanent fund requires permanent funding sources.

New funding should focus on additional rather than already planned investment. It is through a permanent fund that the Union can reignite its flame. At the same time the Union should keep and reinforce the internal market in which barriers to entry are further eradicated, anti-trust busters are active and effective, and competition flourishes.

ENHANCING GLOBAL COOPERATION



ANDREW GRIFFITH

Economic Secretary to the Treasury & City Minister - HM Treasury

A new horizon for UK-EU financial service cooperation

In the UK, Europe and other free countries across the world today, there are growing challenges and geopolitical storm clouds. From climate change and inflation to hostile nation states, these challenges are international, and none of us can solve them alone.

In the face of Putin's barbaric war in Ukraine, international cooperation has been one of our greatest weapons. The coordinated sanctions packages between the UK, EU, US and other partners have been a model of a collaborative and mature partnership. Together we have pledged significant sums to provide Ukraine military, humanitarian and financial aid. Together, we are sending weapons, training and tanks to match Ukrainian bravery and will continue to support our ally in delivering victory.

What this shows us is we have much more that unites us than divides us.

In the financial services space, the UK is committed to working closely with our international partners through the Financial Stability Board and other fora to achieve strong global standards. Recent events illustrate the importance of robust regulatory frameworks and it is important we take the time to understand what lessons we can learn. Financial stability will always be the UK's top priority and, as the Chancellor to the Exchequer Jeremy Hunt and I have been clear, there will be no divergence in the UK for divergence's sake.

It is for this reason I welcome the recent signing of the Memorandum of Understanding on Regulatory Cooperation in Financial Services with the EU. The UK and EU's financial markets are deeply interconnected, and building a constructive relationship appropriate to the scale and nature of that interconnectivity is of mutual benefit. It is the priority of all our respective Governments to grow our economies, and can be done if we work together as reliable partners, coordinating where we have shared objectives and engaging in mutually beneficial trade.

As the City Minister, I am focused on ensuring UK markets are open, effective and underpinned by high standards. One area where the Government has identified opportunity to make progress is in relation to capital markets.

The Chancellor recently announced the Mansion House Reforms, which are designed to make our markets much more innovative. Alongside reforms to the pensions market to boost returns and improve outcomes for pension fund holders, these reforms will help companies grow and list in the UK, and enable us to grasp the opportunities of the future by reforming and simplifying our regulatory rulebook. The benefits of these reforms will not just be felt in the UK, however, as it is in the nature of a global capital market that we aim to boost investment in dynamic businesses around the world.

Our pensions reforms will secure better outcomes for savers and could unlock an additional £75bn of financing for growth by 2030 to benefit promising companies.

These plans are guided by three golden rules: that we will seek to drive better outcomes for pension savers; that we will always prioritise the long-term

integrity of the gilt market; and that our decisions promote the UK's competitive position as a leading financial centre.

I am pleased to see many of our largest DC providers have committed to the objective of allocating at least 5% of their default funds to unlisted equities by 2030, through an industry-led 'Mansion House Compact'. This, together with the Reforms, marks a historic turning point that will accomplish the dual aim of securing a brighter future for retirees and channelling billions into both UK and global economies.

Through this, we can further embrace technologies like AI by bringing together the skills of our financiers, entrepreneurs and innovators. That means making sure our financial services sector has the right architecture to provide the best possible security for investors as well as capital for businesses.

We embark on this journey alongside European and global partners who will be seeking the same benefits and tackling the same issues as we are in the UK. We do so with a cooperative spirit and an acknowledgement that we will do better if we share and reflect on best practice. The Chancellor's announcements at Mansion House, and the Edinburgh Reforms announced in December, continue to build on the UK's vision for an open, sustainable, innovative and globally competitive sector.

Open and interconnected: growing our economies and engaging in mutually beneficial trade.

I firmly believe implementing these reforms will be good for the European and global economy. We know the benefits of an open, market-led approach, which will lower the cost of capital, and we know fragmentation would come at a cost to our continent, as firms look elsewhere.

There is a clear value to the UK's and EU's markets being open and interconnected, and I am committed to playing our part in ensuring we all continue to reap the benefits.



ALEJANDRO PEREZ

Chief Administrative Officer -
BNY Mellon

EU/Latin America cooperation in delivering the benefits of the digital agenda

In the final declaration of their summit in July in Brussels, the leaders of the European Union (EU) and the Community of Latin American and Caribbean States (CELAC) highlighted the importance of cooperation on digital topics.

At BNY Mellon we welcomed this announcement as we firmly believe that such cooperation is necessary.

We believe that digital technologies can bring about a wave of innovation in banking and in capital markets. Digitalization can deliver easier, and lower cost, access to payments and savings products that will be especially important for people currently without access to banking services.

Digitalization and the digital agenda are not simply the digitalization of existing processes and capabilities. They represent an end-to-end client journey providing frictionless access to liquidity and capital involving open architecture, application programming interfaces, and the simplification of processes. They assist in providing

faster access to funding and information in the context of commercial and trade transactions across multiple geographies and currencies. They can create powerful new capabilities, using insights supported by data and artificial intelligence, as well as faster payments and tokenized assets.

To achieve these benefits, and to truly unlock the opportunities for end customers to access systems and capabilities to improve livelihoods, there is a need for financial institutions and markets to collaborate to deliver open platforms and interoperability.

This collaboration will be facilitated by the close ties that exist between Europe and Latin America, the long-standing knowledge of respective markets and infrastructures, and the existence of major financial institutions that straddle the two regions.

But success, and concrete results deriving from collaboration in the digital journey, will also depend on coordination between policy makers and regulators, at a national and regional level, and at a global level. This will be critical to avoid the creation of separated, and inefficient, digital “islands”.

In addition, that collaboration and coordination must be grounded in the regulatory principles that serve as the foundation of financial markets, and the trust that underpins the services that support it.

These principles include the notion that regulation should enable the financial industry to prudently embrace innovations and new technologies while preserving the basic tenets of existing regulation, including client protection, orderly markets and clear regulatory guidelines, regardless of the new technology, asset class or type of entity providing services.

Regulation should enable the financial industry to prudently embrace innovations.

Digitalization and the use of new technologies raise many new legal and regulatory questions. In a globally digitalized world, we shall need certainty and consistency. Otherwise, there is a risk, for example, that new and inconsistent national rules on the use of artificial intelligence will hamper cross-border activities. This will undoubtedly impact the opportunities to provide fair

and equal access to funding and capital across the region.

The global standard setting bodies have recognized these challenges, and in the past few months such bodies as the Financial Stability Board, the International Institute for the Unification of Private Law (UNIDROIT), and the International Organization of Securities Commissions have made valuable proposals for common principles and standards.

Yet it is also fair to say that much of this work is still at an early stage. For some major topics, and some major risks, there is yet little international consensus as to the best regulatory approach. And we have already seen examples of jurisdictions taking significantly different regulatory approaches, with varying impacts on digital innovation.

There is an opportunity for the European Union and the countries of Latin America and the Caribbean to build on their ties and to help tackle these problems. The EU and the CELAC countries of Latin America and the Caribbean represent close to a quarter of world GDP, and the EU is the largest single external investor in the CELAC region.

European investment, and the major European institutions that are present in the CELAC region, can help deliver the benefits of digitalization more rapidly, and can help demonstrate these benefits more widely. Given their major global presence, EU and CELAC public authorities can help develop the necessary global consensus on an appropriate regulatory framework for the digital agenda.

At the recent EU-CELAC summit in Brussels there was not only a declaration of the importance of cooperation on digital topics, but also the announcement of the creation of a digital alliance in order to facilitate such cooperation. BNY Mellon sees this as a very positive step for the future.

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Q&A

ANDREA ENRIA

Chair of the Supervisory Board -
European Central Bank (ECB)

The integration of the EU banking sector and the challenges of global competition

What remains to be done for further integrating the euro area banking sector and breaking the so-called doom loop between banks and sovereigns? What impacts can be expected in terms of financial stability?

The fragmentation of the euro area banking sector along national lines is still a cause for concern. The situation did not change significantly after the establishment of the Single Supervisory Mechanism (SSM) and the Single Resolution Mechanism (SRM): the banking sector is still, by and large, a collection of national banking sectors. One of the foremost rationales for the establishment of the banking union was to break the so-called doom-loop between banks and sovereigns, but after almost ten years two key elements of the banking union are still missing.

First, there is a need to establish a European Deposit Insurance Scheme (EDIS), which would complete the transfer of the whole safety net to the European level. At the moment, the general perception is that in a crisis the credit standing of banks would still reflect the strength of the respective national deposit guarantee scheme and of the sovereign providing the ultimate backstop.

Second, there has been a lack of progress in the cross-border integration of banking business. This reduces the potential for private risk sharing in the European banking market, and thus increases risks to local financial stability rather than reducing them. In fact, the integration of the banking sector plays a significant role in smoothing local shocks. As the former president of the ECB, Mario Draghi, well summarised in a speech some years ago, retail banking integration de-links the capital of local banks from local credit supply. "Because local banks are typically heavily exposed to the local economy, a downturn in their home region will lead to large losses and prompt them to cut lending to all sectors. But if there are cross-border banks

that operate in all parts of the union, they can offset any losses made in the recession-hit region with gains in another and can continue to provide credit to sound borrowers"¹. Also, if a crisis occurs, an integrated market would support smoother resolutions of failing banks, as their assets and liabilities could be more easily transferred to a larger set of potential bidders, including those from other Member States. This would be similar to what we see in the United States, with cross-state mergers and acquisitions.

The two aspects are linked: without EDIS, national authorities are more reluctant to support cross-border integration, fearing that in a crisis, their national safety net would have to support banks failing because of strategic decisions taken elsewhere. On the other hand, without more integration, crises are more likely to occur because of the limits to private risk sharing, and resolving them is more challenging due to the segmented nature of the market. But we need to make progress in parallel on both fronts. I would strongly reject the argument that we cannot move towards greater integration without a fully integrated safety net.

How can progress be made in the completion of the Banking Union? How to address the long-lasting home-host issues?

The difficult negotiations for the completion of the European banking union and the establishment of a European Deposit Insurance Scheme should continue with a renewed sense of urgency. At the same time, we have to pursue all possible avenues to increase the integration of the banking sector under the current regulatory and institutional framework. This requires more commitment and effort also from the side of the industry.

First, "branchification", the process of merging all existing subsidiaries into the parent company and operating through branches of a single, unified legal entity, could enable banks

to use the freedom of establishment enshrined in the Treaty to the maximum extent possible. I suggested this option in my speech at Eurofi in September 2021,² taking inspiration from the widespread use of this model by third country banking groups relocating business to the euro area as a consequence of Brexit. So far only a few European cross-border banking groups have explored this avenue and only some groups in Nordic and Baltic countries decided to implement it.

I think that this is a missed opportunity because it is a solution readily available and completely consistent with the current legislative and regulatory frameworks. If you are a single legal entity structured in this way across different Member States, you no longer have to abide by the capital and liquidity requirements in the various countries where you operate. You can allocate your financial resources however you like. Therefore, there is no issue of trapped capital and liquidity resources and no obstacle concerning the distribution of capital, liquidity and MREL within cross-border banking groups. The constraints to transferring contributions into deposit guarantee schemes (DGSs) across systems could be the only regulatory hurdle standing in the way of such transformation: this is the reason why the ECB advised the co-legislators to slightly amend the framework. But even in the absence of this legislative change agreements can be found, and have been found, between home and host DGSs to support branchification.

In the absence of major legislative changes, cross-border liquidity waivers are another available integration device. They are more complex and deliver more contained benefits, but they can be enacted in the current context. In a blog post jointly authored with my colleague on the Supervisory Board, Edouard Fernandez-Bollo, we proposed enhancements to the waivers framework aimed at overcoming existing scepticism on the side of national authorities. We suggested a contractual approach to the establishment of intra-group guarantees, which could be made enforceable, and therefore credible, using supervisory tools at the European level. Within the banking union, group support agreements for subsidiaries could be enshrined in groups' recovery plans and approved by the supervisory authority – the ECB – which would be neutral, pursuing neither a home nor a host agenda. This could facilitate the granting of cross-border liquidity waivers at the solo level to the extent possible within the current legislative framework.³

Finally, we clearly expressed our neutrality as a prudential authority towards cross-border mergers, which would be assessed against the same yardsticks as domestic mergers. I understand at the moment the cost efficiency rationale makes domestic consolidation more attractive from a business perspective, but hopefully European banks will

soon come to explore ways to develop their franchise and diversify their sources of income, rather than just solidify their competitive position in their home market.

Do EU banks face higher capital and prudential requirements than their US counterparts, as indicated by certain studies? If so, what are the underlying reasons?

First of all, I would question the idea, at times embraced by industry representatives, that the stringency of a given bank prudential framework should be judged solely based on the level of capital requirements. As shown by the March 2023 bank turmoil events, including in the cases of Silicon Valley Bank and Credit Suisse, even well capitalised banks can rapidly collapse when underlying governance is particularly weak. Supervisory intrusiveness is equally key to ensuring the stability of the banking sector. The ECB has for instance been particularly intrusive with regard to interest rate risk, well ahead of the monetary policy shift, and we are escalating supervisory action against long-lasting internal governance deficiencies. These are all areas in which intrusive supervision can make a difference.

Having said that, I would also challenge the idea that European banks face higher capital requirements. Comparing capital requirements across jurisdictions is never a trivial exercise, as several factors can blur the picture. The European legislator has chosen to apply the Basel standards to all banks, including small and mid-sized banks, whereas in the United States rule apply differently depending on banks' size. As a result, smaller banks probably face, on average, a more stringent prudential framework in the EU. Based on what happened in March 2023 amidst US regional banks and the current debate on regulatory reforms in that country, I think that no one would suggest a relaxation of the European setting. Global Systemically Important banks (G-SIBs) are, however, those that truly compete on a global scale. In the case of these players, the average supervisory add-on is probably a bit more conservative in the EU, while being more diverse in the US, where significantly higher capital charges are applied to specialised investment banks. The regulatory treatment is, however, more demanding in the US, due to a host of gold-plating choices, especially on the leverage ratio requirements, tighter limitations on the use of internal models to risk weight assets, and a stricter implementation of the buffers for G-SIBs than is specified in the Basel standards. All this makes the overall capital requirements for G-SIBs higher, on average, in the US than in the EU. Of course, to obtain a complete picture of how

the frameworks compare to each other, we also need to assess the impact of the choices the two jurisdictions are making to implement the final Basel III reforms.

In moments of turmoil a shift by investors and markets from a balance sheet view to a market-to-market view has been observed. What are the consequences of this situation and how can they be addressed?

We clearly saw this shift from a balance sheet view to a mark-to-market view happening in the Credit Suisse case, for example, but also in the Silicon Valley Bank failure and, in the early days of the sovereign debt crisis, in the Dexia crisis. Market participants, analysts, and customers, in particular sophisticated, uninsured depositors, rapidly shift their focus to how much a bank is valued on a mark-to-market basis and how sustainable its business model is based on the latest market metrics. This shift can be very destructive, so we need to give it a lot of attention.

In particular, in this specific macro-environment, banks need to be very careful about how they manage interest rate risk. This is important not only from the earnings perspective, but also in terms of the economic value of equity, because this is likely to be what the market would focus on during a stress. That is why, since the first signs of inflationary pressure emerged towards the end of 2021, we as supervisors have been putting significant focus on banks' interest rate and credit spread risk management practices. Following the March 2023 turmoil events, unrealised losses on securities held to maturity, in particular, have been very

prominent in the minds of analysts and market participants. The Silicon Valley Bank case showed that such losses become an issue in conjunction with other weaknesses, namely those related to funding and liquidity risk, as well as business model sustainability. In my opinion, the best way to address the market concerns that may stem from unrealised losses is enhancing the role of disclosure. Disclosures by banks need to be very granular in order to explain the real situation of the bank. It is particularly important that banks, also with the support of the supervisory authorities if needed, provide market participants with all relevant information to reassure them and dispel any potential unwarranted perceptions.

I have also made the point that securities held at amortised cost should not count as high quality liquid assets, eligible for the fulfilling the liquidity coverage ratio (LCR) requirement. Such a change would certainly reassure market participants about the actual capability of banks to liquidate assets when the need arises. It would also be consistent with the overall purpose of the LCR requirement, which should ensure that a bank can survive a liquidity shock for a relatively long period of time on its own means, enabling a solution to the crisis to be found.

1. Draghi, M. (2018), *Risk-reducing and risk-sharing in our Monetary Union*, speech at the European University Institute, 11 May, <https://www.ecb.europa.eu/press/key/date/2018/html/ecb.sp180511.en.html>
2. Enria, A. (2021), *How can we make the most of an incomplete banking union?*, speech at the Eurofi Financial Forum, Ljubljana, 9 September, <https://www.bankingsupervision.europa.eu/press/speeches/date/2021/html/ssm.sp210909~18c3f8d609.en.html>
3. See Enria, A. and Fernandez-Bollo, E. (2020), *Fostering the cross-border integration of banking groups in the banking union*, *The Supervision Blog*, 9 October, <https://www.bankingsupervision.europa.eu/press/blog/2020/html/ssm.blog201009~bc7ef4e6f8.en.html>

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Q&A

ANGEL RIVERA

Chief Executive Officer -
Banco Santander Spain

Investing in Europe's growth through the financial sector

Are the right measures being taken to improve the competitiveness and growth of the EU economy?

Europe is currently facing strong headwinds such as higher energy prices, widespread inflation or supply chain disruptions, which put pressure on companies and affect their competitiveness and growth.

Decisive measures are needed to increase competitiveness in the EU, and there are two key levers to draw on in regards of these two factors.

Firstly, the regulatory framework affecting companies must be revised to make it more efficient. The introduction by the European Commission of competitiveness control is necessary and very positive for future EU policies and legislative proposals. In this regard, one of the key elements is the financing of companies. In Europe, 70% of business financing comes from banks, so banking regulation must be efficient and should enable banks to achieve their objectives at the lowest possible cost in terms of growth.

We also need to push for greater integration of the single market to allow companies to gain scale. In the financial sector, we must redouble our efforts to develop the Banking Union and Capital Markets Union projects. Deeper and more liquid capital markets are crucial for Europe's sovereign autonomy and competitiveness.

How to improve the competitiveness of the EU banking system? Is there a need for a review of capital requirements and supervisory processes to enhance the competitiveness of EU banks??

There are structural reasons that have led to high fragmentation in the EU. If adequately addressed, this would help the banking sector to be more competitive. A crucial one is the

absence of a European Deposit Insurance Scheme (EDIS). By granting the same level of protection for deposits on the basis of a common funding mechanism that is decoupled from the national level, EDIS would help deepen EU integration and converge towards mutualisation between the various Member States. We are distinct countries with different situations, but if we want to have a real single European market, we need to leave our differences aside and think about what Europe can mean and become.

Furthermore, the expansion of European banks and companies into third countries is a crucial element in maintaining the competitiveness of the European industry and the strength of European values. We need to look closely at where EU legislation is hindering European companies' access to certain markets, thus, limiting their ability to conduct business overseas.

Regarding capital requirements, it is very positive that the Council and the Parliament reached a political agreement on the CRR3-CRD6 package. This milestone will help avoid any doubts around capital requirements not being enough and bring regulatory certainty. Due to this uncertainty and lack of stability, EU banks tend to hold surplus capital. Also, the review of the supervisory process as already acknowledged by the SSM will help to reduce uncertainty and will foster a more efficient management of banks' capital needs.

Regulators should now take into consideration how the overall framework is affecting competitiveness and growth. According to an Oliver Wyman study (*"The EU banking regulatory framework and its impact on banks and the economy"*), a review of capital requirements and supervisory processes could, in a hypothetical scenario, provide capacity for EUR 4-4.5 trillion additional banking lending. Banks would be in a better position to financing the twin transition (digital and green), expanding the much-needed growth, and investments will strengthen the competitiveness of the EU.

The European Commission is putting forward a proposal to set out a framework for a possible

new digital form of the euro that the ECB could choose to issue in the future, as complement to the cash. How do you see this ECB initiative?

With the evolution to digital environments, aspect that the covid-19 pandemic fast-forwarded, a big part of peoples' daily interactions moved to the digital world and new payments means have emerged, such as cryptos. In this context, we understand the initiative of the ECB, as most of the world central banks, to analyze the possibility of launching a digital euro, providing citizens with a digital euro that they could use in a digital economy. The ECB aims to preserve the digital euro as monetary anchor, as well as to reinforce Europe's strategic autonomy providing a pan-European means of payment.

From the design perspective, it is necessary to consider several elements before taking the final decision. First, it is essential to avoid the potential risks that the digital euro poses to financial stability and banks capacity to finance the economy, limiting the use of the digital euro as a store of value, and ensuring an orderly deployment that avoids any potential abrupt adoption scenarios, and avoid presenting the digital euro as a safer asset than banks accounts.

Besides, it is necessary to create the conditions for the private sector so that the digital euro contributes to making payments, and ultimately Europe, more competitive. Therefore, it should be integrated into citizens daily financial lives, be interoperable and leverage as much as possible on existing domestic solutions that are already being successful (such as Bizum, the Spanish payments solution). At the same time, the digital euro will inevitably compete with existing private means of payment. It is key to preserve the level playing field, avoiding crowding out existing domestic private solutions, and creating the conditions for intermediaries to be able to provide digital euro services and to build new added-value services.

To conclude, in order to be successful, the digital euro should provide value for citizens, merchants and intermediaries. At the end the goal is to ensure that the customer can choose among the different payment options freely and reliably, enabling innovation for the benefit of the customers.

What more can be done in terms of policy to enhance the role that financial institutions are

playing in supporting the transition to a low carbon future and meeting sustainability goals?

Banks are already playing a key role in this green transition.

However, the energy trilemma needs to be addressed. If energy is not affordable or reliable, we will not get the growth needed to finance the transition. Growth needed in Europe to finance the transition and where huge sums of money are needed.

Regulators should work closely with banks to encourage the financing of this transition. It is very important that we see the transition to a low carbon economy as part of the EU's growth agenda.

The binary discourse of "green" versus "brown" needs to end. Brown companies need to implement transition plans to a green economy and need to rely on the Banks to finance this transition without penalizing either the companies or the financial sector.

The regulatory agenda is being decisive and will influence the role banks can play. The sustainable agenda depends on all sectors, including Governments, to success. We have to work together and ensure this does not become a burden but a tool to achieve our goals. Three elements are of essence: Governments must set out transition plans and define the tools and policies to support the implementation; there should not be capital requirements linked to ESG risks as the prudential (Pillar 1) framework already enables taking into account their impact: higher capital requirements could jeopardize the transition of the economy; and international coordination, including on reporting and disclosure, amongst authorities has to be prioritised to maximise the impact of the response to tackle climate change and support the transition of the economy and to avoid fragmentation across markets and a lack of competitiveness with other markets.

The culmination of the European Capital Markets Union could play an important role in strengthening Europe's climate transition. Indeed, the EU's own action plan calls for leveraging the capital markets union to support the green and digital transition, potentially giving European companies the ability to access financing conditions similar in depth and liquidity to those enjoyed in US markets.

LESSONS LEARNED FROM THE BANKING TURMOIL



MARGARITA DELGADO

Deputy Governor - Banco de España

Back to basics: sound risk management and strong supervision

The recent banking turmoil has once again shown us that we cannot be complacent and that there is always room for improvement and lessons to be learned (or remembered) when it comes to banking sector-related risks. In this particular case, there is a general consensus that deficiencies in the banks' risk management and governance lay behind the turbulence that arose in some banking ecosystems, especially in the United States. Supervisors have also identified some weaknesses in the implementation of the supervisory framework.

The banking sector is highly leveraged by nature, and it is very prone to bank runs if there is an outbreak of turbulence. Therefore, a sound and well-established governance and risk management framework is a cornerstone for business sustainability. This must include the assessment and implementation of a reliable, viable and profitable business model, which was not the case at the banks concerned.

As has been acknowledged by the US authorities, Silicon Valley Bank's collapse was due to mismanagement. Management was unable to duly manage the extraordinary balance sheet growth, mainly on the liabilities side, improperly exposing the bank to interest and liquidity risks. This unsustainable business model, highly concentrated in deposits, together with unprofitable investments and liquidity mismatches, eroded solvency and trust, triggering a massive withdrawal of deposits. This had a contagion effect to other banks with similar weaknesses. As has been quoted many times, "it takes years to build a reputation and minutes to ruin it".

This is where tough, intrusive and pro-active supervision comes in. As we often point out, supervisors are not bank managers, and sole responsibility for a bank's management lies with its board of directors and senior officers. Nevertheless, the supervisors' oversight role is extremely important. We have to challenge banks' business models, specifically whether they are profitable, reliable and sustainable over the years. We must understand and agree on the multiyear business plans, including the risk appetite framework and capital projections. Such plans should include how banks will adjust to the new environment, not only in terms of macroeconomic forecasts, but also vis-à-vis trends such as digitalisation and the emergence of new competitors and risks.

Moreover, in the event of deficiencies, the supervisory authorities must be empowered and determined to dissuade banks from certain types of risky or unsustainable activities/business lines and, if necessary, enforce all the required measures on time so as to avoid or mitigate these activities.

Although some considerations are being discussed about the need to fine-tune the regulations, at this point in time we must recognise that, without such deficiencies, these recent events would not have occurred. Regardless of regulations, management should run banks in a prudent manner, taking into account and properly addressing all the risks that the banking sector faces. For this reason, I would put management and supervision at the forefront of the causes of this turbulent episode.

Adequate risk management and strong supervision are key to ensuring banking sector soundness.

Aside from the general principle that robust management and a strong supervision framework are two of the main pillars of banking sector stability, there are some takeaways that the EU authorities could consider:

- Assess how liquidity management and supervision could be boosted. We must acknowledge that liquidity has probably changed more than we think. Therefore, supervisors must consider a wide range of tools and metrics, including funding plans and counterbalancing capacity.
- Better assess how factors such as high deposit base concentration and reliance on uninsured deposits could be considered in our supervision and if they could trigger new qualitative or quantitative liquidity measures in the SREP.
- Continue to work on coordinating and collaborating with international authorities.
- Enhance the crisis management framework. The current CMDI review is an opportunity we should leverage to manage crises in a more efficient and harmonised way.

In conclusion, although this turmoil has led the authorities to reflect on its potential regulatory implications, the main focus should be on ensuring an adequate management culture and a strong supervisory framework. These are basic elements and the cornerstone of a sound banking system. Experience time and again shows us that liquidity is the deathblow that triggers banking failures. For that reason, it is an aspect that can never be underestimated. Indeed, sound liquidity management and risk-based supervision are essential.



DOMINIQUE LABOUREIX

Chair - Single Resolution Board (SRB)

The recent banking turmoil calls for evolution rather than revolution

The banking turmoil in the US and Switzerland earlier this year had plenty of noteworthy aspects. First Republic Bank, which collapsed shortly after Silicon Valley Bank, was the largest bank to fail since the great financial crisis, while Credit Suisse was the first global systemically important bank to face such a severe crisis since the introduction of a resolution framework. Both US banks and Credit Suisse experienced unprecedented bank runs leading to massive deposit outflows.

Following these events, it is important to reflect on the global and the EU resolution frameworks. These reflections are already taking place at global level. The FSB has embarked on a fact-finding exercise and the Single Resolution Board (SRB) is a key contributor to this exercise. From the SRB perspective, we already drew some initial lessons in particular in three areas - (i) communication and cooperation between authorities; (ii) liquidity; (iii) preparedness to use the resolution tools.

Word travels fast, across borders, in our interconnected world. A hint from a shareholder or the actions by one authority ripple through the global financial system in a frictionless way. Authorities should bear this in mind and deepen their work on communication plans (for themselves and for the banks). To ensure information sharing, international co-operation for internationally systemic banks should be further enhanced, including in cases where a resolution authority is not in a Crisis Management Group (CMG), or where the CMG is not activated/non-existing. The failure of a systemic bank could cause instability even in places where the bank does not operate directly. While it is not possible to envisage all scenarios given the differences of crisis cases, we should however continue the cooperation across the authorities involved, in order to be ready to spring into action where needed.

International cooperation should go together with cooperation between supervisors and resolution authorities. For example, the joint SRB-ECB-EBA press release providing information on the EU hierarchy of liabilities for loss-absorbency helped reestablish calm in the EU AT1 markets after the write down of Credit Suisse's AT1 instruments on worse terms than shares. More generally, to establish trust, stakeholders should feel that supervision and resolution authorities act seamlessly - as one.

Unsurprisingly, liquidity proved once more to be vital to restore stability. With financial stability in mind, both the Swiss and the American authorities moved swiftly and decisively to provide liquidity. In the EU, the SRB has been working with the banks to improve their ability to identify and mobilise collateral in case of need. Even if banks are very well prepared, we cannot rule out that their liquidity will not be enough in time of crisis. This is especially true considering the sort of rapid bank runs that we have seen in the US and Switzerland. In times of need, our Single Resolution Fund

(SRF) stands ready to provide liquidity. The SRF has now reached nearly €80 billion, and its firepower will almost double if the revised ESM Treaty is ratified. Yet, the liquidity needs of a global bank may go even beyond the SRF means. We stand ready to find a solution for these extreme cases. Likely, having a liquidity line in place ex-ante can reduce the needs to actually draw on it.

Finally, resolution tools need to be ready to use. The SRB successfully concluded a sale after writing down and converting shareholders and junior bondholders in the case of Banco Popular in 2017, and sold two subsidiaries of Sberbank last year. In the US and Switzerland, transfers proved to be effective even for larger banks. This, however, does not make bail-in less of a priority. Rather, it shows that we need to be nimble, with backup options in our resolution strategies. We should be able to switch or combine tools to respond effectively to each situation.

We do not call for a fundamental overhaul of the EU framework but rather for its completion.

Communication and cooperation between authorities, liquidity and preparedness to use resolution tools are not newly discovered issues. These issues were part of the FSB Key Attributes and the EU resolution framework, and the recent cases show that the global and EU framework have stood the test of time. This is why we do not call for a fundamental overhaul of the framework but rather its completion.

For the Banking Union, this means, beyond working on the three issues above, achieving an ambitious and coherent compromise on the ongoing review of the Crisis Management and Deposit Insurance review and making steps towards a common deposit insurance framework.



HIROHIDE KOUGUCHI

Executive Director - Bank of Japan

Lessons learned from the recent banking events

The lessons learned from the recent banking events are being discussed and analyzed in various global fora. I would like to show my own tentative views on what they may mean to global financial stability going forward. I have four points to argue.

First, from a regulatory point of view, the Basel framework has contributed well to mitigate the negative spillover of those idiosyncratic events in the global financial system. Without enhanced capital and liquidity requirements, the banking turmoil contagion should have been much exacerbated. I would like, therefore, to reiterate the importance of full, timely and consistent implementation of all aspects of the Basel standards. This should remain a clear priority for supervisors and regulators around the world. There is an argument in support of further strengthening regulatory requirements to prevent similar events in the future. I do not agree with the idea, however, not least because it would simply induce leakage to less-regulated nonbank financial institutions, thereby potentially eroding global financial stability.

Second, from a supervisory point of view, many challenges have been put on the table. Regulation cannot be a substitute for supervision, because we need a bespoke approach that takes into account a variety of risk profiles of financial institutions. Effective supervision should play a key role to enhance the resilience of global financial system. The vulnerabilities of recently failed banks in business model, governance and risk management were quite idiosyncratic but too essential to ignore. How supervisors can conduct on-site examinations appropriately and prompt banks' management to address expeditiously recognized vulnerabilities, therefore, will be a major challenge down the road. With respect to interest rate risk on banking accounts and liquidity risk, effective pillar two approach is also the key. For example, supervisors can prompt banks that carry too much interest rate risk to reduce it by duration control, diversifying maturities of bond holdings or utilizing hedge measures. With respect to liquidity risk, supervisors should require banks to analyze stickiness of their deposits, conduct stress testing in more stringent scenarios, make necessary arrangements to access central banks' standing facilities in advance, and equip themselves with reliable contingency funding plan.

Third, the resolution plan for G-SIBs was not tested in case of Credit Suisse whereas we recognized some practical issues. In order to address them, communication at ordinary times among authorities to warrant workability of the plan is significant. Since the experience with Credit Suisse has suggested that we may have less time to implement the plan than previously thought, we should reconfirm the practical procedures in advance as necessary.

Fourth, markets' and depositors' loss of confidence in solvency of banks tends to trigger instantaneous bank-runs, especially now that social media and digital banking are so prevalent. Under such circumstances, banks immediately lose their franchise values, and once market participants recognize this, they would start assessing banks' assets and liabilities on mark-to-market or at resolution values. Such risk is in a sense intrinsic to banking activities, since financial intermediation inherently involves maturity and liquidity transformation. The challenge is, however, the speed of contagion of anxiety and subsequent deposit withdrawal. In order to maintain confidence in banks as well as financial systems under current circumstances, the safety net, including lender-of-last-resort function of central banks, well-designed deposit insurance frameworks and other forms of public backstops as needed and appropriate, will play a key role. At the same time, we need to address the moral hazard issue by introducing appropriate incentive mechanism.

Effective supervision should play a key role to enhance the resilience of global financial system.

Financial stability is the cornerstone for sustainable growth. The shift from the low-for-longer environment to the higher-for-longer environment has brought about some challenges to global financial stability.

While the Basel standards have materially contributed in improving the resiliency of global financial system, we need to be very vigilant on global financial stability to ensure that financial institutions continue to provide sufficient credits to the real economy.



ANA FERNÁNDEZ MANRIQUE

Global Head of Regulation and Internal Control - BBVA

Lessons from the turmoil: the urgent is the enemy of the important

In many aspects of life, humans tend to overreact to what is felt as urgent, forgetting what is really important. Therefore, I would like to focus this article on what we thought was important in global regulation and supervision right before the first news about US banks in trouble arrived. After a decade of very significant and structural changes resulting from the global financial crisis, there was a consensus on the need for an active pause, in order to implement the changes and evaluate their effects. We thought it was not the right time to think of new regulation, but rather to refine any piece of the current framework that proved it was not working.

There are many reasons why those ideas are still valid nowadays. First, the turmoil was an idiosyncratic episode caused by banks with very particular business models or situations, of which it is difficult to extract lessons with universal applicability. Second, this has been more an internal risk management and supervisory problem rather than a regulatory one. Maybe one line of action for the future could be to dig in more into supervisory practices and in particular how they could better understand risks embedded in the different business models, tailoring the rules for them. And third, in general terms, it does not make sense to introduce major changes in the EU regulatory framework, which has not been identified as the origin of the problems. Having said this, it is clear that some conclusions from the recent episode can be reflected upon, in order to improve our rules and practices.

First, some changes have been proposed regarding liquidity. Some measures that can be contemplated include putting more emphasis on the concentration of depositors on a single sector, or the level of uncovered deposits, which were not taken into account up to now. However, it is not so clear that a debate should be opened on the LCR or NSFR, which were not applicable to the US banks involved in the turbulence. In Europe we should in any case get an adequate liquidity in resolution tool, because the US or Switzerland are clearly one step ahead of us, which allows them to react very quickly in these situations. The ratification of the ESM as backstop for the Single Resolution Fund is a must, but much more liquidity would be needed in a crisis situation, and it should be provided swiftly.

It would be wrong to conclude that any crisis requires higher capital requirements. Recent events had nothing to do with the solvency levels of the banks involved. There is also debate about whether 'held to maturity' latent losses or gains should be reflected in the capital. Imposing that the capital must always vary due to this cause would be a mistake, as this measure would introduce a significant degree of volatility in the accounts. There is no need to change regulation, as long as supervisors have the information they need to evaluate the institutions.

A different issue is that of proportionality and the scope of application of international standards, where the ball is in the court of jurisdictions like the US, that apply more lenient standards to institutions that in a crisis are deemed to be systemic. In Europe there is a certain degree of proportionality, but most regulations apply to a wide scope of institutions, and recent crises seem to support that approach.

Finally, what we should not do is forget previous lines of work by focusing too much on the lessons from the turmoil. One good example is the revision of the macroprudential policy, and in particular the usability of capital buffers and the right level of the counter cyclical buffer, which has proven to be a difficult topic to agree on. The idea of a positive neutral counter cyclical buffer could work, but the impact should be compensated with the reduction of another buffer in order not to increase overall requirements, since there is no reason to believe that the optimal level of capital has risen.

The reform of the framework was on the right path, so we should not deviate too much.

Additionally, another area where work was intensifying before the turmoil was the framework applicable to Non Banking Financial Intermediaries, especially in the US, where they have access to the Fed. Finally, coming from an international bank that operates in different continents, we think we could also take time to analyze market fragmentation and extraterritoriality a little bit more in depth.

In a nutshell, the reform of the regulatory and supervisory frameworks was on the right path before the turmoil, so we should not deviate too much from it due to the bumps along the way.



FRANCESCO CECCATO

Chief Executive Officer - Barclays Europe

Europe should focus on its existing financial services priorities

The recent banking turmoil, for want of a better expression, was triggered by individual, bank-specific events. The starting point for the analysis of what went wrong, therefore, needs to be the events themselves, which should lead to some common lessons being drawn.

Credit Suisse's issues have been the subject of extensive commentary. As the dust settles, the focus needs to be on the importance of reliable resolution frameworks as the principle avenue for dealing with a bank in crisis. This is not to criticise the Swiss authorities in any way. When looking at the form of bail-in-able debt on the books, they saw permanent write-down of AT1 bonds, as opposed to convertible instruments, and they used what was available to them.

Despite immediate and constructive statements by the ECB and the BoE, AT1 markets understandably seized up as investors reacted to events. The market has since rebounded, with Barclays leading a €1bn issuance for BBVA being the first real sign that AT1 would continue to have its place in the hierarchy. *Permanent write-down* features are a thing of the past; this form of AT1 is now likely to be history.

The situation in the US was clearly very different and the Federal Reserve has conducted a significant and very thorough analysis of the management and supervisory issues that led to the banking failures. This will lead to a programme of change in the US, which will be implemented over time.

One of the most interesting questions posed by the events in Switzerland and the US relates to the "speed of failure" issue. The velocity of deposit withdrawal does raise questions. There have been suggestions that this was accelerated by the availability of digital banking services, but as Andrea Enria has noted, the deposits that were withdrawn more quickly were those that were uninsured, especially those of non-financial corporations and financial institutions, and it is highly unlikely that the treasurers of these companies use smartphones to move deposits.

Whatever the reasons for increased deposit withdrawal speed, good risk management and diversification are the most obvious ways to ensure that an institution is not impacted. However, increasing the velocity (ability to monetise) of your asset side, both in the market and - as a last resort - with the central bank, is just as important. And what about any (residual) concentration risk? If you allow sectoral or client concentration, does it need to be combined with term structures that penalise the swift withdrawal of funds?

These questions are relevant for the EU too, despite the relative stability of its banking market throughout the events of the Spring. The regulatory framework in Europe was shown

to have broadly worked. The European banking sector is highly capitalised and the capital rules are applied widely across the banking sector, rather than to a subset of banks. It has strong liquidity buffers and is increasing the frequency of liquidity reporting. Its supervisory approach is strenuous, and stress testing is conducted against very severe scenarios, even very unlikely ones.

This does not mean that all relevant risks are mitigated in Europe, but it does suggest we do not need broad re-regulation efforts. There are still some technical issues to be considered, for example, on the velocity of the asset side, as mentioned above. Although the Eurosystem's collateral eligibility criteria are broadly relative to other major central banks, perhaps further work needs to be done to harmonise the rules for central bank-eligible collateral across Eurosystem countries. This is particularly relevant for the credit claims framework, and would grant banks more flexibility in terms of accessing Eurosystem credit operations. On the political side, the point of the political cycle that we find ourselves in offers the opportunity to reflect on what the key priorities need to be for the next 5-10 years.

The recent banking turmoil was triggered by individual, bank-specific events.

We need to make more progress on Banking Union beyond the recent crisis management and deposit insurance proposals which are important but, in insolation, insufficient. In addition, we must increase the urgency of our work on Capital Markets Union moving beyond our current focus on a long series of technical tweaks to the European capital markets. Irrespective of recent events, these agendas existed pre-turmoil and their importance now is undiminished.



MICHAEL SCHOCH

Head Governmental & Regulatory Affairs - UBS

Recent events point to the need for targeted reform but no fundamental overhaul

Recent events have put to the test the international regulatory reforms following the Global Financial Crisis (GFC). These reforms have been demonstrated overall to be robust.

While the immediate trigger of recent market turmoil can be identified as an abrupt adjustment to rapid tightening of monetary policy, itself implemented in response to a very significant rise in inflation, the underlying root causes of the demise of SVB, other US regional banks and Credit Suisse (CS), are idiosyncratic. These boil down to poor governance, deficient risk management culture, including liquidity risk, and failure to implement a sustainable business model.

Thus there is, justifiably, a widely-held view that recent crises were not caused by a lack of regulation. Indeed, the long process of reforms following the GFC, now culminating in the implementation of final elements of the Basel framework, helped to limit the consequences of the Spring 2023 stress events and provided optionality to the Swiss and global authorities. The Basel framework, which will soon be implemented in the EU and Switzerland and on which the US authorities are consulting, has proven robust already, even before the significant enhancements coming into force in the next few years.

While the broader overall regulatory framework has also proven very sound thanks to the introduction of Recovery and Resolution planning and reforms to the over-the-counter derivatives market including increased use of margining and central clearing to address systemic risk, targeted adjustments to address effectively the weaknesses that allowed the collapse of SVB and the emergency takeover of CS should be considered. These need to be based on sound analysis of the underlying causes of the events mentioned above.

Increasing banks' liquidity resilience to withstand the unprecedented speed of deposit outflows in the digital age requires special focus and consideration of both the liability and asset sides. On the liability side, the outflow assumptions in the Liquidity Coverage Ratio framework may need to be reviewed, in particular around deposit stability. At the same time, the marginal benefit of a few additional weeks that banks might be able to withstand a deposit run need to be balanced against the related costs for investors.

Any forthcoming regulatory measure should be internationally coordinated and a balance must be found so as not to impede the risk-managed maturity transformation that is, fundamentally, the role of the banking system. Ultimately, banks will need to rely on more diversified funding sources. On the asset side, additional secured funding sources including a wider range of eligible collateral should be available consistently, at all times, across the globe.

Deficiencies in banks' internal governance frameworks and risk control practices cannot be remediated simply by requiring compliance with more demanding prudential standards that are ratcheted up with each stress event. While oversight of those areas is primarily the responsibility of shareholders and banks' management, it is important that supervisors can challenge banks robustly and are empowered to take timely and effective actions to preserve their overall soundness and, ultimately, ensure financial stability. Supervisory tools should include measures that tackle unsustainable business models and critical governance and culture issues that might threaten a bank's viability.

In the CS case, a rescue transaction was the preferred option. It allowed for a credible solution with low market impact. Going forward, ensuring higher effectiveness of early intervention measures and crisis preparedness will also be important. Authorities' toolsets for the earlier stages of a crisis should be enhanced and further legally outlined. The introduction of additional forward-looking measures, based on objective criteria such as price/book value, CDS spreads across peers, and lack of sustainable profitability, would help mitigate weaknesses early on and gain valuable time to allow orchestration of restructuring measures at a time when a credible recovery is still possible. In this regard, mandatory ex-ante valuation of certain asset portfolios by a third-party could provide the potential acquirer with key data points and allow for more comprehensive assessment of inherent risks and respective available capacity to manage them.

Targeted reforms should reinforce and implement more consistently an already credible framework.

The idiosyncratic challenges at the root of recent events need to be further digested before proposing material changes to the regulatory framework. The goal of any potential targeted reforms should be to reinforce and implement more consistently an already sound and credible framework. While we cannot construct a zero-crisis regime, any action should aim at earlier prevention of severe stress situations, ensuring reliable and effective alternatives and a robust toolset for resolution authorities.



ÁLVARO BENZO GONZÁLEZ-COLOMA

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Lessons from the banking turmoil in terms of regulation and supervision

Every time there is an episode of financial turmoil, the first instinctive reaction is to try to identify what is missing or broken in our regulatory framework. However, there is a more pressing question: were the existing instruments and mechanisms used properly?

In the recent episode of financial distress in the US, Silicon Valley Bank (SVB) had prudent capital levels and very generous liquidity buffers. However, something went wrong and as a result, the regulatory debate now dwells on two aspects: (i) the need to review the existing liquidity metrics and buffers, and (ii) the convenience of revamping accounting standards in order to mark-to-market even the held-to-maturity portfolios. Some call for excluding assets which are not marked-to-market, from regulatory liquidity buffers (LCR).

During the global financial crisis, after the collapse of Lehman Brothers in the US, the problem faced by many banks was the difficulty to refinance their positions in the market and subsequently, the lack of sufficient HQLA in order to obtain alternative funding. In this context, governments and regulators were forced to set up public schemes providing guarantees on banks' liabilities (the so called, own issued bonds) so that these instruments could be pledged at the central bank in order to obtain liquidity. Hence, the purpose of these schemes was to create HQLA for banks with dire liquidity positions.

By European standards, SVB had an extremely high LCR with a very large volume of High Quality Liquid Assets (HQLA) which, theoretically at least, should have allowed the bank to seek liquidity from the central bank and restore confidence in the bank's ability to weather through the thunderstorm. Instead, the bank resorted to the market and tried to dispose of those HQLA, which in turn materialized the unrealised losses. If those assets had been pledged at the central bank, losses would not have materialized. This course of action would have provided a large volume of liquidity for the bank and could have also dispelled fears that losses would ever have to materialize.

It could be argued that liquidity buffers should be constructed in order to allow banks to obtain liquidity primarily from the market. However, the experience from previous crisis shows that in situations of very severe stress, with distorted capital markets, only central bank funding can ensure the liquidity of the banking system without destabilizing the financial system.

In the current context of high inflationary pressures and very sharp and unexpected increases in interest rates, banks with held-to-maturity debt portfolios have indeed accumulated unrealized losses on these assets but so have banks with fixed-rate credit portfolios. Such credit portfolios are very common and core to the business of banks in some EU countries which means that they are much more relevant in terms of size,

than bond portfolios. Hence, should banks be required mark-to-market fixed-rate credit portfolios, also, in order to avoid accumulating unrealized losses?

Clearly, this debate is not straightforward. The first step may be to enhance transparency in order to ensure that the market has sufficient information on held-to-maturity bond portfolios and any underlying losses, for all banks, in line with the information published by EBA after the EU-wide stress test. This information today is heterogeneous amongst banks so there is room for improvement.

Transparency must be coupled with tighter monitoring of structural risks, mainly liquidity and interest rate risks, by the regulator. The supervisor in the Eurozone has stepped up its efforts to oversee liquidity in banks with revised liquidity templates and more frequent reporting from banks to the ECB. Banks must also step up their efforts to manage these risks proactively.

Also, this liquidity crisis has brought to the fore a controversy analysed by authors such as Charles Goodhart¹, which is the debate around the possible conflicts between monetary policy and financial stability since most central banks have both mandates. In times of inflationary pressures, can monetary policy affect central bank's ability to preserve financial stability since this would require acting as lender of last resort? What prevails, financial stability or price stability?

On a separate note, the recent turmoil and in particular, the episode provoked by Credit Suisse, has also raised questions and strong concerns around the new resolution and crisis management framework.

The 2007-2009 global financial crisis revealed serious shortcomings in our existing crisis management framework.

Government sponsored bailouts and blanket guarantees on banks' liabilities resulted in massive costs and contingencies for national budgets, originating a severe sovereign crisis².

Problems in banks were tackled by merging weaker banks and creating bigger banking groups, but this also made the too-big-to-fail dilemma even worse.

For the past few years, authorities have set up new resolution authorities with broader powers, established comprehensive resolution frameworks and drawn up detailed resolution plans.

Despite this, in the aftermath of the recent turmoil, many have quickly called to stabilise banks by extending deposit insurance and other government guarantees, similar to what was done in the past. Furthermore, the crisis at Credit Suisse has been,

yet again, tackled through a merger with another bank, sparing shareholders from a big portion of the losses and creating one of the largest, most systemic banks in the world.

All of this begs the question, is the new resolution framework really fit for a severe crisis with the potential to seriously threaten financial stability?

The second question relates to the need for a liquidity-in-resolution tool.

The recent turmoil has illustrated just how essential liquidity is in resolution. The Swiss National Bank provided liquidity support to UBS of up to CHF100bn.

The combined financial firepower of the Single Resolution Fund, plus the ESM backstop, seems small when confronted with the liquidity needs of a single globally systemic bank. The ESM can only lend the SRF up to €68 billion³. Moreover, liquidity in resolution needs to be provided swiftly to avoid contagion. Unfortunately, the ESM can only intervene if the SRB is not able to raise funds from other sources. Thus, the process is likely to be slow.

In sum, there is still an intense debate and reflection process to be had, not so much on the need to introduce changes to our existing regulatory frameworks or on the convenience of introducing new requirements but rather on the use and application of the tools and mechanisms that are currently available.

1. *"The changing role of central Banks". Charles Goodhart.*
2. *In countries like Ireland, blanket guarantees on banks' liabilities covered approximately more than twice the size of its economy. Eventually such contingencies forced the country to seek EU-IMF financial assistance.*
3. *Florence School of Banking and Finance. "Completing a half full or a half empty Banking Union: the introduction of the common backstop". Maria Ana Barata.*

MANAGING RISKS IN THE BANKING SECTOR



NATHALIE AUFAUVRE

Secretary General -
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EU banks have weathered global storms - EU supervisors keep an eye on waves ahead

External stress factors have accumulated at global level: increases in commodity prices, inflationary shocks, volatility on Gilt and cryptoassets, and the failure of some banks in the context of rising interest rates. Despite this challenging environment EU banks have confirmed their resilience.

Higher interest rates supported EU banks profitability thanks to a diversified business model, credit growth and a large deposit base with a 23% rise in net interest margin (NIM) between the first quarters of 2022 and 2023. Moreover, EU banks have further strengthened their solvency ratios and asset quality in recent quarters. The latest EU-wide stress test exercise shows that even

under a severe scenario, featuring a strong decline in GDP as well as high interest rates, EU banks stay resilient thanks to a solid starting capital position which allows them to absorb projected capital depletion. Over the three years of the exercise, this depletion brings the average CET1 ratio of the sampled banks from 15.0% to 10.4%. Banks also maintain their capacity to generate earnings, mainly through higher NIM, which offsets credit losses.

This resilience does not come out of the blue. Recent events show the EU made the right choice in designing a Single Rulebook aligned with international standards and imposed to all banks. In the Banking Union, the role of the single supervisor with intrusive methods of supervision is also key to improve banks' risk management.

Yet, in the current context, there is no room for complacency. First, on the global scene, Basel III standards, especially on liquidity and interest rate risks have proven essential. It is of the utmost importance that they are faithfully and consistently implemented to all banks whose failure could impact financial stability.

Besides, at EU level, despite sound fundamentals, vulnerabilities may arise. Loan demand is set to slow down and funding costs to increase. Higher rates can reduce the value of banks' fixed-income securities, such as government bonds, leading to direct or unrealized losses in banks' balance sheets, although this impact remains limited at EU level (75 bn€ in the EBA ad hoc exercise). As regards credit risk, even though the cost of risk remained low on the first months of 2023, default rates are increasing and banks anticipate a rise in impairments. The tightening access to funding and pricing corrections could in particular put pressure on the commercial real estate segment.

To curb upcoming risks, authorities should leverage on all available tools. Regarding the factors that led to some non-EU banks' demise, existing monitoring and Pillar 2 frameworks can help to mitigate the build-up of excessive exposures to rising interest rates, concentration of depositors and uncertain capacity to monetize liquid assets.

While not calling for a massive overhaul, novel risk features nonetheless invite us to reflect on -proofing banks' regulation and supervision further. For instance,

digitalisation of the economy and social networks could accelerate the speed of bank runs, potentially challenging some assumptions on uninsured deposit outflows in times of stress. The supervision of interest rate risk may also need levelling up. However, regulators should remain careful of potential adverse effects; for instance, generalizing full fair value accounting could contribute to procyclicality of own funds and markets in some cases.

Another source of risk could be banks' connections with non-bank financial institutions (NBFI). Since 2008, the size of the NBFI sector has grown from 42% to 50% of global financial assets, while this sector now assumes a larger role in liquidity, credit, and maturity transformation. This growth has been partly beneficial by diversifying the sources of financing for the economy. However, it also creates financial stability challenges as this sector is less strictly regulated.

EU banks' asset exposures to NBFI entities remain high (on average 9% of bank assets), even if some of the credit risk associated is offset by collateral exchange. Banks also act as intermediary in financial markets for clearing and trading in derivatives markets. Liquidity and credit risks may materialize depending on the ability of the NBFI sector to meet margin calls.

Ongoing challenges show EU banks' solidity and the relevance of their regulation and supervision.

Finally, NBFI play a major role in the short-term funding of banks, a key segment in their daily operations, representing more than half of repo funding to EU banks at Q4 2022. These entities are also significant investors in bank debt securities and place deposits which can be volatile and subject to outflows in stress periods. Hence, a withdrawal of NBFI liquidity could jeopardize banks' ability to fund their operations in particular during crisis periods.

For these reasons, we call for monitoring bank exposures to NBFI and making progress on strengthening the micro and macroprudential regulatory framework for NBFI, as per the FSB work program.



MARGARITA DELGADO

Deputy Governor -
Banco de España

Giving european banking supervision an additional boost

In the last three years we have lived through several challenging events, which have affected the world economy and the European banking system in particular. An unusually prolonged low interest rate environment was followed by two unforeseen shocks – the COVID-19 pandemic and the war in Ukraine, which eventually triggered inflationary pressures and changes to monetary policy, leading to a steep rise in interest rates.

The level of uncertainty has increased significantly and several risks to the banking sector have worsened. In the current context, it seems clear that banking business models with poor governance of credit risk, asset liability management, IT or risk data aggregation and reporting, among other areas, are especially exposed.

The banking sector also faces challenges of a more structural nature, including: (i) the impact of growing digitalisation in our society and the financial services industry with the emergence of new technologies, players and business models; (ii) climate related risks – a relatively new area of supervisory focus of increasing relevance; and (iii) the expansion of non-bank financial intermediation since the global financial

crisis (GFC), providing credit to the market but also representing additional sources of risk to the banking sector through their interlinkages.

Managing risks in this new uncertain environment has become a complicated task for institutions and poses a significant challenge to regulators and supervisors. Banking regulation, for its part, was significantly strengthened as a result of the GFC, with stricter capital and liquidity requirements that have enhanced bank resilience and made banks much better prepared for turbulent times. These improvements certainly have helped, and continue to help, the European banking system to successfully navigate the storms of the pandemic, the war in Ukraine and the recent US and Swiss banking crises. In addition, the full implementation of Basel III reforms is expected to further reinforce banks' solvency.

Under these circumstances, there seems to be no urgent need for major regulatory changes. Regulatory and supervisory bodies could now rather work towards ensuring that the existing wide-ranging banking rulebook is applied correctly and only make very specific adjustments if needed.

Supervision has also been strengthened since the creation of the Single Supervisory Mechanism (SSM) with the development of a common approach that ensures the consistent application of regulation and supervisory policies and fosters risk-based supervision. Nonetheless, it seems to be the right time to emphasise the role of supervisory activities, which should take full advantage of existing regulations. In this regard, we could focus on the following three areas:

1. Allow for sufficient flexibility to be able to adequately respond to the current dynamic environment

Supervision should provide an agile response to an ever-changing environment, finding the right balance between defining a clear strategic plan and allowing for the flexibility needed in the face of the current high level of uncertainty. In essence, the framework should be able to deliver a medium-term plan with relevant activities aimed at improving the structural weaknesses identified and, at the same time, be open to the possibility of shifting gear and deploying resources to address new, unexpected challenges that may emerge.

2. Advance further in setting risk-based supervisory priorities to achieve greater effectiveness

Over the last years, the supervisory framework of the SSM has evolved

in the right direction by giving increasing prominence to achieving greater supervisory effectiveness with a risk-based approach instead of principally aiming for compliance with a set of methodologies and procedures. Continuing along these lines, the supervisor could further develop and implement a risk tolerance framework to focus on each bank's key vulnerabilities and empower the use of supervisory judgment.

3. Design more action-oriented supervisory measures to enhance the impact of supervision on banking activities

Banking supervision has to be intrusive and dig deep into banking operations, structures and decision-making processes. The findings identified should be directly linked to the measures requested, with clear indications to the bank and planned follow-up actions. Furthermore, the supervisor needs to review the actual effectiveness of its activity, with a regular assessment of supervisory results, and draw lessons for the following planning cycle.

It is time to emphasise the role of supervisory activities taking advantage of existing regulations.

In summary, banking supervision and regulation are becoming increasingly complex with the need to deal with emerging and structural challenges. In this context, an enhanced supervisory strategic direction is gaining increasing relevance. We propose the three action areas mentioned earlier as a way to further strengthen European banking supervision.



ELIZABETH MCCAUL

Member of the Supervisory
Board - European
Central Bank (ECB)

Current risks and vulnerabilities in the European banking sector

The sound policy decisions implemented following the great financial crisis have brought undeniable benefits. The euro area banking sector remains resilient¹, and thanks to prudential regulation and supervision, banks are in a good position to withstand the three major macroeconomic challenges we now face: rising interest rates, inflationary pressures and subdued GDP growth, and the economic fallout from the pandemic and Russia's war in Ukraine. The aggregate Common Equity Tier 1 ratio of banks directly supervised by the ECB stood at 15.5% in the first quarter of 2023, compared with 15.0% the previous year, and the aggregate liquidity coverage ratio was 161.3%, up from around 140% before the pandemic.

The significant macroeconomic uncertainty has been reflected in financial market tensions, with credit risk, liquidity risk and funding and interest rate risk key areas of concern. The ECB is addressing these issues as part of its supervisory priorities.

The supervisory strategy underpinning our priorities assesses both cyclical

and structural challenges amid a risk landscape shaped by three medium-term trends.

- Persistently high inflation, the unprecedented pace of monetary policy tightening and the difficult geopolitical situation could lead to new shocks and, in turn, further asset price corrections, while the uncertain economic outlook may give rise to asset quality concerns.
- The digital transformation of the financial sector is challenging banks' business models, underscoring the need to strengthen governance. With the ongoing geopolitical uncertainty and banks relying more heavily on third-party providers for their digital strategy, cyber risk is on the rise.
- Climate risks have become more pronounced since the start of the war, with Europe facing an "energy trilemma", i.e. how to make energy secure, affordable and sustainable.

We are keeping a weather eye on the potential for market dislocation effects. The fast-paced normalisation of monetary policy is leading to asset price adjustments and higher debt servicing costs. This may result in further market corrections and/or increasing credit, market liquidity and funding risks. Short-term fiscal pressures remain contained, but the outlook for sovereigns may deteriorate if financial conditions tighten and additional fiscal support is needed.

**Asset price corrections,
while the uncertain
economic outlook
may give rise to asset
quality concerns. Cyber
risk is on the rise.**

The recent market turmoil highlights how important it is for banks to be able to withstand unexpected short-term liquidity shocks and to have sound and prudent asset liability management (ALM) frameworks. Even if a bank has excess liquidity, it could still fail owing to shortcomings in ALM practices. A bank runs a reputational risk if its management and internal controls are perceived to be weak. And when there are also doubts about the business model, market confidence may erode, potentially exposing the bank to capital and liquidity vulnerabilities.

Asset quality concerns rise as the economic cycle weakens, making credit risk one of the most pronounced risks.

Inflation and interest rate increases have not resulted in a material deterioration in asset quality, but there have been growing signs of this over the last three quarters. We have observed a – so far orderly – turn in the real estate cycle, particularly in commercial real estate markets. Our recent stress test also showed that leveraged finance exposures carry a high degree of credit risk and market risk which could materialise in a downturn.

We are also keeping a close eye on emerging risks in the non-bank financial intermediation (NBFi) sector. In the current environment, if liquidity risks in this sector were to materialise, it could lead to a drop in the funding NBFi entities provide to banks. As this type of funding is relatively more sensitive to the credit quality of banks, and since market sentiment remains fragile, the strong links between banks and the NBFi sector could amplify banks' funding pressures if the soundness of their fundamentals was somehow called into question by the market.

Changing customer preferences and increasing competition from new entrants is another area of attention. Banks are under increased pressure to speed up their digital transformation strategies and rethink their business models, and they also face fierce competition for IT talent. Moreover, surging cyber and IT-related risks stemming from the geopolitical situation and banks' increasing reliance on outsourcing are also considered among the most pronounced in our assessment.

Finally, amid the current energy trilemma, banks face medium-term transition risk as they shift to a green economy. Tackling climate-related and environmental risks must be a priority, and banks need to incorporate these risks adequately within their business strategy, governance, and risk management frameworks.

The risk landscape is constantly evolving, and we will adapt our supervisory strategy in line with it.

1. ECB (2023), 2023 stress test of euro area banks – final results, July.



JOSE MANUEL CAMPA

Chairperson - European
Banking Authority (EBA)

EU/EEA banks: potential pressure from the asset and liability side

The macroeconomic outlook has remained highly uncertain, with high and persistent inflation, rising interest rates and slower economic growth. It has impaired consumer and business confidence while at the same time pushing banks' risk appetite lower. Macro-economic uncertainty not least affects banks' loan growth as well as asset quality. Latest EBA data shows that outstanding loans towards households and non-financial corporates (NFCs) remained stable over the first quarter this year. Going forward, EBA risk assessment questionnaire (RAQ) results point towards slower lending growth rates. A rising share of banks aim to, e.g., decrease their real estate related exposure as well as consumer credit. This might in turn negatively affect GDP growth, as well as banks' net interest income.

The challenging economic environment was not yet mirrored in asset quality metrics. However, the EBA RAQ indicates that banks expect asset quality to deteriorate in the next 12 months across all segments. The outlook for residential and commercial real estate, as well as SME and in particular consumer credit seems to be more negative than

for other exposures. These are loan segments in which sticky inflation and increasing interest rates could particularly challenge overindebted borrowers. It remains to be seen how asset quality will further evolve, after it had demonstrated resilience, but the outlook tends to be rather deteriorating than improving.

The EU banking sector's capital position is stronger than ever before and should help absorb any potential deterioration in asset quality. At the end of the first quarter 2023 EU/EEA banks reported an average CET1 fully loaded ratio of 15.7%. The capital headroom above Overall Capital Requirements – OCR – and Pillar 2 Guidance is close to 500bp.

The strong capital position is also reflected in the 2023 EU-wide stress test, whose sample covered 70 banks. The results of the exercise show that European banks remain resilient under an adverse scenario which combines a severe EU and global recession, increasing interest rates and higher credit spreads. Under the adverse scenario, the capital depletion is 459 bps. Higher earnings and better asset quality at the beginning of the 2023 both help moderate capital depletion under the adverse scenario. Despite combined losses (credit, market and operational risk losses) of EUR 496bn, EU banks remain sufficiently capitalised to continue to support the economy also in times of severe stress.

**Banks' loan growth
and asset quality as
well as funding costs
might face challenges
going forward.**

With the events at SVB, interest rate risk in fixed income portfolios has moved into the focus. Banks apply many different approaches to interest rate risk management, including for instance hedging of open position through derivatives or other instruments, usage of replicating portfolios, structural hedges and fund transfer pricing (FTP). The topic has always been part of supervisors' work. Looking at EU banks these bonds represent about EUR 1.3trillion as of February 2023 (data for the EBA's stress test sample, i.e. 70 banks). The EBA estimates aggregated net unrealised losses of EU banks' bond holdings at amortised costs at around EUR 75bn. These potential losses are not expected to be realised in the absence of a liquidity shortfall. Banks actively

manage these portfolios as part of their interest risk management.

Another recent focus are risks related to non-bank financial institutions' (NBFIs). Credit risk associated with the exposures towards NBFIs is one interlinkage between banks and NBFIs. Additionally, if asset values drop and investors start to withdraw funds from NBFIs, the latter might need to look for liquidity by either selling assets or withdrawing deposits they hold with banks which might affect banks' funding composition, and not least banks' funding costs. To mitigate such risks, the regulatory landscape should evolve towards a further assessment of the risks arising from NBFIs to financial stability.

Furthermore, operational risks have not abated. Key risk drivers for operational risks include information and communication technology (ICT) as well as cyber related risks. They also comprise circumvention of anti-money laundering and counter financing of terrorism (AML/CFT), including sanction related breaches. Results of the EBA's latest RAQ show that nearly two third of banks agree that cyber risk is a key driver for operational risks. It is followed by conduct and legal risks.

ESG related risks also need to remain high on banks' agendas. EU/EEA banks already offer a wide range of green and sustainability-linked loans, with for instance proceeds-based green loans and sustainability-linked loans being the most common products in banks' lending to large corporates. On the liability side, the share of green bonds in non-preferred senior and HoldCo issuances reached 24% YtD, whereas the share in preferred senior was 12%. For both sides of the balance sheet there is still a long way to go until ESG related products and financing are much broader reflected in banks' daily business.



DR. NATHANAËL BENJAMIN

Executive Director of
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Navigating the shift in the environment

Over the past year and a half, the global macro environment has undergone a fundamental shift away from the conditions that prevailed over the previous decade. The era we have entered is dominated by monetary tightening, growing digitalisation, and climate change. And while it initially appeared that this shift was progressing smoothly, we have now seen a number of crystallised risks – most recently the failures of Credit Suisse and Silicon Valley Bank in March – belying the notion that we can leave a decade of benign economic conditions without any bumps along the way.

Annually, the Bank of England publishes the letters we send to bank CEOs about our supervisory priorities for the year ahead. This year, for international banks, those priorities included counterparty risk, and financial risks arising from climate change. They have never been more important.

Though the collapse of Silicon Valley Bank and Credit Suisse earlier this year shook markets, as at time of writing the consensus outlook in many economies remains positive. The US in particular has proved resilient, with falling inflation, a robust labour market, and growing GDP.

But there are risks to this consensus. As the IMF note, a ‘plausible alternative scenario’ is that credit conditions in the US tighten significantly. And idiosyncratic events, be they natural or cyber, are never far away.

Such consensus breakdown can manifest itself through counterparty risk, which is a particular focus for us.

The past decade has seen non-banks increase their share of direct risk taking in the economy, with market risk morphing into counterparty risk. We have repeatedly called out many banks’ tendency to sleepwalk into large and concentrated counterparty exposures. Archegos was an example, but last year’s disruptions to the nickel and gilt markets highlighted this issue too. So although it is interest rate risk that happens to have crystallised earlier this year, our focus on counterparty risk as another symptom of the ongoing macroeconomic shift is undiminished.

Private equity and private credit markets are a particular case in point. Traditional leveraged finance has stuttered lately, and there is an emerging trend toward illiquid private equity financing and private credit. This has created a complex web of exposures, and a risk that banks underestimate their aggregate direct and indirect exposures to underlying counterparties and connected collateral. That is not a good place to be should credit conditions begin to deteriorate, or should those counterparties start to feel the squeeze of the tighter monetary environment.

**The past decade has
seen non-banks increase
their share of direct risk
taking in the economy.**

Repo matched books are of equal concern. The notional size of these books makes them important for sovereign debt markets and the wholesale financial system in general. But events have shown that in the current environment, even ‘safe’ securities can see volatility that was historically unimaginable, resulting in large collateral and margin flows that can shake unprepared counterparties.

Last year also highlighted the risks that can materialise for banks with commodities exposures, notably in metals such as nickel and rare earths, as well as energy markets. Climate change – and the energy transition – is now an integral feature of the environment banks operate in. The

green transition could see commodities markets and their associated risks change drastically, as demand rises for supplies to produce clean energy.

When banks interact with the commodities sector, especially when providing hedges, it is vital that they do not yield to commercial pressure by agreeing to unsuitably low levels of initial margin – giving their counterparties the mistaken impression that such hedges are cheaper and less risky than they truly are. And jolting margins up or turning the taps off at the eleventh hour on those counterparties is certainly not conducive to financial stability. So this is a risk that firms must handle carefully, ensuring that while they’d want to avoid hedging costs becoming prohibitive, the cost should always reflect the risk that actually remains with them.

Whilst I have touched here on a handful of specific supervisory priorities, an ongoing focus of ours is firms’ business model and culture. In this tougher environment, it will be more challenging for bank business models to remain sustainable. That means not trying to pick up pennies in front of a steamroller. This year showed that confidence in the viability and credibility of a bank’s business model is crucial for its clients and for the market. Because once that credibility is lost, there is only so much that healthy capital and liquidity ratios can do to save you.

And how can banks achieve sustainability and inspire confidence? By ensuring they have competent people with integrity who create a sound risk culture. It all starts or ends with people. And that is a good thing.



FERNANDO VICARIO

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

EU banks' vulnerabilities can be resolved at supervisory level

Europe's banking system is stronger now than it has been for a generation. The post-euro crisis reforms have generally worked, with significant improvements across capital, liquidity, and asset quality. Even profitability – for a long time the weak spot of European banks – has been recovering, showing double-digit return on equity in 2023, the best since 2007. Banks have also managed the sudden reversal of central bank rate and liquidity policies well.

At the same time, the monetary and macroeconomic environment is exposing the balance sheets of European banks to new and additional risks, which have become apparent during the recent banking turmoil.

First, the risk of unrealised mark-to-market losses on bond holdings has been under the lens of investors and supervisors. Even if securities held at amortised cost can be used to obtain central secured funding without crystallising losses and EU banks' liquidity coverage ratios show a sizable buffer of high quality liquid assets, a shift in the market perception

can rapidly cause an impact on the stock price and, in turn, depositors' behaviour. The reality is that any assessment of unrealised losses needs to be made in conjunction with the diversity, stability and 'stickiness' of the institution's deposit base – those with a high proportion of retail, insured deposits and commercial operational deposits are less prone to experience stress.

Second, while higher interest rates are generally positive for NIM, higher rates also have an impact on banks' funding costs. Competition can cause deposit rates to rise, catching-up with the asset side. This is combined with a general surge in wholesale funding costs caused by the replacement of TLTRO financing with a higher amount of bond issuance. It should also be clear that this rise in rates has led to lower profits for banks, but it should also be recognised that banks have remained at healthy profitability levels.

Finally, tighter credit standards may curb demand, as seen with commercial real estate, residential mortgages and leveraged finance, offsetting some of the above mentioned benefits on margins.

In addition to the above, EU banks are also exposed to other, hard-to-quantify risks, which should not be disregarded. This includes geopolitical risks (such as unpredictable outcomes from the war in Ukraine), cyber attacks and climate change related financial risks, the consequences of which are starting to become directly observable on banks' balance sheets.

Many of these vulnerabilities in the banking system can arguably be addressed by supervisors.

One of the lessons from the market turmoil experienced by specific small regional banks in the US is the need for greater focus on risk management and operational readiness. Each institution needs to apply internal liquidity stress testing assumptions that are tailored to their deposit mix, which are evaluated by their supervisors. The institutions also need to assess whether they have access to the full range of facilities in their treasury functions, so they can respond swiftly in times of stress to the changing market environment.

Many of these vulnerabilities in the banking system can arguably be addressed by supervisors, without requiring a broader regulatory overhaul. The ECB supervisory arm has been scrutinising banks' interest rate risk positions well before the emergence of the Silicon Valley Bank case earlier this year, and the 2023 EU-wide stress test will also provide an opportunity to understand the health of the banking sector.

Supervision can also be a tool to address exposures to Non-Bank Financial Institutions (NBFI) vulnerabilities through sound counterparty credit risk management, without the need to increase banks' capital requirements, which might instead be counterproductive.

The recent banking turmoil can be an important reminder of the need to complete the Banking Union, starting from the recently proposed crisis management framework review, considering the visible consequences of weak resolution frameworks for smaller banks.

More broadly, the completion of the Banking Union is also needed to enable European banks to compete globally, and indirectly, have the Euro take its proper place in global reserve currencies. There is currently a large gap between European and US banks, with European players modestly scaled compared with the five largest US institutions, with revenues and profitability being consistently lower.



KRISTINE BRADEN

Europe Cluster Head and
Chief Executive Officer -
Citibank Europe Plc

The EU financial system is well positioned to face a challenging environment

Since the last Eurofi conference in Stockholm, the macro-economic outlook has remained challenging, with geopolitical risks and inflationary pressures weighing on GDP growth. At the same time, the resilience of corporates, households and sovereigns has been tested by higher interest rates and the financial sector has proven resilient. Spillover effects from recent market turmoil have remained limited and yet, we should be watchful for where risks may arise as the high inflationary environment persists.

First, liquidity risks. While bank liquidity ratios remain robust in Europe, the past months have shown that in the age of online banking, deposit withdrawals can occur at a speed not seen before. This raises questions for policymakers about the current outflow factors under the Liquidity Coverage and Net Stable Funding Ratios. It has also led policymakers to re-assess the European toolbox for emergency liquidity support. The Chair of the Single Resolution Board, Dominique Laboueix, recently

highlighted that while the Single Resolution Mechanism provides the necessary powers and tools to restore solvability of failing institutions, it falls short in effectively handling liquidity stress during resolution actions. He has therefore called for new powers for the European Central Bank to fund banks in resolution, potentially backed by an EU government guarantee. Finally, in an environment of high volatility, market liquidity is often impacted, with composite indicators for the bond markets performing below trend.

Second, credit risks. On the one hand, the ECB's monetary tightening helps to increase bank profitability and improve capital ratios. This is particularly true for banks with large retail operations. On the other hand, it has pushed real estate markets into correction mode and tightened the financing conditions for companies and consumers. Inherently, rate increases increase the costs for borrowers to service their debt. While this may lead to an increase in non-performing loans in the coming months as higher costs impact borrowers with weaker repayment profiles, it is unlikely to pose a major threat to the banking sector's financial stability.

In July, the European Banking Authority reported that non-performing loans remained stable at around 1.8% of total loans. This does not relieve banks of their duty, however, to plan for every scenario. In this sense, the increases in loan loss provisions we have seen across the sector are helpful to prepare for the potential deterioration in asset quality. Many consumers and companies successfully managed to build up a cushion during the past years of more accommodative monetary policy. Furthermore, Europe's labor market remains very strong. While masking important regional differences, the EU unemployment rate of 5.9% is at an all-time low. This should continue to positively impact consumers' ability to spend and service their debts.

The European economy faces numerous challenges but has proven strong and resilient.

Third, risks from the non-banking sector. The economic slowdown and tightening financial conditions also create liquidity and credit risk for Non-Bank Financial Intermediaries (NBFIs). These institutions play an increasingly important role in financing the real

economy and in managing the savings of households and corporates. The financial assets of the sector accounted for 49.2% of the global financial system in 2021, compared to 42% in 2008. They certainly are an important part of a diversifying capital market ecosystem in Europe, though they typically fall outside the supervisory mechanisms in place for the banking system. Non-bank financing may become a source of systemic risk if it involves maturity/liquidity transformation or leads to the build-up of leverage. The diversity and growing involvement of NBFIs in credit provision, including on a cross-border basis, may result in stress in the sector being transmitted to other parts of the financial system and to the broader economy. Both the European Systemic Risk Board and the Financial Stability Board will continue to play an important role in monitoring these risks in the coming years.

In conclusion, as the European economy faces a higher rate environment and lower growth, it could lead to liquidity risks and credit risks for banks, NBFIs, corporates, and consumers. However, Europe's resilience remains strong and could be strengthened further through greater openness and diversification. Policymakers should focus on monitoring risks and increasing the sophistication and depth of European capital markets.

For the banking sector, continued integration of supervision and resolution mechanisms will further improve its strength. The recent proposal for a Crisis Management and Deposit Insurance (CMDI) framework is a useful step in that direction. Over time, further measures to complete the Banking Union will reinforce Europe's leading role in financial services.



OLIVIER VIGNERON

Chief Risk Officer and
Member of the Management
Board - Deutsche Bank AG

European regulation undermines the basis for European strategic autonomy

The turmoil of March and April 2023 was an important test case for European banks, big and small, and the European regulatory framework. It showed that European banks were resilient to shocks, given their strong fundamentals, with risks mitigated by a diversified deposit base, robust liquidity ratios and relatively contained unrealised losses.

However, the current direction of travel of European policymakers, especially in the areas of digitalisation and payments, will leave the European banking sector less financially stable and prepared for future challenges. All of this leads to the biggest risk, which is that Europe will not be able to have a financial sector capable of supporting the sustainable and digital transition and achieve wider Open Strategic Autonomy.

The European Commission has stated that Europe requires € 620 bn of investments annually to meet the Green Deal objectives and € 125 bn annually to close the investment gaps for digital transformation. This aside from the € 384 bn that is needed for the reconstruction of Ukraine.

The vast majority of this funding will need to be provided by European capital markets. Banks and governments can only provide part of it. The latest data (New Financial Research) show, however, that the share of EU27 capital markets globally has fallen from 19% in 2006 to 10% in 2020 and to 9% in 2022. While it is encouraging that many policymakers, and the Eurogroup, prioritise the topic of capital markets, it will still take years for European capital markets to develop and catch up.

European banks therefore remain the main source of private funding in Europe. Against this background, the European banking sector should be considered as strategically important for the challenges facing Europe.

Unfortunately, European policymakers are designing the future regulatory framework without taking these strategic considerations into account, making it even more challenging for European banks to perform their core function: transformation of financing. Most recently this can be seen in the areas of digitalisation and payments:

- **Digital euro:** the ECB and European Commission are on a path that will limit the funding power of European banks, funding power that is needed to finance the sustainable transition. This would be due to the ECB extracting deposits from banks balance sheets, deposits that banks consequently cannot use to turn into lending for the economy.
- **Payment Services Directive 3 (PSD3):** the implementation of PSD2 was a large-scale deliverable for all European banks. It imposed an open banking concept and new rules for access to account information with a legal prohibition to charge for that access. Current proposals on PSD3 will further increase these operational costs and continue to assist third parties in competing with banks at zero costs of their own. These costs prevent investments in making EU banks themselves more efficient.
- **Open Finance:** this proposed framework will increase mandatory data access of third parties to banks' data across products. Data access includes account information for mortgage, credit and savings accounts, savings and investments data, and input data related to firms' creditworthiness assessments. Again, this increases operational investment, and it will be essential to ensure that sustainable business models and adequate compensation remain possible.

- **Retail investment Strategy:** the EC package aims to improve the distribution of financial products to retail investors by focussing primarily on the price of these products. Other important aspects, such as risk, return or sustainability preference are neglected. This will lead to a much more cost sensitive market with reduced product diversity and innovation for the benefit of retail investors.
- **Politically-driven restrictions on cloud service providers:** proposals for an EU framework for cloud security may close EU banks and corporates across critical sectors off from best-in-class cloud services. Use of U.S. Hyperscalers (Google, Microsoft, AWS) may no longer be possible or only through EU cloud service providers such as Telekom/T-Systems, Orange, OVH. The same would apply for Software-as-a-Service (SaaS) providers, such as Adobe. While we support developing European alternatives to the Hyperscalers, the result would be not only higher cost, but also a limited offering of applications and services, including AI applications which are offered in the cloud – with implications for efficiency, profitability and innovation.

While we understand the rationale behind many of these proposals individually, it is important not to lose sight of the bigger picture. Policy options may achieve individual goals at first glance, such as improving comparability for retail investors or reducing reliance on third country technology while increasing business opportunities for local providers; however, they all come at a cost. When seen in the broader context of the economic and sustainable transition and Open Strategic Autonomy, these costs, especially when added, weaken the funding capacity of European banks and their competitiveness within the global banking community.

It is essential that the next European Commission reverses this direction of travel and takes a more holistic and future-oriented approach, which allows the European banking sector to contribute to the strategic priorities of the EU. This must include targeted adjustments to remove barriers, incentives for innovation, and ensuring resilience while stepping away from far-reaching business model interventions which lack clear benefits.



HANNES FROTZBACHER

Chief Risk Officer -
Erste Bank Croatia

Banking in times of inflation – new risks on the horizon

Long gone are the times when the world was complaining about record low inflation rates. For the banking sector this exceptionally long period was marked by an abundance of liquidity and record low (and negative) interest rates, as central banks hoped to grease economic activity and to avoid a Japan-like deflationary low-growth scenario. Following the last act of this period, the covid pandemic, when markets were again flooded with liquidity, the long-forgotten textbook case of inflation resurfaced with vengeance: way too few goods (and services) met way too much liquidity. Seemingly making up for the preceding decade, the developed world suddenly found itself in double-digit inflationary terrain.

Within a year and a half, the “low-for-ever-narrative” was history and replaced with a “back-to-the-70s narrative”, which was aptly underpinned with sky-rocketing energy prices triggered by the Russian war. Central banks in the high-income countries quickly swung into action and hiked rates at a yet unheard-of pace. For banks this resulted in several challenges.

Monetary policy: Credit indicators show that monetary tightening is finally starting to bite, as banks in the EU are facing slowing credit demand. In the

non-euro areas of emerging Europe (such as CZ, HU, RO & PL) private sector credit growth has turned negative. Calls for a relaxation of household loan regulations are getting louder. Given the very aggressive rate hiking cycle in the Euro area and in Central and Eastern Europe (CEE), there is a risk of asset quality deterioration, not least because real estate prices in many EU markets are now stagnating or even falling. This development could, however, be mitigated by rising expectations for monetary easing along with income stability thanks to tight labor markets.

Economic risks: A renewed jump in energy prices would be a high-risk event for corporates and subsequently for banks. While inflation has been falling, there is a risk of “higher for longer” as inflation might turn out to be stickier than anticipated. Along with elevated inflation levels, the engine of the European recovery after the global financial crisis - DE - is showing signs of weakness. Lacking demand from Europe’s biggest economy would be a severe problem for all countries which are part of the DE value-chain and consequently for exposed financial institutions.

Monetary tightening is starting to bite, but we are also moving in direction of a “soft landing”.

More broadly speaking not only DE, but the entire EU manufacturing sector is currently in contraction. If this trend persists, it could sooner or later spread out to the EU’s services sector. This would most probably also affect the labor markets, which usually lag the economic cycle. Slowing economic growth and a jump in unemployment rates mean for banks that the risk of worsening NPL ratios would rise.

Political risks: Banks are facing rising populism in several countries which includes measures like bank taxes as well as regulatory measures directed at banks which are harmful to credit growth. This situation could worsen, depending on the outcome of several elections due in the upcoming months (including SK, PL, AT & at EU level). Risks on public debt will also have to be monitored, given the reduced support from the ECB and the uncertainty of fiscal consolidation plans.

Funding & liquidity risks: At the same time funding and liquidity risks are

back on the agenda due the ECB’s quantitative tightening as well as the increased levels of uncertainty related to the collapses of the Silicon Valley Bank and Credit Suisse. Following the repayment of the still outstanding TLTRO facility banks’ funding costs could face more pressure. Although most EU banks’ liquidity ratios are expected to stay at comfortable levels, liquidity dynamics will receive more attention. Some selected players in the market might have challenges to keep their desired ratio (LCR/NSFR) levels, which also means, that competition for deposits could increase. Finally, the US banking crisis is not over yet. Equity prices and CDS spreads of regional banks have remained at elevated levels and contagion risk to Europe are limited but non-negligible.

In conclusion, the resurgence of inflation has forced central banks to hike rates at record pace. This policy change has now started to unfold its desired effects: economic activity is slowing, and inflation rates are coming down. For banks the situation is currently still well manageable from a risk perspective. If the slowdown goes far beyond a “soft-landing” scenario the pressure from factors such as asset quality deterioration, rising NPL ratios, political risks or higher funding costs could increase significantly.

On a positive note, we should, however, not ignore that the latest forecasts clearly point in the direction of a “soft landing”: forecasts see the Eurozone as whole growing in 2023 & 2024. Inflation is declining and labor markets continue to be extremely resilient. Growth in the EU will be driven by Southern Europe and CEE, with HR taking the lead in 2023 with a growth forecast now at 2.6%.

Forum organised with the contribution of the Eurofi members



FUTURE OF THE BANKING UNION



HARALD WAIGLEIN

Director General -
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How to close Pandora's box by ensuring progress for the internal market?

While the end of the legislative cycle of the current European Commission and Parliament is already foreseeable, political debates about controversial topics have re-started aiming to strengthen the Internal Market by finalising the Banking Union in the upcoming legislative cycle.

For a start, Pandora's box was opened by the proposal of an amended legal framework for the Crisis Management and Depositor Protection within the European Union to align and strengthen the common practise within the EU. The European Commission is striving to give resolution authorities more flexibility in situations where small and medium-sized banks have failed. The proposal expands the possible use of resolution tools and intends to

minimize costs in situations where market disruptions are present also on regional or national level.

A common mutualisation of deposit guarantee funds (EDIS) is not foreseen in the proposal. But other elements are highly sensitive: The gap to access the Single Resolution Fund (SRF) shall be closed by the use of national deposit guarantee funds or financial means from the public sector while incentives for resolution authorities to consequently demand the removal of obstacles to resolution from banks are lowered. Furthermore, the proposed broadening of the coverage of deposits will lead to additional requirements for capital and eligible liabilities and have effects on the target level of the funds of Deposit guarantee schemes and the Single Resolution Fund.

Secondly, it is foreseeable that discussions on EU's macroprudential framework and practice will start again. Hopefully, this discussion can be returned to Pandora's box with more legal certainty and EU-spirit. An effective, transparent and common practice throughout the European Union is urgently needed to end the race to the top for capital, liquidity, eligible liabilities, leverage-related indicators and other safeguards requested from Member States and authorities involved.

The application of the final set of the Basel III standards by banks will ensure that banks and banking groups fulfil higher prudential standards. They will have to implement further risk-reducing changes while the introduction of the Output Floor will reduce the discrepancies of capital requirements between banks using internal models and banks using approaches with less deviances. These upcoming regulatory changes will hopefully lead to more confidence of supervisors in the reduction of risks in banks and banking groups under their remit. We thus have been more than glad that after long and intensive discussions between the Council, the European Parliament and the European Commission during the trilogue negotiations on the Basel III-finalisation in the first half of 2023, the involved parties finally have been able to achieve a very well balanced and consistent compromise package.

However, the controversies around the final trilogue of the Basel III-package, which was related to a provision

requesting a Commission report also with regard to Home-Host-related matters, showed the fragility of the dead-locked discussion around liquidity and capital waivers. At the moment, I am not sure, whether the European Commission will decide to start another attempt to foster market integration in the banking sector during the next legislative cycle by legislative proposals which shall encourage cross-border-waivers for liquidity, MREL and capital.

I fully understand and support the constant request of the banking sector and the European Central Bank (ECB) for easing cross-border flows of capital, MREL and liquidity and the rationale of the economic considerations behind. However, I do not expect noticeable improvements during the next legislative cycle in regards to the long implementation period of the Basel III-finalisation and the amendments watering-down its content.

Progress can only be achieved with a step-by-step-approach.

The main reasons for the so-called „home-host-conflict“ are based on a lack of confidence in the responsible behaviour of the banking sector and politicians from other Member States in times of crisis. Former discussions have shown that progress can only be achieved with a step-by-step-approach and a discussion culture between Member States which is based and committed to mutual respect, tolerance and dialogue.

The statement of the Eurogroup in inclusive format of 16th June 2022 was needed to formulate common ground in the CMDI-discussion and should serve as guiding principle in the negotiations in my view. However, the efforts of politicians will not replace the key precondition for trust, banks and banking groups which act in a responsible way also in times of crisis.



DOMINIQUE LABOUREIX

Chair - Single Resolution Board (SRB)

The SRM is critical for a complete single market for financial services

The Treaty of Rome, signed in 1957, established the single market and outlined a roadmap towards full freedom of movement of capital. Since then, the completion of this roadmap has been a multigenerational effort that continues to this day.

After almost seventy years, with, among others, the introduction of a single rulebook and the Banking Union, we have achieved an integrated framework. In fact, banks can operate throughout the EU and the Single Supervisory and Resolution Mechanisms provide for crisis management and prevention regardless of Member States' borders.

Freedom of establishment in Europe has come a long way. One practical example of this progress is the success of digital banks in the Banking Union. Some of these digital banks have grown in a few years to serve millions of clients within the European Union through their branches. This would not have been possible without the reforms listed above. However, these digital banks, also offer food for thought as to what reforms are still outstanding. Their clients may depend for deposit insurance on a DGS, possibly small,

located in one single Member State. Clearly, this is neither a sufficiently Europe-wide nor a clear-cut solution. European authorities should deal with European banks, and European clients should expect European oversight.

Regulatory fragmentation creates the wrong incentives and undermines trust. In addition, fragmentation has a clear impact on banks' incentives to integrate. One of the issues that pan-European banks could face is ringfencing of capital, loss absorption and liquidity requirements on subsidiaries. Ringfencing is a circular problem as it is inconsistent with a complete Banking Union but it is also a reaction to an incomplete Banking Union. Trust is what can break this vicious circle.

To build this trust, the Banking Union must be complete. Unfortunately, though, the Banking Union's third pillar - a European deposit insurance system - is missing and remains out of reach for the time being.

Nevertheless, to further increase the credibility of the Single Resolution Mechanism (SRM), the Single Resolution Board (SRB) has been intensively working on developing its capabilities and policies to deal with cross-border bank crises. Our ultimate goal is to foster trust in the Banking Union, in general, and the SRM in particular.

As an example, the SRB has worked on the operationalization of the Single Point of Entry (SPE) strategy. In particular, since 2022, the SRB has been focusing on rooting out obstacles to the implementation of cross-border bail-in whilst working on the resolution powers in the execution of SPE strategies. In addition, our experts are studying the use of arrangements, including contractual, safeguarding the availability of sufficient resources to support subsidiaries. We believe that this workstream will be critical to ensure that banks (and resolution authorities) are able to execute cross border bail-ins with minimum friction.

Currently, certain safeguards are in place, such as a clearly prepositioned internal MREL. BRRD2 sets a requirement for the level of prepositioned internal MREL counterbalanced by the possibility to grant waivers. We have not hesitated to grant waivers when the conditions were met.

Devising and implementing policies have been at the core of our business since our inception in 2015. In fact, in the last eight years, we have been focusing on requesting the banks to develop their resolution planning and execution capabilities, on preparing the resolution plans and on designing

resolution policies. In a word, we have been busy with capacity building.

Since this year, the SRB is entering in a new phase. Now the time has come to operationalize our plans and policies and check the bank's capabilities. We test, regularly, that banks have been correctly implementing our policies and that the SRB (and the SRM at large) have indeed "what it takes" to resolve any kind of bank under our remit, including pan-European institutions. The SRB has already organized resolution weekend simulations (dry runs). Dry runs are thematic. As the last example: how to operationalize a cross-border bail-in. These dry runs will become more frequent over time. In addition, we are also asking the banks to execute dry runs themselves in order to test their ability to undergo a bail-in.

SRB's work is critical to ensure trust in the SRM but legislators should not renounce a complete BU.

Our work, as the one described above, is critical to ensure trust in the SRM but we can only operate with the tools at our disposal. In order to have a true single market for financial services, legislators need to step in and complete the Banking Union. The Crisis Management and Deposit Insurance (CMDI) proposal recently published by the European Commission is a step in the right direction but the third pillar of the Banking Union remains a necessary condition for a complete single market.



JUKKA VESALA

Head of Group Credit
Risk Control - Nordea Bank

Why there is little cross-border branching in the EU

Nordea is still the only large EU banking group that has changed its legal structure from cross-border subsidiaries to branches. Our example shows that this transformation can be done and that there are clear benefits from being able to operate a “one bank” model, but also that there are still many obstacles, which can prevent banks from embarking on this transformation.

After operating a few years with a cross-border branching structure under SSM supervision, we can see that the anticipated benefits from the simpler legal structure have actually materialised. These include: clearer governance and accountabilities, simpler and more effective balance sheet and liquidity management, avoidance of many duplicated requirements on subsidiaries, ability to cater for large financing needs (scale benefits from a large balance sheet), one prudential supervisor, improved resolvability, and reduced reporting burden.

However, getting the new legal structure in place was very complex and cumbersome, which can in itself deter banks from changing their structure – even in cases where authorities take a neutral stance and do not, in effect, enforce preference for a subsidiary structure. This includes transition costs e.g. related to deposit

insurance contributions, resolving numerous authority concerns and obtaining a large number of approvals, and the operational burden taking focus away from regular banking business.

The main problem probably lies in the fact that “branchification” has no legally defined turnaround time or long-stop date for decision in the EU. We face broad and unprecise requirements as to the content of applications and scope of examination (e.g. “public interest”). There is lack of coordination between authorities (e.g. forwarding of information and notifications between home and host supervisors) and limitations in national law as to when the competent national authority may grant its approval. Finally, there is a need to apply for all approvals and permissions when moving domicile even when valid approvals exist, e.g. regarding internal models. Further challenges are brought by divergent national implementations of options and discretions under CRR. These obstacles are mitigated, but not yet completely removed, even under the single supervisor within the SSM.

Once having overcome the initial obstacles and operating a “one bank” structure, one can see that there is still considerable room for further harmonised regulation and supervisory practices across jurisdictions especially between the SSM and the rest of the EU. We can still have gold-plating of EU prudential rules by local authorities (e.g. on the definition of default). The main issue is, however, that macro-prudential requirements are not harmonised or coordinated in the EU; not even within the SSM. Macro-prudential buffers are currently applied at totally different levels, and there is no consideration of the total capital requirements faced by individual banks.

**Common EU
requirements should
be trusted to deliver a
strong financial system.**

The consequence is that banks can have vastly different capital requirements just depending on their country of location. This can be illustrated best with our situation at Nordea – we are subject to the high SSM micro-prudential standards as well as the high Nordic macro-prudential buffers not applied elsewhere in Europe to the same extent. This combination leads to the fact that our overall capital

requirements increase out of sync with other major European banks.

In addition, AML and conduct supervision is still national and not sufficiently co-ordinated. We also have varying non-prudential regulation, such as merger directive, banking secrecy, company law, shareholder rules etc.

There is strong confidence in effective prudential supervision and robust rules on capital, liquidity and risk management in the EU. These are strong assets for the EU banking industry. However, at the same time the obstacles to cross-border “branchification” and national discrepancies prevent us from obtaining the benefits of a truly single market.

For investors, it is very difficult to understand differences in requirements that do not correspond to the bank’s risks, such as those stemming from the un-coordinated macro-prudential capital requirements. In this way, non-harmonised requirements can hurt banks’ ability to compete on a level playing field and attract capital and interfere with the effective allocation of capital across banks and blocks cross-border mergers.

The EU should progressively address the remaining hurdles – both within the SSM and particularly between the SSM and the rest of the EU. The common EU regulatory requirements and well-coordinated micro/macro-prudential supervision and resolution should be then trusted to do the job of delivering a strong financial system without undue country-specific deviations or concerns.



STANISLAS ROGER

Chief Executive Officer -
SMBC Bank EU AG

International banks and European banks: partners in the Banking Union

Since it was first announced in 2014, there has been significant progress towards the Banking Union, building on the resilience of the EU banking sector, which has been positively transformed following the Global Financial Crisis. The Banking Union has helped to increase financial stability while also generally reducing friction in cross-border business. For international banks, such as SMBC, continuing to be able to access the European financial markets and do business with our customers, many of whom are large European corporates and financial institutions, is of huge importance.

The ability of international banks to access EU markets benefits all banks, international and domestic. The presence of large global pools of capital provides liquidity to the banking system, which in turn increases cross-border activities between banks, helping to create a well-functioning and efficient European banking sector that provides value to customers, and ultimately, the European consumer. Encouraging cross-border activity within the EU relies on three key principles: 1) partnership between banks, 2) robust rules, and 3) regulatory cooperation.

Partnership between international and domestic banks

As recent events have reminded us, the banking system is highly interlinked and individual markets cannot be entirely separated from other markets. This is particularly true for the EU, which has long benefitted from being an open and attractive destination for international banks. This has in turn benefited the EU, with its large corporates and financial institutions able to access large international pools of capital.

Japanese banks have long been invested in the EU. SMBC has had a presence in mainland Europe for over 50 years and we continue to grow our presence and business in the region. We consider ourselves partners in the Banking Union, and in many ways, we are both a European bank as well as a Japanese bank – many of our customers are large EU-headquartered corporates and financial institutions. A well-funded and profitable Banking Union that promotes cross-border business between Member States cannot be separated from the success of the EU as an attractive destination for international banks.

Robust regulatory frameworks

Confidence in the system is a vital component of a profitable and truly cross-border Banking Union. This confidence can only be achieved through robust regulation and well-functioning and efficient business models. To increase cross-border activities in the EU relies on banks being sufficiently profitable, which can only be achieved through genuine economies of scale.

**Confidence in the system
is a vital component
of a profitable and
truly cross-border
Banking Union.**

The resilience of the EU banking system has been transformed since the Global Financial Crisis and this was evident in the way the sector withstood the shock in the EU of recent events. Banks and regulators have shown effective cooperation to implement reforms and this significant investment from both banks and the public sector has paid dividends. However, in a highly regulated and competitive area of financial services, commercial banks require a stable regulatory landscape to invest and

one that recognises the diversity of business models in the sector.

International and European banks have diverse business models, which adds to the strength of the sector and its ability to serve customers of all strengths, size and complexity. Diversification is also an important part of a resilient financial system and can help the sector to better withstand shocks. A regulatory framework that recognises the strength these differences provide will help to promote greater profitability and cross-border activity.

Regulatory cooperation and reform

Just as banks rely on healthy competition and the ability to conduct business cross border, it is important that regulatory frameworks promote this kind of activity. The Banking Union has provided an important example of the benefits of regulatory harmonisation. However, for international banks, many of whom are also European banks, cooperation between EU regulators and third country regulators remains as important as ever. Japan is regarded as equivalent by the EU and is a close partner in promoting high regulatory standards and implementing the internationally agreed Basel framework. We have observed strong regulatory cooperation through the system of joint supervisory colleges and believe that more can be done to share findings across different jurisdictions.

We would urge banks, regulators and policymakers to follow the example of the Banking Union to promote greater harmonisation of rules and the proliferation of cross-border activity.



PIERCARLO PADOAN

Chairman - UniCredit Group SpA

Could Banking Union be revamped by innovation?

Policies to implement and strengthen banking union are both short term and medium to long term. In last year's edition of this column, I argued that in the short-term the introduction of a European deposit insurance scheme and the elimination of ringfencing practices would significantly add to the competitiveness and attractiveness of the eurozone by amplifying the benefits of market expansion and exploiting the early benefits of innovation.

This contribution looks at some aspects of long-term competitiveness and growth capacity that the banking sector needs to fill the gap with respect to competitors, notably the US.

This is partly due to a different market size as well as a more limited contribution of innovation to productivity growth, and a larger role of regulation.

As empirical analysis shows, in the longer run the EU banking industry can reduce the gap and improve its performance thanks to innovation and digitalization, provided the appropriate policies are adopted.

What makes the current innovation episode unique is that, given the nature of the products of the financial industry,

public institutions (central banks) react to innovation shocks. Such a mechanism of increased efficiency thanks to innovation could build momentum for making progress in Banking Union.

Innovation such as the use of artificial intelligence (AI) in banking is introducing significant changes affecting the business models of banks, non-financial firms, and the behavior of individuals. However different factors are at work. For example, digitalization is not only directed at changing the way data are treated but, in the case of AI, has also the additional effect of producing new data which should support productivity to a larger extent. With AI still in the early stages of development, it is therefore critical that regulation in the making, such as the Artificial Intelligence Act, does not hamper innovation, by setting excessively strict rules that do not adequately assess the risks associated with AI. We must take into consideration the potential trade off with the diffusion of AI without a proper understanding of these dynamics.

The introduction of digital technologies has also created the grounds for the development of crypto currencies and stable coins. This has been especially the case of Big Tech companies with the aim of introducing their own privately conceived, payment systems. This has prompted the reaction of authorities and central banks many of which have considered introducing their own digital currencies, mostly with the purpose of avoiding the risk of financial instability.

**Increased efficiency
driven by innovation
could build momentum
for progress in
Banking Union.**

However, issuing CBDCs (Central Bank Digital Currencies) is not without risk. CBDC are substitutes for deposits and significantly increase the speed at which deposits may be withdrawn from banks, encouraging disintermediation. It is thus essential that its introduction be accompanied by regulatory and non-regulatory measures to avoid negative effects on financial stability.

Innovation in banking has significant impacts on productivity. However, this is not uniform across sectors. Also, there is no strong evidence that digitalization improves the performance of firms that are already on the technological frontier, neither that it affects the capacity of

laggard firms to move to the frontier. It also suggests that investment in digital must be complemented by other variables to produce productivity gains. Most notably intangible and human capital, R&D and supportive regulation aimed at increasing competition and efficiency, notably regulation to support venture capital.

A similar but not identical point can be made with respect to artificial intelligence (AI).

What is more relevant is the impact of the interaction between AI and other digital technologies which promises to be quite relevant and extended over time. For instance, the impact of AI could be quite relevant on labor markets with large numbers of workers being displaced but also possibly compensated by new jobs being created provided that new skills are available. Hence well-functioning human capital and appropriate welfare policies are needed to maximize productivity gains and minimize the costs of transition.

In conclusion, general innovation developments such as the diffusion of digital technologies, in particular AI, provide the basic factors to carry out the structural transformation brought about by the environmental, security, social sustainability challenges that the global system is facing. Such transformation requires a significant contribution in investment, both private and public. Financial markets and banks must provide a front-line contribution to these challenges.

European banks can exploit this unique situation to fill the gap they have been facing with competitors. Even more importantly a more dynamic and productivity driven banking industry could well revamp banking union while short term measures discussed above may provide facilitation effects.

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Sustainability risk
Sustainability disclosure challenges



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Payments and AML

Payments and AML

IMPROVING THE EU BANK CRISIS MANAGEMENT FRAMEWORK



DOMINIQUE LABOUREIX

Chair - Single Resolution Board (SRB)

Liquidity in resolution: a missing piece in the framework

Liquidity is central to successful crisis management. Banks depend on trust. If customers lack confidence that their funds will be available on demand, a spiraling liquidity crisis may develop. Such a crisis can potentially drive fire sales of assets to meet increasing liquidity demands, hampering the viability of the bank, the feasibility of resolution and possibly spreading panic across the banking sector and beyond.

The Single Resolution Board's (SRB) resolution toolkit is strong but must be backed up by effective liquidity provisions to ensure the successful resolution of any crisis. While we have the tools necessary to restore a firm to viability, it may take time for market confidence to be restored. Without adequate liquidity support, the failure of a bank may become a self-fulfilling prophecy as market actors seek to ensure that they will not be left in a bank run. This is why in recent cases, the liquidity

provisions have been of a dramatic scale relative to the size of the failing entity's balance sheet.

In some cases, this support can be provided directly by the private sector. For example where a large, liquid bank takes over a smaller competitor, the buyer can meet the liquidity needs of the failed bank thus restoring confidence. However, for the very largest banks it seems likely that some form of public liquidity support would be needed.

Even in the acquisition of Credit Suisse by UBS we have now seen that public support was available to give markets the confidence that the transaction would be successful. Such a funding mechanism should also be in place in the EU. How should we structure this mechanism? We would need to align to the Financial Stability Board (FSB) Guidance while accounting for Banking Union specificities. The FSB set out that the backstop should be of adequate size and be capable of rapid use. Importantly, rapid use is dependent on a lean, quick and efficient decision making process when calling on the facility, ensuring enough flexibility to act in a crisis scenario. In addition, the duration of funding should be no longer than the time needed to achieve an orderly resolution, but sufficiently long that the bank in resolution has time to regain access to private sector funding. Putting these different elements together, in a way that preserves the flexibility of the authorities, will ensure the authorities can rapidly intervene with the funding needed in a crisis scenario.

Importantly, developing an effective liquidity in resolution facility should also support the bank's return to market funding by restoring confidence in its finances and business. It is important to balance adequate incentives for the bank to return to the market without constraining too much the use of the liquidity tool. One thing important to underline is that the amount of support put in place to reassure the markets and customers is not necessarily drawn up by the bank in resolution. The liquidity really needed can be smaller and just for a short period of time, as a good resolution scheme will restore confidence in the bank.

Liquidity can come from several authorities in the Banking Union. The SRB has now built up the Single Resolution Fund, which stands at almost

EUR 80 billion, and its firepower could almost double if the revised ESM Treaty is ratified. This is already an important step but the liquidity needs of a global bank could go well beyond this amount. As such, while we stand ready to play a role in providing liquidity, our role can only be limited. This is why we stand ready to work on developing an effective mechanism for liquidity in resolution in the Banking Union.

For these tail risk liquidity needs, the intervention of central banks is certainly needed. How the necessary protection to the central bank can be managed is clearly a topic of the utmost importance and further technical work is needed. Looking at other jurisdictions, it is clear that providing the support necessary for the central banks to act is key. In Switzerland, the US and the UK, we see that the possibility is in place for a public sector guarantee. This was a key part of making the Credit Suisse transaction credible, and of course we can see these facilities are in place in other jurisdictions such as the US or UK. Discussion is needed in the Banking Union on how we can develop such a facility within our own institutional context.

The SRB's resolution toolkit is strong but must be backed by effective liquidity provisions.

So the question is how can we make real progress on this thorny issue? While we can understand the concerns around committing to providing large amount of liquidity, failing to agree on an ex-ante facility may drive uncertainty that could lead to escalating liquidity needs. Given the nature and size of the facility, a clear political support is needed to make the technical work becoming a reality.



EDOUARD FERNANDEZ-BOLLO

Member of the Supervisory Board - European Central Bank (ECB)

Enhancing the EU's crisis management toolkit

The European Commission has adopted a proposal to improve the EU's crisis management and deposit insurance framework. On 5 July the ECB issued its opinion on this proposal, emphasising the need to maintain the package's coherence to ensure the framework is effective, and calling for the legislation process to be swiftly finalised.

We strongly support the proposed legislative package because of the valuable contribution it would make to improving the efficiency of the banking market. We are indeed convinced that widening the scope of the European harmonised resolution framework is the most cost-efficient way to facilitate an orderly market exit for failing or likely-to-fail banks. The proposed amendments would in certain cases also minimise net asset losses of struggling banks, contribute to stabilising deposits in the whole system and would also require less funding to be mobilised than is the case with depositor payouts. As a consequence, it would provide the private sector with an incentive to offer solutions for the orderly exit of struggling banks from the market. The

proposed legislative package would also avoid sustaining zombie banks and the winding up of banks under national liquidation proceedings, rather than using the common European framework for resolving banks.

However, expanding the scope of resolution needs to go hand-in-hand with facilitating wider and more efficient access to the funds of the European safety net. This does not mean increasing the funds earmarked for this purpose, just increasing the capacity to actually mobilise these funds to support market exit solutions. This is the key objective behind the proposed single-tier depositor preference, and the possibility to count the contribution of deposit guarantee scheme (DGS) funds towards unlocking access to the Single Resolution Fund (SRF). The single-tier depositor preference is from a legal perspective a much simpler solution – even for the sole purpose of a liquidation procedure – than the three-tier system currently in place in the EU, which is possibly the most complicated system of depositor preference in any major financial centre.

Establishing a single ranking for all depositors means the “no creditor worse off” principle can be applied in a simpler way in any resolution situation. In addition, it will help in harmonising the methodology for the least-cost test in a way that facilitates greater use of the DGS in resolution. The ECB – whose mandate it is to preserve financial stability – observes that the general depositor preference has been in place for a long time in the United States, which has the largest bank bond market in the world. As no particular issues have emerged in the US with respect to funding the market exit of banks, it seems highly unlikely that this approach could not be applied to the European Union framework. The ECB is of course fully open to contributing to further analysis and discussions on the potential unintended consequences of this approach and ways to mitigate them.

Using DGS funds to contribute to unlocking access to the SRF would also be key in facilitating the smooth exit of failing banks from the market. Importantly, the DGS bridge mechanism is limited to transfer tools and is subject to additional safeguards. As this proposed amendment relies on the implementation of the resolution framework, I would like to emphasise that it does not exempt banks that are subject to it from the minimum requirement for own funds and eligible liabilities (MREL), or recovery and resolution planning more generally. It therefore actually reduces the potential moral hazard of “gambling

for resurrection”, which relies on more generous national frameworks being applied. Furthermore, the ECB would in all cases be able to withdraw a bank's licence, following its assessment as failing or likely-to-fail, which will also help responsible authorities ensure that banks who should leave the market do so in an orderly manner.

Finally, let me add that as the rationale behind this proposal is to promote early intervention, there is no reason to think that it aims to hinder preventive interventions that could ensure the same objective, in situations involving banks which have not reached the point of failing or likely-to-fail – quite the contrary in fact. In any case, the ECB clearly wants to also strengthen the effectiveness of the early intervention and preventive measures of these mechanisms and could support any further clarifications to ensure this objective.

Wider scope to help failing banks exit the market can improve the effectiveness of the EU's crisis management framework.

In view of the importance of the potential gains in efficiency the proposed legislative package offers, it would be particularly useful to have an open dialogue on its provisions and formulations. This would also dispel any possible misgivings and provide constructive support for its aims.



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Market confidence: the role for a public liquidity backstop

The resolution of Banco Popular in 2017 started an intense debate on the importance of liquidity in resolution: albeit liquidity crises are indeed an inherent feature of the banking industry, the European framework lacks an effective tool to manage liquidity needs after resolution (Constâncio, 2018).

Viable banks can rely on several sources of liquidity (including, central bank lending and market funding). Yet, after entering resolution these funding sources freeze: as the past cases showed, even if soundly recapitalized, the resolved bank will still suffer substantial outflows until it regains investors' trust. Moreover, the fall in markets' and depositors' confidence might also have systemic implications. Even in those cases where liquidity is not the cause of resolution, liquidity will become an issue in resolution.

This clearly calls for the resolution "technology" to include credible liquidity backstops, which must be transparent and easily understood by market participants and depositors (not to put at risk the resolution process and the extent of bail-in). Still, as any form of public support, the backstop could

foster moral hazard, and thus it must be accompanied by sufficient safeguards.

The FSB highlighted the need for introducing a public sector backstop funding mechanism already in 2016. Despite the variety of solutions available in each jurisdiction (resolution funds, deposit insurance funds, resolution authorities, central banks and/or finance ministries), it stressed some common design principles:

- The mechanism should have a credible size (to fund all banks in need), capable of being deployed rapidly, and to be extended for as long as needed to allow the bank to regain access to the market;
- The deployment should be subject to strict conditionalities: i.e. available only if the bank is fully recapitalized and has a viable business plan, while market access to funding is temporarily precluded, and accompanied by constraints to minimise moral hazard;
- The legal regime should make it clear the way to recover any losses incurred, either from shareholders and unsecured creditors or – if necessary – from the financial system as a whole.

The turmoil in the US and the collapse of Credit Suisse (CS) revamped this debate: the takeover of CS was underpinned through the provisions of emergency liquidity assistance (ELA) issued by the Swiss National Bank and other public sector backstops, amounting to dozens of billions of Swiss francs. The Swiss Banking Act had been amended precisely to introduce a liquidity backstop and the plan deployed for CS was therefore able to factor it in.

**A stronger liquidity
backstop in resolution
would support
confidence and make its
use less likely.**

Although available in several other key jurisdictions (the UK and the US), in Europe we lack an adequate public backstop tailored to provide liquidity assistance to institutions in resolution. ELA is limited to solvent financial institutions, requires eligible collateral and, for operations above €2bn, also the ECB's consent. State guarantees on newly issued liabilities are in principle limited to banks showing no capital

shortfall and still rely on the market. Both measures represent national-only safety nets and might be difficult to deploy for cross-border groups. Pending the adoption of the European Deposit Insurance Scheme, equipped also with a liquidity function, within the BU the SRF (€77bn) can indeed be used for liquidity purposes, but even when coupled with the €68bn from the ESM backstop, it still might be insufficient for G-SIBs or under a systemic scenario (König, 2018).

Hence, the EU/BU framework lacks an important safety valve: a reliable, overt, and predictable liquidity public backstop is crucial to make resolution credible. Its mere presence would help restoring confidence in the banking system, making its use even less likely. This, without prejudice to the principle that private sources should remain the primary source of funding for banks in resolution and that resolution planning and preparation is key (SRB, 2020).

For this purpose, a number of options are worth being further explored with respect to the access in resolution to Central bank liquidity facilities (or a new harmonized, centralized facility). For example, the SRF may act as a guarantor, ensuring that any losses would be borne by the industry (including via ex-post contributions), or the liquidity facility could be backed by an EU government guarantee, or the scope of the eligible collaterals for ELA could even be extended. Along a similar line, the ESM backstop facility could be reviewed too, to make the provision of liquidity support to the SRF easier and more automatic, even above the € 68bn cap, or it could be the ESM itself that provides the guarantee to the ECB.

To foster market confidence, access conditions should be made public, and the decision-making process should be predictable.



**JACEK
JASTRZĘBSKI**
Chair of the Board - Polish
Financial Supervision Authority

Clear crisis management rules - basis for the stability of the financial system

In order to prevent uncontrolled bank failures and safeguard public interest, as part of the 'lesson learned' following the 2007–2008 global financial crisis, in 2014 the European Parliament and the Council adopted the Bank Recovery and Resolution Directive (BRRD) and the Deposit Guarantee Schemes Directive (DGSD). The experience, gained also in Poland, in practical application of that regulatory framework has shown that it is necessary to introduce changes to the crisis management solutions. Those necessary changes are partly included in a legislative package on Crisis Management and Deposit Insurance (CMDI)¹, published by the European Commission (EC) in April of this year, aiming at adjusting and strengthening the EU's existing legal framework, with a focus on medium-sized and smaller banks.

Nevertheless, the to-date experience related to the application of the BRRD regime demonstrates, that future regulatory priorities in the field of crisis management should also include additional elements.

In this paper I briefly mention the key objectives that should also be taken into account in connection with further steps of the reform.

1. Ensuring an effective mechanism for supplying liquidity in the resolution procedure.
 - Due to high dynamics of crisis situations the liquidity needs of banks are extremely urgent, while the current EU State aid framework foresees in the case of banks of significant size a requirement of obtaining each time an approval of the European Commission for granting State aid, which is time-consuming.
 - In the case of small and medium-sized institutions the need to obtain the EC approval every six months for prolonging the State aid programme is an additional complication.
 - The requirement of 8 percent bail-in before receiving liquidity support may be an additional hindrance for financial institutions, regardless of their type.
2. Reforming and harmonising insolvency law in the European Union so that restructuring tools similar to those foreseen in the BRRD (in particular, the takeover and the asset separation tools) may be applied also in the case of entities that do not meet the public interest condition in insolvency proceedings.

Future regulatory priorities in the field of crisis management should include additional elements.

3. Preventing a so-called 'limbo effect', which occurs in a situation in which a financial institution does not meet the conditions for insolvency and the public interest condition, but it meets the FOLTF (failing or likely to fail) condition, and as a result it may neither be subject to the resolution procedure, nor to the insolvency procedure. The BRRD in its new wording clearly states that in the case where the FOLTF condition is satisfied but the public interest condition is not, the institution should be subject to insolvency procedure. However,

because the proposal for a directive does not harmonise the insolvency law (including the conditions for insolvency), in legislative regimes of different Member States such a financial institution may not be meeting the conditions for opening insolvency proceedings against it. That means that such an institution may be obligated to maintain a certain part of the MREL recapitalisation requirement.

4. Changing a paradigm according to which, in the current proposals, insolvency (notably – conducted in the absence of harmonisation of the insolvency law, as mentioned above) is foreseen as the default option, although one of the intentions declared by the authors of the legislative proposal is to propagate the use of resolution, especially in the case of small and medium-sized institutions. The crisis management framework should be based on the assumption that the default option is resolution and not insolvency.
5. Providing clear conditions for an entity to be considered as failing – according to the BRRD, an institution shall be deemed to be failing or likely to fail, if the institution is unable to pay its debts or other liabilities as they fall due or there are objective elements to support a determination that the institution will, in the near future, be unable to pay its debts or other liabilities as they fall due. It is not clear what other liabilities are considered – whether or not, for example, the inability to repay liabilities owed to employees or pay social security contributions is sufficient for commencement of the resolution process.

It is without doubt that further legislative activity in the above-identified areas would help improve the effectiveness of the bank crisis management framework in the European Union.

1. https://ec.europa.eu/commission/presscorner/detail/en/ip_23_2250.



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The importance of deposit- related protection schemes for financial stability

On 18 April 2023, the European Commission published a legislative package to revise the framework for crisis management and deposit insurance (“CMDI Review”). The proposal may be promoted as being technical only, but the intention of the EU Commission is to subject the CMDI framework to comprehensive changes which include fundamental policy decisions. It initiates nothing less than a paradigm shift and a complete system overhaul of crisis management for banks, which was established at European level after the last financial crisis in 2014.

The decision of the European legislator in 2014 was clear and precise: Only systemically important credit institutions should fall within the resolution regime and the less significant institutions should regularly be considered eligible for insolvency.

Now, the EU Commission would like to change that. The resolution designed for systemically important banks shall

also be made the standard model for small and medium-sized banks. This will be triggered by a change in the assessment of public interest to be made by the competent authorities: For example, critical functions at the regional level, rather than at member state or EU level, as is currently the case, shall be sufficient to require a credit institution to fall within the resolution regime.

That is going to require funds, of course. So, deposit guarantee schemes (DGS) shall be called upon to finance the resolution of these institutions in addition to the existing resolution fund. The price-tag for this major shift is extremely high and it shall be paid by the existing national protection schemes.

Just to unlock the financial means required for financing resolution tools for small and medium-sized banks, the EU Commission proposes to significantly reduce the overall level of deposit protection.

1. DGSs would lose their privileged position in insolvency proceedings, making it more difficult to recover funds paid for depositor compensation. The function and financial performance of the DGS would be impaired and thus discredited in this way.
2. This would indirectly result in further financial burdens for the credit institutions because the use of DGS funds for resolution combined with the loss of the super-preference in insolvency proceedings would lead to frequent additional funding obligations. In times of crisis, these obligations could end in a domino effect.

The protection afforded by existing national insurance safety nets would be abandoned.

3. The role of DGSs and Institutional Protection Schemes (IPs) shall also be reduced to mere payboxes instead of risk minimisers. As stated in a Joint Declaration and a call for action of all IPs in Europe, their preventive measures using financial resources will be made more difficult or even impossible due to new extensive requirements which are not in line with obligations an IPS has to fulfil pursuant to Article 113(7) CRR.

Is the price to be paid for the paradigm shift towards “resolution for all” worth it? To answer this question, one needs to bear in mind that the global financial system has evolved over centuries, incorporating various mechanisms to ensure financial stability, safety, and consumer protection. Two vital components of this framework are deposit insurance and institutional protection schemes. These tools not only safeguard the depositor’s funds but also contribute significantly to overall financial stability.

Deposit insurance serves two fundamental purposes: protecting small depositors who cannot afford to lose their savings and preventing bank runs.

Of course, it is often argued that deposit insurance can also create moral hazard by encouraging risky behavior from banks because their customers know that their deposits are insured. However, the idea to apply resolution as default procedure to all banks creates a moral hazard problem that supersedes the moral hazard by deposit protection by far. As was the case in the recent failure of the Silicon Valley Bank, any customer – even the most sophisticated ones who are excluded from deposit protection – would entirely rely on their deposits just being transferred to another bank as part of a resolution procedure. As a result, the total number of bank failure would most likely increase as customers would not be encouraged to assess the riskiness of a bank model.

The European Commission’s goal of strengthening crisis management for credit institutions is correct in principle. However, the brief overview of the planned changes alone should already demonstrate that the measures envisaged for such purpose promote the exact opposite effect. With these measures, the protection afforded by existing national insurance safety nets would be abandoned and replaced by a hitherto non-functioning resolution regime. As is often said: Let’s fix the roof while the sun is shining. But let’s focus on the roof that actually needs fixing.



AXEL MARMOTTANT

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Resolution: a way to deal with the failure of small and mid-size banks

The Single Resolution Fund has finally reached its target with ca. EUR 80bn outstanding. The constitution of this fund came at a steep cost for the banking sector, and *in fine* its customers, especially in France. Since its inception, this financing arrangement has never been called so far to support a resolution in the Banking Union.

The CMDI reform is an opportunity to ensure the failures of small and mid-size banks are not dealt with using mutualized funds at the expense of healthy competition and of the consolidation of the European banking sector. In line with the principle of “same risks, same rules”, this should mean an extension of resolution to a larger set of small and mid-size banks, which are also risky as we recently saw in the US:

- The way resolution authorities conduct the Public Interest Assessment (“PIA”) should better capture the financial stability risks stemming from the failure of small and mid-size banks at the local level. It should also better incorporate the higher likelihood that many of these institutions cannot be simply liquidated by paying out depositors

without negative consequences. The proposal of the Commission in that regard goes in the right direction. However, it is essential to put in place safeguards to ensure a harmonized application of the revised PIA. In our view, a summary of negative PIAs should be disclosed to the market.

- Such an enlargement of resolution is paramount to minimize competition distortions in the Single Market. Directly competing against big banks, many small and mid-size banks are not subject today to the constraints of the resolution framework in going-concern, especially fully-fledged MREL requirements and resolution planning works. However, they would benefit from external resources in gone-concern, or be rescued though unviable, without any strings attached. Hence, any PIA that includes the use of mutualized funds in liquidation should necessarily conclude positively on the use of the resolution framework.
- Complying with the SRB expectations for banks and the EBA guidelines for resolvability would ensure small & mid-size banks are best prepared operationally speaking for a crisis. Such a preparation would smoothen the crisis management process and be beneficial for both the public authorities and the sector as a whole.

A strict burden-sharing must remain the cornerstone of resolution, excluding a DGS bridge.

A strict burden-sharing must remain the cornerstone of resolution, excluding a DGS bridge.

The current rule applicable to access the SRF (the 8% TLOF requirement) must remain intact. Moreover, this principle should be extended to other possible sources of external funds while ensuring a more balanced allocation of SRF contributions across the banking sector:

- A stringent burden-sharing requirement should ensure that shareholders and creditors of failing banks absorb their fair share of losses while minimizing the burden on sound banks: the “DGS bridge” introduced in the proposal is inconsistent with such a principle. Moreover, no exemption, be it in the name of financial stability concerns, should be allowed;

- To comply with such requirement and bridge the potential funding gap, small and mid-sized banks should build up a MREL buffer. It is important to recall that Less Significant Institutions in the Eurozone are already highly capitalized. Therefore, echoing the SRF and the existing Pillar-1 MREL rules, the MREL requirement imposed on small-and-mid-size banks should be systematically floored, with a subordination component equal to 8% TLOF;
- If some of them cannot somehow issue MREL instruments, there are other solutions, like a longer transitional period, relying on a higher share of retained earnings or creating an escrow account that could be tapped in resolution. Otherwise, it would mean that these institutions are not viable and should either restructure themselves or exit the market.

Last but not least, we can note the proposed changes brought to the creditor hierarchy actually constitute the cornerstone of CMDI. However, seniorizing non-covered non-preferred deposits would have significant and unintended consequences such as:

- Banks’ senior preferred debt ratings may be affected and the cost for issuing such instruments may rise;
- Day-to-day liquidity management may be impacted as corporate deposits, which are more volatile, may replace short and mid-term issuances;
- It would create moral hazard for depositors;
- The scope of bail-in would be reduced and huge amounts of external resources would likely have to finance resolution while the burden should remain on the failed bank’s shareholders and creditors.

Reforming an unsatisfactory crisis management framework well makes sense, but should not be done at the expense of banks’ customers and in the end, EU citizens.



CHRISTIAN CASTRO TORRES

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Roadmap to a complete Banking Union: the CMDI reform

Banking resolution is considered by many a truly “philosopher’s stone” to ensure financial stability. The reasoning is that, in an ideal world, if a bank could be resolved without externalities (contagion, spillovers or any other form of systemic effects), minimising associated costs for taxpayers and real economy, and efficiently (in an orderly manner, quickly and minimising costs for creditors and the financial system), there would be little one could seek from a gone-concern perspective.

That explains why the CMDI proposal has been so long-awaited, so debatable, and so important. But also, why it is so necessary. The absence of a credible resolution framework would ultimately mean increasing risks to financial stability and the real economy. Besides, a unified crisis management framework for banks in a jurisdiction like the EU should naturally aspire to have an integrated Deposit Guarantee Scheme (DGS) at the EU level. The reason is straightforward. Once a bank fails – or is near to fail – there are different routes to follow in order to decide the best way that DGS funds should be used to protect depositors.

As banks in the EU are part of a still evolving banking union, a crisis management framework in such a context should aim to have an EU-wide scope. Also the DGS, by the same reasoning. This is a simple but powerful motivation for an European Deposit Insurance Scheme (EDIS). Anything less would be a permanent source of fragmentation and, ultimately, a barrier to a complete banking union in the EU. Further, from a practical perspective, the recent financial turmoil in the US illustrated the need for a strong and ready-to-act deposit insurance system that can rapidly cut uncertainty and lack of confidence among market participants. Against this background, an EDIS would help to increase depositors’ confidence regardless their location in the EU, reducing the link between banking risk and sovereign risk.

Recent events also illustrate some elements that have worked, some that have not, as well as gaps and challenges when having to resolve banks. These recent experiences include, as expected, the cases of Silicon Valley Bank in US and Credit Suisse in Europe, but also other previous examples in Europe. Based on that evidence, it seems clear that the resolution framework needs to be practical, effective, and fair.

CMDI should be up to the banking union expectations and conscious of recent experiences.

Regarding practicality, the observed experiences with failing banks have shown the need to complement existing resources with an agile and operational liquidity-in-resolution tool. Such a tool would provide short-term “gone concern” liquidity support to the resolution process, avoiding unwarranted or increasing ex-ante contributions to existing resources. A liquidity-in-resolution tool could directly be implemented by the European Central Bank (ECB), given its experience in providing collateralised funding to the market. Procedural rules should be well defined and known ex-ante by financial institutions. This new mechanism could be inspired, for example, by those mechanisms recently used by the US Federal Reserve. It is worth noting that both the Chair of the Single Resolution Board (SRB) and the ECB itself have flagged the issue of liquidity in resolution.

Furthermore, the sale-of-business tool has been the only strategy followed thus far in the three resolution decisions adopted by the SRB (Banco Popular and the two Sberbank subsidiaries). This strategy has resulted an effective tool in practice, though there is room for some improvements. Under the existing framework, the acquirer of a failing bank is exposed to a broad range of contingent and hidden liabilities. Most of them are generally due to facts or events that were underestimated or unrecorded prior to the resolution process – which in turn has to be done in a quite narrow time window. The effectiveness of the sale-of-business strategy can be enhanced by providing better protection for the acquirer against such a type of contingent and hidden liabilities.

Finally, fairness. The Commission’s proposal on CMDI increases the scope of resolution and the national DGS – for example, by including eligible deposits from non-bank financial entities. It can be argued that extending the scope of resolution would not be fair for stakeholders involved if the framework remains incomplete or not fully operational in practice. In the same vein, clear and strong client identification requirements should be fulfilled ex-ante by non-bank financial firms taking deposits which are now covered by the DGS. They should also remain accountable to their clients for the information provided.

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BANK DIVERSITY IN EUROPE: WHAT EVOLUTIONS?



EDOUARD FERNANDEZ- BOLLO

Member of the Supervisory
Board - European
Central Bank (ECB)

Building on the diversity of European banking business models

European Central Bank (ECB) Banking Supervision has often welcomed the diversity of banking business models in the euro area as they contribute to the overall resilience of the European banking system. Nevertheless, recent events outside the European Union have shown that, at individual bank level, concentration that is not strategically and professionally managed can be a risk, with the potential to seriously destabilise not just individual banks but also groups of banks with similar business models.

For the ECB, this is a reminder that strategic steering, risk appetite and development strategies need to be adapted to specific banking models. It is crucial to have strong governance that takes due account of all the features

of specific banking business models, including those related to legal form and ownership structures.

In the banking union, we have sound banks that have proved capable of ensuring that economic agents have access to financing, even in times of stress, when it is most needed. Thanks to the euro area's diverse banking landscape, during the pandemic it was possible to avoid excluding certain groups of economic agents by meeting different financing needs. This landscape includes both large, diversified banking groups with various legal forms and geographical scopes able to draw on economies of scale and provide flexible digital solutions to reach clients of all types and local or niche players that offer tailored financing solutions to their clientele.

Even now, against the backdrop of rapidly rising interest rates, we are not seeing any signs of a credit crunch driven by a lack of capacity or willingness to lend on the part of banks. Instead, there is a decrease in demand for credit. This has only been possible because euro area banks are well capitalised overall and have sound risk management and governance in place.

We should not, however, succumb to complacency. More severe economic tests are yet to come. Given the strong emphasis banking supervisors place on preventing difficulties, now would seem an appropriate time to ensure the robustness of each type of business model. Banks can use this current room for manoeuvre to invest in digital transformation, which is the future for all business models. Furthermore, they can enhance their strategic capacity to manage emerging risks, in particular environmental and cyber risks, as well as more traditional risks. The key to ensuring sustainability over the cycle is to react swiftly, before clients and counterparties find themselves in more challenging circumstances. Recent events have highlighted the importance of taking into account not only banks' capacity to generate profits, but also their ability to achieve this in a sustainable manner. That way, banks can retain these profits and will be able to raise capital and additional funding should the need arise.

ECB Banking Supervision, with its continued focus on governance, will keep examining and challenging the way in which individual banks assess the

risks they take. In particular, it will look at banks' understanding of underlying risk drivers, exposures and early warning signs. To that end, the Supervisory Review and Evaluation Process (SREP) not only includes assessment stages in which a set of indicators is applied to all banks, but also allows the Joint Supervisory Teams significant discretion in selecting and weighting the relevant indicators based on the specific features of each bank's business model.

For benchmarking purposes, it is important to compare individual banks with relevant peers operating in similar markets and with similar income and funding mixes. We therefore take a multi-faceted approach, by applying classifications of bank business models and country exposure. This assessment is supported by flexible benchmarking tools enabling comparison with various peer groups. The SREP has long been adapted to account for specific business models through the introduction of additional targeted key risk indicators and assessment templates to ensure full proportionality, in terms of intensity and frequency, for smaller banks (less significant institutions) in Europe.

Furthermore, we have pledged to embed agility and a risk-focused approach in this supervision in the long term. To do this, we have decided to introduce a new supervisory risk tolerance framework, specially designed to enable supervisors to better adjust their tools to bank-specific business models. Supervisors will thus be able to focus their efforts where they are most needed and devote more time to addressing the relevant strategic priorities and vulnerabilities for specific banks. We will therefore plan our activities based on a multi-year SREP approach, which will enable our supervisors to calibrate the intensity and frequency of their analyses more effectively, reflecting individual banks' specific vulnerabilities as well as broader supervisory priorities.

This does not mean less supervision, but instead affords a supervisory process that is better focused and more impactful by homing in on the greatest material risks. Concentrating on the specific features of different banking business models will also give us more flexibility to tackle new and emerging risks in the context of a rapidly changing macroeconomic and interest rate environment, in effect mirroring the priorities of banks' own governance structures.



HELMUT Ettl

Executive Director -
Austrian Financial
Market Authority

Stability as the cornerstone of bank diversity in Europe

When talking about bank diversity in Europe and access to bank financing for different economic agents, it is first necessary to examine the degree of centralization or concentration of the respective banking sector, which vary considerably between the various member states and regions. While some member states have a high degree of centralization in the banking sector, the Austrian and German banking sectors, which in my view are comparable in this context, display a higher degree of decentralization.

The characteristics of (de)centralization and concentration, as seen in Austria or Germany, are mostly complementary to the economic structure. In Austria, there is a strong focus on SME financing and regionality plays a crucial role. In Austria, for example, one sector is characterised very strongly by regionality and presence in rural areas, although other sectors are also still present. However, that is not to say that decentralized systems are more stable or more unstable than centralized systems. Austria has experienced both scenarios: previously there were two large cooperative banking sectors, one of which slid into a survival crisis while the other sector proved to be robust and crisis-resistant. Irrespective of whether institutions are organized centrally or

decentrally, the orderly functioning of internal checks and balances and regularly checking their stability remains essential.

Decentralization and the focus on regionality also give rise to local or industry-related concentration risks, which centralized institutions can spread or diversify more easily. In this context, supervision must ensure that a sector-wide balancing mechanism is created. In Austria, this role is performed by Institutional Protection Schemes (IPS).

In Austria, cooperative banks were able to operate profitably despite their purely local and regional business models. In terms of profitability, they show a solid midfield development, as there are no long-term major outliers, for example due to the simplicity of the business model. Their solid RoA and continuing cost-income ratio reduction is also evident. However, such banks now also face challenges due to factors such as digitalisation or the increased basic costs of banking.

Digitalisation, in my opinion, is a central factor in maintaining access to bank financing and avoiding exclusion. Digitalisation allows banking services to be offered even in the most rural regions and can promote a comprehensive access to bank financing for different economic agents. However, in contrast, the threat also exists that this benefit will eventually exclude the digital-averse. Additionally, digitalisation is a major challenge, especially for smaller institutions, that are only able to keep up if they are prepared to undergo permanent modernization.

**European bank diversity
is essential but must be
considered under the
prerequisite of stability.**

Digitalisation and permanent modernization are also necessary to ensure the sustainability of banking business models. A business model – irrespective of whether for a centralized or decentralized bank – is only sustainable if its governance can adapt sufficiently to new circumstances such as digitalization and ESG.

In addition, homogeneous banking rules that apply to all supervised entities are to be supported, but proportional application of these rules is important for maintaining bank diversity in Europe. For example, EBA's Committee

on Proportionality is working intensively on the proportional application of regulation by examining different topics for opportunities to create more proportional rules and drawing up concrete proposals. These are then implemented by the relevant working groups when drafting or revising the respective regulations. Bank diversity is an asset: for example, Austria did not experience a credit crunch in 2008 and the Austrian banking sector's diversity was one factor that always ensured stable financing.

First and foremost, the aim of supervision is to ensure stability in the diverse European banking sector at all times, and to intervene if necessary. Market exits can and do happen and the supervisor's job is therefore to make sure that market mechanisms function well and that unviable or non-sustainable banks can leave the market without causing disruptions.

A functioning deterrent is also essential: the supervisory rules must be followed and banks must solve their problems, rather than the supervisor having to soften regulations. This approach is essential for credibility and social acceptance of supervision, and, above all, for confidence in a functioning financial market.



GIUSEPPE SIANI

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

Consolidation: a complementary perspective

Since the establishment of the EU Banking Union, there have been high expectations regarding the consolidation of banks within the Eurozone. However, despite the potential benefits of such transactions, most consolidation initiatives still take place within Member States and the EU banking sector remains segmented along national lines.

The reasons could be found both in the prudential regulation and European Institutional Architecture. As to the former, CRR-CRD package still provides for national discretions in some key areas, allowing ring-fencing measures; further, waiving certain capital prudential requirements is not possible in a cross-border context. As to the latter, the Banking Union is still incomplete, since the third pillar (EDIS) is still lacking; completing banking union would be the most direct route to foster integration.

The SSM issued in 2020 the Guide on the supervisory approach to consolidation, in order to clarify its expectations and remove potential obstacles to successful deals within the euro area, adopting a neutral stance in the treatment of mergers, without imposing higher P2R to credible integration plans.

In recent years, however, we have witnessed an upswing in consolidation mainly pushed by digitalisation. Two channels emerge in this new context: aggregations based on traditional channels (M&A), and less traditional ones, seizing the opportunities provided by outsourcing key business functions.

Traditional M&A

The digital transformation has fostered financial intermediaries to consider aggregation in order to get the scale, expertise and resources needed. In particular, several reasons make aggregations quite appealing:

- **Increasing technology costs:** The digital transformation requires substantial investments in technology infrastructure and smaller intermediaries may struggle to keep up with these rising costs. By consolidating resources, they can pool their financial strength and technological expertise to effectively invest in digital transformation initiatives.
- **Fostering innovation:** The digital era has opened up opportunities for fintech startups and technology giants. Intermediaries seek partnerships or consolidation with fintech companies that have advanced capabilities in order to stay competitive and drive innovation.
- **Data Analytics:** The digital transformation has unleashed vast amounts of data. Intermediaries can leverage artificial intelligence to gain insights into customer behaviour and preferences. By aggregating customer data, especially asset management companies can get a more comprehensive view of customers' financial profiles and enable personalized offerings and tailored product solutions.
- **Cybersecurity:** The digital age has also raised increased cybersecurity risks and fraud threats. Cybercriminals are becoming more sophisticated, making it essential for intermediaries to invest in advanced security systems and threat-detection technologies, which may be more challenging for smaller institutions.

Aggregations via outsourcing

Nowadays, outsourcing represents a growing trend in the financial sector, with many intermediaries relying on third-party providers (TPPs) to handle various functions, mainly IT ones. This could constitute a different form of aggregation, maybe with blurred

edges and not easy to be immediately identified by supervisors. Similar to the traditional aggregations, external providers can help reduce operational costs by leveraging economies of scale, enabling intermediaries to tap into the specialized knowledge and skills of external providers. Institutions, especially the smallest ones, by leveraging on external relationship could overcome the limit of the size, keep making the business model sustainable over time; no traditional aggregations are thereby strictly necessary.

Furthermore, the evolution in payment systems is introducing new type of intermediaries able to offer innovative payment services, which customers and banks can rely on, with different degrees of involvement. Strategic partnership in this field is growing too, along the lines of the developments in the relative regulatory framework.

**We have recently
witnessed upswing in
consolidation due to
digitalization.**

However, the increased reliance on outsourcing exposes banking and non-bank sector to higher levels of interconnectedness and concentration risk, when multiple intermediaries rely on a limited number of service providers. The gradual implementation of DORA will help mitigate risks related to TPPs, by requiring institutions to meet specific standards when outsourcing critical functions, considering factors such as concentration risk, interdependencies, cybersecurity and data protection.

Against this background, banking supervision should look at the consolidation from both the perspectives and answer to the question: 'Is it still true that the market does not consolidate?'. We should indeed use both the regulatory and the supervisory available tools to assess the risks and all the issues at stake without creating undue obstacles to successful deals.



KAROLIN SCHRIEVER

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

Creating a true level playing field for the EU's diversified banking sector

The EU banking sector has exhibited a remarkable amount of resilience in the face of a multitude of recent and ongoing risk events. Why is it that significant stress in major financial markets and even bank collapses have not spilled over to EU banks? In my view, there are two main factors that contribute to the strong resilience of the EU banking sector.

The first important factor is the demonstrated effectiveness of reforms implemented after the Global Financial Crisis: This relates to structural reform in the shape of the Banking Union with its comparatively streamlined setup of supervisory institutions and with the European Central Bank, the European Banking Authority and the Single Resolution Board at its heart. Banking Union has led to a clear assignment of responsibilities in a way that differs strongly from the sometimes much more complex and overlapping structures seen in other jurisdictions. Apart from structural differences, recent events have also raised attention to the extent of Basel implementation across banking systems, with the EU notably

applying the Basel regime and the EU Single Rulebook to all of its roughly 5,100 credit institutions. This is in stark contrast to jurisdictions that have only applied full Basel rules to a dozen of their largest banks.

But the second, equally important explanation for the EU banking sector's resilience is its unique diversity of business models, risk profiles, and customer bases. The financial networks of the savings and cooperative banks in Germany and other Member States largely contribute to this diversity by providing financial services even in less affluent regions alongside larger commercial and international banks.

Looking at the real economy, the diversity of the European banking sector is a direct reflection of the EU's corporate landscape. In Germany, as in many other Member States, regional banks are vital partners for SMEs in their local communities. German Sparkassen have supported state vaccination campaigns during the pandemic and provided more than 450,000 checking accounts to Ukrainian refugees after the brutal Russian invasion of their home country. This very focus on relationship banking and regional commitment is becoming increasingly important in order to successfully tackle the challenges associated with the transformation towards more sustainable economic activity.

The diversity of the European banking sector is a direct reflection of the EU's corporate landscape.

Meanwhile, smaller banks are increasingly facing fixed-cost disadvantages associated with the ongoing wave of compliance and reporting requirements. While it is right to apply Basel rules to all EU banks even in contrast to other jurisdictions, there is still a long way to go in taking account the characteristics of individual banks, different business models or network structures. Instead, the agreement reached on the EU Banking Package will yet again lead to additional requirements and burdens that are disproportionately affecting smaller banks. New EBA mandates to ensure proportionality and possible relief in reporting are positive, but they need to lead to concrete relief for smaller banks.

A balance between harmonized banking rules and the diversity of business models is also notably lacking in the EU

Commission's proposals for a review of the crisis management and deposit insurance framework. For decentralized, relationship-based banking models in a number of Member States, institutional protection schemes have proven to be highly efficient safeguards ensuring the solvency of their affiliated banks. Not once in the decades-long histories of the Sparkassen's or the German cooperative banks' IPSs had depositors have to be compensated or has a member bank become insolvent.

Changes proposed within the CMDI Review would significantly impair the abilities of IPSs that are recognized as a Deposit Guarantee Scheme. Furthermore, the CMDI Review itself presents as an intermediate step towards a centralized deposit insurance that would eliminate the economic viability of tried and tested IPSs.

Differentiation and necessary adjustments are needed for financial services regulation to allow diversity to thrive. For the further work on Banking Union, this also has to include a practicable solution for IPSs allowing for their continued proper functioning.

In an ever faster changing world, the number of challenges we face continues to grow. In addition to climate change and digitalisation, demographic change, competitiveness and strategic autonomy will become increasingly important for Europe. By driving innovation and adaptability, diversity will allow Europe to keep pace with increasing complexity and dynamism. It also ensures that no one is left behind and that the ever-evolving needs of markets are always matched.

Embracing diversity is therefore the right thing to do. It will make the banking sector more resilient and the economy as a whole a lot stronger. A diverse Europe will be more successful in the long run.



MIKE VELTHAAK

Advisor to the Board -
Rabobank

Acknowledging that EU regulation needs improvement to foster bank diversity

Since the introduction of the Single Supervisory Mechanism (SSM) in November 2014, in response to the global financial crisis and the subsequent European debt crisis, significant improvements in European banking regulation and supervision took place. But we also noticed a rapidly advancing digital transformation of society which creates massive opportunities as it can lead to new business models, the rise of new competitors, better, and/or lower-priced products and services. In this regard, completing the Banking Union is good for the EU customers as network effects create efficiencies of scale, lowering the operational cost of banking.

Still, we are far away from one Banking Union. No progress has been made during the CRR3/CRD6 negotiations to enable banks to move capital and liquidity across the European Union. And EDIS is at gridlock which the recent proposal by the European Commission on the Crisis Management and Deposit Insurance Framework is not going to end.

Nevertheless, bank regulation is not the whole story. Also fiscal, insolvency and conduct law in the EU is still a

patchwork of national rules which hampers the full operationalisation of the benefits of scale that digitalisation can offer. Potentially the use of Artificial Intelligence can overcome certain of these challenges. But also consumers still prefer their national banks that understand their culture over those from other countries, even when they can earn more money on their saving account abroad. Potentially the heterogeneous withholding tax regimes in the different Member States do not help either.

So, one can argue that due to the still nationally oriented banking landscape with many member state specific elements, the banking sector across the EU is still diversified but might become less diversified due to digitalisation. In addition, one could also pose that the current EU regulation leads to many unintended consequences for the supervised bank and that certain premises can be disputed on which (international) banking regulation is based upon, like a focus on shareholder value while we know that a significant amounts of banking groups in the EU are stakeholder based.

The shareholder value model significantly drove the international banking regulation in the last 20 year. It can be characterized by highly innovative, use of internal models, complex legal structures, taking risks and making strong profits, all with its main purpose to achieve maximum value to support the share price. In contrast, stakeholder value institutions strive to strike a balance between creating value for their survival in a highly competitive market by not distributing profits and to bring sustainable and long-term value to the society or the community they serve.

**Certain premises can
be disputed on which
(international) banking
regulation is based upon.**

Between stakeholder value institutions governance arrangement differ, with each having their strengths and weaknesses, but with a common determinant that profit maximalisation is not an objective and excessive behaviour can be identified and contained by the stakeholders.

When bank legislation in the EU is changed, non-shareholder banks continuously must provide arguments why the proposed rules are not fit

for them and strive for adjustments in the regulation. Sometimes this is successful, like with the IFRS discussion about the distinction between equity and liabilities, but most of the time the banks have the feeling that their model is penalised. Like for example the role of institutional protection schemes and the set-up of the crisis management framework where it seems that continuing as a shareholder banking structure is currently the only way to continue after resolution. Or recently in the CRD regarding fit and proper.

Insufficient tailored regulation also has implications on banking supervision as supervising banks in line with the standards is easy. But it requires expertise, seniority, and the backing of the senior management to give a supervisor the room to judge and agree – in line with the arguments of the management of a shareholder or stakeholder bank - why a particular situation applies for a specific bank.

Regarding diversity in banking supervision one can also question the design about the scope of direct SSM supervision. Why is the SSM not only supervising the real large international and pan European banks with a balance sheet total of more than EUR 100 million with a clause that the ECB can intervene in local supervision when it sees a significant risk in a non-SSM supervised bank? Including smaller (non-complex) ones currently in scope cost time and precious resources, which cannot be used for more tailors made bank supervision of the more complex banks or to understand the merits of the governance structure of stakeholder banks.



BENOÎT DE LA CHAPELLE BIZOT

Head of Public Affairs and
Adviser to the President - BPCE

Working hand in hand to preserve banking diversity by 2030

European countries are increasingly under pressure to put forward solutions to the challenges linked to the environmental, digital, and social transitions, which manifest themselves by important investment needs across all European regions. All stakeholders need to be enrolled, notably local communities and SMEs as they play a central role in our economies. In that regard, preserving the cooperative banking model in the EU financial landscape is key.

Banks are unavoidable when it comes to ensuring that those financing needs are met, especially since only few SMEs and local authorities will be able to finance themselves on capital markets. For banks to be the catalysts of these transitions and changes, two features are necessary: a granular approach and a long-term client relationship. Cooperative banks support their clients in the long run and understand the reality of their territories and local economies. This allows us to provide concrete and continuous support to local communities, their inhabitants and SMEs to accompany them in their

transition plans. For example, BPCE is the leading bank for SMEs in France.

Several regulatory and supervisory developments, however, risk undermining the financing of these transitions by weakening the roots of our cooperative banking model. Most notably, the direct supervision by the ECB, whose supervisory processes tend to standardize banking models by referring to common “best practices”, challenges the specificities of the cooperative banking model in terms of granularity of banking networks, decentralization of decisions, etc.

The SREP review in 2024 is thus key for the preservation of banking diversity in Europe: its procedures and processes should be adapted to the diversity of banking business models by reviewing how the SSM assesses a bank’s profitability and sustainability of its business model, designs its benchmarks, and puts forward its recommendations.

On profitability, for instance, our capacity to put earnings into reserves is comparable to listed groups, even though their net incomes are higher. A better indicator for supervisors could therefore be the residual income after distribution, and the actual capacity to endogenously create CET1. This would be a better indicator, since dividends reduce the profit channeled to CET1 for commercial banks, whereas cooperative banks do not need to pay any cost of equity for their accumulated reserves, and this is not factored in the return on equity.

The SREP review in 2024 is key for the preservation of banking diversity in Europe.

As stated by the Expert Group to the Chair of the Supervisory Board of the ECB, the “ECB’s supervisory approach appears to be too capital centric”. When assessing the viability of our business model, the SREP should also focus on qualitative measures, such as our ability to serve customers and small companies, as maintaining banking activities in all regions of France is key for our business. Therefore, before each recommendation from JSTs, the supervisor should make sure that the business model of the bank is being considered.

The SSM could thus elaborate a “business model adequacy test” that could apply to JST recommendations. Symmetrically, a bank should be able to raise an issue regarding the integrity

of its business model to JSTs (impact of a recommendation), who would then have to assess the issue. The actual process should be further defined by the SSM in close coordination with cooperative banks representatives.

Benchmarks should also not be the gold standard of supervision if they do not recognize in practice the specificity of banking models in Europe, especially those who proved to be sustainable over time. Benchmarks should be made transparent, and supervisors need to adapt samples according to the different business models. The SSM should make sure that the transparency of different benchmarks and the suitability of the samples are the cornerstone of supervisory analysis. JSTs should not be guided only by standardized benchmarking for banks’ profitability, cost and risk management, and governance.

Beyond supervision, regulation itself could lead to numerous unintended consequences on the different business models if we don’t look at the big picture. For BPCE, it is essential to preserve the DNA of our Group and support our 35 million customers, whether they are individuals, professionals, associations, corporates, or local authorities, over the long term and at every stage of their lives. It is also vital for our economy, and as a result overall – including financial – stability.

For instance, cooperative elective processes are a key part of our identity and legal structure. We believe that Fit and Proper regulations must respect this, especially with regards to the Basel III compromise and the future EBA work on this.

We stand ready with European cooperative banks to work hand in hand with the SSM and regulators to ensure that banking diversity remains an important drive of financial stability in Europe by 2030.

GLOBAL AND SOLVENCY II INSURANCE FRAMEWORKS



ALBERTO CORINTI

Member of the Board of
Directors - Italian Insurance
Supervisory Authority (IVASS)

The dilemma of setting a global capital standard in insurance

On 9 October 2013 the IAIS announced its plan to develop a risk-based global insurance capital standard. We are now nearly at the end of a long journey that will lead to set this standard, the so-called ICS. The IAIS recently issued a final consultation paper on the ICS as PCR, i.e. as capital requirement according to the IAIS standards. The result of the consultation will feed into the finalization of the ICS, whose adoption is planned for December 2024.

In the light of the many challenges encountered in these 10 years of work, as well as of the strong scepticism that still accompanies the project, one could wonder whether we are moving in the right direction and even whether it is worthwhile to try and set a global capital standard.

The challenges to find an agreeable design and calibration of the standard

are apparent, and understandably related to the different national supervisory approaches, legal backgrounds and market features. Scepticism mainly stems from the foreseeable difficulties to reach a sufficiently consistent implementation of the standard across different jurisdictions, also considering its minimum harmonization approach. In this perspective, the risk that the global standard could contribute to hide actual differences would become real. In other words, we could end up considering comparable what is actually different. In this case, the standard could even be an obstacle to effective supervision.

As an insurance supervisor, I think that despite the risks, challenges and scepticism, setting a global capital standard in insurance remains an essential and worthwhile objective.

**Over time, the challenges
will be outweighed by
the benefits.**

It is apparent that having a consistent metric to measure risks and capital would finally allow more effective prudential supervision of international groups. Clearly, this would facilitate supervisory cooperation. Macro-prudential considerations would be more effective, as a common metric to measure risks would allow for easier detection and management of systemic risk concentrations. A consistent approach towards capital requirements would also be a precondition to reach a consistent level of protection to policyholders and to ensure a level playing field for insurers.

At the same time, we should obviously be aware that setting the standard would be only the first step in achieving all these objectives. The next key step would require actual consistency in its implementation.

In general, it is safe to predict that consistency of the standard will not be sufficient when first implemented. The discretion left to national jurisdictions in transposing the standard as well as to national supervisors in interpreting many aspects of the standard will remain

significant. In this regard, Europeans can easily draw the lessons from the first implementation of Solvency II, which - despite its maximum harmonization approach - still presents areas lacking genuine consistency.

In particular, the criteria to assess the comparability of the US Aggregation Method with the ICS will be outcome-based and, above all, mainly focussed on the comparability of the situations that trigger supervisory interventions. Even assuming that this type of comparability is achieved, it will not be sufficient to ensure a true level playing field between insurers in different conditions. Just to give an example: two companies might show the same ratio between capital requirements and available capital, but with a different amount in the numerator and in the denominator. This could trigger equivalent supervisory interventions but would not result in a level playing field.

In this context, I believe that it will be key to be stringent in recognizing relevant misalignments at national level, be aware of the consequences of these misalignments and be as transparent as possible in explaining them. At the same time, the IAIS and all parties involved, starting from the first implementation, should continue to follow a path towards progressively enhancing global convergence - which I dare to predict will be long and difficult.

Following this path, it will be crucial for the IAIS to work on its implementation assessment with quality and accuracy. Based on the assessment, the IAIS should then be able to provide application guidance and, if necessary, review the standard to limit excessive misalignments and promote convergence. In the meantime, it will be necessary to rely on sufficiently detailed and comprehensive disclosure of the solvency calculation, in order to avoid the obfuscation of differences and to allow the proper interpretation of solvency indicators by supervisors, insurers, consumers and all other users. The role of national supervisors will be essential in this respect.

All in all, it is true that a genuine global capital standard is still a long way ahead, but we are marching in the right direction and it is worthwhile to keep momentum. Over time, the challenges will be outweighed by the benefits.



VICKY SAPORTA

Chair of the Executive
Committee - International
Association of Insurance
Supervisors (IAIS)

Finalising the ICS global capital standard for international insurance groups

Many journeys to Santiago de Compostela are long and winding and undertaken by individuals wholeheartedly devoted to reaching a conclusion, bolstered by a great deal of faith. So too has been the journey to finalisation of the Insurance Capital Standard (ICS).

Over a decade ago, the International Association of Insurance Supervisors (IAIS) embarked on its journey to develop the global solvency standard for internationally active insurance groups (IAIGs). This journey is now in its final mile. Over the summer, we have been consulting on the final standard. This will be adopted at the end of next year, taking on board comments from this consultation. With the adoption of the ICS we will have a global minimum solvency standard akin to that developed by our colleagues at the Basel Committee.

At the core of our role as a global standard setter is a commitment to supporting the development and maintenance of fair, safe and stable insurance markets

for the benefit and protection of policyholders and contributing to global financial stability. The ICS supports this by providing a comparable solvency measure across jurisdictions, promoting sound risk management and minimising undesirable pro-cyclical behaviour while balancing risk sensitivity and simplicity. Having already adopted the qualitative element of our common framework for the supervision of IAIGs (or ComFrame) in 2019, finalisation of the quantitative element (namely the ICS) next year means that ComFrame will then provide a complete framework that establishes global minimum supervisory standards for the effective group-wide supervision of IAIGs.

We have designed the ICS to provide a consolidated minimum group-wide standard for IAIGs, allowing for a globally comparable risk-based measure of capital adequacy. The standard addresses all material risks of IAIGs, targeting a 99.5% Value-at-Risk over a one-year horizon. In essence, the ICS will provide a common language for cross-border discussions on insurance group solvency in a world in which we face many common and interconnected global risks, while also respecting the differences of our insurance markets.

**A robust global standard
which will support
a resilient global
insurance sector.**

Thanks to the extensive data gathering and analysis undertaken to develop the standard, plus the current five-year ICS monitoring period (2020-2024), the ICS is one of the most meticulously observed, consulted upon and empirically driven international financial standards. The monitoring period has provided a period of stability in the design of the ICS, to assess its performance over the business cycle. Experience has shown us that the ICS performed well, with year over year comparisons producing consistent results, even under the stressed market conditions we have experienced because of the global pandemic.

We have been using this rich data set throughout the monitoring period to learn lessons and make adjustments as necessary to the design of the final standard. We have benefited from the active participation of insurance groups, representing a third of the worldwide life business and a quarter of non-life insurance business, providing both data and technical input during

the monitoring period. Discussions at their colleges of supervisors have also provided valuable feedback on the ICS's performance. Additionally, we have conducted numerous workshops with volunteer groups and supervisors across the globe.

IAIS members are committed to the implementation of IAIS standards. Some members, for instance the European Union, Japan and UK, have already announced their intention to have a consistent implementation of ICS in their regulatory regimes. In parallel, the United States is developing an Aggregation Method to a group capital calculation, which, if deemed comparable, will serve as an outcome-equivalent approach for implementation of the ICS as a prescribed capital requirement. Earlier this year, we published the final criteria that will be used to assess whether the Aggregation Method will provide comparable outcomes to the ICS. While distinct from the ICS, our consensus on the criteria and robust technical process for the Aggregation Method comparability assessment will ensure the credibility of a truly global capital standard and comparable outcomes.

Following the adoption of the final ICS next year, the IAIS will employ a structured and robust approach to assess its implementation across jurisdictions. The exact timing of implementation assessment has not yet been determined, noting that transitional periods for implementation are common where requisite laws and/or regulations must be adopted by relevant jurisdictions.

We will end next year with a robust global standard, which will support a resilient global insurance sector, and is testament to the significant journey we embarked on more than a decade ago.



MARTIN LANDAIS

Director, Insurance Division -
DG Treasury - Ministry of the
Economy, Finance and Industrial
and Digital Sovereignty, France

Let's bring to a close the good work on Solvency 2

The revision of the Solvency 2 directive, which trialogue is about to begin, brings up significant political issues that are relevant not only for the insurance sector but also for the European economy and sovereignty as a whole. As we are on the verge of success to develop a safer, more efficient and competitive insurance sector across Europe, we need to be wary not to lose the substance by grasping at the shadow of a standard which would be only one by the name.

The Solvency 2 review will empower insurers to play a more significant role in financing European growth while ensuring policyholders' confidence in the single market's ability to protect them.

First, the review aims to facilitate insurance companies' active participation as long-term investors in the economy. Due to the long-term nature of their business, insurers should take a more prominent role in the CMU. This is why France, in collaboration with its partners, seeks to go beyond EIOPA's 2019 proposals regarding the relaxation of the Long-Term Equity Investment regime. Some progress was already made, namely at the European Parliament level, but the

negotiations on the delegated regulation will play a crucial role in this regard.

Second, the review will enhance cross-border activities' supervision. This involves better coordination and cooperation among national authorities. While supervision remains a national responsibility, increased collaboration between supervisors is necessary as we deepen the single market.

Third, the review will enhance the countercyclical aspects of the framework, notably through the volatility adjustment, which is a very powerful counter-cyclical tool. The introduction of macroprudential instruments will also contribute to increasing financial stability, especially in a context of economic and financial turbulences such as the one we are currently navigating through.

The review will also improve the insurance sector's consideration of climate risk.

The current compromise includes provisions addressing the impact of insurers on biodiversity and the implementation of new European climate stress tests. Additionally, it mandates insurers to develop specific plans detailing their exposure to ESG risks, especially transition risk, as well as the actions they will take in the short, medium, and long term to mitigate these risks effectively.

The review will empower insurers to play a more significant role in financing European economy.

Finally, the review is on track to foster the development and competitiveness of the insurance market.

First, the review should not increase capital requirements. The pandemic has demonstrated that current capital requirements are sufficient to ensure the sector's resilience. Overall, the compromise text of the reviewed directive does not create any additional requirements compared with the existing text.

Second, the review aims to simplify prudential rules. For the least risky companies, prudential rules will be alleviated. The automaticity of the regime for these companies relies on a comprehensive set of objective criteria.

Last but not least, the competitiveness of our insurance industry is at stake in this review. That is why the notion of international level playing field was introduced in the recitals by the Council's compromise, to make it clear that we are not discussing European prudential rules from our Ivory tower. Of course, we must avoid a race to the bottom, and ensure that the level of prudence is adequate, but we should be mindful of the global context, and by this, I mean both the discussions on an international capital standard, and the review plans of the United-Kingdom.

Indeed, we have to make sure that the ongoing discussions about the International Capital Standard (ICS) do not undermine these endeavors.

The ICS is being developed with the relevant purpose of establishing a common approach applicable to internationally active insurance Groups. Efforts are underway within the International Association of Insurance Supervisors to accomplish this goal by the end of 2025. It is worth noting that the standard ICS shares several similarities with the quantitative aspect of Solvency 2, thanks to the joint efforts of the Commission, EIOPA and national supervisory authorities.

However, the standard ICS is not the cornerstone of this exercise. On March 9, 2023, the IAIS released comparability criteria, which raised significant reservations, notably from France, for being too blurry. Currently, the design of the capital requirement has been stabilized, but the issue of comparability between national methods and the ICS remains unresolved.

In this regard, the question of equivalence is pivotal. We should be careful that it does not undermine the level playing field principle, and thus all the good work done on the Solvency 2 review. We, Europeans, will need to be very cautious to safeguard an even, competitive and fair insurance market.



PETRA HIELKEMA

Chairperson - European
Insurance and Occupational
Pensions Authority (EIOPA)

Final boarding call for the ICS

With an expected time for the adoption by the International Association of Insurance Supervisors (IAIS) by end-2024, now is the final boarding call for shaping the international Insurance Capital Standard (ICS). In these last stages of development of the ICS, EIOPA remains fully engaged and calls on all EU stakeholders to engage as well. Since the beginning, EIOPA has aimed for a minimum global capital standard that reflects the main features of the Solvency II framework, enabling Solvency II to become a practical implementation of the ICS.

In place since 2016, Solvency II introduced a forward-looking risk-based approach to assess and mitigate risk in the EU insurance sector. This framework has proven to work well over the years, strengthening the sector's resilience to weather financial, pandemic, and geopolitical turbulences.

In its advice of 2020, EIOPA supported a gradual review of Solvency II as an important element of good regulation and aiming at keeping the framework fit for purpose. The review should be evolutionary and balanced, to keep the current level of protection of policyholders. EIOPA's recommendations for the review

included improvements to appropriately cope with changing macroeconomic environments, in particular for insurance products with long-term guarantees. We recommended completing the regulatory toolbox with macroprudential tools and measures, a comprehensive recovery and resolution framework and a European network of insurance guarantee schemes. Furthermore, EIOPA supported increasing proportionality across the three pillars of Solvency II, especially regarding low risk undertakings. Solvency II is now being considered by the co-legislators.

Solvency II is a competitive regulatory framework. European insurance groups and insurers successfully do business internationally based on Solvency II. The review of Solvency II should preserve that. We should keep in mind that competitiveness is more than the level of capital requirements and aim for sustainable competitiveness that relies on fair pricing and credible risk assessment, to build resilience and trust.

Turning to the ICS, the IAIS has already achieved great progress working with its members, with the agreement of ICS 2.0 in 2019 and the launch of the five-year monitoring period. Thanks to the information gathered during the past monitoring exercises, we were able to learn from each other and shape the candidate ICS as a Prescribed Capital Requirement (PCR) to appropriately capture the risk profile of Internationally Active Insurance Groups (IAIGs). We strongly believe that the introduction of a minimum risk-based regime globally that reflects the key elements of Solvency II will enhance global financial stability, consumer protection and level playing field across IAIGs. The candidate ICS as a PCR is now tested through the 2023 monitoring exercise and publicly consulted.

EIOPA urges all EU stakeholders to actively engage in the last steps of the ICS

In EIOPA's view, the candidate ICS as a PCR goes in the right direction of implementing sound risk-based supervisory frameworks globally and is consistent with the main features of Solvency II. For example, internal models are now acknowledged as part of the candidate ICS as a PCR, allowing the recognition of the specificities in the risk profiles of large, sophisticated groups.

Another important aspect of the implementation of the ICS is the comparability exercise of the ICS with the Aggregation Method (AM) – not part of the candidate ICS as a PCR – developed by the United States and other interested jurisdictions.

EIOPA believes that the IAIS criteria being used to assess whether the AM provides comparable outcomes to the ICS are sufficiently robust. These criteria were developed to provide a foundation to assess whether the AM delivers comparable outcomes to the ICS.

However, it is important to emphasize that the robustness of these criteria alone does not guarantee the comparability of outcomes. The agreed criteria are merely a framework that guides the assessment process. The true assurance of comparability will have to come through a thorough, evidence-based, and quantitative assessment that builds upon these criteria.

Only through such a rigorous process, that can start once we have a published version of the AM, can the IAIS conclude if it produces similar, even if not necessarily identical, results over time that trigger supervisory action on group capital adequacy grounds.

We are now in the last stage of shaping of the ICS. EIOPA regrets that a number of European IAIGs are not actively taking part in the ICS development process. Together, we can achieve a better ICS that also aligns with the key fundamental principles underlying Solvency II.

EIOPA urges all EU stakeholders to actively engage in the last steps of the ICS. The ICS plane is about to depart, and this is the final boarding call.



FRANK GRUND

Chief Executive Director
Insurance and Pension
Funds Supervision -
Federal Financial Supervisory
Authority, Germany (BaFin)

Improving the risk-based framework in Europe and creating a global framework with the ICS

My opinion is clear: Solvency II has – for the most part – been an undoubted success since its entry into force. The risk-sensitive regulatory framework has been invaluable in enabling the early identification and better assessment of risks. However, as is natural for such a comprehensive framework, it has also become clear that improvement is needed in certain areas. It is with good reason that a review of Solvency II has been initiated.

More tailored treatment of long-term guarantees

With regard to quantitative requirements, the treatment of long-term guarantees takes on a key role. The extrapolation of the interest rate term structure and the volatility adjustment are core measures here. We welcome the fact that the review will lead to targeted improvements in these measures, in line with the idea of “evolution, not revolution”. The volatility adjustment, as a result, is expected to have a significantly larger impact – this will

require a very careful calibration to avoid “overshooting” effects which may put the functioning of this instrument at risk.

Regarding interest rate risk – another important component in Pillar 1 – the review will lead to more adequate risk measurement: a significant improvement compared with the current status.

Current environment underlines need for risk-adequate supervisory requirements

In recent years, the world has gone through turbulent times. The pandemic, the current geopolitical situation and the recent rise in interest rates and inflation have led to new risks and vulnerabilities. The effects of climate change, too, are becoming more and more evident. Overall, the sentiment in financial markets remains fragile, with a high degree of volatility and uncertainty. In light of all this, it is paramount that we maintain risk-adequate supervisory requirements.

An undue reduction in capital requirements would send out the wrong signal and could damage the foundations of Solvency II, which lie in the adequate identification of risks. We need to maintain a balance; the review must not be at the expense of the resilience of the sector. Against this background, we view the latest policy proposals as a cause for concern.

Reducing the burden on insurers is not an end in itself: such measures must be risk-appropriate.

Proportionality

We welcome the fact that the SII review will strengthen the principle of proportionality by introducing a framework providing for risk-adequate relief measures for small, non-complex insurers. This will facilitate a uniform approach for dealing with companies whose risk profile calls for simpler solutions. But in our efforts to improve proportionality, we must not lose sight of the fact that this is not simply about relief for the sake of relief – and therein lies the challenge. Reducing the burden on insurers is not an end in itself: such measures must be risk-appropriate.

Sustainability: reflecting climate-related risks in Solvency II

It is essential that the increasing climate-related risks are properly reflected in the

Solvency II framework. We welcome the sustainability proposals from the EU COM in the SII review. However, it is worth emphasising that Solvency II is a risk-based regime that is not compatible with measures like green supporting or brown penalising factors. A big challenge behind climate-related risks is that – unlike many other risks – they cannot be observed in historical data. We therefore need appropriate forward-looking methodologies to analyse climate risks.

Balancing heterogeneity and standardisation: achievements and challenges of the Insurance Capital Standard (ICS)

At the global level, the International Association of Insurance Supervisors (IAIS) is continuing its work on the Insurance Capital Standard (ICS) based on principles that resemble those of Solvency II. We fully support the introduction of the ICS and its main objective to establish a risk-based consolidated group-wide capital standard for Internationally Active Insurance Groups (IAIGs), which will lead to comparable outcomes across jurisdictions. To ensure a risk-based approach, it is of the utmost importance that internal models are included in the ICS in order to adequately reflect the heterogeneity in the IAIGs' risk profiles.

Currently, the ICS is in public consultation. In addition, the IAIS is assessing whether the aggregation method developed by the USA provides comparable outcomes to the ICS.

Overall, the development of the ICS is already well advanced and, in our view, it has so far been a success. Due to its importance, we welcome the fact that many large European insurance undertakings continue to participate in the process: international insurance groups should not miss this opportunity!

The next steps will depend on the results of the consultation and the outcome of the comparability assessment of the aggregation method. The adoption of the ICS is currently scheduled for late 2024.



MIREILLE AUBRY

Director Prudential Regulation
Standards & Foresight - COVEA

Reviewing Solvency II and upgrading insurance resilience & competitiveness

The “2020” Solvency II review was intended and expected to bring improvements in the regulation that entered into force on 1 January 2016 and to the supervision of the insurance sector after having taking stock of its fitness to initial expectations as well as complementary ones in respect of new dimensions such as the drastic evolutions of the macroeconomic environment, sustainability issues and new and evolving risks. Improvements are expected for an enhanced adaptation and relevance of the framework and its continued efficiency with a special strong attention to the long-term instrumental dimension of a resilient and performing insurance sector at the service of the society and the economy.

The relevance of the solvency II production and monitoring is dependent on adequate risk-based valuations serving the clear objective of sustainable resilience based on appropriate indicators while putting the interest and security of policyholders at the core. Markets, regulation and supervision should serve the interest of citizens and not the contrary.

An efficient regulatory framework should be robust, cost effective without unwarranted interferences. By robust we mean a regulation that avoids being biased to temporary and/or short-term conditions as well as averts over parametrizing valuations that renders modelling fragile and bound to inappropriate swings that can trigger poor decisions to the detriment of adequate balance and countercyclicality. Bias towards artificial consensus should also be avoided and topical situations must be correctly reflected to avoid destroying innovation, diversified approaches and models that are utmost valuable for effective adaptation to different needs and diverse risks.

To improve reliability the key items under intense scrutiny and expectation for adequate calibration for the solvency II review are the discounting risk free yield curve, the interest rate risk and the risk margin and additionally to enhance insurers’ investment capacity the long-term equity risk.

Under the EIOPA’s proposal for a new extrapolation methodology for the yield curve of basic risk-free interest rates used to discount the best estimates of insurance liabilities the convergence alpha parameter towards the ultimate forward rate or long-term anchor parameter is too low when set at 10% and the industry is expecting a value of at least 15%. This is working against the stability of the prudential reserves and is leading to exaggerated volatility immediately affecting the own funds and in turn increasing the volatility of solvency ratios.

The volatility adjustment is another major fitting factor that should account for adequate discounting so that assets and liabilities movements display consistent behaviors and that unsuitable assessments of risks are avoided in the context of long-term asset and liability management whereby fixed income securities are held until maturity. It is paramount that the volatility adjustment fulfills its role notably in turmoil times to work against amplifying the crisis and triggering counterproductive actions.

In the same vein the EC’s proposal to extrapolate the curve beyond its liquid part under the SCR interest rate shock is key to consistency of approaches with the calculation of the best estimates in the central prudential balance sheet and to maintain a limitation to overstated volatility.

The risk margin is providing an addition to the best estimates to ensure the transferability of reserves. This should nevertheless not conduce to harming

long term liabilities insurance products with prohibitive costs while long term should factor the time-dependence of risks in the projection of future capital requirements, with later years having a lesser contribution to the risk margin and more stabilized long-term charges should be promoted.

Last, in order to enhance the insurers’ investment capacities and their crucial role to financing a sustainable economy, the criteria governing the eligibility of equity portfolios to the long-term equity risk are long awaited to be workable and reflective of the key drivers of long-term investment strategies while preserving the agility of such investments so that they remain performing with the best prospects. The choice of the market timing must remain in the hand of insurers’ tactical monitoring enabling timely and countercyclical sales and purchases.

**An efficient regulatory
framework should be
robust, cost effective
without unwarranted
interferences.**

On the field of competitiveness, it is worth noting that the IAIS’s Insurance Capital Standard (ICS) project which is based on Solvency II was intended to create the conditions for fairer markets at global level. The finding is that the ICS generally requires less capital than Solvency II but more than other frameworks.

The Solvency II review is an opportunity not to be missed to fix the unlevel playing field by which European insurers have to hold more capital and are disincentivized to act long-term to prepare a more resilient future. European insurers have less investment capacity and are impeded with their products offering.

3

DIGITALISATION AND TECHNOLOGY

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Q&A

SCOTT MULLINSManaging Director, Worldwide
Financial Services - AWS

Well implemented DORA will lay the foundations for the next stage of digital transformation

How are technologies and innovations, such as cloud and AI, changing the structure of the financial industry and the way financial services are provided and consumed? What challenges does it pose for the industry and policymakers?

New technologies and innovations have always been adopted by the financial services industry. The recent options for the industry, in areas such as cloud and artificial intelligence (AI), have fundamentally changed and reinvented the relationship between customers (both consumers and businesses) and the industry and given those customers more optionality and enabled digital transformation. This has helped deliver an efficient and convenient structure for customers. For example, an EU-based global bank uses AWS for near-field communication (NFC), or wireless, payments in its mobile banking app across its network, delivering a solution for customers to make payments that is both convenient and secure.

At AWS we focus on the customer and think about change in terms of how customers can leverage these innovations in their own business. We think about how the current state of the world is challenging existing business models and revealing new business opportunities. How to choose the right services to address a particular business challenge or opportunity. How to make those services work with existing investments in technology. How to meet unique requirements that are applicable to use cases in specific industries. How to effectively navigate the choices that come with executing transformational change, and in catalyzing innovation.

Technology change brings challenges for policymakers and regulators as well. They need to adapt and modernize their approach to ensure a consistent and effective framework for the use of technology, including cloud, that also supports the digital transformation of the sector.

In the EU we will see this through the Digital Operational Resilience Act (DORA) taking effect in January 2025. As the EU institutions set out the details in level 2, it is important that the implementation remains flexible enough to handle increasingly dynamic complexities in the financial and technology spaces. This will ensure that the EU can leverage technological change and be well set for future ones as well.

What new trends are we seeing in terms of digitalisation and what role is cloud playing in these new developments?

Since the last EUROFI in Stockholm, technologies such as generative artificial intelligence (AI), have come to the fore in public consciousness and received widespread media coverage in a way we have rarely seen in recent years. AI has application across society and this is no different in the financial services (FS) industry.

Amazon has invested heavily in the development and deployment of AI and machine learning (ML) for over two decades for both customer-facing services and internal operations. AWS has been delivering meaningful innovation supporting generative AI for years through services, partnerships, custom-designed chips, and developer tools—all grounded in giving customers what they need to build generative AI applications. We put these new technologies and capabilities in the hands of all builders, not just technology companies with resources.

For the financial services industry there are four areas where generative AI is already making an impact: improving customer experience; increasing productivity of knowledge workers; understanding market and customer sentiment; and driving product innovation and business process automation. As leaders in the financial services industry move forward, they will need to define the problems they want to solve using generative AI and establish a cloud strategy to pursue new solutions.

And like all AI, generative AI is powered by ML models — very large models that are pre-trained on vast amounts of data and commonly referred to as Foundation Models (FMs). We believe the potential of FMs is incredibly exciting, and cloud can help drive the next wave of innovation by making generative AI easy, practical, secure, cost-effective, and responsible for customers. In doing so, we can support taking this technology out of the realm of research and make it available to customers of any size and developers of all skill levels. This is democratizing access to FMs and generative AI for customers. Customers get the flexibility to choose the way they want to build with generative AI: build their own FM with purpose-built ML infrastructure; leverage pre-trained FMs as base models to build their applications; or use services with built-in generative AI without requiring any specific expertise in FMs.

It is important that, as regulators look at the use of AI in financial services, they keep in mind that we are at the beginning of a journey through usage and customer benefits as well as responsible AI use. As such, making sure a principles-based approach that is adaptable to future developments is crucial in any measures that are implemented.

What are the main issues to address for preparing the implementation of DORA from a CSP perspective and are they being appropriately tackled in the work underway led by the ESA Joint Committee?

AWS is committed to working with the financial services community on the implementation of DORA, while enabling financial entities to increase agility and enhance their resilience and above all, to innovate. Technologies such as the cloud enable digital transformation and rapid innovation while improving the security and resiliency of financial firms. As financial entities continue to adopt these technologies, a harmonized, clear, and proportionate regulatory framework can help drive innovation, security, and resilience.

Our view is the DORA can support the digitalization of the EU financial system by delivering on these objectives. However, the regulatory approach set out in DORA is the first of its kind globally and it is important that regulators, financial entities and providers work together to ensure the EU financial services sector can continue to benefit from technological innovations. This is especially important in light of an increasingly complex cybersecurity landscape where threats continue to proliferate and new preventative measures are constantly being developed. The consultations that have been published so far are open and comprehensive on the approach - so it is good that we have the opportunity to share our views directly ahead of implementation.

Are further evolutions needed to adapt the EU regulatory framework (financial and digital regulation) and the current oversight approach to the digital world and notably to the increasing role played by cloud services in finance?

The first priority for the EU is implementing DORA appropriately as this will lay the foundations for the next steps of use of cloud services in finance. But in doing so, there should also be an awareness of how things fit with, for example, the forthcoming UK critical third parties (CTP) to the financial sector regime and the work of the Financial Stability Board (FSB) to deliver a toolkit on third-party risk management and outsourcing.

Any future developments to the regulatory and supervisory framework should consider the evolving technology landscape. Given the global nature of both finance and technology, coordination and interoperability across jurisdictions is critical in order to secure a consistent approach to risk management and avoid market fragmentation. The establishment of an internationally consistent and fair framework for the use of cloud services is something that supports the digital transformation of the sector globally. DORA is an important part of this. In addition, given the rapid level of technological innovation, we strongly believe that during implementation process policymakers should make sure that DORA is flexible enough to handle increasingly dynamic complexities in the financial and technology spaces.

TECHNOLOGY TRANSFORMATION AND POLICY IMPLICATIONS



PETRA HIELKEMA

Chairperson - European Insurance and Occupational Pensions Authority (EIOPA)

Harnessing the benefits and managing the risks of digitalisation in insurance

The digital transformation in the insurance and pensions sector cannot be ignored. It can have a positive impact on (re)insurers, consumers, as well as for supervisors. But it also brings new or increased risks. As supervisors, our job is to make sure that we can harness the benefits while managing the risks.

New actors, including InsurTech start-ups and BigTech companies, are already entering the insurance market, both as competitors and as cooperation partners. At the same time, insurers' reliance on third-party ICT providers and contractors has accelerated across the value chain. Access to new technologies and the emergence of new business models likewise appear to accelerate.

We are seeing an increase in automated distribution, that is the Application Programming Interfaces (APIs) used to distribute insurance products via platforms, embedded alongside other financial and non-financial services. Ecosystems grow more complex, yet they can provide seamless consumer experiences. This can change the extent and nature of conduct and prudential risks, while Decentralised Finance (DeFi) and Peer-to-Peer (P2P) insurance using digital platforms promise to raise new challenges around resilience, mutualisation, accountability and transparency.

On an important but more evolutionary level, innovative ICT solutions can allow undertakings to implement significantly more efficient processes, reduce operational costs, and open the door to new products and services that may have been uneconomical in the past.

However, the risk of ICT security incidents, including cyberattacks, is also greater due to increased use and complexity of technology. This can have a considerable impact on the operational functioning of undertakings. Moreover, dependency on larger ICT service providers could also lead to concentration and contagion risks.

Innovation is in constant state of evolution, led by a cycle of hype: The metaverse and Web3 were trending topics last year, raising questions on potential implications for insurance, for example, through cyber insurance coverage on intangible assets. This year new Large Language Models have taken centre stage. Here, impacts along the insurance and pensions value chains can be readily seen in areas including communications, marketing, advice, claims management, and

process automation. ChatGPT-like tools can also potentially be used to support the work of supervisory authorities.

There has also been an uptick in potential regulatory change. The AI Act aside, earlier this summer the European Commission published a legislative proposal on a Framework for Financial Data Access (FIDA), which aims to establish clear rights and obligations to enable customer-led data sharing beyond payment accounts, including in insurance and pensions. This may form the foundation for new data-driven financial and information products and services.

In this changing environment, supervisors must work harder to understand today's innovation and technology—both its impacts on new business models and consumers, and its potential benefits for supervisory processes.

EIOPA aims to support this supervisory work: for instance, by launching a public consultation on an insurance dashboard use case to bring technical considerations to the discussion on open insurance. We also support National Competent Authorities in scanning the innovation horizon. Through a Digitalisation Market Monitoring Survey, EIOPA is gathering input on insurers' digital transformation strategies to better understand how undertakings use or plan to use innovative business models (such as digital distribution and communication channels, as well as insurers' partnerships with start-ups and BigTechs) and technologies (for example blockchain and artificial intelligence).

Supervisory skills need to be enhanced to face challenges raised by digitalisation and understand new forms of risk. Cooperation is a great enabler of this, allowing not only the building of knowledge, but also the exchange of experience. Last year the European Commission, together with the European Supervisory Authorities and the Florence School of Banking and Finance, launched a new EU Supervisory Digital Finance Academy, aiming to share and grow knowledge and expertise on financial innovation. This is one step towards supporting a European supervisory community that is better able to adapt and respond to changes stemming from innovation.

EIOPA's key priority is to support the supervisory community and the industry to mitigate the risks and seize the opportunities of the digital transformation, including by further promoting a data-driven culture.



SARAH PRITCHARD

Executive Director, Markets and International -
Financial Conduct Authority (FCA)

The UK's regulatory approach to growing digitalisation of financial services

The digitalisation of financial services is changing the way consumers use services and make decisions, and how markets operate. At the FCA we are developing new regulatory frameworks, and supporting innovative solutions through our Regulatory and Digital Sandboxes, to enable the benefits from digitisation to be captured, while ensuring that harms and risks are addressed.

Rapid technological innovation and increased demand for immediately accessible, mobile and intuitive financial services has resulted in increased complexity and dependency on IT in financial services. Risk of operational disruption and potential harm to consumers and market integrity have consequently increased. This is why, as of March 2022, the UK introduced an operational resilience policy to enable the financial sector to better prevent, adapt, respond to, recover, and learn from operational disruptions.

Under this new regulatory framework, firms are responsible for identifying their important business services, setting impact tolerances for each of these, and then ensuring that they can operate within these by 2025. If disruption occurs, firms are expected to communicate clearly, for example providing customers with advice about alternative means of accessing the service and providing timely notification to their regulators.

With so many financial services having become reliant upon certain Critical Third Parties (CTPs) to deliver their services for example - as of 2020, nearly two thirds of UK firms used the same few cloud service providers - we must be clear where responsibility lies when things go wrong. Responsibility remains with the firms who use third party services and it is our expectation that those firms identify and mitigate the associated risks. But to further strengthen the regulatory framework, the FCA, alongside the Bank of England and the Prudential Regulation Authority, has recently been given new powers, under the Financial Services and Markets Act 2023, to regulate CTPs to set standards for their services to the UK financial sector.

The use of Artificial Intelligence (AI) and Machine Learning within the UK financial services sector has also grown rapidly in recent years. A 2022 FCA survey conducted jointly with the Bank of England suggests that the trend is expected to more than triple in the next three years. AI in financial services can bring many potential benefits to consumers. For example, the ability to use Generative AI and synthetic data helps to improve financial models and cut crime, and the ability to personalise products and services to people may help financial services to better meet consumer needs.

As a data-led regulator, the FCA is training its staff to make sure they can maximise the benefits from AI. We established

one of the first emerging technology research hubs to monitor trends, have invested in synthetic data capabilities, and have established a Digital Sandbox, the first of its kind used by any global regulator, using real transaction, social media, and other synthetic data to support Fintech and other innovations to develop safely. This is an increasingly important area of research for the FCA. Our Synthetic Data Feedback Statement highlighted industry perspectives and the significant challenges of accessing and sharing data - particularly for smaller firms. However, there is a real potential for synthetic data to help combat fraud and money laundering.

The FCA has also set up the Synthetic Data Expert Group to explore these issues in more detail with stakeholders across industry and academia. Internally, the FCA has also developed its supervision technology using AI for firm segmentation, monitoring of portfolios and to identify risky behaviours.

We cannot tackle the risks and opportunities of innovations and AI as a regulator in isolation.

However, we cannot tackle the risks and opportunities of innovations and AI as a regulator in isolation. It is vital that we have a globally co-ordinated approach. The FCA plays an influential role internationally both bilaterally and within global standard setting bodies. The FCA is a founding member and convenor of the Global Financial Innovation Network and we are also one of four regulators that form the UK Digital Regulation Cooperation Forum, pooling insight and experience on issues such as AI and algorithmic processing. Through this joint work we are collaborating on identifying and understanding how quantum technologies could impact digital markets and consumers. Separately, we are also hosting the global techsprint on the identification of Greenwashing in our Digital Sandbox, and we will be extending this global techsprint approach to include AI risks and innovation opportunities.



MICHAEL WEST

President - Moody's Investors Service

As technology reshapes the credit risk landscape, new policy challenges arise

Rapidly evolving technologies such as artificial intelligence (AI) and distributed ledger technology (DLT) are poised to transform finance as we know it today. These technologies have the potential to bring advantages through increased process efficiency, new products, and economies of scale, but they also bring new policy challenges and risks.

The impact on the credit risk landscape will be determined by the way the costs of and benefits of these technologies are distributed, as well as the speed, direction, and magnitude of change. These trends, in turn, depend on the actions and interactions of consumers, workers, businesses and governments. Below, we outline four key considerations as change unfolds:

Addressing market concentration risks

Innovation can lead to a rapid transformation of entire sectors, potentially changing the rank ordering of companies' credit risk profiles within each sector. For instance, new entrants can dislodge established players if they lack the strategic vision, execution capacity or financial flexibility to invest in new technologies. Over time, depending on competitive dynamics, a few firms could capture a substantial share of the value that new technologies create.

Unchecked, such market concentration could have negative macroeconomic and social consequences, and ultimately thwart the very innovation that created it. Effective regulation, however, can ensure that market concentration risks are avoided.

Keeping 'negative externalities' from digitalization in check

As AI and DLT help businesses and economies reap efficiency advantages, they may also generate negative externalities, such as increased cyber security risks, data privacy concerns, entrenchment of historical bias patterns and the introduction of errors.

Existing regulations may be adequate to keep a check on the extent to which new technologies exacerbate pre-existing risks. But new risks will be introduced, particularly by AI, requiring enhanced governance at the corporate level to limit social, reputational, and legal risks as well as greater vigilance and additional measures from policymakers to ensure that technological progress serves the public good.

Using technologies to tackle public policy challenges and yield 'positive externalities'

Governments too leverage technology in pursuit of public policy aims. Both AI and DLT can offer governments the means

to increase efficiency in the delivery of social services and to expand financial access and inclusion, all of which would likely be positive for sovereign credit profiles.

As an example, new digital assets, including Central Bank Digital Currencies (CBDCs), could foster greater financial inclusion by reducing transaction costs and widening access to financial services. However, digitalization also brings associated privacy and financial stability risks. Here again, policy actions could achieve an inclusive distribution of the benefits of technology that also minimizes unintended negative consequences.

Harnessing economic gains while limiting societal disruption

AI and DLT could undertake tasks ranging from customer service to custodial transaction recording, offering time and cost savings. But some of these gains may be achieved by displacing human labor. On the one hand, this could partly offset the demographic headwinds of aging populations in many countries that will reduce labor supply. On the other hand, the potential for a significant increase in redundant workers or deceleration in incomes poses social risks and policy challenges. For instance, threats to workers from AI have been cited in recent labor strikes by screenwriters and actors in the US.

Additionally, during any technology transformation process there is likely to be a mismatch between the labor skill sets that are required to take advantage of new technologies and those that are available. The wider the gap and the longer it persists, the greater the risk that full productivity gains from

As technology reshapes the credit risk landscape, new policy challenges arise.

technology will not be harnessed and that social risks will escalate. Closing this gap will require retraining workers and equipping those entering the workforce with the skills to succeed in the new economy.

In conclusion, in harboring both benefits and risks, AI and DLT are similar to transformative technologies before them. A clear, shared understanding of new technologies' risks and benefits can help us better manage them.



CHRISTIAN EDELMANN

Managing Partner Europe - Oliver Wyman (UK)

AI can transform finance - if firms clear three hurdles

When ChatGPT launched last November, generative AI quickly became of huge public interest. Already, 62% of people across nine nations say they have experimented with generative AI tools in the last three months, according to survey data from the Oliver Wyman Forum.

The excitement is warranted. Generative AI holds the potential to help financial services firms re-imagine their entire businesses around the needs and desires of their customers.

There are at least four areas where generative AI can help firms dramatically improve their operations. In customer service, conversational AI assistants can understand and speak natural language, allowing firms to create customized mass outreach to customers. In marketing and communications, AI can design visual product and brand content for logos and packaging, create website layouts, and write blog posts, articles and social media posts. In tech and IT, AI can help with code generation, reducing the time and resources need for software development, and create synthetic data to train machine learning models or test applications. And in terms of personal productivity, generative AI can create automated notes and summaries of meetings, help people manage priorities and tasks, and assist with scheduling.

But first, firms must clear three short-term hurdles that make it difficult to embed the technology today.

First, generative AI poses unique risks that traditional AI systems don't have to contend with. One is defamation: programs inadvertently producing defamatory content. Another is hallucinations and opaque logic and processing. Generative AI also creates confidentiality concerns such as data leakage and copyright issues. To address these, financial institutions need to beef up their governance, data quality, talent functions and other dimensions.

The second hurdle: regulators. The potential perils of AI span the enterprise, including operations, technology, legal, compliance, process, data, technology and reputational risks. Banks need an enterprise-wide framework to holistically manage these risks. Government bodies have offered guidelines on best practices in the US, the EU, the UK and Hong Kong. When these guidelines turn into hard rules, we estimate fines for lack of governance could approach 6% of the industry's global revenue.

Another hurdle is the technology itself. Today's models lack desires and self-directed learning. They have extensive knowledge of the world, but don't "know what they know," and lack any sense of truth. As for reasoning, models' abilities remain brittle and likely to fail unexpectedly, especially when asked to apply logic and knowledge in new contexts. And they

don't yet offer predictability, with unwanted outputs creeping into models frequently.

As a result, significant productivity improvements from generative AI will take time. Learning curves are steep, there is still insufficient scale of adoption, and model tweaks and redesigns have been slow. Firms must navigate a collision course: In one direction, ongoing advancements are likely to drive more widespread use as tools become integrated into our daily lives, much like the iPhone. In the other direction, regulatory bans could lead to unsupervised and unsafe AI tool usage, and the potential for employee misuse needs to be managed.

Past technologies have overcome such obstacles. It took e-commerce 20 years to reach 10% of retail sales. The personal computer took 10 years to get to 42% usage across US households. Electrification took 40 years to deliver measurable productivity gains across the UK. There is good reason to believe generative AI one day will be ubiquitous in the financial services sector and throughout society.

How to get there?

In the short term, firms should encourage safe engagement through training and limiting access to safe use cases. Over the longer term, companies will be able to target AI capabilities toward key business pain points, invest in technical training and tailored upskilling to improve usage. Eventually generative AI will drive large-scale organizational transformation, helping companies understand inter-department workflows to integrate technologies across the enterprise and adjust people and processes as needed.

Generative AI holds potential to help financial services firms re-imagine their entire businesses.

The ultimate possibilities lie in AI's ability to help institutions reorganize entire business units based on the wants and needs of their customers. There is little doubt that customer-first platforms, powered by AI and offering rich, flexible user experiences, are the industry's future. The race is on to get there first.

This contribution has been co-written by Sian Townson, David Waller and John Lester.



PHILIPPE LAURENSY

Managing Director, Head of Strategy, Innovation,
Product Developments and M&A - Euroclear S.A.

New technologies in finance: driving towards the unknown with known objectives

Since its creation 55 years ago, Euroclear has always been supportive of the development of new technologies that could make the financial market safer and more efficient. Each time there has been a major technological change, Euroclear has been embracing it and adapted to the new reality. Should it be with the internet revolution, the digitalisation of paper-based securities or the emergence of cloud, Euroclear seized these opportunities for the benefit of the EU securities market. The transactions are today faster, cheaper and safer than they have ever been and those innovations allowed the emergence of new venues, business models and opportunities.

The advent of AI, DLT and other new technologies will be no exception. Euroclear, like many market players, is actively investigating, testing and using those new technologies. For example, we have been experimenting AI for some time to predict settlement fails and facilitate the handling of client queries. When it comes to DLT, after having lead many experiments and studies over the last years, we are about to launch in production our D-FMI with digital securities issuance services (D-SI). This will mark a first major step in Euroclear's transition to a tokenized environment. It is however fair to say that it is still relatively early days and many roadblocks will have to be crossed before they can achieve major scale and have a real impact in the EU securities market.

In the meantime, there is not one technological innovation that will not be investigated and tested by the market to achieve more efficiency, transparency, speed and cost reduction. Taken individually, each of those new technology shows disruptive power. When combined the developments that can come from DLT, CBDCs, Web3, generative AI and Open finance, have an even greater transformation potential.

While our traditional securities market structure and the existing value chain could be disrupted in several ways, any major evolution will have to aim for ultimately benefitting the issuers, the investors and the industry as a whole. To make sure this reshaping brings more benefits than drawbacks, it will be critical for market authorities to carefully follow and guide this transformation. EU regulators will have a crucial role to play by setting the fundamental objectives Their legislative decisions targeting news technologies should follow two main drivers: (i) bring benefits to the EU and its CMU (ii) do not compromise on the safety and stability of the financial system. The EU will achieve its ambitious targets only if it successfully manages to combine these two elements.

While EU authorities already submitted and voted several ambitious legislations to frame this transition, many more legislative actions will need to be taken over the next decade. In doing so, several aspects will need to be looked at:

First, regulatory and supervisory authorities will need monitor and analyse the evolving market dynamics and risks associated with these technologies. Legislative changes can be made only after having performed an in-depth impact analysis of these transformative technologies. Regulating too fast can either stifle innovation by imposing inappropriate (and costly) requirements or bring undue risks in the regulated financial markets.

Second, given the global nature of securities markets, there is a need for international cooperation and harmonization of regulations to avoid regulatory arbitrage, ensure a level playing field and facilitate interoperability.

Third, ensuring investor protection, market integrity and financial stability must remain a paramount objective. Regulators must ensure that the high standards achieved over the last decades are not weakened with the advent of new technologies.

And finally, regulatory authorities should not forget that if the market transformation triggered by new technologies is done without the end-purpose of benefiting the EU capital market as a whole, it could end up reversing many progresses made over the last decades in terms of market fragmentation, competitive dynamics and financial stability risks.

**It will be critical for market authorities
to carefully follow and guide this
transformation.**

New technologies will transform the EU capital market, the way it will change remains however uncertain. All we know is that it must lead to an improvement of the current structure and processes. Nobody wants a step backwards or even a status quo in the sense of Prince of Lampedusa's famous quotation "*Everything must change for everything to remain the same*". This enhancement objective will only be reached by having market innovators and legislators supporting each other in their endeavours. New technologies will only truly blossom with the combination of these two forces.



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MARKUS FERBER

MEP, Committee on Economic
and Monetary Affairs -
European Parliament

Harnessing the power of artificial intelligence for financial services

If there has been one megatrend in 2023, it is certainly the rise of artificial intelligence. The emergence of artificial intelligence chatbots such as ChatGPT or Bard has shown many people how powerful artificial intelligence software can be for certain applications. However, they have also shown how flawed such technology can be and it has also become apparent how problematic such tools can be in the hands of malicious actors. In that sense, the public debate we are having these days about how to deal with AI is a healthy and important one.

As with every newly emergent technologies, there are risks, but also chances involved. In order to avoid the risks, but to harness the chances, it will be key to get the regulatory framework right. The European Union intends to take the leadership

on that issue with the first regulation on artificial intelligence, the AI Act, for which the European Parliament passed its negotiation position only a few weeks ago. The key idea is to go for a risk-based approach and tailor the regulatory requirements to the risks inherent to the technology involved. While this sounds good in principle, it is a somewhat problematic approach for a nascent technology.

Given that many of the chances and risks related to artificial intelligence are not immediately clear at this early stage in the life the technology, there are natural limitations based on a simple categorisation of applications into "high risk" or "low risk". We should in any case be very careful not to close the door on any technology or application purpose that might come with both chances and drawbacks too early. Otherwise, we can never be sure what kind of innovation we will prevent from happening.

For precisely that reason, a principles-based and not overly restrictive approach towards regulating AI is warranted, particularly when it comes to financial services. After all, dealing with the digitalisation of finance is nothing new per se. Financial markets have learned how to harness the power of big data and regulators have learnt how to reign in algorithmic trading - most notably through the framework in the revised Markets in Financial Instruments Directive (MiFID II). In that sense, EU financial services legislation seems well equipped to handle the challenges of AI and will only get better once the pending proposals on the Digital Finance framework are adopted and eventually implemented.

In the financial services sector, there are some obvious applications for artificial intelligence in terms of data processing, modelling, fraud prevention, improvements and standardisation of customer interactions and process automation. We should be careful not to deprive European financial services firms of such opportunities by applying an overly restrictive regulatory frame. Other jurisdictions are certain to make the most of the powers of artificial intelligence and we should be careful not to create any unnecessary competitive disadvantages for European players that are active in international markets and are already facing tough competition anyway.

At the same time, it will be key that if new rules dealing with AI aspects are introduced at any time, this is done on a European level. After all, the most disadvantageous scenario would be a plethora of 27 competing national rules that would make cross-border business even more difficult. In that sense, the AI act is a useful development as it comes early in the life of the technology, but firmly establishes the supremacy of European law in that space. That means, however, that getting the details right, matters.

**A principles-based and
not overly restrictive
approach towards
regulating AI is
warranted.**

Artificial intelligence will cause disruptions in certain markets and the precise impact is still difficult to assess at the early stage we are in. However, there is reason to be optimistic about artificial intelligence given the productivity gains that will come along with this technology. While the doomsayers already predict the end of life as we know it, history tells us that even the most disruptive innovations end up to be a net positive over the medium to long term.

Had mankind not embraced innovation every time it came along, our most sophisticated tools would still be sticks and stones. Therefore, there is no reason to fear innovation and change and there is no reason to fear AI.



BARBARA NAVARRO

Head of Research and Public Policy - Banco Santander

Exponential technologies and the future of the financial sector

Banks are natural born innovators. From Middle Ages to nowadays we have been trailblazing the avenues of technologies. Historically banks have built solutions leveraging on new technologies to anticipate consumer habits and facilitate progress. Contributing to prosperity of communities and society has been at the front and center of our strategy through decades. This can only be done embracing technology.

The quest for seeking value and delivering it to shareholders have pushed banking top management teams to explore the so-called digital transformation. Exponential technologies have already become a must for banks to compete and have already transformed the way we do banking. The financial industry is leading this digital transformation.

- Technology has opened the way to rethink how traditional businesses work. The development of tokenised securities is one example that shows how markets can be transformed by technology. We have already issued native digital bonds which show that DLTs and smart contracts can drive efficiency gains by automation and disintermediation of this markets,

enabling for example more inclusive access of retail investors and providing new financing alternatives to SMEs.

- But we don't need to look so far to feel the change. The payments business is probably the one that has more profoundly changed in the last years. Payment have become instant, contact-less, fully integrated into our digital lives. P2P payments are becoming part of our daily lives. Solutions such as Bizum in Spain are used today by more than half of the Spanish population to make P2P payments every day. And we want to go further by exploring how tokenized deposits could enhance programmability and provide solutions to new payment needs in the economy (M2M, IoT...).
- Technology is enabling also to improve our risk manage capabilities. Thanks to AI we can anticipate better customer needs and help them meet their financial commitments. We are strengthening our AML and cyber security models by identifying new malicious patterns. And at the same time, we can offer new services to our clients, for example to manage their investment portfolios through robo advisors, that until now were available only to high-net-worth clients. And together with technologies such as GPT language models we are exploring new ways to improve efficiency in our operations while reducing our operational risk.
- Finally, technology has also transformed the way we operate. We are migrating our core banking to the cloud, with 80% of our IT infrastructure already on the cloud. This transformation will allow the bank to be more agile developing new services, to access easier and faster to our transactional data, and to be more efficient reducing at the same time IT infrastructure energy consumption by 70%. Cloud has become key to meet the needs of the business in an efficient and flexible way, as well as to be able to scale our services globally.

As this transformation is accelerating, European authorities are in the process of developing and implementing the new regulations that will shape this digital transformation. DORA, MiCA and the DMA have been positive steps forward that now need to be further developed in second-law regulations. New regulations being discussed such as the AI act and the data act or the recently proposed FIDA in the financial sector, will set the framework for the future development of the data economy, and the development of the European industry in strategic technologies such as AI or cloud. Europe is also in the process of developing a European digital

identity and *e Digital Euro*, that will provide citizens with public solutions to manage their identity and to pay with public money.

Public-private collaboration is key to ensure that regulation enables the digital transformation.

We are at a decisive moment that will define the role of Europe and of our companies in the future digital world. In this context, it becomes more important than ever to work together, public and private sector, and across sectors, to ensure that regulation and policy action becomes an enabler for this digital transformation, increasing competitiveness and creating new opportunities for economic growth, while building on our European values. The pace of innovation requires this close collaboration to understand opportunities and risk, to identify and fill potential regulatory gaps and solve as well, existing barriers for the successful adoption of these technologies.

At the same time, digital is global. And therefore, global alignment on regulating this digital transformation is also key to enable companies to innovate at scale and on equal foot across-regions.



KSENIA DUXFIELD- KARYAKINA

Head of Government
Affairs and Public Policy,
Regulated Industries -
Google Cloud, Europe

AI in financial services - Enabling responsible service innovation

Cloud-enabled artificial intelligence and machine learning can significantly improve services and processes in the financial sector by driving innovation through the automation of tasks, accelerating decision-making, and personalizing customer experiences. Google is a pioneer in AI, and has been investing in the technology for many years. We have made significant open source contributions, and - in line with our Bold and Responsible AI commitments - we continue to evolve our long-standing AI governance processes to ensure we remain global leaders in delivering responsible products to the market.

AI can become a major driver of competitiveness for the EU financial services firms. The technology can help firms accelerate growth and revenue, improve operational efficiency, and manage risks. Remarkably, it can solve data challenges that traditional solutions cannot. For example, Enterprise AI can be used to automate data capture at scale,

which can help firms - and governments - improve their efficiency and accuracy. The Google Cloud Generative AI App Builder allows developers to quickly ship new experiences including bots, chat interfaces, custom search engines, and digital assistants. Vertex AI builds, deploys, and scales ML models fast, and with fully managed ML tools for use cases. These solutions can help firms of all sizes adopt AI and reap the benefits of this technology.

One prominent example of AI application at scale is improving regulatory reporting, including anti-money laundering processes. In turn, we need to look at risk management considerations. Google Cloud published a white paper, written in partnership with the Alliance for Innovative Regulation (AIR), which addresses the question whether existing Model Risk Management guidance continues to be relevant for AI/ML models. While this thought leadership aims to foster dialogue, use cases show concrete advantages. Earlier this year HSBC revealed how Google Cloud's AML AI has helped them advance anti-money laundering efforts and improve transaction monitoring: the bank has been able to achieve nearly 2-4 times more confirmed suspicious activities and eliminate 60% of false positives. This is just one example of AI's added value in financial services. Others include BNY Mellon's use of AI to predict settlement failures or Commerzbank's ML application to enhance the customer experience.

AI can become a major driver of competitiveness for the EU financial services firms.

In order to reap the competitive benefits of AI, firms need to address a number of challenges. These include ensuring data quality and standardization, and transforming legacy IT infrastructure. The public debate of generative AI raises questions on how to apply this technology in a responsible and risk-controlled manner. It will augment existing technology as well as create new opportunities for enterprises in delivery of services (customer service, manufacturing, research, product development). It is important for customers to ask if generative AI is actually suitable for their use case. Today, we see use cases for personalized financial recommendations, capital markets research, enhanced virtual assistants, document search and

synthesis, and translations of changes in regulatory / business requirements into code.

The financial services industry has long been a leader in risk management. The incoming regulatory framework for AI, such as the EU AI Act, will be a decisive factor for adoption of AI innovation to the benefit of consumers and financial institutions. Google supports the development of a responsible AI framework that encourages innovation while protecting consumers.

Our CEO Sundar Pichai is very clear: "AI is too important not to regulate, and too important not to regulate well." This requires a technology-neutral, proportionate, and flexible framework. And legal requirements should not act as barriers to the adoption of general-purpose or generative AI solutions by financial institutions. The AI Act should therefore focus on high-risk applications only. Potential benefits and harms are best managed by experts in financial services. National financial services regulators are best placed to assess matters related to AI in their industry. Importantly, many existing rules and standards in financial services already apply to artificial intelligence. The AI Act should complement where needed without increasing uncertainty.

As generative AI technology continues to develop, it is likely that we will see even more innovative and creative applications for this technology in the years to come. Getting the regulatory framework right, Europe has a chance to distinguish itself as a leader in digital innovation.



TSVETELINA PENKOVA

MEP - Committee on Industry,
Research and Energy,
European Parliament

The transformative impacts of AI and new technologies in finance

In recent years, the financial landscape has been undergoing a seismic shift driven by rapid advancements in technology. The convergence of artificial intelligence (AI), cloud computing, distributed ledger technology (DLT), and central bank digital currencies (CBDCs) is reshaping the way financial services are delivered, accessed, and regulated. These innovations have the potential to revolutionize competitiveness, bolster resilience, and transform the regulatory landscape. However, with the rewards come potential risks, prompting a critical evaluation of existing frameworks and policies.

The integration of AI, cloud computing, DLT, and CBDCs into financial systems promises profound impacts on competitiveness and resilience. AI enables institutions to process and analyze vast volumes of data with unprecedented speed and accuracy, thus enhancing decision-making and risk management. This technology enables the creation of more sophisticated algorithms for portfolio optimization, fraud detection, and credit scoring,

ultimately leading to improved financial services and products.

Cloud computing, on the other hand, offers agility and scalability to financial institutions. It allows them to streamline operations, reduce costs, and access computational power on demand. This flexibility is particularly valuable in times of crisis, enabling institutions to adapt swiftly to changing market conditions and maintain business continuity.

DLT, commonly known as blockchain, has the potential to transform the way financial transactions are recorded and verified. Its distributed and immutable nature can mitigate risks associated with fraud and enhance transparency. In trade finance, for instance, DLT can streamline cross-border transactions, reducing the time and costs involved.

CBDCs introduce a novel form of digital currency issued by central banks. They can improve payment efficiency, reduce settlement times, and enable financial inclusion. Additionally, CBDCs can serve as a resilient alternative to traditional payment systems, ensuring access to funds even during disruptions. The interconnectedness of financial systems, coupled with the reliance on digital infrastructure, makes them susceptible to cyberattacks. Data breaches, unauthorized access, and system failures could have catastrophic consequences. Moreover, the use of AI in decision-making processes poses ethical challenges, such as bias in algorithmic decisions and lack of accountability.

The decentralized nature of DLT, while enhancing transparency, also presents regulatory challenges. The cross-border nature of many DLT applications necessitates international cooperation and consistent regulatory frameworks to address issues like jurisdiction and legal enforceability.

**Collaboration between
regulators, financial
institutions, and
technology providers is
crucial.**

CBDCs introduce both opportunities and risks. While they can enhance payment systems, the widespread adoption of CBDCs could potentially lead to bank disintermediation, impacting monetary policy transmission. Additionally, privacy concerns arise as central banks gain access to granular transaction data.

Existing financial regulatory and oversight frameworks, as well as digital policies, are facing the challenge of adapting to the fast-paced evolution of technology. The Digital Finance Package, horizontal data policies, and AI frameworks introduced by various jurisdictions aim to strike a balance between innovation and risk mitigation. These frameworks often focus on consumer protection, data privacy, and market integrity.

However, the dynamic nature of technology requires ongoing reassessment of these frameworks. Regulators must collaborate with industry stakeholders to develop agile regulations that foster innovation while addressing emerging risks. International coordination is vital, given the borderless nature of many technological applications.

To ensure that the benefits of digitalization outweigh potential risks, a multi-pronged approach is necessary. Strengthening cybersecurity measures, promoting responsible AI development, and enhancing data privacy protection are essential steps. Institutions should also prioritize robust contingency plans to ensure operational resilience in the face of cyber threats or system failures.

Collaboration between regulators, financial institutions, and technology providers is crucial. Regular dialogues can foster a deeper understanding of technological implications and enable the development of responsive regulatory frameworks. International standard-setting bodies play a pivotal role in harmonizing regulations across jurisdictions.

CRYPTOASSET AND STABLECOIN REGULATION



MARTIN MOLONEY

Secretary General -
International Organization of
Securities Commissions (IOSCO)

Crypto-Assets: delivering investor protection and market integrity outcomes

As I wrote back in April, the argument to leave crypto outside the regulatory net to facilitate innovation is exhausted. Since then, regulators globally have made impressive progress to capture crypto-asset activities within our net.

At IOSCO, in late May, we consulted on policy recommendations to address the proximate investor protection and market integrity risks in crypto-asset markets. Application of existing IOSCO Standards, bolstered by these recommendations, will facilitate effective supervision, enforcement and international cooperation in respect of entities who engage in activities relating to crypto-assets ("Crypto-Asset Service Providers / CASPs") with the goal of promoting regulatory compliance.

While the full suite of Recommendations are essential to the delivery of effective

regulatory outcomes in crypto-asset markets, let me pinpoint two elements, conflicts of interest and custody.

CASPs engage in multiple activities under one roof through a single legal entity or a closely affiliated group of legal entities in a wider group structure, often structured in an intentionally non-transparent way to obfuscate the legal entity that the investor is transacting with.

The significant conflicts of interest must be identified and mitigated, and may necessitate separate licenses as seen in traditional financial markets. In some cases, the conflicts may be unmanageable and therefore legal and functional disaggregation may be necessary.

Safeguarding client assets is at the heart of investor protection. Key custody risks relate to asset segregation, re-use of assets, liability and ownership considerations. CASPs have evidenced a clear inability to effectively safekeep client assets, starting with Mt. Gox in 2014 through to the multiple instances of misappropriation and loss of client assets in recent years.

Regulators around the world need to work in a coordinated manner to stamp out regulatory arbitrage.

Tackling custody-related risks in crypto-asset markets is informed by traditional financial markets. Risk mitigation measures including recordkeeping and reconciliation requirements; separation of client assets from proprietary assets and fundamental disclosures to help investors understand the risks they are exposed to by allowing CASPs to safekeep their assets.

Turning to financial stability risks, thankfully interconnectedness and transmission channels from crypto-asset markets into the real economy are limited at present.

The FSB published their two sets of High-Level Recommendations in July. Given the high-level nature of the FSB Recommendations and the prevalence of non-FSB member jurisdictions with material crypto-asset activities, policy measures from IOSCO are critical in ensuring the regulatory net captures bad actors across the globe, while setting out more granular

regulatory expectations for regulatory authorities and market participants alike.

The IOSCO measures acknowledge that jurisdictions are at different stages in tackling crypto-assets. Some jurisdictions have existing regimes which capture crypto-assets and the corresponding activities. Other jurisdictions have sought to develop new, bespoke frameworks to remove any supposed lack of regulatory clarity.

Look no further than MiCA in the EU. The co-legislators' measures are aligned with the IOSCO Recommendations as they seek to introduce guardrails for CASPs to bring much-needed investor protection and market integrity.

One of the greatest challenges we have as regulators is to achieve the right level of global cooperation to ensure that borders are not abused, particularly with inherently cross-border crypto-assets. Given the global nature of crypto-assets, regulators around the world need to work in a coordinated manner to stamp out regulatory arbitrage. Unfortunately, an EU framework alone will not solve the crypto-asset conundrum.

IOSCO's wide membership, over 130 countries who together regulate more than 95% of securities markets, uniquely positions us to deliver regulatory outcomes in the coordinated, global manner needed.

The IOSCO Recommendations on Crypto-Assets and on DeFi will be finalised by the end of this year. Attention then turns to adoption and implementation. IOSCO has a long standing record of implementation monitoring but jurisdictions must first be given time to adopt the Recommendations and build them into their regulatory frameworks. For some jurisdictions it will be a challenge to meet these standards and it is reasonable for them to take some time to put all the elements in place. Having said that, I am very confident that we will get full take-up across our global membership in the next couple of years which will fundamentally change the way crypto-assets are regulated with consistent outcomes achieved across jurisdictions.

The development of an effective regulatory framework is not solely the task of regulators but rather a joint effort with all crypto-asset market participants. This provides CASPs and other participants with the opportunity to restore some credibility by bringing activities into compliance with accepted global standards.



JOSE MANUEL CAMPA

Chairperson - European
Banking Authority (EBA)

Regulating crypto-assets: advancing sound practices

In the year to-date, the crypto-asset market has been characterised by pockets of market turmoil, yet sustained retail and institutional interest in tokenisation, and use-case proliferation. This year can be seen as a tipping point in terms of regulation, with significant progress towards consistent and effective standards at the EU and international level to regulate not only so-called stablecoin issuance, but also the wider crypto-asset ecosystem.

In the EU, the Markets in Crypto-assets Regulation (MiCAR) entered into force on 29 June, starting the clock on an intensive phase of work as industry and supervisors prepare for application (in the case of asset-referenced token (ART) and electronic money token (EMT) issuance, from 30 June 2024, and for crypto-asset service provision, 6 months thereafter).

To facilitate convergence in the transition to the application of MiCAR to ARTs and EMTs, the European Banking Authority (EBA) has published a statement addressed to issuers, and to national supervisory authorities, with the objectives of reducing the risks of potentially disruptive and sharp business model adjustments at a later stage, fostering supervisory

convergence, and facilitating the protection of consumers. The statement includes 'guiding principles' to which issuers are encouraged to have regard until the application date, encompassing topics such as disclosures to, and fair treatment of, potential acquirers and holders of ARTs and EMTs, and sound governance, including effective risk management.

Under the MiCAR, the EBA is responsible for ART and EMT 'level 2' and 'level 3' work (i.e. technical standards and guidelines) and has published a first set of consultation papers covering the information to be included in applications for authorisation to issue ARTs, qualifying holdings, and complaints handling. The majority of the EBA's consultation papers will be published in autumn 2023, including on important mandates relating to governance, own funds, and reserve assets. The EBA strongly encourages industry feedback.

**2023: a tipping point
with major strides
towards unified,
effective standards in
the EU and globally.**

Additionally, the EBA is accelerating its own preparatory steps for the supervision of significant ARTs and EMTs under MiCAR, as well as promoting dialogue between supervisors on market developments and supervisory experience to-date. Focus areas include consumer protection and money laundering risks - another area in which consultations can be expected before year-end on mandates under the Funds Transfer Regulation as extended to crypto-assets.

Looking beyond Europe, the EBA continues to engage actively in the crucial work at the international level to promote regulatory convergence and mitigate risks of forum shopping - both necessary elements if we are to see truly global robust and resilient crypto-asset markets.

The Financial Stability Board (FSB) published last July recommendations to promote the comprehensiveness of regulatory approaches to crypto-assets.⁴ These recommendations take account of the lessons learned from recent crypto-asset market developments, and include enhancements regarding the regulation and supervision of 'global stablecoin' arrangements, and new recommendations for crypto-asset activities and markets. These additional measures to mitigate risks of conflicts of interest within the

sector and, importantly, to strengthen cross-border supervision are much welcomed. The EBA will be paying close attention to these recommendations as we further develop the framework for supervisory colleges for all significant ARTs and EMTs under MiCAR.

Additionally, the Basel Committee on Banking Supervision (BCBS) continues to assess bank-related developments in crypto-asset markets, including the role of banks as stablecoin issuers and custodians of crypto-assets, and broader potential channels of interconnections within the crypto-asset ecosystem. It will also monitor the implementation of its December 2022 prudential treatment of banks' crypto-asset exposures, carrying out reviews as appropriate. This is crucial work to ensure that we have not only aligned regulatory standards, but also aligned implementation, on the classification of crypto-assets for prudential purposes.

In light of the ongoing developments at international level and acknowledging the importance of fully implementing the Basel standards on banks' exposures to crypto-assets in the EU, the recently agreed CRR/CRD package will include a transitional prudential treatment for crypto-assets taking into account the strict legal requirements introduced in MiCAR and specifying amongst others the capital treatment of EMTs and ARTs.

Overall, regulatory progress is strong, but much work lies ahead as industry and supervisors work to embed the new frameworks - work that depends on continued sound collaboration and coordination between industry and supervisors and among supervisors and I look forward to our discussions at EUROFI.



JÉRÔME REBOUL

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MiCA and next steps: the way forward for addressing crypto risks in the EU

Introduction

Recent events such as the fall of FTX have highlighted the need to address the risks of crypto-asset activities aimed at retail consumers and have developed in a global cross-border manner.

From its entry into application in 2025, the EU's MiCA regulation will regulate the issuance and offering of crypto-assets to the public across EU jurisdictions and the admission for such crypto-assets to trading on crypto-asset platforms operating within the EU, and will seek to address the risks that this new asset class poses to consumers.

The entry into force of MiCA will address the main risks stemming from crypto

MiCA intends to provide one of the first comprehensive frameworks for crypto-asset activities across the EU. It places a number of obligations across different types of crypto-asset service providers (CASPs), including crypto

asset trading platforms, custodians, and on offerors or issuers of crypto-assets, including stablecoins.

Concerning AML-CFT risks, MiCA points to the requirements of the EU's AML Directive, which CASPs and stablecoins issuers will have to comply with. In particular, the text addresses the risks through the angle of governance and fitness and propriety of individuals and shareholders.

Alongside these obligations, MiCA sets forth prudential, organisational, and conduct of business requirements. MiCA also implements rules for the safekeeping of client asset and the prevention of market abuse. In particular, CASPs will be required to hold regulatory capital, make a certain number of disclosures, and address conflict of interests, including in the context of the wider group they belong to.

With these requirements, MiCA intends to address the risks and issues posed by the lack of information that users of crypto-assets might face, the risks related to governance and overall robustness of service providers, and the specific risks of market abuse linked to the trading of crypto assets.

MiCA will also specifically address the risks pertaining to the issuance and use of stablecoins, subjecting their issuers to stricter requirements, including around the maintenance and funding of reserves, redemption obligations, and specific governance requirements.

Level 2 requirements will need to clarify a few topics

Following the publication of the level 1 text in June 2023, a number of areas remain to be clarified via the upcoming level 2 publications, with ESMA and the EBA intending to publish several consultation packages in several stages up until Q1 2024¹.

These areas in particular include the form and content of notifications and applications by regulated firms intending to provide crypto services and by CASPs and the governance requirements applicable to them, transparency obligations especially applicable to platforms, requirements applying to issuers of stablecoins (including own funds and liquidity management), and market integrity requirements.

The key priority for the coming months and years should be supporting a smooth and fast implementation of MiCA

MiCA excludes certain areas from its scope such as non-fungible tokens (NFTs) or DeFi activities, where

these are entirely decentralised or disintermediated. Some issues are also left unaddressed by MiCA: for instance, there exists a number of issues with large global crypto players that would certainly deserve further thoughts.

However, the top priority for regulators should be to support a swift implementation of MiCA provisions. Relatedly, supervisory cooperation both within the EU and with third countries is needed to give supervision its full force over global players.

What are the potential impacts in terms of risks and financial stability of the greater role that institutional investors are expected to play in cryptoasset activities and are these appropriately addressed by existing regulations?

Despite the recent uncertainty and volatility in crypto-asset markets, there has been an increased interest from participants in these². Participation from institutional players could make the impact of a problem in the crypto world much larger as interconnection with the global financial system will grow.

MiCA intends to provide the first comprehensive frameworks for crypto-asset activities within the EU.

Institutional investors also need other forms of crypto assets that support different use cases such as stablecoins, which tend to be among some of the most used assets on crypto-asset platforms.

For regulators this comes with greater responsibility, but this is also an opportunity as traditional financial players will only add to the pressure in the crypto industry to move towards a fully regulated world.

1. <https://www.esma.europa.eu/esmas-activities/digital-finance-and-innovation/markets-crypto-assets-regulation-mica>
2. https://www.amf-france.org/sites/institutionnel/files/private/2023-07/CARTOGRAPHIE%202023_EN.pdf.pdf



TEUNIS BROENS

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Crypto after the hype: regulatory hurdles and the role of banks

Following the spectacular demise of some well-known crypto names over the past 1.5 years, the public's interest in crypto has waned. But this may have a silver lining. Now that the attention has shifted away from the hype and “number go up”, there is renewed focus on applications that foster useful innovation. And while some jurisdictions are still contemplating how to fit crypto assets in their regulatory edifice following FSB and IOSCO guidelines, the EU has most of the building blocks in place for a regulatory framework:

- Crypto was already subject to anti-money laundering and counter financing of terrorism (AML/CFT) requirements since 2020 (AML Directive 5), topped up with an extension of the “Transfer of Funds” Regulation earlier this year.
- Basic investor protection measures are included in the incoming Markets in Crypto Assets Regulation (MiCAR). These include suitability assessments for investors and responsible publicity and transparent information about product risks and costs.
- Financial market integrity is also covered in MiCAR, including e.g.

trade execution obligations and trade monitoring to prevent market manipulation.

From a financial stability perspective, the EU's CRR3 will implement the relevant global Basel standard for exposures to crypto-assets by 2025, and includes a transitional regime until then. While the EU regulatory framework is taking shape, some issues remain:

- As EBA and ESMA are still consulting and developing Level 2 and 3 measures, regulatory and supervisory requirements have not crystallised fully yet;
- Significant parts of the crypto universe are not subject to MiCAR, most notably decentralised finance, meaning lack of regulatory clarity may slow down any explorations there;
- The prudential treatment of crypto assets as included in CRR3, applicable from January 2025, takes a welcome differentiated approach to crypto, distinguishing e.g. stablecoins and tokenised “traditional” assets. The EU transitional regime however is much more restrictive, hampering bank explorations in the coming 1.5 years;
- MiCAR requires the development of sustainability indicators, on which ESMA will soon issue a consultation. The energy intensity of some blockchains (like bitcoin) has been a hotly debated issue. Less energy hungry alternatives are available, but they come with trade-offs, in terms of increased software code complexity and potentially more vulnerable network governance. The right balance has yet to be found.

So while the EU regulatory road towards crypto use cases has been paved, it is certainly not free from potholes. But what exactly are those use cases, beyond hype and speculation? At this point, ING mainly sees applications in areas where efficiency gains can be made. This includes cross-border and micro (machine-to-machine) payments, but also securities trading and settlement. Obvious initial roles for banks include wallet, identity and custody services. Further roles can be envisaged in transaction and treasury services, advisory and portfolio management.

But to facilitate further innovation, the crypto universe is first in need of a virtually risk-free means of payment. Recent experience has made clear that unregulated, unbacked stablecoins cannot play that role. Global stablecoins are politically unpalatable, as they compromise monetary sovereignty. Banks are obvious candidates to issue payment tokens, as they already provide the vast majority of money in the traditional financial system.

Banks could issue “tokenised deposits” using their existing balance sheet and banking license.

Alternatively, banks could issue stablecoins, covered by MiCAR. There are subtle but important differences between the two, and we think at this stage they could co-exist in a well-diversified monetary-financial system, serving different use cases. Key characteristics of both tokenised deposits and stablecoins include their well-regulated nature and their issuance by well-known (groups of) banks. This inspires confidence, and sets both tokenised deposits and bank-issued stablecoins apart from unregulated stablecoins that have earned such a notorious reputation.

To facilitate further innovation, crypto is in need of a virtually risk-free means of payment.

Having a trusted and euro-denominated means of payment available on a blockchain infrastructure is a necessary condition to enable much-anticipated use cases. The bank-issued means of payment could serve as the payment leg of instantly-finalised securities and foreign currency transactions. Other areas of interest include on-chain working capital and supply chain financing.

Stablecoins and tokenised deposits could also stimulate development and adoption of peer-to-peer investment, funding and insurance products, where intermediaries may play an advisory role.

Beyond the hype, crypto is now back to earth, and that's good news. Potential use cases of crypto don't eliminate the role of intermediaries like banks, but do change them considerably. Banks and regulators are well-advised to keep an open mind as to what crypto can bring, and to be prepared.

DEFI OPPORTUNITIES AND CHALLENGES



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Why DeFi should lead us to innovate in regulation

What is DeFi?

At first glance, DeFi can be defined as a set of crypto-asset services, similar to financial services, performed without the intervention of intermediaries. The concept remains however unclear. A set of criteria is often used to identify its outlines: (i) an architecture based on public blockchain; (ii) protocols based on smart contracts; (iii) a decentralised governance, sometimes around a “decentralised autonomous organisation” (DAO); (iv) the absence of a custodian for digital assets.

Nevertheless, “pure” DeFi projects are rarely encountered. Even more so, the DeFi ecosystem is paradoxically highly concentrated in many respects and depends on centralised players to perform certain functions, while the governance of blockchains or applications is sometimes heavily centralised (concentration of governance tokens in the hands of a small number of players, existence of admin keys...).

One might question the interest of the subject today: the ecosystem is currently of limited size, with a net total value locked – to avoid double counting as much as possible – of 40-50 billion USD in the first half of 2023 (less than 10 % of the market value of crypto-assets). Moreover, use cases are limited and more related to speculation than to serving the real economy.

DeFi has nevertheless attracted considerable interest, both in the public debate and from supervisory authorities, notably because of what it could foreshadow for the future: “tokenization” of finance, benefits of blockchain technologies for a wide range of activities in all sectors of the economy. Another reason for the supervisors’ interest obviously lies in the risks that DeFi carries.

Risks related to DeFi

In addition to the fragilities of the crypto-asset ecosystem, highlighted by a number of recent bankruptcies, DeFi carries specific risks.

This is first the case for decentralised governance of blockchains or protocols: an individual or a small group of individuals can make decisions that are detrimental to minority owners. This issue is all the more important given that many DeFi protocols are decentralised in name only (“DINO”).

Moreover, the blockchain infrastructure and DeFi applications have been subject to numerous computer attacks. In fact, the advantages of DeFi can create its specific vulnerabilities: for instance, open computer code makes it a target exposed to all.

Finally, the volatility of crypto-asset prices, the complexity of the products offered, the proliferation of scams, theft and hacking have exposed retail customers to high risks of capital loss.

Regulatory avenues

These risks obviously call for a framework, primarily to protect users, especially the most vulnerable among them. This regulatory framework must be innovative. Indeed, while regulation must be technology-neutral (“same activity, same risks, same rules”), it cannot be technology-blind: for example, it must take into account some of the technical characteristics of DeFi when they generate specific risks. Therefore, the regulatory framework cannot simply replicate traditional regulation, but must innovate,

for example by drawing inspiration from regulations in other sectors.

With this in mind, the ACPR recently published a discussion paper on regulatory options for DeFi. This paper does not express the ACPR’s definitive position, but seeks to develop an initial analysis of regulatory options with a view to discussing them with all stakeholders (in particular during a public consultation, which recently took place). The proposals cover the three main strata of DeFi.

Firstly, ensure the resilience of the blockchain infrastructure that support DeFi, for example by imposing security standards on public blockchain and limiting the risks of concentration of transaction validation capacities in the hands of a few players or, as an alternative, impose the use of secured private blockchains.

Secondly, strengthen the security of *smart contracts* via a certification mechanism covering the security of the computer code, the nature of the service provided and governance. Interaction with non-certified smart contracts would be either discouraged or prohibited, through the regulation of contact points (see below). The proposal is inspired by the EU’s product safety regulations, with the idea of imposing obligations on products, even where there is no producer.

The regulatory framework must innovate, for example by drawing inspiration from other sectors.

Thirdly, regulate access to DeFi, in order to protect users, especially retail customers. Intermediaries – or “access points”, whatever their form – that provide access to DeFi must comply with rules of good conduct and be subject to due diligence and advice as well as to know-your-customer (KYC) requirements, where necessary.

With these proposals, the ACPR wishes to contribute to the gradual development of a European or even international regulatory framework that strikes the right balance between innovation and protection.



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Regulatory and supervisory challenge to decentralized finance

The events of the past year have highlighted the volatility and structural vulnerabilities of crypto assets and related players which led to increasing doubt about the crypto market ecosystem. They have also illustrated that the failure of a key service provider in the crypto asset ecosystem can quickly transmit risks to other parts of that ecosystem, and if linkages to traditional finance were to grow further, spillovers from crypto assets markets into the broader financial system could increase.

It has now been four years since Financial Action Task Force (FATF) extended its global standards on anti-money laundering and counter-terrorist financing to apply to crypto assets and crypto asset service providers. According to FATF findings some jurisdictions have introduced regulations, but global implementation is relatively poor, and compliance remains behind most other financial sector players. And then there comes decentralized finance (DeFi) that offers the promise of an emergent alternative financial architecture that prioritizes disintermediation

and decentralization to empower individuals along crypto principles.

In this light, the EU has approved the Markets in Crypto-Assets (MiCA) Regulation, that marks another step in the decentralized finance sector, making digital finance available to European customer and business. New regime could represent a positive boost for the EU crypto businesses and the EU economy overall, but its success is highly dependent on the upcoming development of practical implementation standards. If MiCA proves to be workable for the industry, consumers, and regulators, it will have a global impact.

MiCA Regulation is expected to strengthen the supervisory framework applicable for crypto asset service providers. However, regulation excludes fully decentralized services from its scope, that leverages distributed ledger technologies to offer services such as lending, investing, or changing crypto assets without relying on a traditional centralized intermediary. DeFi relies on publicly distributed ledgers and automated digital (smart) contracts to provide financial services without requiring the presence of intermediary agents. MiCA Regulation mandates a development of a report to be drawn up within 18 months of its entry into force, assessing, among other things, the value of and procedures attached to a European regulation on disintermediated finance.

DeFi is a relatively young branch of crypto family. Activity in DeFi gained traction during the last decade and as of now has not grown to present a considerable financial stability risk. The risk for retail and institutional investors however is more prominent. Considering potential policy choice there is therefore a need to access how and which risks from the DeFi protocols should be addressed. Another area is guidance on DeFi acting for crypto service providers to combat money laundering and criminal activities and link between DeFi activity and traditional financial sectors.

A standard approach to the regulation and supervision of financial markets has been the setting of rules to guide and delimit the scope and behaviour of financial intermediaries by setting capital requirements, liquidity ratios, rate controls, know-your-customer rules, and anti-money laundering detection settings. Regarding the DeFi it is important to keep in mind that some of the risks associated with disintermediated finance are closely linked to the specific features of the technology used. The transparency of computer codes, governance issues, the composability of smart contracts, their

reliance on blockchain – all these are advantages of disintermediated finance and factors for their vulnerabilities.

Additionally, structural flaws embedded in both DeFi, and crypto assets more generally stem from the underlying economics of incentives rather than just technological limitation or complexity of the ecosystem. In view of these risks, one can argue that the regulation of disintermediated finance cannot simply replicate the systems that currently govern traditional finance. On the contrary, regulations must consider the specific features of DeFi.

DeFi poses a general challenge to standard policy frameworks.

While public attention to the regulation and monitoring of DeFi systems is growing, the very nature of service provisioning in DeFi poses a general challenge to standard policy frameworks. At the centre of this challenge lies the absence of legal entities - both on the supply side and the demand side - upon which policy institutions have traditionally enforced their requirements. These key features should be accessed in shaping the future of DeFi and interaction with the rest of the economy keeping in mind that prime objectives of public policies is to ensure that benefits from innovation do not come at an irremediable cost.



RICHARD TENG

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Give DeFi the time to show its potential

As is often the case with other disruptive technologies, the public discussion about the regulation of Decentralised Finance, or DeFi is coloured by hard to reconcile views about its risks and potential.

DeFi is as old as the Ethereum blockchain, which was launched in 2015. But it only got on the radar of regulators in the years of 2020 - 2022. During the DeFi Summer, the Total Value Locked in DApps, the reference indicator, increased from a few hundred million dollars to \$180bn. At the end of July, it was about one quarter of that, according to Defi TVL aggregator DefiLlama.

DeFi refers to the provision of financial services without intermediaries, through open protocols that allow for programmability and composability. It is associated with blockchain technology and the concepts of 'tokenisation' and smart contracts.

DeFi already provides alternatives to traditional services, especially when involving crypto assets (e.g. lending, trading, investments, insurance). In many instances, it does so in more efficient and inclusive ways. Furthermore, it offers the potential for innovation and the creation of new services that change the way financial markets work. This is why even central banks and traditional finance incumbents are eagerly exploring it.

Innovation comes with risk and uncertainty, but policymakers shall not lean against it. Consumer protection, financial stability, market integrity and other policy objectives must be pursued alongside the support for growth and adoption of the technology.

Importantly, it must be recognised that replicating existing financial regulation and applying it to DeFi would be incompatible with that. Traditional financial markets are heavily reliant on intermediaries, which provide liquidity, clearing, settlement, among others. Existing financial rules are imposed and enforced mostly on these intermediaries.

In contrast, in DeFi, access is permissionless and services are provided by (legally) unidentified agents, through automated protocols. The new setting calls for a bespoke approach to regulation and supervision.

What would the regulation of DeFi look like? This is a fair question to ask, but not one we should rush to respond to. The answer should be given over time, as the technology evolves and financial markets adopt it.

Regulators should focus on incentivising the collaboration among industry players and the development and take-up of standards. This - combined with robust regulation of intermediaries, such as Crypto Asset Service Providers - will lay sound foundations for the development of the ecosystem.

**DeFi is permissionless
and decentralised.
This calls for a
bespoke regulation.**

A self-regulatory approach has three main advantages. First, it can leverage numerous underlying technical concepts and established standards, which take into account the specificities of the blockchain technology. Second, it can address the heterogeneous nature of the blockchain ecosystem by developing tailored approaches through different initiatives. Third, it can offer flexibility to keep up with the pace of innovation and respond to the evolving challenges.

Over time, striking the right balance between standards, self-regulation and any form of regulatory oversight would be the right approach to nurture a crypto ecosystem that is responsible and continues to innovate, grow and provide benefits to consumers.

Binance is fully committed and ready to play a part in this process. In response to a recent consultation paper by the Autorité de Contrôle Prudentiel et de Résolution, the prudential arm of the Banque de France, we proposed the creation of an Observatory of DeFi.

This observatory would be tasked with gathering knowledge and proposing tools that facilitate the monitoring of DeFi protocols and developments in the market. It would promote a shared understanding of the risks and benefits, develop technical expertise and inform the discussion on possible adapted forms of supervision, including the notion of embedded supervision.

This proposal is consistent with the approach of Markets in Crypto Assets Regulation, which excludes DeFi, understood as services provided on a fully decentralised basis, from its scope and makes it one of the subjects of the upcoming review.

With just more than one year to go until the MiCA implementation, our collective focus should be on preparing for it and ensuring the level 2 rules are fit for purpose. This will require significant efforts and dialogue from everyone.

Getting MiCA right should be our collective priority. As for DeFi, give it time to show its potential and prove its worth.



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Centralized intermediaries empower decentralized innovation

The internet revolution promised and delivered major changes in how we connect, learn, engage, exchange, and transact. We can do day-to-day things like share content and pay bills in more efficient, personalized, and instantaneous ways than we would have thought possible 30 years ago. The next wave of innovation has emerged, as technology delivers the societal benefit of disintermediation and decentralization. Important regulatory questions will need to be answered in the short to medium term.

The blockchain ecosystem is a vision of a new and improved internet that uses decentralized blockchains and tokens to enable social and commercial interactions without intermediaries. Blockchain users will build and operate their own content and ecosystems.

Decentralized finance (DeFi) is a growing area, representing open financial infrastructures and decentralized applications built on software protocols such as blockchains and smart contracts. It aims to shift traditional financial systems to peer-to-

peer networks in order to remove third party rent-seeking and control. There is an ever-increasing set of protocols that govern specific systems for DeFi participants. DeFi applications, built and governed by users, can enable those users to gain access to credit, or to save and invest.

DeFi is nascent but growing. Estimates suggest the DeFi market is currently ~50 billion USD in assets, relative to the one trillion USD in the broader crypto market and hundreds of trillions in the traditional financial system. So, it remains important to understand the intricacies of this nascent sector and its evolving links with centralized finance.

Centralized exchanges such as Kraken are not DeFi. Yet, they have become an important bridge to buy, sell and trade tokens that drive innovation by enabling the exchange of value, underpinning governance, and empowering individuals to access new decentralized ecosystems.

**Centralized digital
asset exchanges will
continue to serve as a
regulated bridge to DeFi.**

For over 12 years, Kraken has worked to safely accelerate adoption around digital assets and enable decentralized ecosystems to thrive. We are part of a centralized layer that includes exchanges where you can buy, sell, and use tokens; custodians who can keep them safe; and distributors who can make them widely accessible. We believe secure and well regulated centralized service providers can be engines for growth and connectivity between centralized and decentralized worlds. Many DeFi services providers, such as lending protocols, depend on reliable reference prices for tokens that can be found on liquid centralized exchanges. Customers may also go through centralized players to participate in DeFi, for instance in proof-of-stake ecosystems where token ownership is the key to governance.

Regulation has appropriately focused on this centralized layer and makes it a safe environment for innovation, as the EU's Markets in Crypto Assets Regulation (MiCA) has done. Indeed, the customer protection failures and frauds seen in the crypto landscape in recent times have revolved around fraudulent centralized players.

As developed and emerging economies advance regulatory frameworks in

the crypto markets, there are two principles that should be applied.

First, the risks in DeFi are not the same as in traditional finance. For example, centralized governance risks are diminished in a transparent and permissionless environment; operational and cyber risks are more relevant. The benefits of disintermediation will need to be protected while accounting for the different risks.

Second, as with prior evolutions of the internet, regulating open-source software providers and code writers is not the right path. The user experience through centralized intermediaries such as apps or intermediaries will need to remain in focus. Businesses have the capability to make their apps or platforms compliant, subject to local regulation in ways that software protocols (i.e. the underlying blockchains, smart contracts and DeFi networks) should not be required to do. Early internet legislation did not regulate the underlying technology or protocols such as HTTP (website data), or SMTP (email), and instead focused on the user-facing apps. The principles which governed early internet legislation should be similarly applied to decentralized applications.

Decentralization has arrived and presents innovative potential for society. Centralized digital asset exchanges will continue to play an important role as a regulated bridge to DeFi. It is important to design a regulatory framework that will allow DeFi to remain what it is - decentralized, permissionless technology that is accessible to all - while continuing to focus on effective frameworks for regulating centralized intermediaries who can help drive the next evolution of the internet.

AI: UNLEASHING ITS POTENTIAL IN THE FINANCE



PETRA HIELKEMA

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AI in the insurance sector: industry adoption and regulatory developments

Artificial Intelligence (AI) is expected to play a pivotal role in the digital transformation across all industries and society as a whole. In the insurance sector, AI combined with the internet of things is providing for a wide range of opportunities for future growth and development. As shown by EIOPA's thematic review on the use of Big Data Analytics in motor and health insurance, already in 2018, 31% of the participating European insurance firms were using AI across the insurance value chain, and another 24% were at a "proof of concept" stage. This trend was confirmed in the report on AI governance principles from EIOPA's Stakeholder Group on Digital Ethics in 2021. In a workshop on AI organised by EIOPA earlier this year, industry participants further emphasized the transformative role of

AI and provided clear examples of AI applications in the insurance industry.

While AI is already being used throughout the insurance value chain, recent advancements, such as the rise of generative AI, have demonstrated that we are only seeing the beginning of AI's potential for the sector. The widespread adoption of generative AI by insurance companies is still in the early stages; however, insurers are actively exploring its potential uses, such as providing consumer advice, guiding policyholders through claims procedures, and enhancing pricing and underwriting processes.

In this context, the proposal of the European Commission for a Regulation on artificial intelligence (the AI Act) aims to lay down a uniform legal framework for the development and use of AI in conformity with European Union values. The proposal is currently being finalised by the EU co-legislators in trialogues.

The AI Act has specific implications for the insurance sector. Firstly, it is 'horizontal' and aims to cover all relevant sectors at once. Its cross-sectoral nature can raise challenges with integrating its provisions and their supervision into each sector, notably those that are highly regulated and supervised, such as the insurance sector. Secondly, the AI Act envisages harmonised standards being developed by the European Standardisation Organisations and the provision of guidance and compliance tools to aid providers and users in meeting the requirements. Thirdly, following a risk-based approach, the vast majority of the requirements of the AI Act apply to AI systems identified as high risk.

In light of the specificities of the insurance sector, the development of standards and guidance to facilitate the implementation of the AI Act will play a key role in ensuring a seamless application and preventing potential frictions with the insurance legislative and supervisory framework. While, based on the positions from the European Parliament and the Council, it seems likely that certain use cases in life and health insurance will be considered as high-risk, there are a wide range of other potential use cases where certain transparency obligations and voluntary codes of conduct would apply. In relation to the latter, additional efforts may be needed to ensure coherence between

sectoral requirements and standards under the AI Act, while maintaining proportionality.

In addition, the AI Act is not fully exhaustive in relation to the regulation and supervision of AI and sectoral legislation addressing conduct and prudential objectives continues to apply also to AI when used in the insurance and occupational pensions sectors. Recognizing the potential significance of AI for the insurance sector, EIOPA stands ready to contribute to its regulation and supervision. This commitment includes participating in the governance framework that will be established at the EU level.

We are only seeing the beginning of AI's potential for the insurance and pensions sectors.

As we look ahead, it is evident from the emergence of generative AI that the field of AI is evolving rapidly. The AI Act recognises this and aims to be future proof, allowing for adaptation to upcoming developments. The specific measures intended to achieve this goal are yet to be determined, particularly concerning the governance system, where proper consultation of sectoral expertise is important. Furthermore, the need to adapt to market changes has already been shown, as the Council and the Parliament introduced requirements for generative/foundation models that were not initially anticipated in the original proposal by the Commission. The final extent and scope of the measures are not yet clear, but these will have real impacts on the insurance and pensions sectors.

In conclusion, while AI is already being incorporated into the insurance value chain, the rise of generative AI suggests that its full potential is yet to be realized. The AI Act aims to provide a framework that will help the development of AI in conformity with European Union values. The future impact of the AI Act in the insurance sector depends on the outcome of trialogues and will necessitate the development of guidance for its effective implementation.



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Regulating the use of AI, a challenge for financial supervisors

AI is a profoundly transformative technology

Artificial Intelligence (AI) is now the main driver of digital transformation in the financial sector. Two studies conducted four years apart by the ACPR among French banks and insurance companies have shown the speed of change at play: between 2018 and 2022, in many instances, operational solutions have replaced prototypes.

AI makes it possible to improve the “customer experience”, through *chatbots*, recommendation or decision support systems, as well as better product customization. AI can also automate many internal processes, such as claims settlement for insurers, reducing costs and gradually freeing employees from low-value work. Finally, AI can reduce risks: financial risks, through improved modelling, operational and compliance risks (fraud detection, AML/CTF).

The arrival of large language models (LLMs), with the prospects they open up - particularly in terms of summarising, extracting and classifying information, or generating text or computer code - should further increase the pace of AI adoption.

This rapid development in AI is primarily due to technological advances, made possible by greater availability and diversity of data and more powerful IT equipment. However, new expectations from customers are clearly a second driver of this transformation: they demand easy-to-access digital tools and seamless user experience; immediate answers or help, and at the same time autonomy in day-to-day management (self care).

AI development, however, is not without risks. Besides cyber-security issues, the risk of error, inappropriate or unfair treatment, may be exacerbated when an algorithm operates without human control. It is therefore important to ensure that these risks are properly managed.

The upcoming AI Act provides a sound foundation for AI regulation

The draft European AI Act, currently under discussion, addresses crucial questions about the safety, health and fundamental rights of citizens. In doing so, it aims to provide legal certainty for operators and increase consumer confidence, while creating a level playing field for EU and third country players.

To achieve this, the Act is likely to impose a number of obligations on “high risk” systems: high quality training, validation and test data; appropriate degree of transparency and interpretability of the systems; mechanisms to ensure traceability and auditability of AI systems; rules on cyber-security etc. So-called ‘foundation models’ should be subject to similar requirements. Finally, transparency would be required from all generative AI systems.

Some of the systems used by banks and insurers are expected to be in the scope of “high risk” AI. More broadly, the principles of the AI Act can be expected to gradually infuse all AI systems implemented by the financial sector, either as a voluntary quality standard or through guidance provided by the European Supervisory Authorities (EBA and EIOPA in particular). An important challenge in this regard will be to adequately articulate the new horizontal AI regulation and the specific rules of the financial sector.

The generalisation of AI, and its supervision, will require a deeper understanding of human-machine interactions

Good regulation is nothing without effective supervisory bodies to enforce it. Preparing financial supervisors to audit AI systems is a challenge, requiring in particular a good command of

technology. In addition to adequate human resources, conducting experimentations, possibly in collaboration with the market, may help.

Mastering AI requires in particular that we strengthen our understanding of the complex interactions between machines and humans, whether the latter are in the position of customer, internal controller or external auditor. For example, as part of a research project, the ACPR recently tested how customers perceive the explanations justifying the advice given by a life insurance robo-advisor. To do this, a simplified robo-advisor was developed, or more precisely two versions of it: one giving advice tailored to customers’ profiles, the other providing wrong advice. The authors then conducted a quantitative experiment with 256 participants, most of them financial novices, recruited via a collaborative platform.

The results were counterintuitive: explanations did not significantly improve users’ understanding of the proposal or their ability to follow the advice given, depending on whether it was correct or not. In addition, the explanations provided in the form of a conversation wrongly increased users’ confidence in incorrect proposals made by the robo-advisor.

**AI requires that
we strengthen our
understanding of the
interactions between
machines and humans.**

This example is a first illustration of the challenge ahead: by profoundly transforming processes in the financial sector, AI will require regulators and supervisors to rethink their practice, taking into account the changes that algorithms will induce in human behaviour. The learning curve promises to be long but exciting.



MANEL CARPIO

Partner, Risk Advisory -
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Generative AI regulation, an essential shield against risks

In recent months, we have witnessed the disruptive emergence of certain types of generative AI, as well as various use cases in different contexts. The development of these tools has also generated a race among large technology companies to deploy generative AI systems and has raised a lot of interest among users. This competition has also led to relevant differences between the current models, such as the ability or not to access queries on the internet, the type of access to the models (private and exclusive, open source or hybrid); and the accuracy, complexity and quality of the answers produced.

While there are many advantages to incorporating generative AI into a company's operations, it is also important for organizations to be aware of the associated risks, such as those related to privacy and data protection. Therefore, in order to safeguard sensitive or confidential data, some European data protection agencies have even limited or temporarily banned its use. Another relevant point is the intellectual property of the content generated with these tools. To date, companies in the sector tend to cede authorship of the content generated to users, which avoids the loss of intellectual property. However, the debate about the intellectual property of the training data is still open.

Furthermore, there are other risks, such as hallucination, where AI generates incorrect or biased information framed in a coherent and well-written text. Overreliance on these technologies, which requires human supervision in certain cases. The lack of transparency and traceability to the sources of the information, and the possible lack of ethics and impartiality in decision-making processes based on the content generated, are also factors to consider. And, among others, the privacy of training information and that which is shared at the time of consultation.

However, various governments and supranational institutions have initiated legislative projects to mitigate the risks of AI. At the European level, work has been done to develop a regulation to ensure the ethical and responsible use of AI, as well as the management of those that may affect people's health, safety, or fundamental rights. This European AI regulation (AI Act) is a law proposed by the European Commission (April 2021) to regulate artificial intelligence within the EU. It is based on the classification of AI systems into four categories, depending on the level of risk, and on the definition of a series of requirements for those with the highest risk.

GenAI tools have a differential value in multiple contexts but must be used with caution due to the associated risks.

At the end of 2022, the European Council published a new version of the text with some significant changes, such as the definition of an AI system, the definition of biometrics or the systems that would fall under the high-risk category, among others. In the latest version, in June 2023, the European Parliament published its revision of the text, now including novel concepts such as the definition of foundational models or generative AI, which did not appear in previous versions. Following this revision, the trilogues discussions between the Commission, the Council and the Parliament have begun, and the final text is expected to be published by the end of this year.

Financial institutions will also be at the heart of the matter and will play a very relevant role in the next few years. Some of the High-Risk Artificial Intelligence Systems listed in the AI Act will belong to Banking (e.g., access

to credit) and Insurance (e.g., access to health and life insurance) sectors, and although relevant organizations such as the European Banking Federation (EBF) and the European Insurance and Occupational Pensions Authority (EIOPA) have positioned themselves against their systems being included as High-Risk in the AI Act, the European Council and European Parliament seem to have their eyes set on these AI systems having to comply with additional specific requirements such as risk management, data governance, cybersecurity, and accuracy for the foreseeable future.

In the Spanish context, the AI Regulatory Sandbox has been launched, a pilot project that aims to create a safe and controlled environment for companies to test the new European AI regulation. The pilot is open to companies of all sizes and sectors, and offers several advantages, such as access to technical advice and the opportunity to collaborate with other companies and government agencies.

To sum up, these generative AI tools have a differential value in multiple contexts but must be used with caution due to the associated risks. Various international bodies, led by the European Commission, are developing regulations and standards to ensure the ethical and responsible use of these tools, a vital effort to achieve an efficient and beneficial transformation for companies and the economy in general. In this race, the European Union plays a key role, due to the size of its market and its weight in economic matters, so capitalizing on this opportunity and repeating the success achieved with the General Data Protection Regulation (GDPR) is essential to consolidate the EU's position as an innovation hub compared to its main competitors.



SOPHIA WIKANDER

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Open AI in FSI - Balancing risk vs impact & holistic transformational leadership

For several years, it has been a balancing act for banks to create customer value and relevant customer offerings, based on their customer data without violating their customer's trust. The last years technology development and new customer patterns with increased digitalization and usage of AI & Machine Learning and IoT have amplified the amount of data available and thereby also the importance of having a data strategy that clearly defines not only the implementation of regulatory requirements like GDPR but also processes and directives that covers the ethical and business dimensions of how banks and their employees can and should use data.

With the launch of ChatGPT and Generative AI, new use cases have emerged that will increase employee productivity and collaboration and enable enhanced customer service and advisory, improve fraud detection and give organizations and customers real time access to both structured and unstructured data.

With the potential of AI unlocking \$1trillion in incremental value annually in financial services and where we already now see concrete results in for example 45% faster processing of trade executions and 90% less time spent on onboarding technology and eliminating cybersecurity gaps, there is no surprise that banks show a sincere interest in investing and fully understanding and starting to utilize Generative AI within their organizations.

The clear increase in interest in investing in data, cloud and AI to elevate customer and employee experiences goes across the entire organization, from IT to the board, in financial services. However, although there is a strong sense of urgency from banks to utilize the AI potential, we also hear the importance of managing impact versus risk when utilizing AI. In this context the access and handling of large amounts of data is the main concern in addition to preparing and transforming the organization to fully utilize and responsibly manage the new technology and data models.

Despite the strong AI focus from a vast amount of financial institutions the road to fully leveraging AI will take time and require transformation in multiple areas such as; applying advanced analytics and machine learning models for AI-powered decision making on all levels in the organization and creating a platform based operating model that takes into consideration employees, customers, stakeholders, organizational design, processes and procedures and synchronizes that into all layers of the AI stack. The initial and biggest investment will however be in modernizing the core legacy technology to the scalability and flexibility needed to support the computing requirements, data processing and real-time analyses of data in a scalable way.

**Becoming an AI-first
bank requires balancing
risk vs impact & holistic
transformational
leadership.**

The most challenging area for banks might be the talent strategy and the required upskilling to create autonomous business and tech teams that can efficiently manage the new technology and embrace a new way of working. If successful the result will be real time engagement and interaction between employees, customers and partners that will democratize the

availability and utilization of data and services in a new way.

Historically financial institutions have continuously adapted to new technology with an ambition to offer speed, agility and flexibility to their customers. The challenge has always been combining the ever increasing regulatory and compliance requirement and manage scale, risks, security standards and regulatory framework with the need for innovation and transformation to stay competitive and remain a trusted partner.

In a very short timeframe, OpenAI launched ChatGPT only a few months ago, we have seen pockets of AI driven FinTech innovations and a strong willingness to utilize the new technology, however the use cases are still narrow and to a high degree stand alone. To succeed in scaling AI across the organization and execute on a shift that will transform every function and interface in the organization a clear AI strategy and holistic transformation strategy is required.

The Data Act and the European strategy will be an important tool for financial institutions to support the required strategy, leadership and execution to increase the uptake of AI in Financial services. The leadership in the next wave of AI driven innovation requires ability to handle complex and uncharted territories and a willingness to drive transformation across entire value chains, operating models, and management levels in financial institutions in an ethical, unified and responsible way.



MAGNUS HAGLIND

Senior Vice President and
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How to promote responsible innovation in AI

Recent advances in generative AI have thrust the technology to centre-stage of public debate, capturing the imagination of millions with its application to everyday life. The explosion in demand for language models like ChatGPT reflect a milestone in its evolution, with the technology now more widely accessible. This level of interest has prompted excitement and concern in equal measure as stakeholders race to understand both the long-term risks as well as AI's significant potential.

While it's easy to get carried away by extreme scenarios, it's important to remember that we are more than 50 years into the evolution of AI. The technology is already widely adopted across the industry, powering and protecting many of the important systems and processes we use daily. However, thanks to the recent advancement of machine learning (ML) technologies, and an increased understanding of what it can accomplish, the focus on generative AI is finally taking shape. The use of AI & ML is moving beyond exclusive use by data scientists, which will further accelerate its evolution.

AI has now reached a tipping point, and this period of heightened global focus

gives us an opportunity to establish an appropriate and coordinated regulatory response. One that brings together the best of the private and public sectors, ensuring adequate protections are in place whilst not constraining positive innovation.

Use of AI in capital markets

As both a market operator and provider of mission-critical technology to infrastructures globally, Nasdaq has been operating at the forefront of innovation for decades. We recognized the power of technology and data early in our journey and have long been exploring how AI can be used to improve our internal productivity and quality of our markets – enhancing fairness, resilience, and performance.

One example is the implementation of a dynamic order type in the US that incorporates AI to match investors with longer-term investment horizons. It improves fill rates by responding to market conditions on a real-time basis. We are currently seeking regulatory approval for the introduction of this initiative to improve market efficiency and user experience.

But perhaps the most compelling example is within our anti-financial crime business, which provides software to financial institutions globally to help them detect, deter and stop financial crime, and used effectively across our European exchanges.

**The approach to
regulation should
be proportionate to
the risk posed by a
particular AI system.**

Financial crime is a multi-billion global industry; one that exists beyond single banks, borders, and regulatory regimes. Furthermore, this criminal trade is investing in new technology, including AI, in the same way as any global industry; therefore we must ensure we respond appropriately. For instance, wrongdoing thrives in the absence of coordinated data sharing, preventing advanced technology from identifying patterns of behaviour across the banking ecosystem.

In our own business, we have been able to establish data lakes that bring together anonymised transaction data from more than 2,400 banks which, together with the power of AI, is able to identify suspicious activity across multiple institutions.

Across the company we will always seek areas where aspects of AI technology can enhance the customer experience and increase productivity in a responsible way. To ensure we adopt the technology appropriately, Nasdaq has created a set of AI ethical principles built around transparency, fairness, accountability, and reliability, which we apply when developing products and services. As part of that approach, we operate a risk-based internal governance framework which includes oversight by an internal AI Governance Committee.

Our insight and expertise in this technology is anchored through decades of investment and experience.

An appropriate regulatory response

With the technology now available at a far broader scale, balanced regulation is important to ensure adequate safeguards are in place. Collectively, we have the opportunity to establish an overarching framework that guides organizations across all industries. However, we must be alive to the risk of stifling the level of innovation necessary to develop advanced and sophisticated approaches to market manipulation and money laundering.

The approach to regulation should be proportionate to the risk posed by a particular AI system and not overburden efforts to modernize our capital markets, including leveraging the latest capabilities in cloud, AI and ML. Where possible we should draw on existing legal frameworks to avoid overlap and incorporate clear definitions and case study examples. And we must protect against models that inadvertently discriminate against protected characteristics.

Ultimately steps taken to enhance fairness and resilience of our markets, whilst encouraging innovation to support a more efficient flows of capital through the system, will generate tangible benefits for economies and communities across the world.

EU23

We thank the **Spanish EU Council Presidency** and **the partner institutions** for their support to the organisation of the Eurofi Santiago Forum



CYBER AND DIGITAL OPERATIONAL RESILIENCE



GERRY CROSS

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DORA – Building on existing principles

The European Supervisory Authorities (“the ESAs”) are tasked with jointly delivering the regulatory standards implementing the DORA ICT risk management framework. The Joint Committee of the three ESAs has established a Sub-Committee to deliver these standards and the first batch of Level 2 policy products was launched for public consultation mid-July. Included in the public consultation are four draft regulatory technical standards (RTS) and one set of draft implementing technical standards (ITS).

These technical standards aim to ensure a consistent and harmonised legal framework in the areas of ICT risk management, major ICT-related incident reporting and ICT third-party risk management. The consultation for the first batch runs until 11 September 2023.

The second batch of policy products is expected to be launched for public consultation towards the end of this year. Stakeholders in the DORA Regulation

are invited to take this opportunity to provide important and valued feedback on the draft technical standards to ensure a solid policy product that is addressing key ICT risks while also being implementable.

The reliance on ICT across all industries is reflected in the development of specific ICT best practice frameworks since 1990. These frameworks have also been used, to various degrees, by the financial sector and specific guidance on ICT risk management were issued by the EBA (Guidelines on ICT and security risk management, 2019) and by EIOPA (Guidelines on information and communication technology security and governance, 2020).

The core principles expressed in these guidelines and best practice frameworks focus on the identification of ICT risk, the protection against identified risks, the detection of abnormalities in providing ICT services to the business, the timely response to detected abnormalities and the recovery to normal ICT operation. DORA builds on these existing ICT risk management principles taking proportionality into account.

DORA builds on these existing ICT risk management principles taking proportionality into account.

Implementing DORA and the requirement to identify ICT risk will challenge some firms, especially those with complex ICT systems, as it requires a detailed understanding of the ICT assets and systems supporting business functions. However, in order to adequately protect and ensure the resilience of business services provided to customers, financial entities must first understand what ICT assets support these business functions before they can adequately protect these ICT assets against identified risks.

DORA is also concerned with risks that originate from the provision of third-party ICT services and addresses these risks through detailed ICT outsourcing requirements and by introducing an

oversight framework for critical third-party providers (CTTP) of ICT services to financial entities. A public consultation on a Call for Advice (CfA) on the criticality criteria for CTTPs ended in June. Finalising the CfA will take into account the feedback received from more than 40 interested parties before its submission to the EU Commission later this year.

The CTTP oversight framework is currently being developed and the ESAs in collaboration with competent authorities are focusing on the development of organisational structures to deliver the oversight alongside the drafting of the RTS on oversight conduct.



FRANÇOIS- LOUIS MICHAUD

Executive Director - European
Banking Authority (EBA)

Addressing dependencies on critical providers through EU oversight

The Digital Operational Resilience Act (DORA) establishes a comprehensive framework on digital operational resilience for EU financial entities. The first pillar of DORA aims at consolidating and upgrading ICT risk requirements that have so far been spread over in different texts of the financial services legislation, to increase operational resilience and foster convergence and efficiency in supervisory approaches when addressing ICT third-party risk in the financial sector.

The second pillar of DORA introduces an EU-wide oversight framework for those providers of ICT services to financial entities that will be designated as critical (CTPPs – Critical Third-Party Providers). This is to ensure that EU financial entities relying on such providers are not exposed to critical risks that may compromise financial stability and the funding the EU economy.

In practice, one of the three European Supervisory Authorities (ESAs – EBA,

ESMA and EIOPA) will be designated as Lead Overseer for each CTPP. Oversight activities will assess whether each CTPP has in place adequate mechanisms to manage the ICT risks which they may expose EU financial entities to.

Proper collaboration between the ESAs and EU financial supervisors will be essential. To that end, the ESAs will be setting out a comprehensive cooperation and coordination framework building on the existing institutional architecture enhanced by new structures.

First, the existing Joint Committee of the ESAs that already facilitates cross-sectoral coordination in relation to all matters, including on ICT risk, will be supported by a new Oversight Forum. The latter will bring together representatives of all relevant competent authorities, with steering and consultative powers, to promote a consistent approach in monitoring ICT third party risk and designating CTPPs at the Union level.

Second, the coordination of oversight activities among the ESAs will be performed through a Joint Oversight Network.

Third, at operational level, Joint Examination Teams established for each CTPP will bring together ESA and competent authorities staff to support the Lead Overseers carrying out their oversight activities.

EBA is looking forward to increasing the stability of the EU financial system through DORA.

All in all, the ESAs, competent authorities, resolution authorities, the ECB, SRB, ESRB and ENISA will closely cooperate to enhance situational awareness and identify common cyber vulnerabilities and risks across sectors. This is in particular reflected in the 'dual mechanism' at the core of the oversight framework: the Lead Overseer will assess whether CTPPs have in place adequate processes to manage the risks posed to financial entities through their oversight activities (e.g. by requesting information from the CTPPs, conducting on-site inspections and off-site investigations and issuing recommendations to CTPPs on its findings) and competent authorities, as part of their prudential supervision of financial entities, may require financial entities relying on the CTPPs to take additional measures to address the risks identified in the Lead Overseer's recommendations.

Due to the inherent cross-border nature of the provision of certain ICT services, the Lead Overseer may also exercise its powers on premises in a country outside of the EU which is used by the CTPP to provide services in the EU. For this purpose, DORA envisages the possibility for the ESAs to conclude cooperation arrangements with third-country authorities.

The DORA oversight framework will require some adjustments from all involved parties: third-party providers servicing EU financial entities, financial entities when managing their ICT risks, competent authorities when rolling out their supervisory toolkit and the ESAs regarding their new oversight functions. Preparations from both private and public sector players are starting now so that the oversight framework be effective when DORA becomes applicable in 2025.

The ESAs are preparing in a joint manner for the implementation of DORA. They are preparing a set of 'level 2' regulatory products (technical standards and guidelines), in accordance with the DORA mandates, of which some have already been published for consultation. They are also launching work on the set of processes and procedures that will be required to operationalise the oversight framework through adequate methodologies and resources.

Increasing the stability and the integrity of the EU financial system through the introduction of the oversight framework is a welcome development, to which the EBA, together with the other ESAs, is looking forward.



DENIS BEAU

First Deputy Governor -
Banque de France

DORA: key conditions for a successful regulatory transformation

The Digital Operational Resilience Act (DORA) is a welcomed development in the EU regulatory framework. It is set to harmonise and increase Information and Communication Technology (ICT) resilience standards and requirements for the whole European financial sector. But it will live up to our expectations only if implemented effectively.

This requires producing high quality texts for the technical standards to be elaborated by ESAs and NCAs, in line with the Level-1 text but also with the state-of-the-art for supervisors and professionals in matters of ICT operation management and cybersecurity. They need to be clear and pragmatic for financial entities and practicable for supervisory authorities (with a high stake in coordination with the various authorities and EU institutions). To this end, feedback from the industry through the public consultations will be carefully considered to have a properly calibrated and usable framework.

Smooth articulation among financial supervisory authorities is also needed to ensure the overall coherence, effectiveness and efficiency of the

framework. To that end, the roles of different designated and competent authorities will need to be clarified for determining the scope of entities subject to threat led penetration tests (TLPT) and leading such exercises.

The efficient functioning of the pan-European coordination framework for cyber-crisis within the financial sector (named EU-SCICF), to be set up by the ESRB, will also need to be ensured. Going further, a full cooperation between authorities in charge of the DORA and the Network and Information Security (NIS2) frameworks is also needed at Member State level. For instance, the NIS authorities still need visibility on major ICT incidents affecting the financial sector, and should assist NCAs in handling incidents or crisis, providing their technical expertise.

A good illustration of these implementation challenges is the new oversight model for critical third-party providers (CTPP). The assessment of the risks arising from critical providers (in particular the ones established outside EU) is a new mandate for public authorities.

This is the most observed piece of the DORA regulation from outside Europe. The new framework has to deliver significant results, and supervisors need to be empowered with all the necessary tools to make it so. The upcoming operational framework should reach the ambitious level of oversight set by DORA.

As DORA marks a breakthrough, its implementation requires clear and effective secondary legislation.

On-site inspections are a key tool for guaranteeing that critical service providers meet DORA's requirements and comply with the requests of the Joint Examination Teams. In that sense, they should not be reduced to mere 'courtesy visits' and should rather align with the intrusive model followed by the SSM for bank inspections.

Another key question relates to the providers that will be designated as critical. It is important to identify the critical providers supplying the ICT services that pose the most important risks. The criticality is not merely size-based and the sensitive nature of the ICT services should be considered.

Finally, the supervisors will also have to assess whether the clients of the CTPPs duly strengthen the management of their third-party risks and resort to all their contractual powers provided by DORA.

National supervisors will have to upscale their internal resources for this new role. Scarcity of talents in IT and cyber risk management will pose a challenge for all authorities.

A condition for success will be to embrace a cooperative approach. As far as possible, ICT tools, human resources and information channels should be pooled among domestic and EU supervisors to avoid unnecessary duplications. Domestic supervisors have experience in terms of ICT-risks monitoring and this experience needs to be fully leveraged for establishing an efficient oversight framework.



GIUSEPPE SIANI

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The long path for digital resilience

Technology and ICT risks have overtime assumed an increasing importance for regulators and supervisors as well as for financial entities, due to endogenous and exogenous drivers.

As to the former, technological innovation influences significantly business models and the strategic decisions of financial entities: digitalisation and cloud computing are modifying the way they operate, thus providing new opportunities to satisfy clients' needs, reducing internal costs and improving internal processes. In several cases the operational model is entirely based on technology: this is the case for example of the so called *challenger banks*. Hand in hand with digitalisation, also the dependence on ICT providers and the interconnection among financial entities increase. Technology provides opportunities but also operational, legal and reputational risks. In addition, ICT providers can represent a single point of failure given that one incident can spread over the system.

As to the latter, irrespective from the financial entities decisions, the ecosystem they operate has changed materially too, due to the technological innovation itself, given for example the increasing number of cyber-attacks

and the rising of frauds to customers mostly based on social engineering. These exogenous elements should therefore be factored into business decisions too in order to properly manage IT/cyber risk and, eventually, preserve data integrity.

The NIS2 Directive, the general ICT risk regulation, and DORA, the financial sector Regulation, address endogenous and exogenous ICT risk factors; they also introduce a cross-sector and cross-country harmonised framework aimed at enhancing ICT security. Both regulations take into account principles and technical standards that have long been used in the financial sector - thus incorporating lessons learnt from the past - and integrate them with safeguards for new risk factors; for example, DORA is not limited to ICT risk but also addresses those new risks that arise from third parties thus introducing an oversight regime for the critical ICT providers.

An interconnected world requires global rules for cyber and operational resilience.

Despite the comprehensive package, DORA is a principle based regulation that can be implemented by the financial entities according to their size and risk profile; DORA also provides for a simplified regime for the smallest and less interconnected entities and some limited discretions at national level to address proportionality. It will be then the (not new) challenge of supervision to understand if the concrete implementation of DORA from the entities in scope is consistent with the financial entity risk profile, actually applying the proportionality principle. Some significant challenges still need to be addressed:

1. **Legislative process:** DORA requires the completion of the regulatory process in 18 months, which must absolutely be complied with;
2. **Cross sector harmonisation:** DORA provides uniform rules for any financial entities regulated by the European legislation, from the traditional banks to new crypto asset providers. To guarantee the overall system resilience, as national authorities, we should apply the same ICT security principles as provided by DORA even to those financial entities, regulated according to the national legislations, not in the scope of DORA¹;

3. **Oversight regime of critical TPP:** the oversight regime will imply a complex interaction among authorities: we must design an effective cooperation framework, as it is key for successful implementation;
4. **Harmonisation of supervisory methodologies:** having a common regulatory framework among countries and sectors is not enough: it is necessary to develop common methodologies, under the ESAs coordination, to ensure consistent implementation.

What further issues remain? In an interconnected world, we need global rules and common principles for cyber and operational resilience. It is therefore important to leverage on the ongoing work of the international standard setters to assess whether common requirements are properly implemented and the risks consistently supervised; a lot has already been done, but we should never lower our coordination efforts

This looks particularly key in the case of cyber-attacks: should unfortunately a cross jurisdictional event occurs, all the community (financial entities, authorities) should be prepared: we have made a lot of progress at the international level (e.g. within the G7 countries and the EU) developing systemic cyber incident coordination frameworks. But we still need to work on this topic defining common incident reporting frameworks, secure communication channels among authorities, conducting more case simulations on different adverse scenarios and developing cyber incident response plans.

1. *As an example, among the others, I refer to financial companies specialised in consumer credit, leasing and factoring.*



MATTHEW MARTINDALE

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Targeting strategic resilience

For several years now, operational resilience has been at the top of the regulatory agenda for financial services. Understandably so, with regulators acutely aware of the threat of disruption to financial firms, and by extension to their customers, particularly in times of stress. They also recognise that in the digital age, the interconnectedness of the global financial system means that disruption can spread rapidly.

Underpinning the many regulatory initiatives is the common desire to create a financial services sector that is more resilient to disruption, reducing the risk of wider contagion, financial instability, harm to end-customers and reputational damage.

Firms are operating in an environment that has long been in a state of simultaneous and overlapping crises. All signs indicate that polycrisis is the new normal. The question firms need to now ask themselves is not 'if' but 'when' will the next crisis strike? And when it does, will they be positioned to remain worthy of their stakeholders' trust?

Firms that recognise this opportunity and invest in building a strategic operational resilience capability will gain a significant competitive advantage over those who view it as just another compliance exercise.

Cyber and ICT security risks are greater than ever due to the accelerated adoption of technology and increasing sophistication of external bad actors. The regulatory response has included the Network and Information Security (NIS2) Directive and the Digital Operational Resilience Act (DORA). But developing rules and regulation is one thing – making them work is another.

So, what do we mean when we talk about successful implementation of DORA and NIS2? And where do the challenges lie for firms and regulators?

KPMG member firms are working with clients to prepare for new requirements and to help them create future-aware resilience cultures. Key to this is the conviction that it is possible to develop a single strategic resilience capability that can meet the needs of multiple regulations and jurisdictions.

The starting point is the plethora of regulation that firms must deal with, at a local, regional, and global level and across different disciplines, including many legacy regulations. We know that across this patchwork of regulation not all the requirements will be aligned, therefore it is critical that firms take a wide view and focus on the big picture.

Proliferation of rules- based regulation should be considered an enemy of strategic coherence.

Much is made of the complexities and nuances of different sets of requirements - these are important as they translate to real costs and implementation challenges for firms. Taxonomies vary, for example, between EU and UK definitions of 'important' or 'critical' functions. DORA and NIS2 also have a stronger focus on technology assets, that must be made more resilient to ensure continuity of service, than on other capabilities. In other areas, such as critical third parties, there is less divergence – requirements relating to lifecycle and criticality criteria are broadly similar in DORA and the equivalent UK regulatory proposals. However, there are potential complexities within the EU itself, where DORA's focus on technology vendors may present challenges due to the necessary uplift from the EBA guidelines on outsourcing to DORA's coverage of all third parties.

However, to focus only on where discrepancies lie risks focusing only on compliance and not on improving

resilience in the system. Regulators have a role to play here in ensuring interoperability between rules and sufficient convergence so that firms can take a pragmatic approach.

There is also a continuing debate on whether prescriptive or principles-based rules are most appropriate. Again, coming from the perspective that developing enterprise-wide resilience must be the goal, prescriptive requirements run the risk of becoming very compliance driven. The proliferation of rules-based regulation in the resilience space should be considered an enemy of strategic coherence – the real prize is strategic resilience.

Elevation of the resilience agenda to board and ExCo level is a welcome and necessary development. Firms should take an enterprise-wide approach - considering technology, cyber security, data, people, third parties and facilities within their organisation and across the supply chain – to deliver real resilience.

The quest for resilience, whether from technology or business process perspectives, will fail if responses are mobilised in silos. Regulators and firms must increasingly recognise the interlinkages across the industry and into the wider economy. NIS2 brings strategic integration across sectors and industries, picking up non-regulated providers and demonstrating again the broader theme of integration and connectedness. As it becomes increasingly difficult to know what 'financial services' is and where it begins and ends, greater connectivity is required to provide a secure ecosystem.

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EUROFI REGULATORY UPDATE

EUROFI VIEWS MAGAZINE

OPEN FINANCE: INNOVATION POTENTIAL AND POLICY PROPOSALS



FRANÇOIS-LOUIS MICHAUD

Executive Director - European Banking Authority (EBA)

The FIDA proposal: balancing innovation, security and societal objectives

In June 2023, the EU Commission published a proposal for a framework for Financial Data Access (FIDA), often also referred to as 'open finance'. The proposal extends the obligation to provide access to financial data beyond payment account data to also cover loans, savings, investments, occupational and personal pensions, and non-life insurance. The proposal covers customer data that financial institutions typically collect, store and process as part of their normal interaction with customers, who can be either natural persons or business customers. This includes, for example, data collected for the purposes of carrying out an assessment of suitability and appropriateness for investment products and for creditworthiness assessments for mortgage products. The aim is to establish rights and obligations

to manage the sharing of such data – if the customer wishes so – within the entire financial sector, to enable the development of innovative financial products and services for users, and to stimulate competition.

While the FIDA proposal can therefore be seen to be a continuation of PSD2, it fundamentally differs from it in the sense that it would not impose uniform obligations for all products in scope right from the start. Instead, firms in scope would need to agree on an industry 'scheme' first. This is a market-based approach that offers significant opportunities for data-driven innovation in the EU financial sector, in a way that avoids otherwise extensive legal requirements with which all financial institutions would have to comply.

FIDA's novelty in that regard is that the eventual success of the proposed framework would depend on the industry to agree, within a period of 18 months, on several issues, such as the liability regime and the functionalities that should be met by the access interfaces used for data sharing. We have seen with PSD2 the challenges arising from the respective starting positions of data holders on the one hand, and those of third-party providers whose business relies on accessing data held by data holders. One should also keep in mind that the FIDA proposal covers a much wider range of data compared to PSD2.

Another key success factor for FIDA is the trust that consumers will have in the proposed regulatory framework. Here, too, the experience acquired in the implementation of PSD2 will be important. Let us remember that the strong customer authentication requirements that were imposed from 2018 have significantly reduced fraud in the payment industry, for some payment instruments as much as by 60% or more. FIDA's current proposal requires data holders and data users to comply with new Digital Operational Resilience Regulation (DORA) but, unlike PSD2, it would not mandate any security requirements for the authentication of customers.

Relatedly, the requirements in Art. 10(1)(d) of the FIDA proposal prohibits financial data sharing schemes to "impose any controls or additional conditions for the sharing of data other than those provided in [FIDA] or under other applicable Union law".

This appears to limit the possibility of data holders to decide on the applicable security requirements for sharing data in scope of FIDA.

Negotiations should also allow to further discuss the nature of the data that is in scope of FIDA and the 'data use perimeter' in Art. 7 FIDA, as well as the delineation between the data collected as part of a creditworthiness assessment of a consumer (Art 2(1)(a)). The same Article would mandate the EBA to develop guidelines on how data within the scope of FIDA can be used to assess the credit score of a consumer, which based on the recitals, would include the objective of mitigating risks of financial exclusion of customers with an unfavourable risk profile. This will be an opportunity to discuss trade-offs between the objectives of promoting data-driven innovation and those of protecting vulnerable groups of customers. Given their importance for society overall, some thought may be given to how best to mitigate these issues in the 'Level-1' legislation directly.

FIDA continues the EU's welcome drive for innovation & competition, but some aspects need refining.

Finally, FIDA would be a good opportunity to reassess the rationale for keeping different legal regimes applicable to account information service providers, which under PSD2 are subject only to registration, as opposed to financial information service providers, which under FIDA would be subject to authorisation, even though their business models look very similar if not identical.

The EBA looks forward to the FIDA proposal being finalised and stands ready to assist the co-legislators as necessary in the process.



ERIK LJUNGBERG

Head of Group Brand,
Communication and
Sustainability - Swedbank

Open finance framework - opportunities and challenges

In Swedbank we are committed to be there for our customers when and where they need us. This includes personal relations as well as offering the most relevant digital services and creating personal finance overview. Thanks to open banking and PSD2, we create new possibilities for our customers using APIs. Payment accounts from more and more banks can be added to create a personal finance overview for the customer in the mobile app or the internet bank. We foresee that open finance will lead to new opportunities in building innovative financial services, rightly designed leading to increased financial literacy among EU citizens. A broadened regulatory framework will support the banking industry to proactively continue the development of relevant services as well as strengthening customer protection and people's financial health.

Even though the potential is high, there are challenges to consider. The proposed EU legislative framework, the Framework for Financial Data Access (FIDA), must be carefully developed. It is vital that cyber resilience and

customer protection are ensured. Also, it is crucial that the framework supports innovation whilst ensuring sustainable business models for all parties. The data integrity of our customers will always be our responsibility. Handling customer data is as important as handling their financial assets and it must be done in a long-term sustainable manner. In Swedbank, our ambition is to take part in and to encourage improved and easy-to-use digital services, produced by us as well as by third-party providers. Albeit, without ever compromising customer integrity and safety.

Opening data to third-party access increase privacy risks and create vulnerabilities. This is concerning especially given the geopolitical situation and the security situation in Europe, where banks are attacked daily. The demands for operational security and technical robustness have increased, for example through the Digital Operational Resilience Act (DORA) and banks work persistently on security. At the same time, customers may not always fully understand what data sharing entails and where privacy risks arise. In practice third parties may include approvals "buried deep" in agreements which are difficult to detect, creating opportunities for organized crime. This means that requirements for participating in the data sharing framework, including the contractual liability of the members of the data sharing schemes, must be high.

**A gradual approach
with different timelines
for each data category
would be helpful.**

Permissions dashboards that provide an overview of shared data, can help customers keep control of whom they share data with in a secure and trusted way. Yet, the information displayed in the dashboard will reflect a contractual relationship between the third party and customer. As a bank, it is difficult to take responsibility for data that exists between the customer and the third party and ensure that it is also accurate. Therefore, we would welcome clarifications from the EU Commission related to the allocation of responsibilities.

Voluntariness and fair compensation models are essential for a well-functioning and innovative financial market. The data to be shared should be based on a real business case and a customer demand. In this regard,

it is crucial to learn from the PSD2 implementation where the regulatory framework did not lead to the high level of innovation as expected. Innovation driven by clear business cases have a higher probability of success to create value for customers and society while building a base for regulatory development.

Introducing a gradual approach with different timelines for each data category would reduce the risk of potential problems and provide better preparation for addressing the challenges that may arise. Such approach could also facilitate the process of identifying relevant business cases and give participants an increased possibility to focus on the long-term value creation, for the benefit to customers, society as well as service providers.

Finally, cross-sector data sharing is essential if real opportunities for the EU economy are to be seized, as this could help identifying new innovative use cases for the benefit of society – not least within the area of sustainability. One example is data sharing between the energy sector and the financial sector. In Sweden for example we have already seen some good innovative solutions for tracking energy consumption with the aim to support the reduction of energy consumption and energy transformation process. Data sharing will be mandatory within the financial sector but not in other sectors.

Data from other sectors will be valuable to unlock the full potential of innovative solutions, tackling and solving issues within a multitude of areas thus creating a better tomorrow.



DIANA PAREDES

Chief Executive Officer &
Co-founder - Suade Labs

Open Finance: empowering data- led innovation

Open finance (OF) emerges as a revolutionary concept, poised to transform the financial industry by leveraging the power of data. By facilitating secure data sharing between financial sector intermediaries and third-party providers, OF unlocks a treasure trove of personal and non-personal customer data. This, in turn, enables the provision of enhanced financial products and services, fosters healthy competition, and propels financial inclusion to new heights. Nevertheless, to fully harness the potential of OF, addressing the challenges of data privacy and security, API utilization, and data standardization becomes imperative. Armed with collaborative efforts and a steadfast commitment to responsible data sharing, OF leads to a new era of data-driven innovation, ushering in a customer-centric and highly competitive financial landscape.

OF brings an array of significant benefits that extend to customers, financial service providers, and supervisors, fostering an effective drive towards data-led innovation in the finance sector. OF opens new horizons for customers, offering enhanced financial products and services tailored to their needs. It empowers them with an aggregated view of their past, present, and future financial situation, enabling more informed decision-making.

Additionally, the streamlining of data collection and processing activities makes it easier to compare prices and features, facilitating seamless product or provider switches. Financial service providers stand to reap rewards from heightened customer satisfaction. By collaborating with fintech startups, they can also co-create innovative solutions and optimize their operations.

OF additionally enables them to conduct more effective creditworthiness or insurability assessments, fostering better risk management practices. Finally, OF provides unparalleled visibility to regulatory authorities and supervisors into the financial system. With access to aggregated data from various institutions, they gain comprehensive insights into market trends, potential risks, and customer behaviors. This information equips them to implement more targeted and effective policies, enhancing the stability and resilience of the financial sector.

However, OF implementation introduces new risks and challenges. The increased flow of customer data between multiple parties increases the potential for data breaches and unauthorized access, putting customers' sensitive financial information at risk. This necessitates robust security measures and strict adherence to data protection regulations to safeguard customer trust and confidence in the system.

**Addressing the
challenges of data
privacy, API utilization,
and data standardization
is imperative.**

Moreover, certain financial institutions are cautious about sharing customer data, seeing it as a vital competitive advantage for customizing services to individual needs. They worry that OF could disrupt their revenue streams and market position while granting competitors access to valuable insights. Another challenge lies in API usage, as they play a crucial role in securely sharing data between financial service providers. Collaborative efforts are essential to establish common API standards, promoting efficiency and reducing implementation complexities. Additionally, data standardization poses a hurdle in the development of OF.

With multiple data formats and structures used by various institutions, aggregating and analyzing data becomes

more challenging. Standardizing them would enable better data integration and utilization, more accurate risk assessments, improved customer profiling and advanced financial modeling.

Therefore, establishing an EU open finance framework entails crucial considerations to unlock these benefits and drive data-led innovation in the finance sector. Key areas of focus include data ownership and consumer protection, both of which play pivotal roles in shaping a trustworthy and information-secure environment. As such, explicit consent should be mandatory for data access, allowing individuals the flexibility to withdraw their consent when needed. Additionally, stringent security requirements, including robust authentication measures, must be in place to fortify data protection. To provide a solid foundation for the responsible management of data within the OF ecosystem, clear liabilities must be defined for data accessing, processing, sharing, and storage.

Moreover, achieving a level playing field and equitable sharing of costs and obligations among the various stakeholders participating in and benefiting from OF is paramount. Finally, standardization of data, technical interfaces like APIs, and operating principles holds utmost significance in fostering efficient OF ecosystems. While industry-driven initiatives can address API standardization, regulatory involvement becomes crucial to ensure uniformity and establish minimum standards.

Leveraging existing regulations and standardisation projects further strengthens the underpinnings of OF, promoting seamless collaboration and innovation across the financial industry.

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Q&A

ALBAN AUÇOÏN

Head of Public Affairs -
Crédit Agricole Group

Is the digital euro fit for purpose?

Is there a clear use case for the digital euro? What are its factors of success?

The major criterion for launching a digital euro should be a clear benefit for citizens. There is no clear new-use case identified for the digital euro, however, and citizens, as in China, would have difficulty understanding the added-value of Central Bank Digital Currencies (CBDCs) compared to current digital payments.

Although the technology is available, it is difficult to predict how customers will react to this new form of central bank money and to what extent the general public will adopt it. A failure would have a negative impact on the euro, which is now very popular, and on the ECB itself.

The success of a digital euro cannot be taken for granted. For the moment, the needs and expectations of citizens have been neglected, as the digital euro has mainly been seen as a way to cope with the challenge of private stable coins or foreign CBDCs.

What are the main business-model challenges faced by the digital euro? What will be the price/cost and investments for using digital euros for citizens, merchants (physical point of sale) and e-merchants? Who earns what for what service in the scheme?

The digital euro could require major investments by the ECB and, consequently, public costs. At the same time, intermediaries (banks, merchants, etc.) will support significant expenses for the build and run of new infrastructures. These costs will be in addition to those already incurred and unavoidable for many players (EPI, instant payment). All these cumulating costs should be carefully assessed before any decision.

The ECB will also have a large room of manoeuvre to set or cap prices and fees, which may disadvantage existing and future private payment solutions. Banks would be obliged to participate in the digital euro system without a clear view on financial compensation. Nevertheless, in order to encourage innovation and offer real value-added services to customers, Payment Service Providers (PSPs) must be able to price their services according to the costs incurred. The list of free basic services should be reduced and the criteria for identifying comparable means of payment should be precisely defined to serve as a reference for the pricing of the future CBDC.

Today, payment systems in the euro area work correctly at a reasonable cost and cover the needs of the population.

The area in which the service can be improved is instant payment, because only a small proportion of payments is instant now. There is, however, a new regulation in the pipeline to foster instant payments, and huge private investments are being made, which should not be put at risk by public-private competition.

Commercial banks should not be driven out of the payment business in favour of a public scheme, and sufficient revenues must cover the cost of new infrastructure for the financial sector.

The central bank's digital currency could also threaten the business model of commercial banks by competing with their collection activities and disrupting their funding capacity.

In order to minimise the negative impact on banks' lending capacity and their crowding out of payments, a limit on the holding of digital euros should be set. This cap should be consistent with the banks' role in financing the economy, with the use of this digital euro as a payment method rather than a store of value, and, lastly, with the average amount of retail payments. Indeed, a massive outflow of bank deposits into the digital euro would negatively affect banks' lending capacity and pose a serious threat to financial stability.

Of course, the digital euro should not be remunerated, as rightly proposed by the draft regulation of the Commission. Otherwise, it could massively drive liquidity outflows from

commercial banks and launch competition between the public and private sectors.

Beyond these elementary precautions, it may be necessary for the ECB to provide banks with specific access to liquidity, in case of significant outflows of deposits towards digital euros.

Does the recently published legislative proposal provide an appropriate framework for the launch of the digital euro?

A solid legal framework will also be vital. The European Commission presented a long-awaited legislative proposal. It is important that there is a level playing field between digital euro and cash. We believe it is necessary to allow Member States to propose exceptions within their own jurisdictions in order to meet the specific needs of each Member State.

Certainty and clarity on the modalities regarding the holding limits as well as compensation for intermediaries are crucial.

The legislative proposal on the digital euro gives a major role to the ECB. It is questionable whether the ECB's current mandate is sufficient to implement a solution that goes far beyond a digital form of cash. This is a main issue for the European Parliament and the Council.

According to the legislative proposal, the digital euro will be legal tender, which will lead to its mandatory acceptance with minor exceptions. We believe that Member States should be able to decide exemptions within their jurisdictions in order to meet specific national needs. Ultimately, the legislative draft on digital euro on the one hand and the ECB project on the other hand, are highly mutually dependent. A digital euro can only be issued with firm backing from European legislators. However, political consensus alone is not enough. Acceptance can perhaps be mandated, but usage cannot be forced.

What are the potential risks and concerns associated with the introduction of a digital euro? How may they be addressed?

Firstly, there may be a contradiction between citizens' aspirations for anonymity and protection against money laundering or other fraud. Indeed, to prevent illegal activities such as money laundering or terrorist financing, the authorities should be able to trace transactions in individual and justified cases.

The ECB is considering specific privacy features such as anonymity below certain thresholds or a low holding limit. Finding the right balance will be difficult, however, many countries are accustomed to cash payments, which are anonymous, even for large amounts.

The second point of concern is that of 'knowing your customer' because that is the role of commercial banks and not of central banks.

Banks have numerous regulatory requirements including anti-money laundering and combating the financing of terrorism (AML/CFT). In this context, for security and operational reasons, data relating to digital euro transactions for the benefit of customers should be transparent for banks.

Information sharing in the fight against financial crime is essential between commercial banks, financial intelligence units, law enforcement agencies and authorities. Restricting commercial banks' access to transaction data would facilitate domestic or cross-border criminal activities.

It seems essential that the deployment of the digital euro relies on commercial banks being capable of ensuring proper customer identification (KYC) while respecting the protection of privacy (GDPR).

This role must be remunerated, however. It is currently paid via the fees for the services provided by banks. Nevertheless, what will happen for the digital euro, and how to avoid duplication of costs for commercial and central banks' digital euro payment schemes?

Finally, liability rules in the event of fraud during the funding or defunding process should be clearly defined. Particularly in the case of a third party payment initiation process: the liability for fraud must be the responsibility of the PSPs that initiated the funding or defunding transaction and not with the PSPs that holds the commercial account.

DIGITAL EURO BUSINESS CASE



HARALD WAIGLEIN

Director General - Federal Ministry of Finance, Austria

Digital Euro - Europe's way forward in a digital age, isn't it?

As we are in the midst of the highly anticipated autumn 2023 waiting for the European Central Bank (ECB) to decide on the possible adoption of its own retail central bank digital currency (so-called "digital euro") it is worth taking a look at this project.

Recently several central banks, in particular the ECB and the Bank of England have shown explicit openness towards central bank digital currencies (CBDC) stipulating that CBDCs will be needed to anchor the value of money in a cashless digital age.

At European level we often hear that a digital euro would boost Europe's strategic autonomy and would make Europe less dependent from third country entities and BigTechs. As a matter of fact, Europe does not have its own payment champions like the USA as of today. In a world of geopolitical tensions, there is certainly a bit of discomfort about being rather reliant on third country private sector companies for its payment infrastructure. Besides that, there is hope that issuing a digital euro would provide an incentive and make it easier for European banks to come up with a national European champion, that could challenge third country-based payment providers.

The questions, however, arise what the expected market share of the digital euro with all its unique design features could be and how this digital euro could then be contributing to the above mentioned strategic autonomy of the EU. Forecasting any future market share is rather challenging. Thus, we should focus on the main drivers of and obstacles to the expected market share and the digital euro's potential contribution to Europe's strategic autonomy.

The design feature that has the biggest impact on the potential market share of the digital euro derives from ECB's commitment to ensuring that both ECB (Eurosystem) and traditional commercial banks are not in competition, but in cooperation. Many bankers had articulated mistrust towards the digital euro saying that the digital euro as risk-free public money issued directly by the ECB would become a safe haven in a crisis and therefore make bank runs more likely. In response to this concern the ECB decided to set limits to individual digital euro holdings - at for example EUR 3.000 (final amount to be determined) - in order to ensure there is not massive outflow from commercial bank accounts into digital euro wallets.

Taking a closer look at this design feature, it becomes obvious that this holding limit results in reducing a lot of potential of

the digital euro to be broadly adopted and successful. In the end, we face a Goldilocks problem where the ECB wants the digital euro to be quite successful but not too successful to avoid market distortions amongst commercial banks and the banking system as a whole causing financial instability.

Another pivotal aspect having a significant impact on the potential market share of the digital euro is a convincing narrative promoting a broad adoption, meaning that European citizens need to understand why this digital euro with a holding limit of e.g. EUR 3.000 is their "number one payment method of the future". The tricky thing is that for most consumers the digital euro would be absolutely indistinguishable from their ordinary retail deposits and the unique feature of the digital euro wallet being fully backed by public money is something most people already mistakenly think is true for their deposits at the bank.

Need to come up with a compelling use case that really wins people over.

Another key reason why it is so hard to explain the added value of the digital euro by saying that we need government-backed public money fit for the digital age could be the following: the past decades lots of very honorable and important economists and politicians have argued and the narrative has gotten established that the monetary system could not function well without certain anchors to gold or the USD. And in the end, it proved to be wrong with fiat currencies in place without anchor today. ECB's narrative justifying a potential introduction of the digital euro is likely to suffer the same fate.

To conclude, the ECB and every central bank across the globe thinking about introducing their own retail CBDC need to come up with a compelling use case that really wins people over to establish a retail CBDC with relevant market share. Central bankers often bring forward reasons why they as a central bank think it is crucial to have a retail CBDC, but struggle with demonstrating "real-life" advantages. So, the following questions need to be answered: why do we need a digital euro with all the other existing digital payment methods in place? Why would it be great for consumers to have the digital euro in their daily life?



FIONA VAN ECHELPOEL

Deputy Director General - European Central Bank (ECB)

Digital euro: designing a new means of payment for Europeans

In the last years, the preference for electronic payments in the industrialized world has been growing, the euro area being no exception. The European Central Bank (ECB) has launched the digital euro project to guarantee that European citizens can continue paying with public money, also digitally.

Same as banknotes, a digital euro would be accepted at any shop, in all countries of the euro area, including e-commerce. By providing an additional way to pay with public money, we would ensure that our monetary system remains resilient. In addition, a digital euro would provide a platform for innovation and in turn reinforce the strategic autonomy of the European payments sector.

Since the launch of the digital euro investigation phase in July 2021, the ECB has been looking into the most suitable design choices and ways to distribute a digital euro. The goal is to ensure that it brings benefits for all stakeholders while tackling any potentially negative consequences.

Consumers would benefit from a new means of payment, in addition to cash and other electronic payments. It would be secure, user-friendly and inclusive, usable online and offline. As a public good, it would be free for daily use for citizens – as is cash.

The “free basic use for private individuals” principle is a key pillar of the compensation model. Supervised intermediaries, like banks, would be responsible for distributing a digital euro to citizens. The Eurosystem thus proposed a compensation model that would offer economic incentives for intermediaries similar to other electronic payments, and that would cover operational costs of distributing a digital euro. At the same time, intermediaries would be able to negotiate fees with merchants for digital euro services. However, the model allows for a cap to prevent excessive fees not in line with comparable electronic means of payment. All these aspects are now reflected in the recent legislative proposal by the European Commission. Besides the incentives foreseen in the model, merchants would benefit from a European-based solution to receive payments instantly from anywhere in the euro area.

To achieve a seamless and harmonized payment experience for Europeans, the distribution of a digital euro would rely on a scheme: a single set of rules, standards and procedures that would be applicable to all intermediaries across the euro area. The cost of establishing and maintaining a digital euro scheme would be solely born by the Eurosystem. The scheme also seeks to re-use existing rules, standards, and infrastructure as much as possible to minimise any additional investment costs for intermediaries. For that, the public-private collaboration in the Rulebook Development Group is essential and testimony of our commitment to engage closely with all stakeholders.

The distribution model for a digital euro would keep intermediaries at its core, as they are in today’s financial system. To prevent undue risks to this functioning system, the amount of digital euros users could hold would be limited. The exact specification of this limit can and should only be done closer to a potential issuance.

A digital euro aims to make digital payments easy and secure for every European.

In terms of privacy, which is a key concern for consumers and policymakers, the ECB would not have access nor store personal information from users. Digital euro transactions would be as private as allowed by European law. Similarly, a digital euro would be designed in a way that it is also inclusive of elderly citizens, people with disabilities as well as users with limited financial or digital abilities. For instance, the Eurosystem could develop a dedicated digital euro app to which all euro area citizens could have equal access. Likewise, intermediaries could integrate digital euro services into their existing banking apps. People without a bank account would also be able access digital euro via public, designated intermediaries, like a post office, and people without digital devices may use a physical card to pay with digital euro.

In short, a digital euro aims to make digital payments easy and secure for every European citizen everywhere in the euro area. The findings of the two-year investigation phase of the digital euro will soon – in autumn this year – inform the ECB’s Governing Council decision whether to move to a preparation phase.



PHILIPPE BORDENAVE

Senior Executive Advisor to General Management
and the Chair of the Board - BNP Paribas

Why is ECB so hastily wanting to build a direct current account to citizen?

Many central banks are conducting research about CBDC but only three countries have undertaken an effective launch through June 2023: Jamaica (JAM-DEX), Bahamas (Sand Dollar) and Nigeria (e-Naira)¹.

China is extending progressively the experimentation with its e-Yuan for its own motives – including regaining control of the payments ecosystem from private sector players – which are quite distant from European values.

We do not see any urgency to build the Digital Euro. Of course, central bank money should not be left aside of the digitalization of society but the ECB makes clear that the digital euro is to complement cash not replacing it. Existing means of payment cover all citizens' needs to date. The request to pay in central bank money for e-commerce needs to be demonstrated. The cost of the project for all stakeholders shall be extensively evaluated to make sure it does not overweight the expected benefits.

The argument of an absence of a pan-European payment solution neglects the SEPA framework that already provides a complete offer. It will be further developed with Instant Payments, unless their adoption is slowed down by under investments arising from the need to finance the launch of the D€.

The European Payments Initiative (EPI) – which received public support from European institutions – will offer its first services in 2024 after a pilot phase by the end of 2023.

Public intervention should be limited to addressing market failure. Subsidiarity should prevail.

While Distributed Ledger Technologies projects (Libra...) were at the origin of the initiative, the ECB says now that the D€ will probably be a simple scriptural euro just as the existing payment systems. In the absence of DLT, the D€ will not bring added value to the tokenisation of the economy. It will be of no use as an exchange currency for the crypto asset being developed in the markets.

By itself, a digital euro is not a solution that can guarantee European sovereignty in the payment's domain. Actually, it could be feared that large digital players would leverage on the digital euro to lock even more their customers within their ecosystems. Everybody noticed that Amazon has been selected by the ECB in its front-end prototyping exercise.

As an European bank, we strongly believe in European values notably primacy of private enterprise, free market, fair competition and privacy. Public intervention should be limited to addressing market failure by setting high level principles-based regulation. Subsidiarity should prevail.

Co-legislators will hopefully take all the time needed to carefully analyze all aspects of the project notably privacy issues and financial stability and draw a clear line between public intervention and private initiatives.

1. Source: cbdctracker.org



JOSÉ ANTONIO ÁLVAREZ

Vice Chair - Banco Santander

From high-level policy objectives to day-to-day payments

In October, the European Central Bank will present the conclusions of the digital euro investigation phase. It has been two years of intensive work in which the ECB has evaluated different design options to respond to the policy objectives to be achieved with the digital euro, those are to reinforce Europe's strategic autonomy, and to provide a monetary anchor against a potential disappearance of cash in everyday payments.

This initial phase has shown the complexity of the project and the importance of ensuring the right design. It is essential to avoid by design the potential risks that the digital euro poses to financial stability, limiting the use of the digital euro as a store of value, and ensuring an orderly deployment that avoids any potential abrupt adoption scenarios. Besides, it is necessary to create the conditions for the private sector so that the digital euro contributes to making payments, and ultimately Europe, more competitive. As it would happen with any other means of payment, the digital euro will be adopted only if it provides value for citizens and businesses. At the same time, intermediaries should also play a key role in this new ecosystem, by integrating digital euro payments into people's day-to-day financial lives, explaining how to use it, solving citizens' doubts, and offering new services to customers.

From the point of view of future users, the question that immediately arises is what is the added value that the digital euro will bring to citizens in their everyday payments. Although the level of payments development across Europe is not the same, in general European citizens already have a wide variety of available means of payment that they use daily. And we see new solutions appearing every year. It is therefore not obvious how to translate the high-political objectives that the digital euro aims to achieve into concrete benefits that would motivate citizens to use it.

From the payment service providers point of view, the digital euro will inevitably compete with existing private means of payment. It is the aim of the Commission and the ECB to bring optionality to citizens in their payments. The challenge for authorities is then how to:

- Avoid artificially crowding out existing domestic private solutions which are being successfully used, when trying to encourage the adoption of the digital euro;
- Create the conditions for the private sector to provide digital euro services and to innovate and build new added-value services on top of the digital euro.

The market shows that there are no free of charge services, and when they are free it is because they are being monetised in another way. And the costs for the private sector for first deploying the digital euro, and then to provide services can be very significant. Leveraging on existing payments

infrastructures and domestic solutions that are being successful as much as possible would be the most efficient and effective way to distribute the digital euro reducing these costs. However, still there will be a cost for providing these services.

We need to think of the right compensation model that ensures on the one hand that the costs for providing these services for intermediaries are properly covered, and at the same time, that the digital euro competes on an equal footing with other existing private solutions, avoiding the crowding-out effect that would be detrimental for the competitiveness of the sector.

The legislative proposal submitted by the European Commission, which will be discussed extensively by the legislators in the coming months, opens a new phase for further deepening the design of the digital euro. The ECB will also continue to analyse these issues during the new preparatory phase which is expected to start later this year.

The digital euro will only be successful if creates value for citizens, merchants and intermediaries.

A calm and in-depth analysis of these matters is needed to ensure that, if the digital euro is issued, it will deliver value to citizens, businesses, and intermediaries, and will contribute to a more competitive, efficient and innovative payments market. Otherwise, there might be other possible solutions that could be considered to achieve the policy objectives set for the digital euro.

Finally, in my view there would be value in also exploring the benefits of issuing a CBDC in the wholesale space, which are probably clearer. A wCBDC could offer significant improvements in cross-border transactions in terms of costs, speed, access, and transparency, and could also contribute to the secure development of tokenised financial markets enabling market participants to benefit from the advantages of DLT (such as programmability), while continuing to provide safe settlement in central bank money.



MANUEL GALARZA PONT

Head of Compliance, Control
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Building a safe and solid path towards a Digital Euro

The path towards a Digital Euro (D€) is being built as we speak. The ECB's technical investigation-phase is expected to end by October. In addition, the ECB is working on a Rulebook to support the distribution of the D€ via supervised intermediaries. Private sector professionals are actively contributing to this work. In parallel, the European Commission has proposed a legislative framework for the D€, involving three Regulations. This legislative process is also expected to consider feedback from stakeholders.

The path towards the D€ is completely new, without precedents in the EU. Perhaps, the closest experience was the adoption of the physical euro in 1999. Despite differences, some lessons can be drawn. A clear one is gradualism. In due time, and if the final decision is to go ahead with the D€, a "start small" approach can prevent disruptions, giving authorities some flexibility, and time for people to adapt. In fact, for the physical euro, there was a transitional period between 1999 and 2002 with phases of introduction. A start small approach has also the benefit of avoiding irreversible scenarios.

From a customers' experience and needs perspective, the D€ has two key differential features in comparison with other digital payments options. First one is privacy. Yet, the consensus is that privacy should not hamper AML/FT and fraud controls. For the on-line D€, the same AML/FT and fraud procedures/monitoring applied to existing digital payments can be replicated. The off-line D€ is more challenging though. A solution could be to define a threshold below which access to personal data by Payment Service Providers (PSPs) will be minimised. The second clear feature is the possibility of doing instant payments between individuals, including EU cross-border payments, both inside and outside the euro-zone. These two features rank at the top of EU citizens' preferences.

The D€ is expected to have a legal tender status. As such, the path towards the D€ has also to define the financial intermediaries that will distribute it. Distribution by banks will be mandatory. In principle, distribution by payments and electronic money institutions would also be possible. Banks are financial entities with a long and proven experience bringing certainty with regard fraud controls – with digital fraud attempts increasing at double-digits rates in the last years – and ensuring compliance with AML/FT requirements. All this reinforces the need to start small in a controlled environment, particularly in a scenario with off-line operations. Therefore, it would make sense to start by restricting distribution only to PSPs with a strong and testable track-record in AML/FT and fraud monitoring.

The ECB is also considering a holding limit, which would limit the amount of D€s a person can have. As defined by the EU Commission proposed Regulation, the D€ should work as

mean of payment – not as an investment or to store substantial amounts of D€s. The holding limits aims to ensure this, thereby preserving financial and monetary stability. Evidently, these are key concerns.

The initial proposal by the ECB set the holding limit at 3000 euros. By contrast, the amount of cash payments that most consumers make, and the amount of cash consumers store in physical wallets appears to be much lower (eg: 500 €). This calls for a detailed bottom-up impact study to set the limits, along with an assessment of the suitability of a transaction limit and overall volume limit on wallets. But, to actually enforce any limit will be equally important. One wallet (vs the option of multiple) will allow a better control of the limits, with lower costs and fewer technical barriers, and will provide a better customer experience.

The path towards the Digital Euro should be gradual and guided by careful assessments.

The D€ should also provide right incentives for financial intermediaries, also considering operating costs and the stock of investment in new infrastructure – very significant in some cases. As proposed by the EU Commission, merchants will pay a service charge accordingly to a compensation scheme. Such a scheme should be mindful of existing remuneration models in terms of fees for services, should offer a similar level of incentives as electronic payment alternatives, and be competitive with other providers.

In addition, it would be efficient to use existing instant payment infrastructures in place. Just in Spain, Italy and Portugal there are more than 40 million users. This is material if compared with the 110 million end users of D€s estimated by the ECB in a medium scenario. Most importantly, using existing infrastructure would work as a catalyst for the D€, as it would be integrated into platforms that have already been able to consolidate habits among users.

Forum organised with the contribution of the Eurofi members



DIGITAL EURO ROLE AND CHALLENGES IN THE EU PAYMENT LANDSCAPE



BURKHARD BALZ

Member of the Executive
Board - Deutsche Bundesbank

Digital public money for everyday life

Our everyday lives are turning increasingly digital. Take, for example, digital-only products like video streaming services, which are already commonplace today. But combinations of digital and analogue processes are ubiquitous, too. An e-commerce store offers access to a broad or highly specialized selection of products.

A digital purchase there then turns into a delivery in the analogue world. Many people see these processes as entirely routine, and evidently have great interest in letting digital elements intrude into their everyday lives. Public money is lagging behind these advances to a degree: central bank money is not yet available to the general public in digital form, only as physical cash. In the longer run, central bank money as legal tender may develop into a niche product, because people tend to opt for payment instruments that work smoothly in any payment situation.

Against this background, it is only reasonable for central banks to think about adding a new digital dimension

to central bank money. This is why the Eurosystem is considering a digital euro. We have a clear vision of what the digital euro should be: digital money that people in the euro area can use everywhere in their everyday lives.

To be an option that people are likely to choose, any digital means of payment needs to satisfy the requirements of simplicity, reliability and security. Those standards might sound self-evident, but it will take a huge effort to achieve them. After all, what makes digital money and using it simple?

First, it has to be usable in nearly all the payment situations people usually encounter. That's why the Eurosystem is envisaging the entire range of scenarios, from payments at the point of sale, to person-to-person payments, both in physical proximity and remotely, through to e-commerce. However, a payment instrument not only has to be usable in as many situations as possible – people also need to see it as convenient. For that to happen, various decisions have to be taken. For example, how should a payment with a digital euro be triggered? Contactless payments are widely used and popular nowadays. Offline payments could add a new dimension to this technology and bolster resilience in the system and privacy in payments. However, QR codes have potential as well, since they can generally be used in all scenarios, including for remote payments, which are not feasible with contactless payments.

Another aspect of the simplicity requirement is how people can access the digital euro. Access must be possible without barriers and thus, ideally, via familiar and pre-existing channels. Hence, financial intermediaries are ideally placed to make this possible. Moreover, leveraging existing relationships and players would promote the healthy coexistence of private and public money. The reliability of the digital euro is no less important. One dimension of this, which is also closely related to simplicity, is the guarantee to the payer that the digital euro will be widely accepted.

The digital euro's envisaged status as legal tender provides a sound footing for this. For merchants, meanwhile, the widespread rollout of the digital euro owing to its status as legal tender will, if anything, create cost advantages. The more merchants accept the digital euro, the more efficient it

will be for each additional merchant to do the same at their own point of interaction. In practice, merchant fees could be attractive due to both strong competition and regulatory supervision. The security of payments relates primarily to data security and privacy. The key here is to guarantee the best-possible level of protection while giving users the opportunity to retain control over their data.

With the digital euro, data would not be exploited by intermediaries without the user's consent, and the technical design would make it impossible for the Eurosystem to trace transactions back to identifiable users. However, a digital euro that is designed for widespread retail use will only be a success if the private sector is also on board. Banks as the most important group of intermediaries would play a crucial role as an access point to digital euro.

**Digital money that
people in the euro area
can use everywhere in
their everyday lives.**

To allow banks to integrate the digital euro as seamlessly as possible into their existing systems and processes, it will be important for the digital euro to reuse as many of the existing standards as possible so that the integration costs remain low as a result. This is what the scheme behind the digital euro is also intending to achieve.

On the road towards delivering simple and secure payments with a digital euro, some challenges still lie ahead of us. For example, a fraud detection system has to be set up in combination with the highest levels of privacy. It should be solved in public-private partnership that might allow infrastructure for various products to emerge beyond the boundaries of the digital euro. And this could also broaden the view: from digital money for the people to a standard-setting piece of European infrastructure.



ALEXANDRA JOUR- SCHROEDER

Deputy Director General for
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Services and Capital Markets
Union - European Commission

Towards a digital euro?

The world of finance is undergoing a seismic change as a result of the digital revolution. As people increasingly prefer to pay digitally, the use of cash is declining, although it will not disappear. In line with this, central banks around the world are now looking into issuing their own digital currencies. For the euro area Member States, the ECB is investigating the possibility of introducing a digital euro, as a complement to physical cash. It would be a digital form of central bank money that could be used by citizens and businesses alike for their retail payments, and would be convertible one-for-one with cash.

Private money – bank deposits, and electronic money solutions – ultimately relies on our confidence that it can be converted, at par, into central bank money. Thus, the smooth functioning of our payment system ultimately depends on central bank money playing its anchor role. But for this to continue to be the case, central bank money should evolve with changing technologies, payment habits and financial ecosystems. Hence, the digital euro project.

There are, of course, many questions about how a digital euro would work in practice. Answering these at this stage is not easy, as the ECB continues to reflect on these matters. It has completed its initial, exploratory phase of this project. In October 2021 it moved on to the investigation phase, which involves considering what a digital euro should look like. This phase is expected to conclude in October of this year.

In parallel, the European Commission has recently taken two important decisions. Firstly, we have adopted a proposal which safeguards the use of cash as an accepted form of payment. Secondly, we have proposed a Regulation establishing the digital euro and regulating its essential aspects. This would allow the ECB to go ahead and issue a digital euro, if it decides that it would be worthwhile doing so.

Regarding consumers, a digital euro needs to support financial inclusion. A big advantage of a digital euro is that it could potentially be used by those without a bank account. In addition, paying in digital euros could be possible even without an internet connection. The digital euro should also have usage and service features that are simple and easy to handle for all, including for people with disabilities and older persons. And its distribution should be as broad as possible, including for those who do not have, or wish to have, a bank account. This is why we propose that some public authorities and post offices in Member States distribute the digital euro.

**A digital euro could
offer many potential
advantages, both
for consumers and
companies.**

Another key consideration is data privacy. The ECB will have to implement data protection rules agreed by the European Parliament and the Council, under the supervision of the European Data Protection Supervisor. The Commission proposes that citizens be given the possibility to use the digital euro without internet connection for proximity payment, with a level of privacy comparable to cash: no bank will see what you spend your money on. Also, all data will have to be encrypted so that neither the ECB nor national central banks can identify individual data transactions. In today's digital payment systems, this level of data protection is unprecedented.

How will financial services firms be impacted by the launch of a digital euro? All payment services providers under PSD2 should be in a position to distribute the digital euro. We expect competition in the market to best serve people and businesses, including by the provision of value-added services, e.g. conditional payments or the ability to split person-to-person payments among multiple parties. Thus, the digital euro should lead to the development of innovative, pan-European products around this new ecosystem.

Finally, the digital euro should be designed so as to avoid potential adverse impacts on financial stability and the provision of credit to the real economy. The excessive use of the digital euro for investment purposes, and the associated risk of sudden, large shifts from bank deposits to the digital euro, should be avoided. This is why the Commission has proposed that digital euro holding should not bear interest.

Overall, a digital euro could offer many potential advantages, both for consumers and companies. And we also see strategic reasons for doing so, given that other central banks are also moving forward in this area. Once the ECB has completed its investigation phase, it will decide whether to initiate a preparation phase to look at developing and testing the new digital currency. We look forward to working closely with them on this project.



MINDAUGAS LIUTVINSKAS

Vice Minister of Finance of
the Republic of Lithuania

The uptake of the digital euro will define its success

The ECB has made considerable progress during the investigative phase of the digital euro project, and it is now evident that the technical solutions exist to satisfy various objectives raised by policymakers. A significant step forward has also been taken on the legal side with the Commission's proposal to establish the digital euro as a legal tender.

Overall, progress on the legal and technical fronts suggests many promising features of the digital euro to foster innovation, enhance financial and digital inclusion, and make daily payments cheaper, more efficient, and more convenient for individuals and businesses.

However, reaping the full benefits of the digital euro will largely depend on the level of uptake. Broad adoption of the digital euro will be necessary to create market effects and economic incentives that could further boost digital euro usage. In this respect, I would like to highlight a few points critical to the project's success.

The digital euro should be widely accepted in all areas of economic life, with as few exceptions as possible. If any exceptions are granted, they should be aimed exclusively at micro and very

small businesses. Larger exemptions may hinder incentives to use the digital euro and lead to unnecessary market fragmentation.

The digital euro needs to be universally and conveniently accessible. The onboarding process should be smooth and straightforward for everyone, including the unbanked or underbanked segments of the population, thereby promoting greater financial inclusion and empowering individuals to improve their financial well-being. Being a public good, basic services of the digital euro should be free of charges, while costs for businesses should be competitive compared to existing payment services.

Offline payments will be essential to match digital euro functionality with physical cash. It would provide a material improvement compared to existing digital payment solutions, which do not have offline functionality and it could be a compelling incentive for people to start using the digital euro, even for those without a private bank account.

The digital euro should promote competition and innovation by securing a level playing field for companies that aims to build front-end solutions. This should ensure that the digital euro will become a catalyst for innovation, positioning Europe at the forefront of the digital revolution. Close and continuous cooperation with market participants will be critical to leverage the benefits of public-private partnership.

Effective communication will be key to build the necessary trust for widespread adoption.

Effective communication will be key to build the necessary trust for widespread adoption. Three pivotal points need to be clearly and comprehensibly conveyed to society to dissipate unwarranted concerns.

First, the digital euro will not replace cash but will supplement it. Moreover, the legal status of cash will even be strengthened by the European Commission's accompanying legislative proposal on the legal tender of euro cash.

Second, the digital euro will have robust security measures to safeguard user data and privacy. It is essential to emphasize that the level of privacy of the digital euro will be equivalent to that of private digital payment solutions, while offline payments will provide even greater privacy, as authorities and

intermediaries will be unable to access information about where the money was spent.

Third, it is crucial for all relevant public authorities to proactively disseminate information about the added value that the digital euro will bring to daily life for both businesses and individuals by introducing a new, fast, reliable, and convenient payment option available everywhere.

At the time of issuing the digital euro, we must be certain that the system will work as intended in terms of scalability, reliability, and speed. We need to be on the safe side that all potential issues are addressed in full before the digital euro becomes available to the public. In this case, patience and thoroughness are more important than speed.

The widespread adoption of the digital euro is paramount not only to unlock the potential economic benefits but also to achieve broader political objectives. With a large user base, the digital euro can pave the way for the emergence of a truly pan-European payments system, competitive with established payment service providers. Moreover, broad uptake may serve as a safeguard against the widespread adoption of foreign CBDCs or private global stablecoins, ensuring the financial sovereignty of the euro area in the digital age.

Finally, it is welcome that the ECB has announced the exploration of wholesale CBDC solutions that have the potential for significant efficiency improvements, with likely implications for the euro's stronger international role.



KAROLIN SCHRIEVER

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

Thoroughness versus speed – A digital euro as a public-private- partnership

Central banks around the world are working on central bank digital currencies. As early as 2014, the People's Bank of China launched a retail CBDC project and has been testing their digital Yuan since 2020. So far however, the eYuan appears not to have been met with widespread acceptance among the Chinese population, even though users receive discounts for public transportation and other services when paying via CBDC.

In Europe, the European Central Bank has been conducting research around a retail CBDC since at least 2019. The initial spark was not the rise of Bitcoin, but rather the announcement of big techs to introduce global private currencies, in particular Meta's former plans for a Libra stablecoin. But while the Libra-Diem project has been terminated due to regulatory and public backlash, the ECB's response in the form of a digital euro is alive and well.

The political objectives mentioned by the ECB to make the case for a digital

euro, such as maintaining monetary sovereignty in the digital age, are legitimate. They are by and large shared by the financial industry. However, the Commission's proposal should be examined closely to determine whether it is actually conducive to these overarching strategic targets.

The development and issuance of the digital euro will entail considerable costs, and significant parts of the population perceive the digital euro as a surveillance tool and potential monetary policy instrument. Taking these concerns seriously is of elementary importance against the backdrop of the rise of authoritarian and populist political forces. Public concerns should be addressed and the digital euro should avoid adding fuel to the fire of regressive forces in EU integration. Unfortunately, the remarks on data protection in the EU Commission's proposal are open to contradictory interpretation. In Europe, liberal values, self-determination and decentralization must be strengthened. Whether the mammoth project of the digital euro sufficiently embodies these values in its current setup remains questionable.

With these considerations in mind, the current proposals give more rise to disillusionment than euphoria. The currently envisaged design of the digital euro would be no more digital or innovative than existing payment solutions within the SEPA or a future framework under the European Payments Initiative. A market with different types of payment transactions provides healthy competition and pushes down unit costs. Innovations such as instant payment already exist.

EPI would be a suitable partner to create a large acceptance network for a digital euro.

At the risk of citizens not caring whether they use central bank or commercial bank money, rather coercive measures are planned – such as compulsory acceptance of the digital euro as legal tender. In order to achieve and maintain sovereignty in payments, it would appear to be more conducive for the Commission to pursue an industrial policy strategy hand in hand with European providers. The risk of detrimental effects to a competitive financial sector is not to be underestimated. Innovations will hardly be possible under the planned compensation model.

A digital euro transaction is more than just pushing money from A to B. Processes such as fraud prevention, refunds or anti-money laundering procedures will have to be run in the background by banks. Therefore, it can make sense to rely on proven payment infrastructures such as EPI. EPI is a pan-European project, relying on established European standards and involving the European banking community. There are also major overlaps between a digital euro and EPI in the considered use cases. For these reasons, EPI would be a suitable partner to create a large acceptance network for a digital euro in operational implementation and thus offer customers the best of both worlds. For this, it is important to introduce clear requirements and roles and to delineate them from each other.

Responsibilities of commercial banks, payment providers and the ECB should be clearly defined and separated. Citizens ultimately expect a digital euro as the doppelgänger of cash, storable in a decentralized manner and largely anonymous. It should be examined whether this can actually be better realized in an account or by means of a token. The guiding principle for the digital euro must be to design it as much as possible as digital cash, but with the least necessary amount of structural policy by the ECB.

While Libra's days are numbered, those of the digital euro are beginning only now. With the perceived threat of a global private big tech currency off the table for now, the ECB could indeed take more time to develop a digital euro as a retail CBDC. In the meantime, a wholesale CBDC could be introduced. This would allow the foundation to be laid and initial experience with the technology and infrastructure to be gained. The interim period could then also be used for more in-depth impact assessments on part of the ECB and the Commission. This way, the unfavorable trade-off between speed and thoroughness could be avoided.



RAFAEL MARQUEZ

President, International Card Services - American Express

The Digital Euro: a necessary evolution or an uncertain solution?

As we progress ever deeper into the digital age, the concept of money continues to undergo a transformative shift. One manifestation of this shift is the 'Digital Euro', an initiative from the European Central Bank (ECB) to introduce an electronic counterpart of the single European currency. But as we usher in this new era of finance, a critical question arises: Is the Digital Euro necessary, or is it a solution in search of a problem?

At its core, the Digital Euro aims to modernise European payments by providing an electronic alternative to physical cash. It is part of a broader global trend towards central bank digital currencies (CBDCs). However, the push for a digital version of Europe's single currency has met with a mixed response, generating as much debate and confusion as it has interest and anticipation.

While the declining use of cash is one driving force behind the initiative, the threat from privately controlled digital currencies and other nations' CBDCs is another. However, as the threat from private cryptocurrencies continues to diminish, and the ubiquity of digital transactions grows, the necessity of a Digital Euro comes into question.

Most citizens and businesses are already, in effect, using digital money via contactless cards or mobile banking apps. For many, the nuances of central bank currencies are likely hard to grasp, and the advantages of a Digital Euro over existing payment systems remain nebulous. Thus, policymakers must grapple with the perception of the Digital Euro as a solution in search of a problem.

Ignazio Angeloni, a former member of the ECB's Supervisory Board, summed up the challenge succinctly in a recent interview: "What is the compelling reason for making this reform? This is the big unanswered question. I don't see any big failures in the market that require the public sector to step in and provide a Digital Euro." Therefore, it is apparent that the key to the project's success is the ECB's ability to build a more persuasive case that would rally private sector support and incentivise rapid uptake by consumers.

A closer look at the proposed Digital Euro and the European Commission's accompanying legislative proposal also reveals some pertinent details that should be considered to ensure the project is a success.

Chief among these is the role of non-banks, such as American Express, in the distribution of the Digital Euro. Banks have traditionally been the primary facilitators of payments in Europe. However, in the digital age, non-banks, including fintech companies and other digital payment platforms, have taken on a significant role in the financial ecosystem. Therefore, it is crucial that the Digital Euro scheme does not privilege banks over non-banks. Rather, a level playing field should be maintained to promote competition, innovation, and widespread accessibility.

It is crucial that the Digital Euro scheme does not privilege banks over non-banks.

Another crucial point is the limit on the number of Digital Euro accounts a citizen can hold. Initially, the ECB proposed restricting individuals to one account, to control the number of digital euros in circulation. This suggestion, however, seems unnecessarily restrictive. Instead, citizens should have the freedom to own multiple digital euro accounts, as the industry is pleased to see reflected in the Commission's proposal. This outcome would mirror the current practice of

having accounts with multiple banks and encourage a more dynamic and adaptable digital economy.

Lastly, it is worth mentioning the debate around the fee structures that payment service providers (PSPs) can apply to Digital Euro transactions. While safeguarding consumers and merchants from excessive fees is a legitimate concern, putting a cap on these fees would inadvertently hamper the spirit of innovation and competition that drives the financial industry.

The argument here is subtle but profound: by levelling the playing field and allowing PSPs to set their own fees, the market becomes a fertile ground for innovation. PSPs will be incentivised to differentiate themselves by offering novel services and superior experiences to their consumers and merchants, beyond just competing on the price. The freedom to set fees according to the value they provide would, therefore, promote a more robust and dynamic digital euro ecosystem. Any move to restrain this freedom by enforcing low fee limits could stifle industry investment and innovation. This could seriously hinder the successful execution of the initiative, potentially resulting in a less successful uptake of the Digital Euro.

As policymakers, regulators, and the public at large struggle to comprehend the complexities of this ambitious project, one thing is clear: while the concept of a Digital Euro holds the promise of a more streamlined and inclusive financial future, the devil, as always, is in the details. Policymakers, legislators, and stakeholders must carefully weigh the nuances of its implementation to ensure that this evolution truly benefits the economy and society at large.



PABLO ZALBA

Partner - Deloitte

Introducing the digital euro

The launch of the digital euro (d€) seems increasingly imminent, following the European Commission's June proposal outlining the framework for a possible d€. The digital euro would grant all Europeans access to digital money from the central bank. Given its commitment to safeguard financial stability, the ECB is expected to establish a ceiling for the amount users can possess. The d€ is primarily envisioned as a method of payment rather than as an investment instrument.

What are the expected challenges for citizen adoption? How might incumbent financial institutions be affected?

To examine the citizen adoption challenges ahead of us, we should understand that the EU institutions are not necessarily trying to address significant market failures by introducing the d€. Instead, they are focused on two issues that do not directly personally affect EU citizens. This raises a particular challenge regarding the adoption of the d€ among EU citizens, raising key questions: how can the d€ be introduced without damaging the payments ecosystem and/or causing financial instability?

1. Market failures

Addressing the affordability of the current payment ecosystem is not the d€'s main goal. Indeed, the current legislation on payment services (*PSD2, soon to be replaced by a revised PSD3 and Payment Services Regulation (PSR)*) has proven to be effective at

limiting costs for private individuals and merchants, and the European Commission (Commission)'s legislative proposal for a d€ also foresees a fair compensation for payment service providers (PSPs) distributing the d€. Nor would the d€ be the most cost-effective solution to solve other issues cited by the European Central Bank (ECB), such as a purported lack of cross-border payment functionality and lack of inclusivity. After all, EU legislation could in theory simply mandate universal acceptance across the EU or impose requirements to make payments solutions simpler and more accessible.

2. Issues to be fixed by the d€

The EU institutions are advancing the digital euro project for two primary reasons: to ensure that public money remains central in the economy and to strengthen the EU's open strategic autonomy. These considerations are significant in the long term but not urgent in the short term.

On the topic of public money, studies indicate a decreasing use of cash. While cryptocurrencies have not gained widespread traction yet, there's potential for successful future cryptocurrencies, potentially released by major technology firms. In a scenario where the role of cash is minimised and private payment solutions are dominant, the ability of central banks to maintain economic stability by managing the supply of money would be limited.

Regarding open strategic autonomy, the EU institutions are concerned about the dominance of non-EU PSPs in the EU and the possible rise of a third-country central bank digital currency. In future crisis scenarios, the EU wishes to ensure that it can limit foreign influence on the EU economy and fall back on EU-owned infrastructure.

3. Particular issues arising from d€ goals: holding limits and AML/CFT considerations

The d€ would impact the EU payments ecosystem which, despite its alleged lack of EU-based payment services alternatives, is delivering acceptable results to EU citizens. This is recognised by the ECB, which has stated the aim of the d€ as complementing, not challenging or crowding-out existing payment solutions. It is difficult, however, to achieve this goal, finding the right balance between attractiveness and limitations. The d€ should offer the same benefits as cash and not offer benefits that would make it more attractive than the offerings of private PSPs. It should also incorporate a holding limit, to ensure that the d€ can only be used for payments and not to store value.

Establishing an appropriate holding limit demands the careful consideration of various factors. Primarily, it must not be set too low, as this may make the d€ unattractive to citizens. On the other hand, setting the limit too high could lead to adverse consequences enabling large-scale migration of citizens' savings to d€ accounts, possibly threatening mandatory banks liquidity buffer. Simultaneously, certain banks and PSPs might be forced to make substantial changes to their business models.

The damage stemming from failing to finding the right balance would be disproportionate to the (primarily future-oriented) benefits of the d€ aims from safeguarding the role of public money and achieving the EU open strategic autonomy. The assessment process for holding limits should be comprehensive and robust, avoiding frequent or politically motivated adjustments. These limits should be established with a long-term perspective, based on sound economic principles and data-driven analysis in order to instil confidence among citizens and businesses, and set a conducive environment for financial planning and investment. Minimising unnecessary holding limit fluctuations is required for financial security and sustainable growth.

Since the d€ will be as similar to cash as possible, with the same level of privacy and accessible to all citizens, including those without bank accounts and because the d€ would not be limited to specific purposes, the level of AML/ CFT risk of the offline use of the d€ would also depend on the amount of the holding limit.

Digital euro various use cases and design – how will EU citizens access and use the d€?

The proposed d€ Regulation states that it may be distributed both by regulated private PSPs and by designated public institutions such as post offices. In the fourth and most recent progress report, the ECB assesses that there are enough European PSPs ready to develop d€ solutions and that a d€ could be smoothly integrated into the existing European payment landscape to serve different use cases. This would mean that users would be able to store the d€ in a digital wallet on their phone or within their existing banking apps. Banks could offer 'waterfall' and 'reverse waterfall' mechanisms, automatically transferring any amount in excess of the holding limit onto a savings account or private sector payments solution. This supposes however to explore the potential synergies with existing payment services legislation, as well as the feasibility of incorporating offline functionality that many consider as a vital for the d€ inclusivity.

GLOBAL PAYMENT INFRASTRUCTURES AND CROSS-BORDER PAYMENTS



DENIS BEAU

Deputy Governor –
Banque de France

Using metrics to navigate the fragmented seas of cross-border payments

Fragmentation of the payment ecosystem is looming large following the rise of geopolitical tensions, stressing the need for cheaper, faster, more transparent and more accessible cross-border payments to support international trade, economic growth and financial inclusion.

Three years ago, the G20 established an ambitious plan – the Roadmap – and set high-level quantitative goals to be achieved by end-2027. These goals represented a foundational step of the Roadmap, to define its ambition, provide accountability and, importantly, to steer actions and improvements under the overall programme¹.

Huge work has been accomplished since then; analyses and public-private cooperation have provided key insights and useful tools to impulse change in a coordinated manner. We now stand at a tipping point where concrete

implementation is required in order to achieve meaningful results, including on remittances.

The identification of data sources and the definition of KPIs was a key starting point to allow for fact-finding, at a granular level whenever possible (by use case, by region) and for a good understanding of the challenges. The methodology is now in place and we look forward to the forthcoming baseline estimates of market performance² to better understand the complexity and heterogeneity of the payment ecosystem, disentangling the aggregates to understand the specifics, to steer the G20 programme toward the most impactful initiatives.

Besides the quantitative and qualitative monitoring, a public-private consensus has already developed around what the main areas of focus should be: legal, regulatory and supervisory frameworks; payment systems interoperability and extension; data exchange and message standards. Among the identified priority actions, the interlinking of fast payment systems (FPS) carries a huge potential to increase both the speed of and access to cross-border payments, with additional impacts on competition and prices where those systems are open to innovative actors. Actions around the harmonised implementation of international standards – such as the ISO20022 norm – and the sharing of experiences among public and private actors, including around the governance and oversight of interlinking arrangements, are key enablers for the success of interlinking projects. In Europe, the Eurosystem is pursuing reflections around the interlinking of the European FPS, TIPS, in order to foster European integration and ease cross-currency instant payments.

We now need to make concrete and lasting changes to bring decisive improvements. I see three levers for that. First, we need to maintain momentum, as only a resolute political commitment at the highest level can allow the roadmap to keep the traction and adapt to new challenges as we bring the work forward. Such commitment is key also to promote public-private partnerships and should rely on local outreach by national central banks. Second, the programme needs to reach a large number of jurisdictions, including beyond the remit of the G20 where frictions are more acute. The IMF and the World Bank have a key role to play, through the setup

of technical assistance programmes. Finally, more exploratory work in the field of cross-border payments should be pursued with a longer-term view. This includes increased efforts to define common standards to avoid the emergence of technological silos and the resulting fragmentation of liquidity. To this end, it is essential to focus on the interoperability between our existing infrastructures while keeping in mind their potential interlinking with DLT-based infrastructures in the future.

Disentangling the aggregates to understand the specifics, to steer the G20 programme.

Keeping the momentum on experiments is crucial to advance the analysis on the potential of multiple CBDC (mCBDC) arrangements. It is the aim of the Mariana Project³ conducted by the Banque de France, the BIS IH, the MAS and the SNB, to explore novel options for tokenised FX trading and settlement between multiple wholesale CBDCs. This learning by doing approach will contribute to feed concrete input in the design of a single platform, as envisaged by the BIS with the concept of a *unified ledger*⁴, or by the IMF with the concept of *XC platforms*⁵.

1. Denis Beau (2021), *Shaping the future of cross-border payments*, *The EUROFI Magazine*.
2. *Following G20 approval, the KPI monitoring report will be published in parallel with the FSB's annual progress monitoring report in October 2023.*
3. *Project Mariana: Interim report*, BIS, 2023.
4. *Annual Economic Report, Section 3*, BIS, 2023.
5. *A multi-currency exchange and contracting platform*, IMF, 2022; *The rise of payment and contracting platforms*, IMF, 2023.



SUSANA DELGADO

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Moving towards instant and frictionless: the G20 goals for cross-border payments

In 2020, the G20 made enhancing cross-border payments a priority. The group stated that *“making cross-border payments - including remittances - faster, cheaper, and more transparent and inclusive, while maintaining their safety and security, would have widespread benefits for citizens, businesses, and economies worldwide, supporting economic growth, international trade, global development, and financial inclusion”*.

Discourse around how an efficient global payments ecosystem can foster socioeconomic benefits has been ongoing for years. But the financial services industry is now at a point where commitment to enhancing cross-border payments has never been more pressing.

The pace of change

Since the roadmap's inception, the world has undergone unprecedented transformation. Against a backdrop of rapid globalisation and shifting

geopolitical realities, the need for a frictionless and inclusive international payments system has come to the fore and cemented the importance of the G20's work.

Investment in emerging technologies is also no longer seen as a choice, but a necessary step in preparing for the future. When it comes to payments, we are at a turning point. The metamorphosis of money as we know it is at an exciting juncture, and its digital form could create a more inclusive, connected financial ecosystem. Alongside the emergence of CBDCs and digital assets, we are seeing digitisation at all stages of the payments lifecycle to power this new generation of money.

Measurable objectives

The roadmap marks an inaugural step in recognising global payments as the crucial socioeconomic enabler that they are. Driving this forward is the work of the Financial Stability Board (FSB), which set global quantitative targets for addressing the challenges of cost, speed, transparency and access faced by cross-border payments. These targets play an important role in defining the ambition of the roadmap, and five key areas of focus were identified:

- Committing to a joint public and private sector vision to enhance cross-border payments.
- Coordinating on regulatory, supervisory and oversight frameworks.
- Improving existing payment infrastructures and arrangements to support the requirements of the cross-border payments market.
- Increasing data quality and straight-through processing by enhancing data and market practices.
- Exploring the potential role of new payment infrastructures and arrangements.

The road ahead

Now in its third year, the Roadmap for Enhancing Cross-border Payments continues to be a priority initiative of the G20. The foundational work done during 2020-2021 is moving to practical application of KPIs, working to make the 19 building blocks outlined by the CPMI a reality. The key enabler in realising this will be interoperability and partnership, supported by responsible innovation.

In furthering the G20 goals, institutions need to become more efficient to be able to pass their cost savings to end users by the means of competitive fees and terms. To achieve this, cost mutualisation across industry players is key. Investing in making payments more transparent

and simpler should also be considered, linking them to the backend engines to expose payments terms upfront and in a clear way to end users.

When it comes to speed, it's not just about using the fastest rails, but service level agreements with other actors in the payment chain. As for cost and transparency, collaboration is the enabler to making this a reality for a global network of disparate payment systems.

The importance of partnerships

Industry-led initiatives will only be as effective as the cooperation and gravity they are afforded by market participants. Regular, transparent engagement between the public and private space will be the linchpin to guarantee the success of the roadmap's objectives. This can be encouraged by proactive engagement from certain entities that form the building blocks of cross-border payments. Payment systems, regulating bodies, and key industry participants can all help command a commitment to responsible innovation across payments, in turn fostering public-private collaboration.

Payment providers should look to the g20 agenda in the drive to enhance cross-border payments.

This need for interoperability and partnership will also be crucial in ensuring the successful implementation of many innovation projects that are taking shape across payments. Indeed, accelerating innovation and interoperability go hand in hand in an increasingly complex and fragmented world.

Public consultation, a pipeline of milestones, and ongoing progress review will arm the payments industry with the knowledge to know how far we've come, and what more needs to be done in bringing the G20 roadmap to realisation. Crucial to making this happen will be collaboration from industry participants. They are, after all, the ones that will be effecting change day-to-day for people who make payments around the world: everyone.



DIRK BULLMANN

Global Head of Public Policy - CLS Bank International

Demystifying settlement risk to support the FSB Roadmap

In October of this year, it will be three years since the Financial Stability Board (FSB) published the G20 Roadmap for Enhancing Cross-Border Payments (FSB Roadmap). The initiative has made significant progress in addressing certain challenges in cross-border payments, moving from foundational elements to practical actions that will improve existing arrangements and help establish new ones.

The FSB Roadmap is based on the premise that cross-border payments need to be faster, cheaper, more transparent and more inclusive. Its remit is quite broad, and it is important to recognize that different market segments of cross-border payments face unique challenges. For example, while the remittance business may need to address speed and transparency, this is not necessarily the case in other areas such as wholesale FX settlement.

Building Block 9 of the FSB Roadmap specifically addresses a key challenge for the wholesale market – mitigating FX settlement risk for cross-border payments by encouraging increased adoption of payment-versus-payment (PvP) arrangements. This element of

the FSB Roadmap is supported further by the FX Global Code – a set of global principles of good practice for the FX market. Principle 50 encourages FX market participants to reduce their settlement risk by channelling FX transactions through services that provide PvP settlement.

To facilitate progress and increase transparency in this area, CLS worked with a subset of its settlement members, analyzing trading activity to determine how their trades were settled. The analysis showed that of the FX transactions eligible for CLS Settlement (which currently comprise around 80% of all FX transactions),¹ on average 51% of the traded notional is settled through CLS Settlement. This confirms the key role CLS plays as the settlement backbone of the FX ecosystem.

Much of the remainder of the FX transactions comprises inter-branch and inter-affiliate trades (35%) or trades where settlement occurs via a single currency cashflow or over accounts within the banks' direct control (together, 8%), which leaves approximately 6% of trades exposed to settlement risk that could be settled via PvP in CLS Settlement.² Tackling these transactions and expanding participation in CLS Settlement remains a high priority for CLS.

Another important aspect of increasing PvP adoption is finding alternative mechanisms for non-CLS Settlement eligible currencies, including emerging market (EM) currencies. There has been a significant increase in EM currency trading volumes in recent years, and this is where the majority of settlement risk lies. Public policy makers have repeatedly emphasized the need to mitigate settlement risk for these currencies.

CLS's public-private approach has achieved success in capturing FX transactions for PvP settlement.

CLS has been actively working with the industry to explore alternative PvP mechanisms for EM currencies and has received strong support in these efforts. However, progress in this area must overcome regulatory and geopolitical challenges and will require public and private sector stakeholders to closely collaborate and actively contribute to an industry solution. CLS strongly believes in the power of public-private

sector partnerships, as demonstrated by its creation in 2002 as a private sector response to public sector calls to mitigate settlement risk for FX transactions.

Due to the current challenges in developing alternative PvP mechanisms, for now CLS is focusing on growing CLSNet, its automated bilateral payment netting calculation service for approximately 120 currencies. CLSNet helps to mitigate operational risk associated with trading EM currencies.

By standardizing and automating the netting calculation process, it supports the subsequent netting of payments to reduce the payment obligations exposed to settlement risk while improving operational and liquidity efficiencies. Crucially, a significant portion of the interbank transaction flow through CLSNet is in the deliverable EM currencies that pose the most settlement risk for CLS members.

The FSB Roadmap recognizes the importance of PvP in mitigating risk in wholesale markets, and the continued support of the public sector is critical in achieving this. As a financial market infrastructure at the center of the FX ecosystem, CLS's public-private approach has been successful in capturing eligible FX transactions for PvP settlement. However, due to the current legal and regulatory constraints, bilateral netting appears to remain the most effective way to mitigate risk and increase operational efficiency for EM currencies.

1. [Calculations can be found here: *cls-group.com/insights/shaping-fx-ecosystem/shaping-fx-01-taking-a-central-role-cause-and-fx/*](https://www.cls-group.com/insights/shaping-fx-ecosystem/shaping-fx-01-taking-a-central-role-cause-and-fx/)
2. [cls-group.com/insights/shaping-fx-ecosystem/shaping-fx-02-fx-settlement-risk-to-pvp-or-not-to-pvp/](https://www.cls-group.com/insights/shaping-fx-ecosystem/shaping-fx-02-fx-settlement-risk-to-pvp-or-not-to-pvp/)



BEATRICE LARREGLE

Regional Managing Director,
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Public-private partnership remains critical to improving cross- border payments

Cross-border payments are critical to the global economy, with nearly €9.7 trillion in annual transaction volume fuelling international commerce. However, cross-border payments are inherently more complicated than domestic payments, sometimes leading to challenges with cost, speed, transparency, and access.

Given this complex, fragmented landscape, the G20 Roadmap for Enhancing Cross-border Payments is bringing together stakeholders from around the world to identify challenges and solutions. This work has significant implications for Europe, especially future efforts to further harmonise payments within the single market. A key characteristic of the roadmap's approach has been a commitment to public-private partnership. We see tremendous value in this partnership and believe it is the single most important factor in the success of the G20's work.

To better understand why this partnership is so important, it is worth spending a bit of time outlining the public and private sectors' respective

roles and responsibilities in improving cross-border payments. Let us start with the private sector.

First and foremost, the private sector excels in meeting end users' needs in making and receiving cross-border payments. These needs are ever evolving and vary depending on the use case. For instance, someone making a payment to book a vacation abroad likely has different needs than a migrant worker sending money back home to their family.

We should keep business needs in mind too: for instance, a small business' cross-border payment needs will differ significantly from those of large multinational corporates. As we have written about recently, private sector firms solve for these different use cases with customised solutions, all of which require different considerations in the roadmap.

Addressing user needs also requires that the private sector make continuous investments in innovation. Despite the complexities and pain points facing cross-border payments, Visa and others in the industry are developing innovative technologies and services to drive down costs and make payments faster, safer, and more transparent. Over the last five years, Visa invested over €9 billion to secure and enhance our technology platforms, preventing roughly €24.5 billion in global fraud every year with incidents of fraud occurring in less than 0.1% of transactions.

**Public-private
partnership is the
single most important
factor in the success
of the G20's work.**

We are also committed to streamlining cross-border payments with our global money movement platform Visa Direct, which enables nearly 30 new types of payment flows, including remittances, merchant settlement, and employee pay-outs with real-time capabilities across 190 countries. For business-to-business payments, Visa B2B Connect enables same-day payment services and a seamless cross-border experience by removing some of the frictions associated with correspondent banking.

Even with these investments, the private sector's role is only half the story: the public sector plays an equally important role, especially in addressing today's biggest issues. In looking at

the G20 work itself, an obvious and defining role for the public sector is that of convener. Intergovernmental organisations like the Bank for International Settlements (BIS) and the Financial Stability Board (FSB) embody this role on a global stage, bringing many stakeholders together to find real solutions. This same approach has been especially important in Europe, where stakeholder inclusion is an essential part of the policymaking experience.

The public sector also plays a critical role in establishing frameworks and rules for the system, which protects consumers, encourages fair competition, and maintains financial system integrity. This is perhaps the single most important role in cross-border payments - without rules, end users would lose trust in the system. Here, European policymakers have played a particularly important role as first movers in protecting consumers and harmonising standards and regulations across multiple markets.

Of course, some rules occasionally do more harm than good, especially when rules vary widely across corridors and increase payment friction. Here, we see tremendous potential to improve end user experiences by streamlining regulatory requirements. This is also something the public sector widely recognises and is seeking to address with the G20 work, particularly through the FSB's taskforce on legal, regulatory, and supervisory matters.

The public and private sectors each have their respective strengths and responsibilities when it comes to improving cross-border payments, but neither can do it alone. As the G20 Roadmap progresses, we are encouraged to see that public-private partnership remains at the core of this work, and we commend the leadership of the FSB, BIS, World Bank, and other public institutions driving this work.

At Visa, we remain committed to improving cross-border payments by meeting end user needs and maintaining productive partnerships with governments around the world.

5

EU AND GLOBAL SUSTAINABILITY AGENDA

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CLARITY AND RELIABILITY OF THE SUSTAINABILITY FRAMEWORK



BIRGIT PUCK

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Preventing greenwashing by legal clarity and robust data

The market for financial products with an ESG focus is growing steadily and has blossomed from a niche existence into a well-established and significant segment of the financial market. ESG products are not only structured for a specific group of investors, but for retail, professional and institutional investors alike. Greenwashing is therefore a main concern as it presents a threat to the trust of investors, the EU as a credible standard setter, and efficient transitioning towards a sustainable capital market.

Given the significant proportion of this market sector and the rising demand for ESG products, some product manufacturers might be tempted to put on a green cloak. With the development of clear requirements and a more robust data landscape, as regulators we see an increasing number of indications that demonstrate products' failure to live up to their sustainability promises. We

are obliged to react effectively to such threats, to ensure that truly sustainable products are offered to investors and that market participants complying with the rules benefit from doing so.

Moreover, the European Sustainable Finance framework should not be treated as merely optional. Therefore, we also need to consider how to address green bleaching when firms understate the quality of sustainable products to avoid regulatory requirements.

At European and national level, massive steps have been taken to create a common understanding regarding product classifications. These requirements will be further refined over the upcoming years and demonstrate the importance of cross-sectoral, coordinated actions of the ESAs and the NCAs.

The NCAs in close cooperation with the ESAs will leverage on the proven method of complementing the implementation process of Level I with suitable convergence tools. We will continue to work hard on drafting further purposeful guidance, e.g., on fund names, and to closely monitor the implementation progress of both the NCAs and the industry with ESMA's Common Supervisory Actions.

Sustainable finance is an ongoing endeavour, not a one-off effort.

With a short-term perspective, guidance by the ESAs and NCAs helps to mitigate the most pressing legal uncertainties. But we also need a change in the regulatory framework to definitively clarify the requirements of what constitutes a "sustainable investment". Different public and private labels in use today give some indication of the specificities of the ESG products, but our next medium-term regulatory milestone should be an agreed and well-established European label.

The sustainable finance project also demands market participants' full buy-in. It is insufficient to rely on regulators to create a fully-fledged framework and then to mope about the complexity of ESG integration. The industry must step up to provide coordinated ideas and

initiatives on how to facilitate an effective and efficient market for sustainable products. ESG integration should be seen as an economic opportunity, rather than as a regulatory cost.

Furthermore, we must ensure that we possess the relevant tools. The data to assess the performance of assets and the underlying companies needs to be robust and allow for comparability. Sustainability reporting standards under the CSRD framework will enhance the data quality and data availability. This information will allow for a meaningful analysis of companies seeking funding from the capital market and significantly boost our efforts for a sustainable economy.

ESG rating providers and ESG data providers play a pivotal role in granting access to information on the impact of capital to its ESG objective. For that reason, we need to have a clear picture about the size, structure, business operations, methodology and funding of ESG rating and data providers. Considering the influence and market power of such providers, I fully support the European approach on supervising these entities.

ESMA as a direct supervisor can best promote a consistent level of transparency around how ESG factors are considered. Equally, the robustness of ESG data will foster trust and allow for meaningful analyses of the ESG European market.

Sustainable finance is an ongoing endeavour, not a one-off effort. Let us all work together to achieve our common goals: a clear regulatory framework, a consistent understanding and a convergent application of the relevant provisions.



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The EU sustainability- related regulatory framework: looking ahead

The EU “sustainable finance” legislative framework is still in the process of being implemented, but a set of key regulations have already entered into force, such as the Sustainable Finance Disclosure Regulation Level 1 (SFDR) and Level 2 texts (Regulatory Technical Standards) and the Taxonomy Regulation (TR). SFDR and TR are important milestones towards building and enhancing transparency for investors on Environmental, Social and Governance (ESG) characteristics of financial products and thus contributing to channel private investment into the transition to a climate neutral economy, as a complement to public funding.

The objective of SFDR and TR is also to improve the comparability between financial products having ESG characteristics, notably through the implementation of standardised disclosure requirements on how Financial Market Participants (FMPs)

intend to meet/have met those ESG characteristics.

The nascent nature of the sustainable finance package nevertheless triggers important challenges for stakeholders, some of those challenges requiring an immediate response, in that they may contribute to increase the threat of greenwashing and thus call into question the credibility of the sustainable finance package. Such examples include a clear definition of sustainable investments under SFDR, further specifications for financial products disclosing under SFDR Article 8 and Article 9 and addressing interlinkages between TR and SFDR.

On the topic of the definition of “sustainable investment”, the European Commission has recently granted increased flexibility to FMPs, requiring them to carry out their own assessment of each investment and hence disclose the corresponding underlying assumptions. While this approach comes in with benefits, it also has caveats, one of them being the potential to hamper comparability of financial products offered to end-investors.

The sustainable finance package nevertheless triggers important challenges call into question the credibility of the sustainable finance package.

In addition, FMPs are currently given an important flexibility on the granularity of the disclosure on the “*underlying assumptions*”, in particular on the details of the methodology used (for example, thresholds under the pass-fail or revenue-weighted approach), such that investors may not always be in a position to make a sufficiently informed decision on the proposed investment.

A lack of specification on the underlying criteria of what constitutes a “sustainable investment” also appears dichotomic in comparison with the very detailed requirements of TR regarding the definition of Taxonomy aligned activities, while keeping in mind that Taxonomy-aligned activities systematically qualify as sustainable investments under SFDR. In addition, there are key differences between concepts common to SFDR and TR, like for example the level at which the “Do No Significant Harm” assessment (activity v/s entity level) needs to be performed.

Further work towards a better alignment of the different regulations to reflect the commonalities of the underlying concepts of the sustainable finance framework thus appears fundamental. Clarifying those concepts is a real mainstay ahead of defining a consistent and comprehensive approach at EU level to address greenwashing.

Additional work on minimum criteria which would allow the disclosure under SFDR Article 8 and Article 9 is also needed (for example, investment thresholds). While the European Commission has clarified that under SFDR Article 9, financial products shall only be invested in sustainable investments except for cash and hedging, the requirements regarding SFDR Article 8 are far less specific, which means that the spectrum of financial products disclosing under SFDR Article 8 is currently broad, such that it can become difficult for investors to navigate through - and compare - those products. Having said that, appropriate safeguards shall be implemented to ensure that SFDR remains what it was always meant to be, that is, a disclosure regulation.

Enhancing the workability of the sustainable finance rulebook also means that disclosure templates shall be further simplified and standardized to ease a comprehensive disclosure to end investors and most importantly retail investors.

Finally, supervisory convergence remains key for the implementation of the sustainable finance package, also when it comes to addressing greenwashing concerns. Hence, the EU shall remedy those initiatives which may create market fragmentation such as the introduction of national “top up” SFDR and ESG rules and regimes, or differences in the application of SFDR for different financial products (like fund names). Because such fragmentation puts into question the good functioning of the European passport for investment products, and thus the EU Single Market in those areas.



CORNELIA ANDERSSON

Group Head of Sustainable Finance and Investing - London Stock Exchange Group (LSEG)

A big step for ESG data as sustainable finance's enabler

According to LSEG research, 60 000 companies will be subject to CSRD reporting including more than 10 300 non-EU companies. Regulation of ESG data through CSRD will substantially change – for the better – the sustainable investment landscape.

Lack of transparent, robust ESG data reported in a standardized manner is a fundamental impediment to accelerating investor capital allocation to sustainable assets and projects. In 2022, 42% of the FTSE All World index (about 3900 large and mid-caps globally) were still not disclosing basic Scope 1 and 2 GHG emissions. FTSE Russell's 2023 sustainable investing survey shows data availability and quality as the number one barrier to implementation of ESG considerations. The market has therefore naturally turned to estimations and assumptions to fill in this gap, in return fueling potential concerns of greenwashing depending on how rigorous those estimations were established.

Regulators have rightly sought to standardize corporate ESG reporting. The recent major steps made in the

field of ESG reporting will significantly change the face of sustainable finance, starting with CSRD: our analysis showed that at least 10,300 non-EU companies will be subject to the EU ESG reporting – a third of which is located in the US. That's in addition to the 50,000 European companies.

CSRD will also improve ESG data reliability thanks to the independent audit requirement; it will increase the number of firms reporting the alignment to the EU green taxonomy; expand the scope of ESG reporting to all large non-listed companies; and make this entire dataset available free of charge on the European Single Access Point (ESAP) for anyone.

In parallel, the ISSB has worked with stakeholders across the globe to adopt climate-related standards that will serve as a global basis for ESG reporting. The European Commission and the ISSB have managed to keep differences between the ESRS and ISSB minimal. We applaud this cooperation as we absolutely need a common language to address risks that are global in nature.

The recent steps made in the field of ESG reporting will change the face of sustainable finance.

Thanks to ESG data now being regulated, we expect the sustainable finance environment to be drastically different in two years' time, and beyond. The remaining data gaps will be filled with better-quality assumptions as these will benefit from a voluminous sample of reported data, covering all sectors and geographies.

Regulators are now looking at the regulation of ESG ratings and scores providers. Even with the adoption of CSRD and ISSB's frameworks, ESG ratings are here to stay as they provide independent assessments of various ESG risks and opportunities. They could even grow further to help make sense of the mass of upcoming sustainability information.

A relatively recent sector - Refinitiv has been one of first providers of ESG scores back in 2002 - the industry has grown and diversified, measuring many different types of sustainability objectives.

Since ratings are a result of complex assessments, it is logical to ensure a high degree of transparency on

the methodologies and source of data. These ratings are equally used, independently of the nature of their provider (pure players, NGOs or banks) and policy-makers should therefore adopt a same activity - same regulation logic. Such an approach will allow for the same level of quality of disclosures and governance across the industry.

At the same time, the sector is nascent, fast evolving and complex. Opinions differ and evolve. Measuring climate-related risks is changing by the day as research, standards and regulations constantly evolve – the Science Based Targets initiative (SBTi) alone has published 6 revisions or consultations on its standards in the last semester, covering sectors as critical as financial services, aviation, corporate value chains or transports.

Such complexity demands a flexible framework that allows for innovative sustainability solutions to emerge. Policymakers should refrain from imposing particular categories or interfere with methodologies. It is indeed essential to leave enough room for providers to research and refine assessments of ESG risks and impacts. Seeking to constraint a vibrant market which is built on agility, forward thinking and iterations could lead to an overall paralysis of the sustainable finance sector.

In conclusion, as the main ESG reporting standards are being adopted, policy-makers should now focus on supporting a sound implementation by corporates, as well as continue the conscientious effort to create global international alignment across regulators. Ensuring the delivery of globally reliable reported ESG data is the foundation of an effective and trustworthy sustainable finance framework.



DAVID HENRY DOYLE

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Giants or Windmills: how to tell reality from illusion in sustainable finance?

Miguel de Cervantes understood the power of illusion. In his masterpiece, Don Quixote becomes so 'immersed' in fanciful chivalric tales that he can no longer distinguish reality from illusion. As we meet in Cervantes' native Spain, let us examine how the EU sustainable finance agenda can avoid a Quixotic fate of its own by building guardrails to serve as reality checks.

The Quixotic Challenge

Don Quixote's misadventures provide a cautionary tale for sustainable finance practitioners. First, the Gentleman of La Mancha 'lost his wits' by reading too much fiction. He then embarks on an ambitious quest of 'righting every kind of wrong'. However, due to his distorted reality, the wrongs he confronts are often imaginary. Most famously, he mistakes windmills for 'monstrous giants' and charges them with his lance. When his fantasy encounters the unexpected reality of a windmill at 'full gallop', the knight ends up badly bruised.

Today, we face a Quixotic challenge in sustainable finance. Urgent (and

idealistic) action is required to confront the daunting reality of climate change and biodiversity loss. However, sustainable finance is grappling with limited data, new concepts, and unfamiliar metrics. How to tell reality from illusion? Which investments are imaginary giants, and which are genuine windmills?

In addition to the Taxonomy, three guardrails can help us maintain our grip on reality as we cross this frontier. First, CSRD must be applied consistently across Member States to generate high quality data. Second, sustainability labels for financial products are needed to avoid confusing investors. Third, ESG ratings should conform to minimum standards to ensure their assessments are robust, clear, and transparent.

CSRD

The base layer of reality must be high quality assured sustainability disclosure. As ESMA's Report on Greenwashing notes the 'reversed sequencing of EU legislation - with CSRD coming into force after SFDR - has led to difficulties accessing data needed by financial market participants (FMPs)'. With CSRD now within reach its rules must be applied consistently to generate reliable data for all users. Helpfully, ESMA has identified ESG disclosure as a new Union Strategic Supervisory Priority to coordinate supervisory practice. Commission guidance to ensure proper CSRD implementation must also support this essential guardrail.

Don Quixote's misadventures provide a cautionary tale for sustainable finance practitioners.

SFDR

Subjective judgement will remain a feature in identifying sustainable investments under SFDR. The Commission's Q&A confirmed that FMPs must 'carry out their own assessment for each investment and disclose their underlying assumptions'. This carries potential risks as the Commission noted that 'this policy choice gives FMPs an increased responsibility towards the investment community' and FMPs must 'exercise caution when measuring the key parameters of a 'sustainable investment''. However, the acceptable parameters are still unclear. Challenges also remain in interpreting the sustainable investment

definition and Do No Significant Harm principle. Without guardrails the risk of parallel sustainability realities may increase.

The potential misuse of the SFDR as a labelling regime has also been recognised by regulators. The use of Articles 8 and 9 as shorthand for sustainability performance demonstrates a clear market appetite for product labels. Indeed, ESMA notes that the 'establishment of a reliable and well-designed labelling scheme for sustainable financial products... would be beneficial'. To avoid further confusion and to meet this market demand sustainability labels should therefore be introduced as an additional guardrail under SFDR.

ESG Ratings

Finally, ESG ratings can provide a useful reality check on sustainability performance and risks. However, these assessments must also have guardrails to ensure appropriate transparency, governance, and management of potential conflicts. Users should know what ESG ratings measure and how. Equally, it should be recognised that ESG ratings represent an opinion on reality - rather than assurance of reality - and different ESG ratings providers can measure different factors. The IOSCO recommendations for ESG ratings, including freedom from political or economic interference, should also be central to the EU's proportionate regulation of these tools.

Given the existential nature of sustainability challenges Don Quixote's quest to 'dream the impossible dream' may resonate with us. However, in confronting these challenges we must not allow the underlying facts of reality to become distorted. With clear guardrails, we can overcome the Quixotic challenge and pursue investments to bring about the transition with increasing confidence.

CONVERGING GLOBALLY ON SUSTAINABILITY STANDARDS



LEE WHITE

Executive Director -
IFRS Foundation

A global baseline of sustainability-related disclosures for capital markets

The International Sustainability Standards Board (ISSB) issued its inaugural standards in June. The standards mark a new era for sustainability-related disclosures in capital markets worldwide, enabling companies to communicate sustainability-related risks and opportunities to investors, including the effect climate-related risks and opportunities have on its prospects.

This article aims to delve into the significance of the ISSB Standards and their potential impact on the global investment landscape.

IFRS S1 provides a proportionate set of disclosure requirements that enable companies to communicate their sustainability-related risks and opportunities over the short, medium, and long term.

IFRS S2 is designed to be used with IFRS S1 and focuses specifically on climate-related disclosures. It incorporates the recommendations of the Task

Force on Climate-related Financial Disclosures (TCFD), further enhancing transparency of climate-related risks and opportunities for investors.

As a result, on 6 July the Financial Stability Board has announced that the work of the TCFD has been completed – with the ISSB Standards marking the ‘culmination of the work of the TCFD’. Furthermore, the Financial Stability Board has asked the IFRS Foundation to take over the monitoring of the progress on companies’ climate-related disclosures from the TCFD.

The adoption of both IFRS S1 and IFRS S2 will empower investors to make informed decisions based on consistent and comparable disclosure of sustainability-related information provided alongside financial statements – in the same reporting package.

The Standards, which are suitable for application around the world, have been developed to be used in conjunction with any accounting requirements. They are also built on the concepts that underpin the IFRS Accounting Standards, which are required for use – fully or partially – by more than 140 jurisdictions.

The ISSB developed IFRS S1 and IFRS S2 in response to calls from corporates, investors, the G20, the Financial Stability Board, and the International Organization of Securities Commissions (IOSCO). This broad support demonstrates the urgent need for a comprehensive global baseline of sustainability-related disclosures.

Adoption of the ISSB Standards

Now that IFRS S1 and IFRS S2 are issued, the ISSB is committed to supporting their adoption in jurisdictions and by companies. A Transition Implementation Group is being established to assist companies applying the Standards, and capacity-building initiatives will be launched to facilitate effective implementation.

The ISSB is also collaborating with jurisdictions seeking to require incremental disclosures beyond the global baseline, ensuring flexibility while maintaining consistency. Furthermore, the ISSB is working with the Global Reporting Initiative (GRI) to support efficient and effective reporting when the ISSB Standards are applied in combination with other reporting standards.

Endorsed by securities regulators

On 25 July, IOSCO endorsed the ISSB Standards following a comprehensive review. IOSCO now encourages its 130 member jurisdictions, regulating over 95% of the world’s securities markets, to consider how they can incorporate the ISSB Standards into their regulatory frameworks. The endorsement from IOSCO confirms that the ISSB Standards are fit for capital market use. This endorsement, reminiscent of the endorsement of IFRS Accounting Standards, underlines the potential of the ISSB Standards to become the global language of sustainability disclosure.

High degree of alignment

On 31 July, the European Commission issued the European Sustainability Reporting Standards (ESRS), which will come into effect in 2024. To ensure alignment and interoperability the European Commission, EFRAG, and the ISSB have worked jointly on their respective climate-related disclosure requirements.

The collaboration between these entities has led to a high degree of alignment, reducing complexity and duplication for entities using both the ISSB Standards and ESRS climate standards. A navigation tool will assist entities in efficiently applying both sets of climate-related standards and identify incremental disclosures required by only one set of standards. One of the main differences is the inclusion in ESRS of impact materiality requirements, beyond an investors’ perspective.

Better information for better decisions

As we confront the risks and opportunities posed by sustainability, it is important to apply the same rigour to achieve the same consistency in sustainability information as applies to the accounting.

The ISSB Standards mark a crucial milestone in sustainability reporting, providing a global baseline that fosters consistency and comparability of information in capital markets. By offering a common language for sustainability disclosures, these standards will empower investors to make informed decisions, build trust in companies, and allow markets to price in sustainability-related risks and opportunities.



UGO BASSI

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ESRS: striking the right balance between transparency and proportionality

The Corporate Sustainability Reporting Directive (CSRD) entered into force at the start of 2023. The centrepiece of the directive is the introduction of mandatory European sustainability reporting standards (ESRS) for companies in scope. Once adopted, these reporting standards will facilitate the delivery of the European Green Deal and underpin the EU's sustainable finance agenda. The standards confirm the EU's position as the global front-runner in terms of ambitious rules on sustainability reporting.

The ESRS cover the full range of sustainability issues, from climate to social and human rights. As required by the CSRD, mandatory reporting standards will ensure that companies are fully transparent about their impacts on people and the environment, well as about the risks and opportunities they face from climate change and other sustainability issues. They will be a key tool to combat greenwashing. These standards will also help companies to communicate and manage their sustainability performance more efficiently.

One of the objectives of the Commission in adopting the ESRS was to ensure a balance between the provision of relevant, comparable sustainability information which promotes greater transparency and facilitates sustainable investments, while also ensuring that the standards are proportionate and do not impose excessive burden for companies.

Stakeholder feedback received during the public consultation recognised that the draft standards would achieve the proposed policy objectives, but also underlined the challenging nature of many of the reporting requirements, in particular for companies that will be reporting sustainability information for the first time. In light of this feedback and in line with reporting reduction efforts, the Commission has made a number of targeted modifications to the draft ESRS submitted by EFRAG. These modifications will ensure that the ESRS are proportionate, without undermining the achievement of the policy objectives.

Firstly, the Commission is proposing additional phase-ins for some of the reporting requirements, on top of certain phase-ins already proposed by EFRAG. These additional phase-ins mainly apply to companies with fewer than 750 employees and focus on reporting requirements considered to be particularly challenging for companies. The additional phase-ins will give these companies more time to prepare and to spread the initial start-up costs over a number of years.

The ESRS provide for ambitious sustainability reporting, while ensuring proportionality.

Secondly, the Commission has made a limited number of reporting requirements voluntary instead of mandatory. The draft ESRS submitted by EFRAG already included many voluntary datapoints. The Commission has further converted a number of the mandatory datapoints proposed by EFRAG into voluntary datapoints. This includes, for example, reporting a biodiversity transition plan and certain indicators about self-employed people and agency workers in the undertaking's own workforce.

Thirdly, the Commission has given companies more flexibility to decide exactly what information is relevant in their particular circumstances. In the jargon, this is referred to as making more of the reporting requirements

“subject to materiality” (i.e. it allows companies to omit information if it is not relevant in their particular circumstances), as opposed to being mandatory for all companies.

The materiality approach means that if the information is relevant in the case of the reporting company, it must be reported. The alternative approach – saying a reporting requirement is mandatory for all companies regardless of any materiality assessment – runs the risk of requiring companies to spend time and money reporting irrelevant information. The ESRS require undertakings to perform a robust materiality assessment to ensure that all information necessary to meet the objectives and requirements of the CSRD will be disclosed.

Furthermore, all reporting will be audited, and the CSRD specifically requires the auditor to check the company's materiality assessment. In the case of listed companies, the reporting must also be supervised by national competent authorities. Together with the discipline that will come from scrutiny by financial markets and other stakeholders, there are sufficient safeguards to ensure that companies will report all required information.

Mandatory common standards will provide a cost-efficient solution for companies, allowing them to use one coherent set of standards to report credibly about their sustainability performance instead of having to use multiple different standards and frameworks. Moreover, the cost of ESRS needs to be weighed against the benefits to users of sustainability information, including investors, and the overall benefits of progress towards a sustainable economy.



DANIELA MARILUNGO

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EU and ISSB: aligning sustainability reporting standards

Given the scale of the effort needed to transition the global economy to net zero carbon emissions by 2050, the world cannot afford to maintain multiple, disparate climate reporting standards. Such duplication risks confusing investors and increasing operational costs for businesses, thereby diverting resources away from the transition. Globally recognised sustainability standards are key to setting high quality and interoperable reporting worldwide.

At an international level, the ISSB's second published standard, IFRS S2, is built upon the strong foundation provided by the Task Force on the Climate-Related Financial Disclosure (TCFD) framework. TCFD is well understood by reporting entities and their investors, and its use has proliferated, becoming a core element in corporate climate reporting.

This proliferation demonstrates that the cost-benefit equation regarding its application appears justified; we can expect that balance to continue as S2 is adopted and implemented. It is likely

that, in time, several major economies will adopt climate reporting standards that are based on S2. This is supported by the successful track record of the IFRS accounting standards which are now used by over 145 countries around the world. Globally accepted standards are better understood by investors and other market participants, decrease the cost of capital and facilitate capital flows.

The ISSB standards were in part shaped by the Stakeholder Capitalism Metrics initiative, itself developed by the World Economic Forum's International Business Council. The IBC, under the chairmanship of Bank of America, organized the work with the global big 4 accounting firms EY, Deloitte, PWC and KPMG. Nearly 200 companies are committed to reporting according to the IBC framework. Building on that collaboration, the WEF and ISSB have recently agreed to convene a group of sustainability professionals to provide insight and practical examples to encourage voluntary reporting, following the release of the ISSB's standards.

Globally recognised sustainability standards are key to setting high quality and interoperable reporting.

In the EU, the European Sustainability Reporting Standards (ESRS) adopted by the Commission provide a comprehensive sustainability reporting framework. Yet significant reservations remain about the feasibility of in-scope businesses implementing this framework effectively. Concerns centre on obtaining reliable data from companies in the value chain, as well as the practicality of complying with all the provisions, notably the impact materiality assessment, within the specified timelines. Moreover, rushing the implementation will lead to poor quality data and inconsistent disclosure practices, that in turn might result in a loss of credibility in ESRS reporting. A timely interpretation mechanism by the Commission and application guidance by EFRAG is needed to help achieve high-quality disclosure, notably on how to identify and assess the impact on people or the environment.

Striking the right balance between the need for more transparency while not overburdening companies with reporting is vital. That's why materiality should be the cornerstone of reporting, as it establishes which disclosure a

company needs to provide under the ESRS. However, the ESRS risk placing an unnecessary burden, including when companies are required to assess materiality at multiple levels – for example at the consolidated, country and subsidiary levels. As large companies generally operate across different countries, with multiple subsidiaries, the assessment at different levels creates additional complexity but without the benefit of decision-useful information.

Since the publication of the draft ESRS by EFRAG in November 2022, there has been significant progress between the European Commission and the ISSB to ensure coherence and improve the interoperability of both disclosure standards. This cooperation has indeed resulted in a greater degree of alignment between the ESRS and the ISSB, streamlining complexity and eliminating duplication for entities seeking to adhere to both sets of standards. The aligned definition of financial materiality in the ESRS and ISSB is not only beneficial for companies, which could conduct a single financial materiality assessment for both standards, but also for users, benefitting from greater comparability of reported data.

Although the two frameworks have been developed with a different approach to materiality, greater interoperability will allow entities applying the ESRS to avoid duplication of effort and will contribute to the global comparability of reported sustainability information.

Meanwhile, in the US, the Securities and Exchange Commission's (SEC) Spring 2023 Regulatory Flexibility Agenda of April 2023, indicates that the agency's rulemaking on climate change disclosure is expected to be finalised in October 2023. However, this proposed rule's expected finalisation date has been deferred once already and it is difficult to be certain about its ultimate timeline for implementation. The SEC's proposed approach has elicited a record number of comment letters, containing a myriad of views, illustrating how contentious this topic is for stakeholders in the US economy.

We will continue to make the case for international coordination on this vital topic.



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TNFD package to be published on 18 September: beyond ISSB S1 and S2

ISSB's sustainability reporting standards

The International Sustainability Standards Board (ISSB) published on 26 June the first set of global sustainability reporting standards: IFRS S1 for sustainability-related risks and opportunities in general, and IFRS S2 for the effect of climate-related risks and opportunities on a company's prospects. The International Organization of Securities Commissions (IOSCO) has endorsed these standards on 25 July and has concluded that the ISSB Standards are appropriate for the purpose of helping globally integrated financial markets accurately assess relevant sustainability risks and opportunities, and that they form an appropriate basis for the development of a robust assurance framework to apply to such disclosures. This provides the much-needed common global baseline upon which different jurisdictions can build their own domestic standards.

Next steps

The next step will be for the individual jurisdictions to make decisions on the

adoption of these standards. It should be noted that, while some jurisdictions may decide to directly adopt IFRS S1 and S2 as developed by the ISSB, jurisdictions such as the European Union, the United States, or Japan are to develop their own domestic standards. This was also the case in the realm of accounting standards, with the IASB producing IFRS globally, the European Commission creating a European standard, the FASB a US standard and the ASBJ a Japanese one. While it would be ideal for these domestic standards to be consistent with the global baseline, there are likely to be some differences. It may be premature to make any assessment on such differences in the case of sustainability reporting standards, when the national standards are still under development (the Japanese draft standard is yet to be published).

ISSB's Agenda consultation

The ISSB is also consulting until 1 September on its priorities for the next two years. The ISSB has identified four potential projects: three sustainability-related research projects- 1) biodiversity, ecosystems and ecosystem services; 2) human capital; 3) human rights- and a fourth project researching integration in reporting.

The ISSB is also balancing advancing new projects in a timely manner with its focus on ensuring that its initial two standards are implemented effectively.

The ISSB needs to take up nature as its next project as a priority over implementation of S1 and S2.

While the intention to promote implementation of the newly published standards is understandable, there may be a need to place priority on advancing new projects, at least in the area of biodiversity, ecosystems and ecosystem services, for the following three reasons.

First, the draft European sustainability reporting standards already covers the area of biodiversity and nature along with human capital and human rights. It would be desirable to provide a global baseline for these areas too without too much delay.

Second, given the climate-nature nexus, having a climate only standard for too long of a period will send the wrong signal. Non-nature-based solutions to climate change, such as cutting down

forests to build wind turbines or solar panels, for example, damages nature, but may look entirely desirable from a climate only perspective. It is crucial to follow up on the ISSB's message "*climate first, but not climate only*" with action.

Third, the TNFD framework will be published on 18 September, and it is expected that a number of firms will start disclosing using that framework (some already have). Similar to the case of TCFD, it is desirable for the ISSB to provide a global baseline as a follow up to market led initiatives in developing disclosure frameworks.

In the area of nature too, the consistency between different standards can become an issue. As for the time being, the TNFD framework seems to be well aligned with the European draft standards, especially since the relevant officials have been communicating with each other closely. Extending such alignment with an ISSB standard would be a benefit.

The implementation challenge is likely to be greater in the area of nature, but there may be common elements with climate. It may be more efficient to deal with these challenges together rather than working in the sequence of implementation, standard development, and then implementation again.

TNFD publication

The TNFD will be publishing its first full package on 18 September after two years of work, four beta versions (first in March 2022, second in June 2022, third in November 2022, and the fourth in March 2023), and input from the market. There are already some firms around the world disclosing nature-related issues using these beta versions, but there will probably be more after the release of the September package.

The leaders of the Group of Seven (G7) have stated in their Communique released after their meeting in Hiroshima in May that they "look forward to the publication of the Taskforce on Nature-related Financial Disclosures' (TNFD's) market framework and urge market participants, governments and regulators to support its development."



WANG LEI

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Sustainability reporting practice in China and comparison with EU

ESG and sustainable development are becoming more and more a global consensus. ESG concept has been widely integrated into Chinese social and financial eco-system. Chinese authority has formally committed to the objective of “peak carbon emissions by 2030 and become carbon neutral by 2060”. However, the regulatory requirement of sustainability reporting are not as standardized or comprehensive as in European Union (EU). Chinese companies were encouraged to report on their ESG performance voluntarily, although many large state-owned enterprises and a significant portion of listed companies have initiated the practice to publish sustainability report, alongside the annual financial report.

Chinese ESG related policy framework development

The Chinese ESG has recorded a rapid development despite some lag compared to the western countries. The policy framework become more precise and the requirements are more granular. It covers non-financial corporations, financial institutions and financial instruments. The policies can be classified as three categories, taking into consideration of the policy objectives. First category takes form of guidelines, which encourage the

financial and non-financial companies to incorporate the ESG concept into their business practice. The second category prevails “incentive mechanism”, which grant preferential treatment (e.g. advantageous tax regime or interest rate reduction) to those companies that have demonstrated positive ESG impact realization. Finally, the third type is to encourage ESG related information disclosure transparency.

Despite the voluntary nature of sustainably reporting, Chinese regulators have been actively pushing for greater transparency and disclosure. Several milestones have been accomplished by now. Earlier in 2010s, the Chinese Securities Regulatory Commission (CSRC) and Shanghai Stock Exchange, among others, have issued guidelines and encouraged listed companies to adopt sustainability reporting practices. Additionally, the 2016 Environment Protection Tax Law required companies to disclose their environmental performance, further stimulating sustainability reporting. In 2021, People’s Bank of China has issued a package of Environmental and Green Finance information disclosure guidelines, encouraging financial institutions to publish the information related to their environmental risk management, the impact of their activities on environment and carbon emission.

Global standardization of ESG related reporting has still a long way to go.

More recently in June 2022, the Banking and Insurance Green finance guidelines issued by China Banking and Insurance Regulatory Commission (CBIRC) requires Banks and Insurance companies to promote green finance from a strategic level and integrate ESG goals into internal management procedure and comprehensive risk management framework.

Key figures of ESG related disclosure practice in China

Among all listed companies in mainland China, 28% of them have published annual ESG related disclosure report in 2021, while only 23% of them adopted such practice in 2018. The proportion of the companies that adhere voluntarily to the transparency disclosure has been increased steadily over the last years. The larger companies have a higher disclosure rate. The companies whose market cap exceeded 100 billion CNY (Equivalent 12.5 billion EUR), have more

than 90% of disclosure rate, whilst small cap companies of less than 10 billion CNY (Equivalent 1.25 billion EUR), only have less than 30% of disclosure rate.

Comparison of ESG Information Disclosure practice between China and EU

Both China and EU have formed ESG-related information disclosure regulatory framework, which regulate disclosure scope, content, and degree of enforcement.

EU has more specific and mandatory information disclosure requirements for financial institutions, framed mainly by SFDR, CSRD, Taxonomy regulation and upcoming ESRS. The disclosure covers a wide range of topics, including carbon emissions, energy usage, water consumption, labor practice, board diversity, executive remuneration and other social and environmental issues. China’s disclosure has been mainly on environmental factors, with less emphasis on social and governance aspects. Nevertheless, this may change in the future as awareness and interest in ESG issues increase.

Overall, the EU has been at the forefront of ESG reporting and disclosure initiatives. China has been making progress in this area, but there is still room for improvement in standardization, comparability and enforcement of the publication.

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TRANSITION OF FINANCIAL ACTIVITIES TOWARDS NET ZERO



RICHARD KNOX

Director, Financial Services
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Leading a global transition in finance

The case to accelerate a transition to a low-greenhouse gas economy has never been stronger. But climate change is a global issue that requires global solutions. Policies must be developed in a way that works for both the finance sector and the real economy; that works at home and around the world; and that bridges the goals of tomorrow with the realities of today. Within that global, cohesive approach there is opportunity for the UK and European partners to show leadership on sustainable finance.

Transition plans

Central to ensuring the finance sector and economies can move from where we are today, to where we need to be to reach Net Zero by 2050 is planning for that transition. Transition plans are how firms, both in the financial sector and across the whole economy, set out how they will adapt as the world transitions towards a low carbon economy. This includes actionable steps to meet the commitments firms have made.

Transition plans, and their disclosure, are critical in joining up the strong regulatory and international work on

sustainability disclosures and the strong private sector leadership on net zero commitments, ensuring these pledges turn into real action. Championed by the UK and established in 2021 at COP 26, the Glasgow Financial Alliance for Net Zero (GFANZ) – a voluntary initiative made up of financial firms with global assets of \$130 trillion – has been clear in its ‘Call to Action’ that policy makers should set a target for implementing mandatory net zero transition plans.

Some building blocks for this call and leadership are already in place. Globally, almost 8500 companies and over 550 financial institutions have committed to the UN’s non-state actor initiative. To develop a ‘gold standard’ in how firms plan for the transition, HM Treasury established the Transition Plan Taskforce (TPT) in April 2022. The TPT’s mandate is to bring together industry, academic, and regulatory leaders to develop this gold standard – for both financial firms and the real economy. The TPT will issue its final Disclosure Framework in October this year, setting out this good practice for credible transition plans, to support the global efforts towards the Paris Agreement.

International standards

A key to the framework’s design, and achievement of the Net Zero goal, is global interoperability. The TPT’s Disclosure Framework builds on the International Sustainability Standards Board’s (ISSB) recently published final climate-related disclosure standard (IFRS S2), their definition of a climate-related transition plan, and a wider set of concepts and definitions in the IFRS S1 – their general sustainability requirements standard. The UK Government welcomes the ISSB’s inaugural standards, endorsed by IOSCO, as a necessary new voice to the conversation surrounding transition plans and the ISSB as a key actor in progressing interoperable transition plan standards and mandatory disclosure requirements.

Alongside this join-up with the ISSB, the TPT’s work further addresses this need for international cohesiveness, drawing on the five transition planning components of foundations, implementation strategy, engagement strategy, metrics and targets, and governance identified by GFANZ to solidify the link of the outputs of these two initiatives. Therefore, whilst the TPT’s framework is drawn on in the UK, this link with ISSB and GFANZ will ensure it has global applicability and can

be used worldwide for an internationally consistent approach to transition planning.

To create global momentum in transition planning and disclosure, the creation and adoption of international norms needs to be at the core of approach. Without these, comparability and consistency cannot occur and reporting costs for firms will be higher. Positively, there is a growing global momentum around transition plans in the private sector. However, there is still a way to go to ensure private sector targets and pledges on net zero are realised.

Looking ahead

The UK is taking action to contribute to developing this global approach. Beyond our establishment of TPT and support of GFANZ and the ISSB, the Government committed in Mobilising Green Investment – 2023 Green Finance Strategy (March, 2023) to consult later this year on the introduction of requirements for the UK’s largest companies to disclose their transition plans if they have them. To support the transition, the Government is also commissioning a Transition Finance Market Review to convene market experts to consider what market tools the private sector could provide to ensure there’s a scaling of transition focussed capital raising, building on the TPT’s work.

The UK Government welcomes the ISSB’s inaugural standards, endorsed by IOSCO, as a necessary new voice to the conversation.

Market discipline is important and powerful, and transition planning and disclosure is central to this. Globally we’ve seen investors drive real change in how seriously firms take climate change over the last few years and there is recognition that getting to Net Zero and achieving our environment targets is not just essential to tackling climate change and biodiversity loss, it is also a huge growth opportunity.

Together, the UK with European and global partners can show real leadership at a critical time.



TAKANORI SAZAKI

Regional Chief Executive Officer
for EMEA - MUFG Bank, Ltd.

We need financing to go where the emissions are

Whether it is the stick in the form of the EU Taxonomy or the carrot in the form of the Inflation Reduction Act in the US, the Net Zero Industry Act in the EU or GX strategy announced in Japan, on the road to net zero we will need both the carrot and the stick to ensure sufficient capital is directed towards what the financial sector refer as 'transition finance'.

We welcome the recently announced intention by the European Commission to further define transition finance in the EU framework. Enabling large financial institutions to provide transition finance presents a tremendous business opportunity, resulting from thorough assessments of where climate risk is located in our economies and on our balance sheets. The financial risk resulting from climate change is real, but the success of the financial sectors' mitigation strategy to help reduce this risk will ultimately depend on governments, corporations and financial institutions making adequate and well-informed decisions about how best to deploy capital to transition the entire economy to carbon neutrality. It is possible that deploying transition finance may result in a temporary increase of our 'financed emissions'.

The transition needed to achieve a carbon neutral world is something unprecedented and requires a fundamental transformation of the energy and industrial sectors. It requires a deep understanding of available and credible technologies. It also requires dialogue between policymakers, society and the private sector and for them to come to an agreement about whether current assumptions, methodologies and new technologies available today and in the future will enable us to get to our goal of achieving net zero in a credible, feasible, but also bankable manner.

In Japan, the energy and industrial sectors (glass, cement, steel, paper, chemicals) are responsible for 70% of the emissions. There is often talk about the strong focus of the financial sector on the 'E' in ESG, but if we do not fundamentally reform the global energy system, we will not be able to decarbonize other important sectors that fuel our economies today, resulting in us failing to stay within the 1.5 degree mark. Reducing CO₂ in the energy sector is equally relevant in many other countries across Asia.

Going back to the role of the financial sector, at MUFG, we view providing transition finance as the most sensible approach to mitigate the climate risk on our own balance sheet. We also view it as our responsibility to support the management of the risks associated with the net zero transition as best as we can from today until the point that the world has reached a carbon neutral state. This means engaging with the real-economy and helping our corporate clients to achieve their transition strategies. If we divest, who will help those hard to abate sectors to decarbonize?

Having a transition plan beats no transition plan.

Our efforts and engagement with our clients is essential and we refer to this continuous dialogue as transition planning. Ever since the Glasgow Alliance for Net Zero (GFANZ) published its first Transition Planning Guide in November 2022, many financial institutions have engaged in an intense process of supporting transition planning, with a view to better formulate individual institutions' transition strategy. The considerations, assumptions and strategic decisions resulting from this process will form the institution-specific transition plan. We need to be

careful to make a distinction between the process of transition planning and the transition plan itself.

When assessing individual client's plans, the strategic decisions one bank makes about how best to deploy its capital for the purpose of transition finance - and the result the provision of transition finance would have for the reduction of actual emissions in the real economy - should consider financing results as part of the basis of whether a transition plan is credible. In our case, this means a process of respectfully but thoroughly assessing and challenging our clients' transition plans.

Our commitment to supporting the energy sector's decarbonization - especially in Asia - will contribute to our success for supporting real-economy decarbonization. This means the public and private sector will need to focus on financing to transition away from where the emissions are. All of us need to chip in and, to a certain extent, bare the risks of investing in credible new technologies. I believe large banks are committed and feel some responsibility for ensuring their balance sheets move towards carbon neutrality. Before joining GFANZ, most financial institutions did not have a transition plan.

MUFG has worked hard to define our contribution to the world's decarbonization efforts and today we are starting to put our plans into action. The world depends on those with a transition plan and ultimately, having a plan beats no plan at all.

1. "Financial Institution Net-Zero Transition Plans. Fundamental, recommendations and guidance", Glasgow Financial Alliance for Net Zero, November 2022



BENOÎT DE LA CHAPELLE BIZOT

Head of Public Affairs and
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Accelerating the transition to net-zero

Climate change and environmental degradation are an existential threat to the world as remembered by the European Commission when announcing its Green Deal.

The climate challenge requests more than ever a transition and, to be more precise, a fair transition which is much more complicated... This means unprecedented needs, appraised by the European Commission, in her last report 2023 Strategic Foresight Report "the 2023 SFR", up to 1 200€ billion per year of investment to meet the objectives of the *Green Deal* and *RepowerEU*. Considering budgetary constraints of Member states, the largest part of the financing will come from the private sector.

Bankers are key for this transition, as advising their clients and financing the adaptation of their business model. As part of their day-to-day business, they finance assets and technologies contributing to the decarbonation of the economy and instruments accompanying their clients' transition. In addition, they are offering a wide range of ESG financing tools («green loans/bonds», "sustainability-

linked bonds" ...) and instruments traded on carbon markets.

However, as a link in the economic chain, banks' transition depends and can only reflect the real level of sustainable economy: banks depend on actors' appetites to enter a transition.

In our view, a successful transition implies realistic planning in consultation with all economic actors both at the EU and national level. Public policies need to clearly define the pace & the scale of the environmental transition and ensure its social and economic viability. Public policies will change consumers' behaviors. Corporates will then be able to design their transition plan accordingly.

In France, the Sustainable Finance Institute (IFD) has started to work on this with all public and private stakeholders. It published a report in May 2023 to provide with a shared diagnostic & pragmatic guidance to support the French transition. It assessed its costs to 30-65 billion a year until 2050, far below current available private savings: money is there but not ESG projects.

IFD pointed out the lack of profitability of ESG projects, especially regarding the energetic renovation of buildings, to attract the private sector. It therefore suggests a series of measure co-supported with public funding to bridge the gap between investors and corporates needs. Obviously, the transition of actors must remain economically viable to happen. For this reason, governments have a key role to play in creating incentives to offset potential short-term loss of profitability at national level.

**A successful transition
implies realistic planning
in consultation with all
economic actors.**

The same approach should prevail at international level. As stated in the 2023 SFR, the EU represents only 6.9% of greenhouse gas emissions and around 5% of the world population. The importance to ensure that the rest of the work embraces the transition is key but still uncertain. In the interim, EU should ensure fair competitiveness via extended & effective transition adjustments' mechanisms if it wants to avoid a massive industry & linked services' offshoring. Not less important, transition costs will be finally borne by the most fragile

population. Regulation will need to ensure inclusion to preserve our democracies.

IFD also stressed the complexity and burdensome character of the current ESG regulatory framework, whether French or European. If Europe wants to reach its sustainable objectives, it needs to move on a more pragmatic and inclusive approach. The ESG framework is yet far too complex and does not consider enough the needs of the concerned stakeholders, i.e., the corporate private sector and particularly SMEs more vulnerable to additional costs. For instance, SFDR and the taxonomy have a different definition for sustainable investment; green activities include transitional, enabling activities, 100% green capex....; priority is given to detailed reporting and not to effective transition itself, not so well recognized yet... A faster transition means a more stable, consistent, readable regulatory framework.

In uncertainty, public authorities need to give stability to actors, meaning:

- Clear, precise, simple, consistent, even imperfect regulations, also suitable for SMEs,
- A measurable and effective transition,
- Public-private economic partnerships and social measures to ensure the transition's acceptability,
- A market tool Framework to ensure data availability, easy transparency, fair competitiveness, and some comparability when calculating transition plan for both corporates and banks. The focus on the ETS system & carbon markets should be expanded,
- Pragmatic and intermediary objectives on prioritized sectors. The fit for 55 package is a good starting point but needs an adjustment with social and economic constraints: the rise in energy price, inflation, worldwide competition, the EU autonomy for critical sectors...

More than ever, the establishment of a clear and common set of regulations involving stakeholders (businesses, the financial sector, consumers, and public authorities) is essential.

NEXT EUROFI EVENTS

THE EUROFI HIGH LEVEL SEMINAR 2024

21, 22 & 23 February 2024

GENT - BELGIUM

THE EUROFI FINANCIAL FORUM 2024

September 2024

BUDAPEST - HUNGARY

CLIMATE CHANGE INSURANCE NEEDS



PETRA HIELKEMA

Chairperson - European Insurance and Occupational Pensions Authority (EIOPA)

Policy measures to reduce climate-related insurance protection gaps

Climate-related extreme events can cause significant economic disruption. Direct aggregate catastrophe losses in the EU amounted to approximately €500 billion in the period between 1980 and 2020.[1] It has been estimated that even in a 1.5°C global warming scenario, related losses across the EU will nearly double by 2050, with costs being significantly higher under a 2°C or 3°C average temperature increase.[2]

Catastrophe insurance helps to mitigate the negative macroeconomic effects of disasters. First, it enables the economy to recover faster by promptly providing the necessary funds for reconstruction and limiting the period of lower output. Second, catastrophe insurance can increase resilience by improving the understanding and assessment of climate change risks and promoting risk reduction measures. Third, it allows the

mutualisation of risks and their transfer to private insurance companies, which can provide incentives for resilience.

EIOPA's dashboard shows that in the EU, only one quarter of natural catastrophe losses were insured in the past.[3] The insurability and affordability of climate-related risks is becoming a critical concern for insurers and policymakers, and if no countermeasures are taken, the insurance protection gap is expected to widen.

As a key strategic area of activity, EIOPA aims to address protection gaps by improving risk assessment, risk prevention and adaptation measures, as well as incentivizing appropriate product design and risk transfer for climate change risks. For example, EIOPA developed a dashboard on the insurance protection gap focused on identifying key drivers and improving risk awareness. Access to data and models are essential for this work: to build prevention measures, it is necessary to be able to understand and model the risk. EIOPA therefore released the CLIMADA-app to facilitate the use of an open-source catastrophe model.[4]

We must act now to address extreme weather event insurance gaps to minimise future taxpayer costs.

EIOPA has also been working to identify possible solutions to address protection gaps along three key dimensions. First, the supply side, with a focus on pricing and product design: how can we reduce losses through preventive measures, which are reflected in insurance pricing? This is what we call 'impact underwriting'.

While progress is being made in how insurance undertakings are adapting their non-life underwriting practices to climate change, EIOPA's report on insurers' use of climate-related adaptation measures in non-life underwriting practices[5] shows that the EU insurance market overall appears to be at a relatively early stage. EIOPA sees further room for improvement, especially in terms of standardising the implementation of climate-related

adaptation measures in insurance contracts, for instance through dedicated risk-based certificates and programs.

Second, the demand side: EIOPA published a report on consumers' preferences to understand why they do not purchase insurance coverage.[6] This work, which draws on consumer research and behavioural studies carried out by EIOPA, has revealed several demand-side barriers and drivers that impact the willingness of people and businesses to buy NatCat insurance. These for example include income levels and the perceived unaffordability of coverage, a lack of clarity in terms and conditions, previous negative experiences with insurance claims or the misperception of the risks of a NatCat event. Potential solution could be to increase risk awareness, greater standardization of insurance products or simpler and more consumer-friendly purchasing processes.

Finally, the macro aspect: EIOPA has been studying the macro-economic implications of protection gaps together with the European Central Bank. This macro-related work outlines basic principles to which policy actions should adhere in order to reduce insurance protection gaps. Alignment on risk prevention measures and sharing of costs and responsibilities across the relevant stakeholders is required to ensure "skin in the game" and reduce moral hazard. Ex-ante risk assessment and risk prevention are crucial to the well-functioning of private insurance markets and for lowering the costs for the public sector in the longer run.

1. *Economic losses from climate-related extremes in Europe (8th EAP) (europa.eu).*
2. *Gagliardi, N., Arévalo, P. and Pamies, S. (2022), "The Fiscal Impact of Extreme Weather and Climate Events: Evidence for EU Countries", Discussion Paper, No 168, European Commission, July.*
3. *Dashboard on insurance protection gap for natural catastrophes (europa.eu).*
4. *Open-source tools for the modelling and management of climate change risks (europa.eu).*
5. *Impact underwriting: EIOPA reports on insurers' use of climate-related adaptation measures in non-life underwriting practices (europa.eu).*
6. *EIOPA research sheds light on why households and businesses are reluctant to take out NatCat insurance (europa.eu).*



ROMAIN PASEROT

Deputy Secretary General -
International Association of
Insurance Supervisors (IAIS)

Embedding climate risk into supervisory practices

The record temperatures felt across Europe this summer serve as a stark reminder of the escalating risks from climate change. Extreme weather events like heatwaves, storms and droughts are already having societal and economic impacts, by increasing excess mortality,¹ reducing agricultural productivity and causing property damages. Extreme weather incidents will become increasingly common as average temperatures continue to rise.

Despite these mounting risks, the international community is failing to reach the agreed climate targets. While tackling climate change and establishing a clear policy framework is clearly the domain of governments, insurance supervisors are considering how a lack of progress may impact their prudential and market conduct objectives. Consequently, supervisors are focused on ensuring growing climate risks are integrated into our sectoral risk assessments and are engaging in collaborative efforts to evaluate and address the risks from climate change to the financial system and the societal challenges arising from growing climate-related protection gaps.

The physical consequences of climate change influence underwriting across a range of business lines and impact insurer assets. Furthermore, growing physical risks may trigger a delayed but swift policy response, with insurers having to cope with both increased physical risks and the consequences of transition measures taken to catch up on lost ground.

As the global standard setter for insurance supervision, the International Association of Insurance Supervisors (IAIS), has undertaken substantial work in this area. Three areas of ongoing work are particularly relevant for our discussions in Santiago de Compostela: scenario analysis, disclosure and protection gaps.

Climate-related scenario analysis is still in its early stages but is rapidly evolving as a risk assessment tool. The ultimate goal is to have a clear understanding of the possible range of financial impacts of climate risks on insurers' balance sheets. Such exercises will support supervisors and insurers in developing better strategies to address these risks. For this reason, the IAIS will publish for consultation an Application Paper later this year, guiding members and insurers on conducting these exercises effectively and consistently.

We welcome the recent publication of the climate disclosure standard by the International Sustainability Standards Board (ISSB). Effective disclosure is essential for insurers to understand the risks to which they are exposed through their underwriting business and their investment assets; likewise it is important for insurers to effectively disclose their risks to market participants and stakeholders.

Supervisors are focused on ensuring growing climate risks are integrated into our risks assessments.

The most recent status report by the Task Force on Climate-related Disclosures (TCFD) shows slow progress with insurer implementation of the TCFD disclosures. Since the ISSB builds on the TCFD framework, hopefully this will provide fresh impetus to the widespread adoption of consistent climate disclosures by insurers. In the coming months, the IAIS will consider whether additional insurance specific guidance on disclosures, to complement the ISSB's efforts, may be needed.

Continued improvements in public disclosures and scenario analysis are needed to build on the existing (often qualitative) approaches, to have a more comprehensive, granular, forward-looking and consistent understanding at a global level. We appreciate the complexity of this task and will continue to work closely with the insurance sector as we take this work forward. However, there is no time to waste. Insurance supervisors are clear that insurers should be taking steps now to embed these risks into their enterprise risk management.

From a supervisory standpoint, we look at these issues not only from a microprudential (financial soundness) perspective, but also consider the impact on objectives of financial stability, fair market conduct and financial inclusion. From a macroprudential perspective, the aim is to understand the impact of growing climate risks on the sector as a whole, as well as the possible transmission of climate risks from the insurance sector to other parts of the financial sector and the real economy.

From a financial inclusion and societal resilience perspective, climate change poses a collective action problem; for example, logical risk-based actions by individual insurers could lead to increasing insurance protection gaps, which have a negative impact on consumers and the economy and society as a whole. In November, we will publish a report that considers the role supervisors can play in helping to address natural catastrophe protection gaps.

In light of these growing risks, we remain resolutely focused on agreeing supervisory practices that effectively integrate climate risk considerations into actions taken by supervisors and insurers alike.

1. *Heat-related mortality in Europe during the summer of 2022* | Nature Medicine



EVA WIMMER

Director General - Federal
Ministry of Finance, Germany

Tackling the climate insurance protection gap

Climate-related disasters have increased manifold in recent decades. Climate change poses significant risks to individuals, businesses, and communities worldwide. The escalating frequency and intensity of extreme weather events, rising sea levels, and other climate-related phenomena have highlighted the urgent need to effectively manage these risks.

Effective risk management can be achieved in two ways: making the risks bearable by distributing them among multiple stakeholders (collective risk-bearing) and reducing the losses when these risks manifest (prevention).

Insurance against climate-related disasters is a key instrument of collective risk-bearing. However, as EIOPA's recent data on insurance gaps illustrates, only a quarter of the losses caused by extreme weather events and climate-related events in the EU are currently insured. Reducing this climate insurance protection gap is an important and necessary step in adapting to intensifying climate change. But this is only one part of effective risk management. In order to be truly effective, collective risk-bearing must be accompanied by preventive measures that reduce losses.

The private insurance sector has a threefold role to play in the face of

climate change. First, it can help address the climate insurance protection gap by providing insurance capacity. Second, it can contribute to financing the green transition to slow climate change. Third, it can enhance resilience by demanding preventive measures from policyholders.

First, the private sector can insure against climate-related risks as long as insurance premiums are calculated on the basis of risk. As public sector actors, we should refrain from any attempts to prevent a proper accounting of risks. Premiums must be high enough to cover the insured losses and other associated costs in order to ensure that there will be sufficient private insurance capacity in the market. Then it is up to the private sector to reach prospective policyholders through information campaigns and financial education. The private sector could also design insurance products to include climate-related risks by default, thus requiring policyholders to make an active decision to opt-out of climate-related risks.

The second, but no less important, role of the private insurance sector is its contribution to financing the green transition to slow climate change. Private insurers manage vast investment portfolios, and their investment decisions can shape the transition to a low-carbon economy. Allocating capital towards sustainable businesses, renewable energy projects, and climate-friendly initiatives can have a significant positive impact on mitigating climate change. At the same time, we should adhere to our risk-based framework and the risk-based consideration of investments in solvency capital requirements, which ensure that insurance companies have enough own funds available to cover potential losses.

**Closing the climate
insurance protection
gap and incentivizing
preventive measures go
hand in hand.**

Finally, private insurers also play a pivotal role in incentivizing risk reduction and resilience measures. By offering lower premiums or additional coverage benefits to policyholders who undertake climate mitigation and adaptation efforts, insurers encourage individuals and businesses to invest in measures that reduce their vulnerability to climate risks. Insurers can collaborate with risk engineering firms to provide tailored advice on measures such as

improving building codes, strengthening infrastructure, and implementing disaster resilience strategies.

As public sector actors, we must support these important incentives for further preventive measures by establishing the appropriate political and legal framework for combating climate change and adapting to its effects. This should encompass, among other things, the promotion and enforcement of preventive measures such as adequate building codes prescribing climate-related adaptation measures for buildings in high-risk areas or the general refusal to grant permits to develop high-risk areas. We should also continue to support further efforts to collect data and develop climate models, so that the insurance industry can set appropriate prices for climate risks and the right incentives for corrective action.

Addressing the climate insurance protection gap requires (a) a concerted effort from the private insurance sector accompanied by (b) an appropriate policy framework set by the public sector.

By offering insurance products that include climate-related risks by default, helping to finance the green transition, and incentivizing risk reduction measures, the insurance sector can make substantial progress in bridging this gap. These measures will enhance financial resilience, promote sustainable practices, and contribute to a more climate-resilient future for individuals, businesses, and communities alike.



DEAN CAMERON

Director - Idaho
Department of Insurance

US state insurance supervisors: engaging the industry – closing the gaps

Identifying and closing coverage gaps is a top priority for US state insurance supervisors and the National Association of Insurance Commissioners (NAIC). Inflation has been a factor in driving up premium costs, and some jurisdictions are experiencing larger, more frequent, and even new climate events for which they are not adequately prepared. Those, coupled with a hardening of the reinsurance market, which has left some insurers wary of writing new policies, may result in consumers and communities without a safety net should they need it.

Closing coverage gaps requires a holistic outlook engaging consumers, supervisors, and industry. There are no silver bullets. No single action, report, or rule will provide everyone with a eureka moment to close the gaps. However, with creative efforts from consumers, supervisors, and industry, we can generate potential solutions, especially for vulnerable communities and low-to-moderate income individuals that would otherwise be difficult to insure.

Work has been underway on addressing climate coverage gaps through the NAIC's Climate Risk and Resiliency Task Force, specifically, its Pre-Disaster Mitigation, Innovation and Technology, and Consumer Education workstreams.

Through our Pre-Disaster Mitigation workstream, the NAIC created a list of pre-event mitigation measures that policyholders might take to reduce their risk of loss. The NAIC will use that information to continue the dialogue on consumer risk awareness and education. Combining that information with state-specific information, the NAIC has developed a web-based resource with relevant materials and information regarding mitigation.

The Task Force's Innovation and Technology workstream examines what innovative insurance products are being developed to respond to climate related risks and what technology is used to better understand and evaluate climate risk exposures.

The Innovation and Technology Workstream also examines how parametric products and community-based coverage might help resolve issues with coverage gaps created due to natural disasters. The Workstream will continue to explore different innovative insurance products such as catastrophe bonds and community-based coverage which can assist in improving inclusive insurance.

Closing coverage gaps requires a holistic outlook engaging consumers, supervisors, and industry.

The Catastrophe Modeling Center of Excellence was developed under the Technology Workstream last year. It provides state insurance supervisors with the necessary technical expertise, tools, and information regarding catastrophe-related risks relevant for their region. A formal education program for state insurance supervisors has been rolled out this year. The training will cover how models are developed, how insurers and reinsurers interact with them and what opportunities exist for supervisors to utilize model outputs.

Consumer education, outreach and advocacy are a key pillar of the NAIC's strategic plan and remains an ongoing challenge. This comes down to helping consumers understand the need to

purchase insurance that will adequately cover their exposure to risk and educate them on the resources available to help mitigate risks. This is especially important as surveys show that some consumers do not fully perceive their risks. The NAIC has developed consumer awareness campaigns to address floods, earthquakes, wind, and other perils, as well as a list of actions policyholders can take to reduce their risk of property loss.

State insurance supervisors have also been sharing best practices and mutual learning among each other as part of the NAIC's "laboratory of the states" approach to devise solutions to shared problems – including protection gaps and climate resiliency. Some states have developed successful templates for risk mitigation incentives, such as the Strengthen Alabama Homes Program that provides grants to residents to retrofit properties based on the Insurance Institute for Business and Home Safety Fortified standard.

The South Carolina Safe Home program provides matching and non-matching grant funds to help property owners retrofit their homes to make them more resistant to damage from hurricanes and high winds.

The California and Oregon insurance departments are working on wildfire risk mitigation strategies that include premium incentives for reducing wildfire risk through home hardening.

Other states are taking notice of such initiatives, and we see increased demand for creative public private partnerships on resiliency initiatives.

All these initiatives demonstrate that while there are no silver bullets to closing the gaps, collaboration, communication, education will help. As supervisors face increasingly challenging circumstances and newer gaps emerge, it will remain imperative to think creatively to develop the necessary tools to close them.



CLAIRE SOUCH

Vice President Global Models
and Climate Risks -
Moody's Analytics RMS

Insurability in a changing climate

Increasing weather and climate risk losses are being driven by a complex cocktail; population growth, urbanization, development in exposed areas, rising asset values and higher repair costs. While efforts are being made globally to reduce CO₂ emissions, the scientific consensus is that any warming pathway will result in changes in frequency and/or severity of weather and climate risks.

As a result, concerns are rising about the future insurability of these risks. Whilst there is uncertainty due to the complexity of extreme weather events, coastal flooding risks are increasing as sea levels rise, rainfall is becoming more intense, and droughts are longer and more severe.

Against this backdrop, insurance plays a critical role in disaster recovery and climate risk adaptation. Every percentage point increase in insurance penetration reduces disaster recovery times by almost 12 months, according to a report by AXA. In addition, the risk signal provided by insurance can provide incentives for investments that reduce risks. For example, the benefits of investing in flood defenses or property-level hardening may outweigh the costs when you consider the potential losses that could be avoided. However, according to Swiss Re, in

2022, less than half of global economic losses of USD 275 billion were insured, and that gap is widening.

Recently some high-profile carriers have announced their withdrawal from providing insurance against wildfires in California and hurricanes in U.S. coastal states such as Florida. A trend of increased cost of claims as the price of building materials and repairs escalate, and substantial numbers of claims going through litigation are contributing to insurance cover becoming more expensive. New legislation and reforms have been passed in states like Florida to address problems in the legal system, and the early signals from the June 2023 reinsurance renewals are that catastrophe reinsurance capacity is returning, albeit at a cost.

The private re/insurance market has committed to providing capital to close the insurance protection gap, but knowledge gaps can be a barrier to increased private sector investment. If risk is to be priced accurately and transferred, it must be quantified. While private sector capital is available, it can be expensive where there is high uncertainty in risk levels. And given the changing climate, historical claims data is insufficient to understand risks today and in the future.

**To understand the future
impact of climate change
on damage and loss, we
need new tools and data.**

Catastrophe models developed by independent expert teams of scientists and engineers, such as those at Moody's RMS, have been used extensively by the re/insurance industry for the past 30 years. However, to understand the future impact of climate change on damage and loss, we need new tools and data which provide a forward-looking view of the risk under different climate change scenarios to help the industry plan for the future, design new products and manage their portfolios effectively. Moody's RMS was the first to bring climate conditioned catastrophe models to market in 2021, and these models are now available worldwide.

Equally, public-private partnerships with holistic risk management strategies have a clear role to play. This includes investment in risk reduction and adaptation, within which climate risk insurance can play a critical role for the transfer of residual risks.

For example, Flood Re is a joint initiative between the Government and insurers in the U.K. intended to make flood cover in household insurance policies more affordable. Flood Re incentivizes policyholders to "build back better" after floods, to increase resilience to future floods at the property level. Moody's Analytics modeling is being used by Flood Re to study the cost-benefit of increased investment in larger-scale flood defenses over the next 20 years, as it works with local authorities to ensure the long-term sustainability of the UK flood insurance market.

Moody's RMS flood models analyze the cost of property damage for the present day with existing defenses, along with projected damages in 2040 under both a high and low emissions climate pathway. The impact of increasing flood defense standards on the potential future losses can be quantified, enabling decisions to be made about public sector investment.

Although important, data on its own will not be enough to close the insurance gap amid a changing climate. A regulatory and policy framework is needed that supports the involvement of private sector capital, open markets and provides security and protection for both policy holders and insurance companies. This will enable the formation of public-private partnerships that develop holistic climate risk management strategies, and within these frameworks insurance can continue to play a vital role.



SONIA BARRIÈRE

Head of Strategic Transformation, Member of the Executive Committee - CNP Assurances

Towards a new insurance model to face climate challenge

Due to meteorological and climate-related phenomena, insurability conditions are becoming increasingly tight. Since the end of the 19th century, the global average temperature has increased by almost 1°C, 2.2°C in Europe¹.

In France, we benefit from the natural disaster compensation scheme since 1982. The Cat Nat scheme is based on a public-private partnership between insurers, the CCR² as public reinsurer and the French State, which provides its unlimited guarantee as guarantor of last resort. This scheme is based on compulsory cover for the risks of natural disasters for all car and home contracts taken out in France, subject to an identical additional premium throughout the territory, reflecting a strong pooling of risks between the most exposed and least exposed towns.

Of course, insurers and regulators anticipate a sharp increase expected in claims in the years to come in flood, hailstorm, storm, severe drought in terms of frequency and intensity. They expect a distortion of the claims with a greater

weight of hazards coming under the regime of natural disasters, which raises the question of the necessary adaptation of this regime in the coming years and more generally the adaptation of mitigation measures through reinsurance.

CNP Assurances set up a climate risk committee in 2019 to monitor the progress of the subsidiaries on the management of climate risks. Actions to manage the risks associated with climate change could be structured around five topics:

- Risk assessment: update of the risk mapping, improvement of the modeling of climate risks like storm or hailstorm and the modeling of the forest fires which represent a new peril, impact on a multi trajectory years as in ORSA³.
- Regulatory monitoring: requirements regulatory growing requiring a closed text monitoring, pooling of risks with a partnership public private for a sharing of claims.
- Prevention: for policyholders in terms of warnings, information, and the development of cooperation with the French state and the local communities.
- Risk transfer: reinsurance structures in a tight market, Cat bonds.
- Investment: decarbonization of asset portfolio and investments in sustainable activities.

Push back the limits of insurability through renewed and holistic risk governance.

French insurers believe that long-term and large-scale environmental problems induce a financial risk for the savings and pensions of its policyholders. CNP Assurances have taken strong measures in recent years, to tackle the issue of global warming. By becoming a member in 2019 of the Net-Zero Asset Owner Alliance, we have committed to achieving carbon neutrality in its investment portfolio by 2050 and have therefore set targets for a 25% reduction between 2019 and 2024 in the carbon footprint of its portfolio.

CNP Assurances will take part in the second climate stress test exercise dedicated to the French insurance sector that the ACPR organize again in 2023. The first one, happened in 2020, served to quantify CNP exposures on the scope of its activities in France based on three metrics: the Solvency 2 balance sheet,

the statement income, and the valuation of the investment portfolio. The test involved three transition scenarios to comply with the Paris Agreement, with different efforts to be made according to more or less short deadlines to achieve targets. These scenarios included some assumptions of heightened physical risks to anticipate an increase of claims caused by an increase in pollution and vector-borne disease.

The two highlights of this exercise can be summed up:

- The measures implemented in recent years like reducing the carbon footprint of the investment portfolio, reducing exposure to the thermal coal sector, increasing green investments, will enable CNP Assurances to display greater resilience in a transition scenario unfavorable to companies emitting the most greenhouse gases.
- The potential increase in the loss ratio caused by the occurrence of a physical risk could be offset to some extent by an increase in the pricing of death/disability and term creditor insurance policies.

In conclusion, to cope with the 'cocktail effect' of the environment, the tight economic environment, and increasingly restrictive regulations, CNP Assurances want to address the fundamental mission of insurers and their role within human societies and with individuals. The sector could address these challenges through three high-priority levers for action. The first is to rethink inclusion mechanisms to meet the needs of the most vulnerable groups. Second is to increase responsible investment and public-private partnerships to address new vulnerabilities. Finally, it is to push the limits of insurability through a renewed and holistic risk governance by strengthening the rule of risk sharing, promoting the collective intelligence approach through broader stakeholder engagement, promoting regulatory reforms to encourage social development and practical decision-making.

1. <https://www.statistiques.developpement-durable.gouv.fr/>
2. Caisse Centrale de Réassurance
3. Own Risk Solvency Assessment



PATRICIA PLAS

Group Director of
Public Affairs - AXA

Bridging the climate protection gap: call to intensify the dialogue

The frequency and intensity of natural catastrophes (NatCat) are increasing. The number of NatCat losses has indeed increased by an average of 5% a year over the last 50 years and the frequency of NatCat events has been increasing by about 3% per annum over the same period (Sigma Explorer 2022).

So is the climate protection gap, i.e. the difference between economic losses and insured losses for climate-related disasters (GFIA, 2023). This worldwide issue that appears to be widening in the medium to long term needs to be at all levels and by various stakeholders: Global, European, national, and by insurers. Overall, in Europe, three quarter of losses due to natural catastrophes events are currently uncovered (EIOPA, 2023). On the 560 billion EUR NatCat losses in the EU Member States between 1980 and 2021, 390 billion EUR were uninsured losses (EEA, 2023).

At the European level, closing the climate protection gap is an important pillar of the European Commission's Strategy on adaptation to climate change (released in February 2021) and is also on the agenda of its Climate Resilience Dialogue, a forum for insurers and reinsurers, policymakers, and other stakeholders to

exchange views on climate adaptation and protection gap. EIOPA also recently released two publications on the NatCat protection gap addressing the offer (*EIOPA / ECB Policy options to reduce the climate insurance protection gap* - April 2023) and demand aspects of climate insurance protection gap (*EIOPA Staff paper on measures to address the demand side of aspects of NatCat protection gap* - July 2023).

To tackle this protection gap and mitigate catastrophe risks from climate change in the EU, EIOPA and ECB suggest several actions: insurance coverage by private (re)insurance, national measures (including public-private partnership and ex ante public backstops) but also EU-level measures, such as a public European backstop solution for climate-related natural disaster risks for EU Member States. On the demand side aspects of NatCat protection gap, EIOPA identified several solutions: increase risk-awareness and awareness about the availability of coverage, increase consumers' understanding, rethink the way in which NatCat and household insurance are sold and adapt the premium via obligations to in place risk-mitigation measures.

AXA is keen to contribute to the reflection launched by policy makers on

insurance. To that end, AXA Emerging Customers uses a tailored approach to design products and distribution channels to reach lower- and middle-income populations globally. In 2022, AXA Emerging Customers insured more than 10M customers in 15 countries around the world.

Prevention as well as the offering of innovative and inclusive insurance products are key components to contribute to reduce the climate protection gap. However, these initiatives are not sufficient to fundamentally address the protection gap. Therefore, it will be necessary to intensify the dialogue between private, academic, and public decision makers to explore and put in place solutions. Robust and transparent public-private partnerships will be the success factor to bridge the climate protection gap in the face of increasingly intense climate events.

Robust public-private partnerships will be the success factor to bridge the climate protection gap.

how to remediate the protection gap. Building resilience and assessing the best way to increase prevention are essential pillars to mitigate risks. Prevention helps empowering individuals and businesses to contribute to reducing this protection gap. Innovation is also a key pillar. On that field, AXA contributes to the work of the Insurance Development Forum (IDF), a public-private partnership led by the insurance industry with the objective to build greater resilience for people, communities, businesses, and public institutions that are vulnerable to disasters. For example, in the framework of the IDF, AXA contributed to the development of a parametric rain and drought insurance cover for smallholder corn farmers in Mexico.

AXA also aims at innovating and making insurance more inclusive by enabling populations who have traditionally had less access to



JEAN-JACQUES BONNAUD

Treasurer - EUROFI

Can Europe accept a significant insurance gap in the emerging world?

The growing frequency and magnitude of natural catastrophes raise a pressing issue regarding the affordability of insurance contracts and the resulting indemnities due to the escalating costs of adequate coverage. One potential solution is to incorporate public participation in the pricing of insurance policies. The French catnat system, initiated in 1983 and subsequently improved, has largely relied on public support to reduce risk-based calculations by financing the cost of reinsurance. This approach recognizes the crucial role of insurance in facilitating risk assessment, incentivizing consumers to adopt preventive measures, and aiding societies in transitioning to more sustainable practices.

However, a similar significant problem arises from the challenges faced by some insurance companies, primarily in emerging countries, when it comes to transferring their risks through conventional reinsurance mechanisms. Such a reinsurance gap is critical for emerging countries from a long-term geo-economic and geo-political standpoint. The potential shocks that this situation could inflict on the emerging world underscore its importance.

Indeed, due to the pressures imposed by the COP21 agreement and subsequent developments, many reinsurance companies, predominantly based in developed nations, are refusing to provide adequate coverage to local insurance companies whenever the proposed risks involve fossil fuel usage. This issue is particularly prominent in the majority of electrical infrastructures in the emerging world, where the transition to renewable and non-fossil fuel sources remains slow or unattainable for corresponding governments. Reports of several refusals to consider such risk transfers in Southeast Asia have surfaced, and it is likely that this problem will soon extend to Africa.

The repercussions of such refusals are twofold.

Firstly, non-insured typhoons, floods, or other natural disasters place the burden of indemnities and reconstruction of energy generation or transportation networks on relatively poor states, thereby further hindering their ability to finance essential prevention measures. In essence, this also gradually diminishes the capacity of these states to leverage insurance mechanisms for facilitating a progressive adaptation and transition to climate change.

Joint mechanisms for financing the additional costs of reinsurance compared to those in wealthy countries should also be established.

Secondly, this challenge impacts the long and short-term perspectives of emerging economies, particularly when defining their own transition pathway towards renewable energy. Local insurance companies should be able to present reinsurance programs and portfolios of risks that include a progressive replacement of existing fossil energy infrastructures with renewables. This would enable emerging economies to address expected economic, industrial, demographic, and political shocks.

Addressing these future geopolitical challenges necessitates a collaborative approach, facilitated by the “rich world,” notably Europe. In this perspective the European Insurance and Occupational Pensions Authority (EIOPA), which is already partnering with several emerging states to actively

participate in discussions and planning with UN institutions, the World Bank, and the United Nations Industrial Development Organization (UNIDO).

The goal is to harmonize a global network of scenarios and plans that facilitate the use of reinsurance and insurance. These plans should allow local insurers to temporarily present portfolios of risks that encompass fossil energy infrastructure alongside an increasing proportion of renewable projects.

Joint mechanisms for financing the additional costs of reinsurance compared to those in wealthy countries should also be established.

Additionally, considering the existing resources in individual Just Energy Transition Plans (JETPs), it may be possible to establish a dedicated catnat mechanism for the emerging world with appropriate funding. Such an initiative would require the support of Europe among other relevant stakeholders.

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Q&A

RODRIGO BUENAVENTURA

Chairman - Spanish Securities and Exchange Commission (CNMV)

CMU is way too important to leave it just to financial regulation

Is the CMU initiative moving in the right direction? Should more emphasis be put on growing capital markets in the EU? Is the CMU initiative sufficiently connected to the key strategic objectives of the EU such as the green and digital transitions and the EU open strategic autonomy agenda?

Let me start by the last question: without stronger and deeper capital markets, the green and digital transitions and the strategic autonomy are at serious risk. All of those three projects require way more investment than Europe has ever executed. And EU companies are quite short of capital. Hence, CMU is an essential piece of this agenda.

The CMU initiative is moving, to my mind, in the right direction and has introduced some important ideas to harmonize European markets and national regulations and to make European markets more attractive to investors. But we need to do more on stimulating capital markets. We need to focus on their growth.

The EC indicators show a fragmentation of markets in terms of trading, but not so much in regulatory regimes (most is already in Regulations, with maximum harmonization supervision) and in supervision (the role of ESMA has brought EU national supervisors quite close together). I truly think that addressing fragmentation is not the priority if we want deeper markets, with more companies listed.

We need to act to stimulate listing, investment and to improve the infrastructures, so that growth becomes the priority. The Listing act and the retail investment strategy go in that direction, of course.

Can we do more? Yes: we could use taxation to drive this process, at national or EU level. We could improve financial education so that Europeans understand that they will need to complement their future pensions with their private long-term

savings and that, for that, we should better invest in capital markets. We could channel sovereign and public pension funds into equity markets. We could show to citizens the weaknesses of crypto assets compared to the long-term profitability of equity markets. Or we could convince entrepreneurs, through the right incentives, that public, long-term markets are a necessary complement to bank loans or private finance. But for that you need more than just financial regulation.

What potential drivers of capital market growth may be more taken advantage of in the future steps of the CMU?

One of the elephants in the room is taxation. Including tax incentives can have the greatest impact on the growth of stock markets. In this respect, the DEBRA initiative, which tries to break the traditional tax asymmetry between borrowing and equity raising, is absolutely the right thing to do. DEBRA, is probably more important for the attraction of EU companies towards equity markets than any of the other "classical" CMU initiatives.

But taxation is also important for retail investors. Countries that have adopted a simplified taxation scheme for financial holdings (like Sweden) have obtained very promising results. This may be linked to competition and open finance too. When you have all your financial investments in one intermediary, it's easy and convenient: you get all the info in one app and you get a single report with all the information for your tax filing. Shopping around with other intermediaries is a nuisance, operationally. That's where open finance comes in, as a way to eliminate the nuisance and benefit from real competition. This has been downplayed in the public debate around the Retail Investment Strategy, but I think it is really important to make the investment experience easier if we want to attract more retail investors to markets.

The other elephant is institutional investment and especially pension funds. The US has something close to 30

trillion USD in private pension funds, which invest heavily in equity. That is in a completely different league in the EU. In Spain, for instance, pension funds account for less than 100 billion €, just one third of the AUM in UCITS. And UCITS (and their clients) have very conservative portfolios and very short investment horizons, which is a curse for the liquidity of the equity market. For instance, in Spain, only 15% of the assets managed by Spanish UCITS are invested in equity. That is nothing, in terms of long-term investment! This explains a lot about what should be changed. Without deeper institutional investment, the liquidity of markets will be severely curtailed.

Does the proposed Retail Investment Package set out the key measures needed for increasing retail participation? What are the priorities? Are there any actions missing?

Increasing participation in capital markets will require a change in investment culture that can only be achieved when the retail investor is convinced that investing in capital markets is attractive, safe and cost-effective. In addition, it requires a modification of the current model which is based on the concept of written documents and does not make extensive use of the possibilities of digitalization to inform the investor interactively.

The retail investor must be able to make decisions based on the information they receive, and this information must be clear, simple, easy to understand and not misleading. These measures should contribute to increasing the quality of advice and the confidence of retail investors in the financial industry.

Therefore, RIS proposes a wide range of measures covering the entire retail investment journey: changes to disclosure rules and marketing communications and measures to address conflicts of interest, ensure better investment decision making, improve financial literacy, enhance the knowledge and competence of investment advisors, strengthen cross-border supervision and enforcement. The proposal also includes some more controversial issues, like rules on pricing processes to ensure that products that are offered to retail clients offer good value for money for retail investors. This means that ESMA and EIOPA will develop and make publicly available cost and performance benchmarks against which the manufacturers and distributors must compare their products prior to offering them. However, the definition and practical implementation of this measure is far from simple.

What I think is missing is a coordinated effort at EU level to improve financial literacy and fight fraud. The investors that have gone through a fraud episode are probably not going

to trust again markets for a long time and those that do not understand how important is to invest in equity if you are investing long term will simply not count in the equation we are trying to solve. This is of course a long-term effort, so the earlier we start, the better.

Can significant improvements be expected from the MiFIR review proposals in terms of liquidity, depth and competitiveness of EU securities markets? Are further actions needed to enhance the competitiveness of EU securities markets?

The reform aims to streamline the market, reduce regulatory complexity and eliminate distortions, which I think is to be welcome, as an approach.

As for liquidity, and in particular its relation to transparency requirements for non-equity, I have been witnessing this never-ending debate since MiFID I days. And, to say the truth, the apocalyptic forecasts by those that were opposed to increase transparency have not materialized. It is of course difficult to separate the effect of regulation on liquidity but I think it is clear that those fears have not materialized.

Our mission as supervisors is to safeguard price formation and to protect investors, promoting disclosure of information needed to achieve those objectives. I consider that a successful CTP could reach both goals as it will certainly reduce information asymmetries. And the area in which the benefits will be clearer is on fixed income, first and then on equities.

As for competitiveness, I think we need to embed that dimension in regulation, but never in supervision. It is just natural to take into account this when drafting the rules that will govern markets in the coming years, as it is already the case in MiFIR. This can be seen in the debates around softening the derivative trading obligation when trading with non-EU counterparts, the tick size regime for non-EU shares or the exemption from pre-trade transparency for voice and RFQ.

But we should be very wary of incorporating that parameter on supervisory or enforcement decisions. Supervision should be driven by compliance with the law, not by trying to bend the law to favor EU firms or, worse, the firms from your own Member State. That's why we need a strong ESMA to discipline National Competent Authorities into a convergent, single interpretation of EU law.



Q&A

RENAUD DUMORA

Deputy Chief Operating Officer of BNP Paribas,
Head of Investment & Protection Services (IPS)

Safeguard the access of retail investors to advice and diversification

How important is the development of retail investment for the growth of EU Capital Markets? Is encouraging retail investors to invest in securities markets a relevant objective in the current macro-economic environment.

BNP Paribas concurs with the Commission's objectives:

- to enhance retail investors' trust and confidence to safely invest in their future and take full advantage of the EU's capital markets union.
- to channel private funding into our economy in order to finance economic development, fund the green and digital transitions and strengthen European sovereignty.

Today, international comparisons show that European households tend to prefer more short-term savings products and low risk investments. Beyond the necessary build-up of precautionary savings, investors should also invest for lifetime projects and for retirement. Investment should be tailored taking into account the specific needs and choices of each investor (risk appetite, time-horizon, risks tolerance, ESG preferences and portfolio diversification) as well as his personal situation (age, social and educational background).

The higher interest rates provide new investment opportunities for retail investors but also call for investing a higher share of household's wealth because non-invested savings are eroded faster by inflation. Of course, the most relevant way for households to invest in securities market is through continuous and gradual investment in order to smooth out macro-economic fluctuations.

Does the Retail Investment Package set out the key measures needed for increasing retail investor participation?

Investment decision is a complex process driven by various factors, most of them bearing a strong national dimension due to tax treatment, pension schemes, locally regulated savings products etc. Households therefore need very customized advice to decide what investment fits best their profile, experience and environmental objectives. Moreover, several studies¹ show that between 70% and 90% of investors prefer human advice over digitalized interaction or robo-adviser and the proportion is higher among less wealthy investors. This physical and highly customized advice requires continuous local presence which is costly for distributors.

The proposed Retail Investment Package appears to be largely focusing on cost levels and built on the assumption that a fee-based remuneration model for distributors (as opposed to a commission-based model with inducements) would be more beneficial and attractive to retail investors. However, the impact assessment provided by the European Commission to support its proposal shows no simple correlation between remuneration models and the level of participation of retail investment in capital markets.

Ban on inducements and introduction of value for money tests could have a very significant impact on the industry, specifically on its distribution models and on the range of products proposed to clients. Our main concerns at BNP Paribas are about the proposed inducements ban, the new set of standards for advisory services, and the overweight given to cost parameters. The downside for distribution models with few mis-selling cases since the full implementation of MIFID2, is obvious. This could endanger the primary objective to increase retail participation.

Can a significant impact be expected from the measures concerning inducements, quality of advice and value for money in particular for the development of retail investment. What are the conditions of a successful implementation of the

proposals? Do some measures proposed have potential downsides or unintended consequences?

The quality of advice and the value for money are the key ingredients to foster retail investment. However, we are concerned that imposing a fee-based distribution model and cost benchmarks while promoting Exchange-traded funds (ETFs) versus actively managed funds will not achieve the objective.

Inducement ban on RTO² services does not seem the appropriate policy solution. Full transparency on costs is already in place thanks to MIFID 2. RTO services and execution services include appropriateness tests under MIFID and non-advised sales under IDD³ which provide valuable investor protection and will become even more costly if appropriateness tests are enhanced and Open Finance framework emerges. Moreover, a partial ban on inducement coupled with the need to link any advice to a transaction will lead national regulators to stiffen the definition of advice, therefore extending very significantly the inducement ban in practice. A switch from advice to execution-only would impact the mutualisation of advisory costs, leading to an increase of advice costs for least wealthy households.

The obligation included in the Retail Investment Package for advisors to propose “*a product without additional features (...)*” presumes advised products are necessarily too complex and assumes ETF to be the sole reference. At BNP Paribas, we believe this could have the side effect of reducing the offering and financial innovation as well as increasing concentration risk and introducing a bias to global investment. Actively managed and structured products that have a variety of features by design can be better suited to investors needs as they offer better diversification of underlying assets or payoffs compared to ETFs and can adapt to evolving ESG data or macro-economic outlook.

Value for money (VFM) tests are welcome but relying on cost/performance benchmarks to assess VFM is a strong concern, as centrally defined benchmarks will not sufficiently capture the specificities of the products or services.

The assumption that the cheaper and the simpler the products are, the better it is for the end investor may be questionable. Requiring advisors to offer alternative financial products at the lowest cost possible is moreover redundant with VFM, and materializes an approach driven by quantitative factors only. This is not attentive enough to the quality of services, such as long-term physical relationship and support, and obviously risk management or ESG integration. We all know that these components must be considered when two different offers from two different financial intermediaries are to be benchmarked.

A successful implementation requires simplicity to avoid the accumulation of implementation costs that would increase costs for end-clients. MIFID 2 and IDD have come into force quite recently. We need more time to assess their full impact.

Is the role of digitalization and digital tools sufficiently taken into account in the Retail Investment Package? Could more be done to adapt the Retail Investment Package to the digital age?

Digitalization of client journey and advice should be at the heart of any initiative aiming at increasing retail investor participation in capital markets. While all European banks and distributors are investing strongly in technology, it is a big challenge to build seamless multichannel investment journeys which also allow the possibility of human interaction at every step. Digitalized advice requires high quality granular data on client profile, experience and preferences as well as powerful algorithms to optimize the advice. Artificial intelligence based on large language models will enhance the quality of the interaction between customer and distributors.

Regulation can also contribute to the digitalization efforts. RIS provisions on regulatory disclosures and on marketing to retail clients will contribute by ensuring electronic format as default, clarifying how product disclosures should be presented in a digital environment and introducing additional safeguards for marketing communications. Still, Retail Investment Package could better address risk related to recommendations on social media, which today are partially disrupting advisory processes.

Given the enormous potential of digitalization to increase household investment and the massive investments required, one might question the timing and priorities of the Retail Investment Package.

At BNP Paribas, we believe policymakers should first accompany the digital transformation instead of putting at risk the distribution models and the quality of advice, and then assess whether advice has been sufficiently improved by digitalization and the new Financial Data Access (FIDA).

1. *Ernst & Young advisory (Dec. 2022), Vanguard (Apr. 22) and McKinsey (Feb. 2022) studies*
2. *RTO: Reception and Transmission of Orders*
3. *IDD: Insurance Distribution Directive*



Q&A

DANIEL MAGUIRE

Head of Post Trade - LSEG

& Group Chief Executive Officer - LCH

Openness is essential for the development of attractive European capital markets

How important are EU capital markets for LSEG and how committed is LSEG to their development?

LSEG is one of the largest financial market infrastructures and data providers in the EU. We have approximately 3000 employees across 19 EU Member States (c.24,000 globally). LSEG and EU capital markets are intrinsically connected and crucial to each other.

Within the region, we are an integral partner for our customers across the trade lifecycle. We have extensive experience, deep knowledge and a worldwide presence in data and analytics; indices; capital formation; and trade execution, clearing and risk management across multiple asset classes.

On the Post Trade side of our business, LSEG provides systemically important infrastructure for financial markets. It accounts for roughly one-quarter of the global segment in which it operates and clears the majority of the global interest rate swap market. Regionally, Paris-based CCP LCH S.A. clears the vast majority of the eurozone's government debt repo and CDS markets.

We have a keen interest in the continuing growth of EU capital markets and remain committed to expanding our offering in the region. In addition to being a leading CCP for eurozone's government debt repo and CDS markets, pending regulatory approval, LCH SA intends to launch DigitalAssetClear which will offer, cash-settled, clearing of Bitcoin futures and options contracts. We have also recently expanded our uncleared capabilities by acquiring Quantile, a market-leading optimisation provider with presence in Amsterdam, and Acadia, a leading provider of automated uncleared margin processing and integrated risk and optimisation services for the global derivatives community with presence in both Dublin and Dusseldorf. Whether through its Data & Analytics, Capital Markets or Post Trade divisions, LSEG is deeply committed to supporting a healthy and resilient EU financial ecosystem.

How important is central clearing for the competitiveness and resilience of EU capital markets? What are current strengths and areas of improvement of the EU clearing ecosystem?

As key financial market infrastructures, CCPs ensure financial stability. They support the growth of the economy by facilitating efficient management of capital and they act as superior risk managers.

Our market leading risk management framework underpins everything that we do to ensure resiliency in the market.

Mandatory central clearing became a vital part of the response to the global financial crisis, following commitments made by world leaders at the G-20 Pittsburgh Summit in 2009, to improve transparency and mitigate risks. The clearing obligation materialized in the EU under the European Market Infrastructure Regulation ('EMIR') and has demonstrated its value during recent crises and ensured the resilience of EU capital markets. For example, LCH Group helps manage periods of market stress such as at the outset of the COVID pandemic and the Credit Suisse event ensuring the safety and stability of the marketplace. This was possible as a result of our commitment to the operational, credit and liquidity resilience of our clearing services and adherence to strictly prescribed risk management standards.

Markets are global and CCPs are a mere reflection of how both markets and participants operate most effectively and safely. When looking at improvements to EU capital markets competitiveness, it is essential that EU firms' access to global CCPs and their liquidity pools is not restricted.

If the EU wants to develop flourishing and attractive capital markets, it should first focus on integrating its 27 markets rather than developing regional financial market infrastructures. The objective should be to attract international investment and capital, which will be hard to achieve without fundamental

reforms such as greater integration of EU debt, solvency laws, and tax frameworks, to name a few. The objective shouldn't be regionalism or strategic autonomy, but openness based on a sound regulatory and supervisory framework.

It is also important to note that central clearing isn't the answer to all market needs. The bilateral world also plays a crucial role in the efficient and safe functioning of financial markets. This is why we have recently expanded our services to the uncleared derivatives market, providing risk management, capital, and collateral efficiencies.

As such, we welcome some of the solutions being proposed in the EU, such as the exemption of trades resulting from Post Trade Risk Reduction Services from the clearing obligation, which can significantly reduce risk across cleared and uncleared portfolios, thereby reducing overall risk in the market.

Does the EMIR 3 proposal set out the key measures needed for improving the competitiveness and resilience of the EU clearing ecosystem? What are the potential issues raised by these proposals and should alternative or complementary actions be considered in certain areas?

The EMIR 3 proposal sets out many positive measures that, once implemented, could increase the competitiveness and attractiveness of the EU clearing ecosystem.

Looking at the supervisory pillar, proposals aimed at improving time-to-market for new product and services are welcome. For EU CCPs such as LCH S.A., we need consistency in the approach and timeframes across the EU to enable a faster adaptation to market demands whilst remaining risk management conscious and prudent. This approach will enable EU CCPs to compete on a level-playing field.

Amendments to the MMF and UCITs Regulations opening the door to more buy-side clearing are also welcomed. We would also suggest considering eliminating counterparty risk limits for centrally cleared repo transactions. By doing so, the EU would enable a wider base of market participants to use central clearing, leveraging newly developed Sponsored Clearing models which would further enhance financial stability.

Whilst we are supportive of the measures outlined above, the review of the EMIR framework does include several proposals, such as a new EU CCP supervisory framework, that could be detrimental to the EU clearing ecosystem.

For example, London-based LCH Limited is directly supervised by ESMA, while LCH S.A. has three main national competent authorities in addition to the EMIR college and ESMA's CCP Supervisory Committee. Addressing such supervisory complexity is crucial to improve the competitiveness of EU CCPs. At the very least, EU CCPs of systemic importance to the Union should only be directly supervised by EU authorities. This would help ensuring better harmonisation and implementation of EU rules and supervisory outcomes.

Additionally, measures limiting EU firms' ability to clear EUR IRS will increase their risk exposure and costs. EU market participants should be free to access any CCP irrespective of their location so long as they are appropriately supervised. Such proposals also go against the successful internationalization of the euro. As a reminder, 75% of EUR IRS flows originate outside of the EU. That is more than the USD. By taking the risk of regionalizing EUR IRS flows, we could undo the successful international role of the euro, a key objective of this European Commission.

We understand the EU's desire to develop strong local market infrastructures to support its own economy and attract both local and foreign capital, but that should be achieved organically and through market-led, safe, and stable incentives. Forcing market behaviours will not only go against fiduciary duties and best execution but result in an unlevel playing field with non-EU peers, higher costs for industry, and ultimately increased financial stability risk.

Let me conclude by saying that not only has the UK faithfully transposed the EU EMIR framework it helped develop, but it also requires that market infrastructures adhere to the highest risk management standards. As regulators in other jurisdictions have done, we urge EU policymakers to consider enhancements to EU-UK supervisory cooperation rather than dislocating a global, highly liquid, and efficient market. The signing of the EU-UK Memorandum of Understanding (MoU) and the creation of a joint Financial Services Forum brings about a great opportunity for both jurisdictions to look for alternative solutions that will uphold competition and free movement of capital and ensure the stability of the EU financial system.

Global markets, both from a systemic risk perspective and efficiency for the real economy, are best served by global CCPs, subject to both local and global regulations overseen through supervisory cooperation, globally.



Q&A

GUILLAUME PRACHE

Senior Advisor – Better Finance

For an effective “retail investor strategy”

How important is the development of retail investment for the CMU and more generally for the EU economy? Is encouraging retail investors to invest in securities markets a relevant objective in the current macro-economic environment?

Encouraging retail investors to invest in securities markets is indeed a relevant and very important objective: both for citizens, for the EU economy but also for democracy.

It is more and more important for citizens themselves, as it is now a key component of what the UN call “*financial health*”, and what the EU calls more specifically regarding investments “*pension adequacy*”: It is and will not be effective for citizens to save early and a significant portion of their activity income for retirement and other long-term needs, as Public Authorities and professionals are repeatedly recommending. These savings MUST also provide decent, positive net real returns over the long term.

This is not the case today. BETTER FINANCE estimates that Eurozone savers lost about € 1tn last year alone in net real value (purchasing power) terms. This is jeopardizing their financial health, and is contributing to the impoverishment of middle classes, a key trigger for the rise of extreme politics and of threats to democracy.

One powerful way to improve this appalling situation is to enable them to access:

- Better performing capital market investment products such as listed stocks, bonds and ETFs
- and simple, cost-efficient Pan-European pension savings products like the Individual Retirement Account (IRA) and the “401k” (occupational defined contribution pension) in the US.

This is not the case today. Two short examples:

- Today, money market funds (MMFs) are a much better alternative for short term investments than bank savings

accounts (about 4% return vs. about 1% in Belgium for example). But they are usually not “advised” to EU citizens, and they are more complex (almost no “stable value” MMFs) than in the US. Plain vanilla fixed rate Government bonds are also a “non-advised” and a very difficult to access option for citizens.

- In France, ETFs represent only 1,6% of funds “advised” and sold to retail investors via unit-linked insurance (two thirds of the total retail fund market).

What are the key factors explaining the limited engagement of EU citizens in capital markets?

The main factor is that retail investment is a very peculiar consumer market. EU citizens as **financial healthcare** users are not treated as fairly as – for example – as **physical healthcare** ones:

- Complex and/or hazardous products are not pre-approved by Public Authorities
- Investment prescribers are mostly not independent from providers and mostly compensated by sales kickbacks by these providers.

The result is that simple and cost-efficient capital market investment products such as exchange-traded equities, bonds and funds are very little explained and “advised” to people versus more intermediated, packaged, complex, fee-laden, cumbersome to subscribe to and geo-blocked by Member State products.

One other factor is the lack of access to capital market products such as plain vanilla fixed rate listed bond markets (citizens have recently been crowded out of these very opaque and often illiquid markets) or to simple Pan-European cost-efficient pension savings ones (there is no single market for such products within the EU; only for listed securities and UCITS funds).

Also, let me address the old tune of people’s risk aversion. First, we are all risk averse, and professionals (look at “institutional” investors’ own asset allocations versus the ones of “retail”

investors) and even more so regulators are even more risk averse than individual investors. In particular, regulators should reverse their investment risk scale for long term and pension products, by taking into account their time horizon and the impact of inflation. I must repeat here that money market funds or bank savings accounts are a much riskier pension investment than a cost-efficient diversified portfolio of listed equities. Indeed, both the probability and the magnitude of the risk of destroying the real value of pension investments over the long term is much higher for the former than for the latter.

However, regulators keep rating the former a Level 1 risk and the latter a 6 or 7 one, even for personal pension products, pushing the retail investment professionals to advertise the same. Also, they still require nominal-only performance disclosures.

And the ongoing “financial repression” policies of central banks (which ensure that gross nominal interest rates are much lower than the inflation ones) and of national tax Authorities (which usually tax the largely fictitious nominal investment income instead of the real one) is an additional factor. The ECB should at last consider the financial health of people (and not mostly the short-term interests of overindebted Governments) as one of its policy objectives.

Does the Retail Investment Package set out the main measures needed for increasing retail investor participation? What are the priorities?

This package is a once-in-a-lifetime opportunity to create a Capital Markets Union that works for the people. It includes several positive proposals, but falls short of meeting its purported objectives (EC CMU Action Plan of Sept. 2020):

- “ensure bias-free advice”
- “ensure coherent rules across legal instruments”
- “transparent, comparable and understandable product information”
- “open markets with a variety of competitive and cost-efficient financial services”.

We welcome the specific ban of “execution-only” / “unadvised” sales of retail investment products. However, the scope of this ban is even more limited: Member States would be given an option to ban unadvised sales of IBIPs by making the provision of advice mandatory. Regulators often forget that IBIPs and pension products are much more widely sold (70% of all PRIIPs according to EIOPA) than MiFID-regulated investment funds.

We also welcome the proposals on “Value for Money”. However, their goal is quite modest: only trying to make the already existing EU rules on value for money at last enforceable. And I am quite concerned by the long and complicated process to finalise these measures. EU policy makers should benchmark these proposals to simpler, lighter and quicker practices (e.g., UK FCA’s value assessments).

Are there any missing points in the Retail Investment Package proposal? Do some measures need adjusting or fine-tuning? Are these proposals ambitious enough?

Yes there are.

First, the wording of key investor protection rules would still be unclear and misleading for people:

- «**Non-independent advice**» (MiFID 2) is an EU Law oxymoron and «*investment advisors*» even omit this “non-independent” qualifier.
- «**Investment advisor**» labeling should not be allowed for retail distributors whose compensation is essentially sales commissions paid by providers: such professionals primarily are and should be called salespersons. After all, car dealers never portray themselves as “transportation advisors”.
- The term «**Inducements**» is not intelligible for EU citizens. The first president of EIOPA translated it into plain language as sales kickbacks.

Second, the Proposal fails to tackle the issue of conflicts of interest in a comprehensive and consistent manner across the various categories of retail savings products: MiFID rules on conflicts of interest would not be extended to the other investment products sold to retail investors, e.g., crypto-assets, pension products, crowd-funding. In particular, the MiFID ban on inducements for portfolio management services would not be extended, even to IBIPs.

Third, nothing is proposed to address the appalling content of Key Information Document (KID) for retail investment products to make these key disclosures clear, comparable, relevant and not misleading:

- No ending of the “Pseudo-science” of disclosing future performance scenario only, based on 5 year past performance
- Cost disclosures are not intelligible (“future RIY”), misleading (based on only one future scenario), not comparable and fail to disclose the total annual cost for all unit-linked products.

Fourth, the EU legal mandate to promote simplicity is once again entirely forgotten in favor of the old tune of the need to promote financial education.

Last but not least, the EU equity markets are still highly fragmented, evolving further into dark trading, and too complex for non-professional individual investors. One result is that even when they can invest directly into capital markets, “retail” investors will tend to go to US listed stocks, especially for innovative and high growth opportunities. And barriers to investor engagement within the “single market” have not been eliminated nor reduced despite the promotion of ESG investing, while the greenwashing risk of intermediated products is higher than ever.

The European Parliament and the Member States can still grab this one-time opportunity for the sake of the middle classes’ financial wellbeing and of the future of the European economy and democracy.

CAPITAL MARKETS GROWTH: IMPACT FROM CMU



VERENA ROSS

Chair - European Securities and Markets Authority (ESMA)

It's time to mobilise our CMU ambitions

30 years on from the creation of the single market in Europe, the value of better integrated markets is evident across all aspects of our everyday lives. Taking this a step further, the Capital Markets Union plan launched in 2015 was intended to further unlock the potential of financial markets for the benefit of European citizens and businesses, in a way to truly recognise the free movement of capital.

It is often said that the CMU plan has not yet delivered on its goal of improving the flow of investments and savings across the EU. While there is certainly much more to do, it would be remiss not to acknowledge the successful milestones in this project over recent years, which has led to more harmonised regulatory regimes and more convergent supervision.

Some important initiatives to push forward the CMU ambition have recently been taken. The European single access point, which will soon open up cheaper and simpler access to company information for investors, and the consolidated tape, aiming to provide real time transaction data to investors, are just two examples. Political agreement reached on key files in 2023, such as MiFID/MiFIR, AIFMD and the CSDR, also denotes essential improvements to crucial parts of our regulatory framework for EU capital markets. Discussions on other files such the Listings Act are also proceeding at pace, with hope to finalise it in the current legislative cycle.

Block by block, a true CMU is being shaped. As each action in the 2020 Action Plan is ticked and the most recently adopted components become embedded in practice, we can expect to see tangible results. However, we must remember that building strong and deep capital markets is not just about adjusting our existing single rulebook as necessary, but it is also about being best in class in meeting new challenges and opportunities. This is particularly important in the context of the green and digital transitions, where the EU is building safe and suitable regimes to foster growth, and position Europe well, in these areas.

As the CMU regulatory framework progresses, we must turn our attention to the next frontier – mobilisation of all forces. This means mobilising companies, investors, and other market participants to fully benefit from EU capital markets, especially in Member States where capital markets have historically been less developed. The Retail Investment Strategy marks one important step in embarking on this phase, as it seeks to empower all citizens to safely participate in EU capital markets.

On the flip side, it is equally important that we foster the right conditions for companies, in particular SMEs, to attain financing from the market as an alternative to bank funding.

Nonetheless, mobilisation of all forces also means better cooperation and a more common ambition, going beyond financial regulation, amongst the political decision makers at national and EU level. A lot of the control for developing EU capital markets remain in the hands of national governments. Until now, depending on the urgency and history of different Member States with regards to their capital markets, we have seen varying levels of success. For example, Sweden is often cited as a European success story in this regard, with a stock market capitalisation of 227% at the end of 2021 (versus 81% for the EU27). They have achieved this success by creating an appropriate ecosystem that supports start-ups, embraces a deeper equity culture, incorporates balanced tax incentives, and remains underpinned by strong supervision. Other countries like Denmark and the Netherlands also have some success in this regard, especially when it comes to mobilising national and private pension schemes to embrace domestic equity investment.

We must turn our attention to the next frontier – mobilisation of all forces.

While it is important to recognise the value of our diverse national markets in the EU and learn from each other about what domestic measures have contributed to success or not, it is not enough to consider this our end game. Member States need to reorientate their focus from being competitive against one another to building an integrated capital market that can be collectively competitive towards the rest of the world.

Mobilisation towards a genuine strong, single EU capital market that is attractive to European and international investors and allows EU companies to find funding and growth opportunities requires a further push to break down remaining barriers.

ESMA remains committed to this vision. We will continue to work with the ESMA Board members to do what we can to make this true single European capital market a reality.



MARIE-ANNE BARBAT-LAYANI

Chair - Autorité des Marchés Financiers (AMF)

European supervision remains the missing piece to complete a true CMU

The past year was marked by a number of economic and political challenges, from the war in Ukraine, to the resurgence of inflation and the end of a decade of low interest rates. Financial markets experienced high volatility, and a significant fall both in equity markets and in bond markets, and the crypto-asset universe saw its first crises. In a difficult global context, the need for the European Union to develop autonomous and competitive financial markets, to enhance access to market financing for companies, to support the EU economy in the long run and to improve its resilience against future crisis remains necessary.

An essential milestone in this perspective, the Capital Markets Union must be completed. It is the key to create a true Single Market in financial services that provides businesses with a greater choice of funding, offers new opportunities for investors in a protective environment and makes the financial system more resilient. We are now at a stage where effective delivery becomes critical for the credibility of the whole process, and for the EU to compete and lead in international capital markets.

Beyond the sectorial proposals in the CMU package that are currently being negotiated and will have to be implemented, there is still a strong need to enhance European supervision and support supervisory convergence across jurisdictions. In this field, in spite of the persistent political resistance to more centralized supervision, we must address the needs of investors and financial market players for more coherent treatment across Member States.

Ensuring more harmonized supervisory practices on the ground is crucial for pan-European players that have a cross-border reach and need a common supervisory stance, as well as for investors, in particular retail, who deserve the same level of protection all across the Union. The EU capital market needs a harmonised and unified supervision that ensures a level playing field for all market players and eliminates arbitrage opportunities.

In this respect, and a minima, the functioning of supervision in the context of cross-border activities within the EU needs to be strengthened, even more so as digitalization grows. Indeed, a number of shortcomings have been observed in recent years by ESMA and NCAs in the supervision of cross-border provision of financial services to retail within the Single Market, at the home NCA level. A new balance of responsibilities has therefore to be considered, while retaining the full benefits of the European passport. Concretely, the EU supervisory framework should be reviewed to provide broader abilities for host NCAs to effectively exercise supervisory powers where financial firms undertake meaningful activity in their jurisdiction - as well as an effective system for the exchange of relevant information between authorities.

By exception, host supervisors and ESAs should be allowed to intervene in a timely fashion in case of serious risks to investor protection and the proper functioning of markets. And ultimately, the principle whereby an investment firm should provide at least a part of its services in the country where it is authorised should be clarified and enforced, to avoid any regulatory forum-shopping undermining the Single Market.

On another front, more convergence could also be achieved by ensuring further harmonisation in the implementation of EU legislation. For instance, the EU should complete the European authorities' toolbox, and equip them with the power to issue so called no action letters as it exists in other jurisdictions. The EU needs the flexibility and legal tools to avoid the deadlocks which may occur where it appears that a legislative requirement cannot be complied with, in exceptional circumstances; or when a coordinated approach with third country authorities proves necessary. This is essential for the market as a whole, and to put the EU on an equal footing with third countries.

Supervision in the context of cross-border activities within the EU needs to be strengthened.

Beyond completing a well-functioning Single Market for financial services and protecting retail investors in the context of the CMU, two other major priorities must be pursued at EU level going forward. As the finance industry and investment behaviours continue to evolve, we should continue to promote more sustainable finance, by developing and clarifying regulations to ensure the rules' consistency. And pursue the thinking on innovation for the construction of an appropriate regulatory framework on subjects requiring it, such as Decentralised Finance, open finance and artificial intelligence.



JOS DIJSSELHOF
Chief Executive Officer - SIX Group

CMU: accelerating progress toward financial integration and economic growth

The Capital Markets Union (CMU) 2020 Action Plan sets forth ambitious goals to enhance integration and efficiency within the European Union's financial markets. It addresses central issues such as providing access to equity for SMEs, creating safer markets for individuals to invest in the long term, and integrating fragmented markets into a genuine single one. The aim is to create the preconditions for ensuring the long-term financing of European industry in all its forms and to support major European projects, particularly in the areas of digitalization (Digital Agenda) and sustainability (Green New Deal).

The EU's efforts to monitor the progress of the CMU (Capital Markets Union) through key indicators have shown slow advancement since the program's initiation in 2015. Notable points from the monitoring report ("Monitoring Progress towards CMU: a toolkit of indicators") include:

1. **Market Funding Ratio:** Non-financial companies tend to finance themselves today at a slightly higher percentage with capital market instruments instead of bank lending.
2. **Retail Investments:** Household investments have decreased significantly since 2015, with a slight recovery in the last two years, despite a general higher savings rate during the Covid crisis (offset again by the restraints caused by the soaring inflation). Most European countries still lag behind the investment rates we see in the US.
3. **Home Bias Indicator:** There has been some improvement in international investment within the EU, with an increase in cross-border investment.

The above-mentioned indicators are examples from a list out of 30 indicators deriving from the EU's actions. They give an idea of the variety of actions taken by the EU. However, this has too often led to a focus on technical details, often at the expense of addressing larger structural issues. In order to accelerate the CMU's developments and to also make listing in Europe more attractive compared to the US, and potentially also Asia, this needs to change!

In short, while the EU has taken various actions to promote CMU, progress has been slow. To achieve the desired results, a shift towards addressing broader structural challenges is necessary.

Financial market infrastructures (FMIs) play a pivotal role in the efficient and robust functioning of capital markets and in accelerating their development. By strengthening FMIs, the EU can bolster investor confidence, promote liquidity, increase transparency, and reduce risks within its capital markets. It will be able to address the needs of various market participants, including small and medium-sized enterprises (SMEs), start-ups, and investors. Simplifying capital access, improving transparency, and reducing administrative burdens will improve the access to funding and encourage cross-border

investments. In addition to the aforementioned investments by institutional and retail investors in Europe, global capital is required to raise the funds necessary to implement the European Union's major projects in the area of digitalization and sustainability. Only well-functioning European wide capital markets - including the UK and Switzerland - along with attractive long-term projects, can ensure this influx.

To accomplish the CMU's ambitious goal of creating advanced capital markets, it is important to focus on strengthening FMIs and implementing comprehensive reforms. Legislators and regulators need to embrace necessary changes and facilitate regulatory harmonization, streamlined procedures, and alignment of national rules are essential steps to foster the development of the CMU.

Important examples of overdue measures include efficient tax rules that do not favor one type of capital over another and allow for easy settlement even across national and European borders, or insolvency rules that ensure the same understanding and legal certainty across the EU. Another key issue is to establish a true level playing field between different types of trading venues such as stock exchanges, Multilateral Trading Facilities, and Systematic Internalizers. To realize the CMU's full potential, these issues must be tackled head-on.

It is important to focus on strengthening FMIs and implementing comprehensive reforms.

In conclusion, by leveraging the capabilities of an FMI by creating an adequate regulatory framework, we can make our capital markets significantly more attractive compared to the US and other regions. This would provide our industry with the tools necessary to remain competitive at the global level, and thus reducing the reasons for European issuers to raise capital abroad. It is important that CMU measures are streamlined to reduce their complexity, enhance harmonization, and accelerate the speed of implementation.



TAREK TRANBERG

Head of Government Relations, Europe - Optiver

More is needed to get EU capital markets back on track

Looking ahead to the next legislative mandate after the European Parliament elections in 2024, two pieces of legislation strike us as particularly critical. Both offer policymakers the opportunity to make powerful progress toward the goals of the Capital Markets Union (CMU). One is the prudential regime for investment firms (IFR/IFD), and the other is MiFID II. It's critical that in reviewing these two frameworks policymakers consider Europe's capital markets holistically in a way that encourages (safe) growth and promotes a diversity of market participants.

It is encouraging that the European Commission has asked the EBA and ESMA to deliver technical advice on the IFR/IFD review. We hope that revisions to this framework will ultimately deliver on its original intention, which is to provide a bespoke prudential regime for investment firms appropriate to the diverse nature and range of their activities. What policymakers should avoid is a framework that largely pushes investment firms, especially those that deal on own account and provide liquidity in all major asset classes across EU markets, back into a regulatory category intended for banks.

We are concerned however about recent decisions to treat EU consolidated investment firms differently from non-EU consolidated firms when classifying them under the prudential framework - which works to the disadvantage of EU firms. These latest changes will disincentivise liquidity providers from increasing, or even maintaining, their activity in EU markets. This is not only detrimental to proprietary liquidity providers, but also reinforces the steady trend of declining volumes and liquidity in EU markets. The end result will harm markets' core risk transmission function and create a smaller, more expensive investible universe for end-investors (institutional and retail alike).

We urge policymakers to seize the opportunity for reform here, to ensure that European markets remain an attractive place for existing firms to grow and for new firms to establish themselves.

On the market structure side, after months of tough negotiations, EU policymakers have finally agreed on revisions to MiFID II, marking an important milestone in the CMU project. Policymakers should be applauded in particular for reaching a consensus on the two most divisive topics: a consolidated tape (CT) and payment-for-order-flow (PFOF) rules, which both sit at the heart of the MiFID review and CMU.

With a political agreement now in place, the focus now turns to developing the supporting technical rules and agreeing an implementation timeline. Brussels lawmakers must be vigilant and ensure these next steps do not offer critics a final opportunity to dilute the rules or introduce unnecessary complexity.

We're encouraged the EU has opted for a blanket-wide PFOF ban, especially given the late push for an approach that would have given EU nations the option to permit the practice. Banning market makers from paying for retail flow will remove a potential conflict of interest and impose a level playing field across the EU that should stimulate competition among retail brokers. However, member states that already allow PFOF will be given until June 2026 to phase it out. We hope the grace period does not present an opportunity to reverse or weaken the ban.

The consolidated tape proved to be an even more contentious issue. Negotiators struck a delicate compromise that will see the creation of an anonymised pre-trade feed - showing the best available price for a given security from multiple venues - in addition to a post-trade record of transactions. Given the strong opposition to a pre-trade tape from some corners of the market, getting any form of pre-trade across the line is a laudable achievement. However, there are questions on how useful it is to know the best price for a given stock without knowing where to obtain that price.

EU capital markets need further reform to ensure that they remain attractive for a variety of firms.

Regardless of this progress, important details remain unresolved and offer those philosophically opposed to the CT a chance to further frustrate the process. For example, the approach to revenue sharing and governance of the CT operator will play a large role in determining whether the CT project ultimately succeeds or fails.

Overall, whilst we are closing out the current legislative mandate with some meaningful progress towards CMU, much still remains to be done to make EU markets more attractive for investors and firms alike.



SIMON JANIN

Head of Corporate and Public Affairs - Amundi

The success of CMU is key for the financing of the green and digital transitions

With a level that has been exceeding 12%¹ for the past decade – even above 25% during the Covid-19 pandemic – the Eurozone benefits from one of the world highest saving rates. As the excess of savings over investment surpasses €300 billion each year², a better mobilization of this surplus towards productive investment is necessary. And this, in a context where the European Union (EU) needs to achieve both its green and digital transitions. To this aim, the European legislative framework is a key element to ensure that capital markets participants, and notably asset managers, can effectively contribute to channeling more savings towards the financing of the economy.

No doubt that, over the past few years, the European institutions have increasingly realized the importance of private capital to finance these transitions along with the need to ensure more strategic autonomy for the EU. Indeed, transitioning towards a low-carbon economy will go hand in hand with reducing our dependencies on some critical sectors that are key for the transition, which demands production to be built in Europe, to avoid notably supply chain vulnerabilities. And in order to foster more long-term investments that will support European strategic ecosystems, asset managers would benefit from more integrated, deepened and less fragmented capital markets.

Against this background, the European Commission’s Action Plan on Capital Markets Union (CMU), published in September 2020, is definitely a step in the right direction. And, as part of this action plan, the development of long-term investment products such as the European Long Term Investment Fund (ELTIF) is a good example of how a pragmatic review can efficiently contribute to the financing of the European economy whilst increasing the engagement in long-term products by retail investors. In this respect, level 2 measures supplementing ELTIF regulation currently being drafted will be key to ensure that the newly adopted level 1 text fulfills its whole potential. In particular, it is essential to make sure that future technical standards are fit for purposes and are not jeopardizing the ability for retail investors to benefit from a larger access to this investment product.

In addition, the upcoming launch of consolidated tapes (CT) in both fixed income and equity markets – as recently agreed by the EU co-legislators – will provide financial markets with more transparency, thus make them more competitive, attractive and resilient for investors. The information provided by the CT will help both retail and professional investors to make appropriate investment decisions and will also contribute to improving best execution and liquidity risk management. A CT will also help reduce market fragmentation, fostering market efficiency and competitiveness. To achieve this, a balanced business framework will have to be found by ensuring free access to CT for retail end-investors while keeping costs at a “reasonable level”.

We also fully share the overall objectives of the Retail Investment Strategy, released last May, which aims to make the EU a safer place for citizens to invest in the long term and to encourage participation in capital markets. However, a number of measures suggested by the European Commission in its proposal are very complex and – by focusing only on costs – are just simply missing the target. In particular, the “Value for Money / benchmarks” approach is giving rise to a potential “administrative” price regulation that is very questionable both operationally and as a principle. Conversely, we believe that more attention should be paid on measures that will ensure that retail investors receive streamlined and meaningful information. This would be the most efficient way to help them making their choices and reducing their risk aversion, which remains on average at very high level within the European population (notably if we compare with other jurisdictions, for instance in the US).

Asset managers would definitely benefit from more integrated and less fragmented capital markets.

Lastly, we strongly recommend looking at the granularity and the coherence of all the measures adopted as cumulative effect should not be overlooked. It is also important to stress that a “competitiveness check” should systematically be carried out before the adoption of any EU legislation. And this to ensure that European players benefit from a regulatory framework which preserves their competitiveness and enables them to fully play their role in closing the investment gap, especially in strategic sectors.

1. See Eurostat, Euroindicators, 40/2023, 5 April 2023.
2. See Eurostat, Banque de France, October 2021.

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**MARIE-ANNE
BARBAT-LAYANI**

Chair - Autorité des Marchés
Financiers (AMF)

A unique opportunity to foster retail participation in capital markets

Through the retail investment strategy published in May, the EU is set to encourage consumers to invest more money in capital markets, creating the conditions for enhanced retail participation through all types of intermediation channels. It is indeed high time that retail investors were placed at the heart of the Capital Market Union.

The new set of reforms aims to address perceived shortcomings in the current EU regulatory framework for retail investment, namely that retail investors find it difficult to access relevant, comparable and easily understandable information to make informed investment choices. The reforms go a long way to harmonize and standardize investor information, namely on costs and charges. They work on the assumption that some investment

products may not always offer sufficient value for money to investors and that the latter need to be given easier access to appropriate products at the lowest cost without suffering from conflicts of interest. Hence a specific focus of the Proposal on the way financial products are designed and distributed. Overall the reform should aim at lowering the cost of investing for savers.

The practice of simulating product returns taking into account all applicable costs is already observed with some firms at the product design phase and ESMA guidance already exists on that aspect. The Proposal brings it to a new level: it turns such pricing process into an integral part of the product governance requirements, thereby enshrining the concept of “Value-for-money” in the Level 1 rulebook. While the objective of ensuring that retail clients get their money worth when investing in financial products is worth pursuing, the Proposal raises some fundamental questions as regards the way products should be compared to their peers in order to identify cost outliers.

An approach whereby pan-European benchmarks of costs and performances would be developed for each family of products displaying similar features might look enticing at first glance. Yet, it also raises concerns that it may run into methodological problems, while taking years to develop in view of the new full-scale product reporting exercise that must be set up as a precondition. How peer groups will be defined and how the pricing process will filter through outliers must be considered with care. The EU needs a framework that avoids excessive complexity and misunderstanding of the concept that would thwart its appropriation by firms.

The EU initiative aims at supporting EU citizens in their investment decisions. The AMF strongly believes that financial advice must be provided in the sole interest of the client and must remain accessible to all investors, even the less wealthy, and care must be taken to ensure that access is easy throughout the country, so as not to create geographical inequalities.

The AMF has been involved in national works to promote clear and responsible advertising of financial products with a specific focus on social media and the role of online influencers. It is therefore very good news that the Proposal should clearly define investment firms’

responsibility vis-à-vis the content and use of the marketing communication conveyed through social media. This is one illustration amongst others, where the proposal is commendable in its attempt to take stock of new technological developments, such as digitalization.

The topic of cross-border retail financial services has also been addressed in the Proposal, which is welcome. The possibility for investment firms and banks to provide services across the EU is a key plank of the single market for investment services. In 2022, according to ESMA, around 380 firms provided services to retail clients on a cross-border basis and approximately 7.6 million clients in the EU/EEA received investment services from firms located in other Member States. This calls for heightened scrutiny on how the home and host authorities interact when non-compliant firms cause detriments to retail investors in jurisdictions other than the one where they have established their headquarters and have been authorised.

It is indeed high time that retail investors were placed at the heart of the Capital Market Union.

In this respect, as a recent ESMA peer review clearly demonstrated, home competent authorities may sometimes lack the proper expertise and resources to sufficiently supervise how their firms comply with consumer protection rules when operating in host jurisdictions. The Proposal acknowledges that and puts forward a number of interesting, concrete tools which may facilitate cross-border supervision, and eventually foster retail investors’ confidence in the single market. A more ambitious approach could also be explored, what with certain additional safeguards against regulatory forum shopping.

The AMF has so far taken an active part in the debates that led to the adoption of the draft Proposal and will follow with great interest the forthcoming negotiations in the hope that the final text will enhance retail investors’ confidence to invest in financial products that correspond to their needs.



GUILLAUME BÉRARD

Advisor - Financial Services
and Markets Authority,
Belgium (FSMA)

Retail Investment Strategy: a subtle balance to maintain and further fine-tune

The long awaited Retail Investment Strategy (RIS) is an ambitious proposal that adopts a holistic approach in order to address different types of issues that can impact retail investors, while also drawing the lessons from years of application of MiFID and IDD, and taking into account digitalisation. By doing so, the RIS intends, amongst others, to improve retail investors' trust in capital markets. Such trust is essential to encourage people to invest, which in turn is important to help them to prepare their future and it can contribute to the financing of the green and digital transition.

It is fair to say that if most stakeholders agree with the goal of attracting retail investors on EU Capital Markets, views differ regarding the best manner to achieve this, as demonstrated by the very strong and divergent opinions expressed about the RIS, depending on whom you speak with.

As a financial services and markets supervisor, we welcome the approach

adopted by the Commission and think that the RIS contains key measures that go in the right direction. Status quo is not an option if we want to enhance retail investors' trust. We need to ensure that retail investors are empowered to take more informed investment decisions, are duly protected by a coherent regulatory framework across different sectors of the capital markets and are financially well educated.

However, as always, the devil is in the details and it will only be possible to say that the RIS is effectively going in the right direction once the details will be known. The RIS can thus be seen as a first step, building on existing requirements, but it will be important to ensure that the following steps, i.e. the delegated acts and the work to be done by ESMA and EIOPA, are appropriate, in order to have a framework that works, achieves the goals pursued by the Commission and is possible to supervise as well as to enforce.

Besides that, we also need to be cautious and a number of factors need to be borne in mind to achieve a satisfactory outcome at the end of the negotiations about the RIS proposal.

Firstly, the RIS could be described as a castle of cards. Many of the proposals made are very closely interrelated and it seems important to keep the balance achieved in order to address adequately the problems identified by the Commission along the retail investor journey. Modifying substantially some of the key elements of the proposal, for example the value for money requirement, would negatively impact such balance.

Secondly, ensuring – as proposed by the Commission – that products or services with similar characteristics are regulated in the same way is critical. The understandability of the regulatory framework by retail investors is necessary to improve their trust in markets.

Finally, some key measures proposed in the RIS could benefit from some further clarifications or fine-tuning, directly in the level I text, to better achieve its goal and avoid negative side-effects.

Let me mention two key sets of elements to illustrate this.

The first one concerns several measures related to the assessment to be done when a product is advised to a retail investor. The best interest of the client test should be further clarified – for example the concept of product without additional features that are not necessary to the achievement of the client's investment objectives and that

give rise to extra costs – as should the interaction between that test and the suitability test.

The second one is about value for money. Many stakeholders have stated that the Commission's proposal is too focused on costs. An equilibrium might need to be found among three main angles: costs and charges, risks and return, and service and quality. Investors should be able to evaluate costs, but also the investment returns and the other service benefits. The assessment of the most advantageous combination of these elements may vary from client to client, which may imply to have a more nuanced approach than what is currently proposed. In any case, if elements other than costs (such as for example the quality of the service) were to be taken into account, it would seem important to ensure that this is not done to the detriment of the issue of costs and their impact on performance. Indeed, high costs and low returns do not help to build trust. Guidelines might also be needed regarding justifications of deviations from the relevant benchmark and developing relevant benchmarks will be a complex as well as critical task.

**Status quo is not an
option if we want
to enhance retail
investors' trust.**

Last but not least, as a supervisor very strongly active in the field of financial education, we welcome and support the proposal to enhance financial literacy. Indeed, providing, for example, information to help retail investors to compare costs and charges is only beneficial if such investors are sufficiently financially educated to understand the usefulness of such information and use it.



VERENA ROSS
 Chair - European Securities
 and Markets Authority (ESMA)

Retail Investment Strategy: challenging but essential

The Retail Investment Strategy, as one of the key initiatives under the 2020 Capital Markets Union Action Plan, aspires to boost retail participation in the EU capital markets. While regulation alone cannot guarantee that more EU citizens tap into markets to mobilize their savings, it certainly can help to mitigate some of the key factors discouraging investors from engagement. Lack of trust, high costs, concerns about risks and returns, conflicts of interest, information unclarity and overload, and complexity of financial products all are areas where regulatory focus is needed.

ESMA has supported the preparation of the Strategy with several pieces of advice and our recommendations feature prominently in the final text. The first assessment of the proposal is thus positive from the ESMA perspective. We very much welcome that the needs of retail investors are now moving centre stage in building the European Capital Markets Union. Having said that, details do matter and must be carefully considered during the legislative process.

ESMA welcomes the intention to align the investor protection frameworks for insurance and investment companies. With a view of ensuring a genuine level playing field and regulatory efficiency,

the asset management sector should, in our view, also be considered in these cross-sectoral harmonization efforts.

For ESMA, the priority is to ensure a secure environment for those wishing to invest. Their investment journey should be seamless and safe, irrespective whether it takes place locally or across borders, in a face-to-face interaction or virtually. In the supervisory realm, reinforcing authorities' cooperation on cross-border issues is a welcome and necessary step to prevent potential investor detriment. The proposal to establish an electronic database underpinned by reporting requirements on entities' cross-border activities will formalise data collection and sharing in this area, based on ongoing ESMA work. Importantly, the Strategy also foresees reinforced precautionary powers for host supervisors as per our advice.

ESMA also called for clarifications around authorities' ability to intervene on misleading marketing practices and our recommendation has been heard. However, the level of ambition proposed for the responsibilities of supervisors should be made equally high when it comes to the liability for misleading advertising. From this perspective, further improvements might be needed to better capture unregulated entities and individuals promoting financial instruments online.

At ESMA, we have been committed to empower retail investors to make well-informed decisions, for example by supporting availability of reliable and understandable product information.

For ESMA, the priority is to ensure a secure environment for those wishing to invest.

We therefore welcome the proposals followed our advice and aim to make full use of the digital possibilities to enhance the investors' experience as well as to improve comparability of information. While fully supporting the standardization of cost information ex-ante, we believe it is worth also exploring harmonisation of cost disclosures provided after the purchase of a financial product.

When it comes to the framework for packaged retail investment products (PRIIPs), a broad review of the regulatory framework would have been preferable to the proposed subset of targeted amendments. This should have included

adapting the KID to allow for more flexibility in the use of performance scenarios and the possibility to display past performance for investment funds.

It should also be acknowledged that the Strategy proposes numerous challenging tasks for ESMA once it gets to the implementation stage. Perhaps the most demanding work is expected around the development of the 'value for money' benchmarks. While the feasibility of implementing such benchmarks in practice raises some challenges, for ESMA, the success of this mandate will depend on clear definitions, data availability, consistency among regulatory mandates and reporting regimes, as well as transparency vis-à-vis investors. The planned reporting requirements for both product manufacturers and distributors in this context are helpful. The data could prove useful for other supervisory purposes as well. For example, ESMA could use the collected data to build and feed a publicly accessible fund comparison tool.

Getting the Retail Investment Strategy right is important for Europe's investors and capital markets. To achieve this, we will all need to keep the key objectives of the strategy in mind. Ensuring a safe investor journey must be part of this effort. At ESMA, we look forward to supporting the co-legislators during their deliberations.



CYRIL ROUX

Deputy Chief Executive
Officer - Groupama

Retail Investment Strategy - a cross sectoral perspective

The EU Commission has adopted on May 24, 2023 a broad-ranging retail investment strategy (RIS). A number of its stated objectives, such as the fair treatment of customers, ensuring their best interests are served by distributors, avoiding conflicts of interests, value for money, etc. are general principles that are not specific to retail investments.

Accordingly, the RIS can be seen as the most up-to-date template for the fair treatment of EU citizens as retail customers of goods and services. It would thus be desirable to extend the RIS principles to other retail products as well as to residential properties, where some if not all of the same issues of potential market failures, information gaps, conflicts of interest and the like might arise. This article is an early attempt to extend the RIS to outlays other than retail investments; its author welcomes further contributions to this effort.

For most households, the most significant outlay in their lifetimes is the purchase of their homes. In many EU countries, such sales are done predominantly through real estate brokers who will typically offer to the prospective buyers of property a range of homes to choose from. However, the current market structure is such that brokers will only offer properties that have been entrusted to them by sellers,

and those may not always fit the best interests of prospective sellers.

Accordingly, a Residential Property Transaction Regulation modeled on RIS should be enacted, to ensure that brokers

1. run a questionnaire of the accommodation needs of their prospective clients detailing the age composition of the household, their likely place of residence, work, or study for the next ten years, the number of bedrooms and bathrooms needed on a yearly basis for the same duration, the ability of each household member to access the accommodation without an elevator (a proper carve out of RGD for individual medical information needs to be designed to that effect) and run a model for the likelihood of divorce;
2. offer at least one simple, low-cost accommodation fulfilling the aforementioned needs under (1.), whether or not such an accommodation belongs to their current range of properties. This Regulation should also ensure that brokers;
3. advise the clients whether their accommodation needs would be better served by long term rental and provide a comprehensive choice of rental properties, if need be by teaming up with agents of the same area having a sufficiently broad choice of properties to let. When real estate markets are entering a downturn, as in 2023, real estate brokers would be mandated to point out to their clients, especially first-time buyers, that their best interest would be to postpone any purchase until such time as prices bottom out.

of due costs (such as lavish celebrity endorsements, fashion shows on the Great Wall of China or similar places) to the said Authority, which would enforce retail prices of say, sought-after leather bags or luxury brand sneakers in a range of 5 to 10 times their production costs, in line with reasonable market practice.

Influencers (including those operating from non-EU locations) would be requested to go through an extensive training program vetted by the Authority ensuring that their TikTok advice would be given with only the interests of the prospective buyers at heart. And more generally, shop attendants at brick-and-mortar stores would be refrained from earning any sort of volume or value commissions, which could skew their advice to shoppers in favor of more extensive items or – heaven forbid-, be tempted to vouch that the latest fashion flatters the prospective wearer when disinterested advice would very much indicate the contrary.

Of course, all clothing shops, not excluding purported luxury shops, would be requested to display prominently and offer sensible patent leather shoes, plain sneakers, and simple apparel, affordable to all EU citizens, at any point of sale, as a readily available value for money alternative to their branded offerings.

This paper only skims the surface of the extension of the RIS principles to purchases other than retail investments. But there is no reason to withhold the benefits of the RIS to the purchasers of properties, clothing or durable goods, when it stands to reason that a fair treatment of EU retail consumers would be achieved by such a desirable extension.

**To ensure fair treatment
of all EU retail customers,
consider generalizing the
RIS approach.**

Turning to apparel and leather goods, especially those running in the thousands of euros, where value for money and conflicts of interest may be most prominent issues, a Consumer Protection Regulation, taking another leaf from the RIS playbook, should be considered. The establishment of a European Apparel and Luxury Goods Authority seems necessary to ensure that undue costs, conflicts of interest and value for money are properly addressed. In particular, companies would submit their pricing structures, gross and net margins and itemization



TOBIAS PROSS
 Chief Executive Officer - Allianz
 Global Investors GmbH

Why not take measures to increase retail participation?

The overall objective of the EU's Retail Investment Strategy ("RIS") is to grow retail investor ("investors") participation in capital markets.

However, the key themes of the RIS seem imbalanced and do not address the required conditions to meet this goal. Emphasizing a low-cost sales environment will not per se attract new investors. The measures will mainly benefit investors already invested or open to invest in capital markets.

Costs are certainly important. However, when comparing product features and costs, only a like-for-like comparison is a fair comparison. Claiming that execution only purchased funds are cheaper than funds being purchased following investment advice is misleading. Advice always comes at a cost, either paid by inducements or upfront by the client directly. The cost of advice paid directly by the client must be part of the calculation of costs and returns of execution only purchased funds for a fair comparison against funds that are bought following investment advice. Further, an inducement ban will not increase retail participation but rather shift investors from advised to execution only sales channels (see UK & the Netherlands).

Considering that only about 20% of EU investors feel comfortable in making investment decisions (according to the Kantar study), policy action should focus first on financial education before creating an environment that requires confidence and investment skills from investors. Without sufficient financial knowledge or (affordable) advice, investors may lean towards influencers or other untrained advisors – ultimately a recipe for creating unintended risks, increased mis-selling and deteriorating trust in capital markets.

How do we achieve more retail participation?

Instead of placing the emphasis on costs, the RIS should extend its focus to the demands and needs of investors and address issues that currently withhold investors from investing. It should constructively nudge investors in capital markets and create an investment environment that is fair, transparent, and understandable – in short, one to trust in. The number of investors without any investments in financial products (excl. deposits) can be as high as 70% (depending on EU country). It is therefore essential that regulation fosters an environment that reaches investors who currently do not invest and demonstrates to them why they should invest (e.g. inflation, pension provision).

Key themes of the RIS seem imbalanced and do not address the required conditions to meet its goal.

Financial literacy could serve as the basis to achieve this goal. It is critical for the success of the Capital Markets Union that investors overcome their fear and mistrust in capital markets. Early financial education with use-cases is important to foster financial inclusion. The EU should create an environment that allows investors to reflect on their changing personal situation, associated needs and promotes an understanding of investing as a solution. In addition to introducing financial education to school programs, online platforms and social media, the metaverse will become important in reaching and educating future investors.

In combination with gamification, a powerful information toolset could be created to familiarize investors with the basic concepts of investing and

financial instruments. Higher financial literacy will enable investors to assess the value proposition, associated risks and costs of financial products – all in all leading to better investment decisions, which would make current regulatory initiatives towards price controlling obsolete.

Gaining trust in capital markets should be supported by pension and tax systems that reward retirement savings. A private pension pillar that fosters participation in capital markets with certain tax levies would send the right signal and nudge for investors. The demographic challenges in the EU (e.g. baby boomer generation entering retirement age over the next 5-20 years, growing life expectancy) combined with low pension rates (standard pensioners receive on avg. 66% of pre-retirement earnings at EU level, 53% in Germany) requires action and changes to current pension systems. In Germany, we seem to be taking first steps in the right direction by introducing the "Aktienrente" (literally: equity-pensions), signaling that long-term investments in capital markets are positively contributing to returns and are supported by the state.

Overall, the focus of the RIS should be to achieve financial inclusion of investors via financial literacy and motivate member states to lead by example in adopting pension systems that support investing in capital markets. The application of digital tools and communication channels in connection with the move to digital by default and a simplification of disclosure documents will be crucial for attracting new investors.

Risks and returns of financial products as well as qualitative characteristics such as ESG should be considered and addressed in the advice process to provide customers with the most adequate products for their needs.



CHRISTIAN STAUB

Managing Director Europe -
Fidelity International

The right retail policy mix will empower as well as protect investors

In assessing the question 'Has the Retail Investment Package set out the key measures needed to increase retail investor participation?' it is important to remember Commissioner McGuinness' own identification of three key goals to this strategy. Effective policy must, she said:

- **Empower** investors to make appropriate decisions;
- **Ensure** investors are appropriately protected; and
- **Enhance** investors' trust and confidence in financial services firms and the capital market participation they provide.

These are excellent ambitions, and yet the current package risks delivering only on point two of the Commissioner's plan.

The Retail Investment Strategy (RIS) provides the platform to raise the bar on retail financial framework which in turn can support increased investor participation AND investor protection in European capital markets. While value for money proposals will certainly ensure higher levels of investor protection, they are centrally focused and risk enhancing trust in ESMA more than in the financial

services firms and markets with which investors interact. It also risks missing the opportunity to improve the way information about investment products is provided to retail investors-making it more meaningful and standardised through the adaptation of disclosure rules to the digital age and to investors' growing sustainability preferences.

More worrying is the fact that supervisory intervention is currently focused on cost not value. In pursuit of the 10% of funds that cost the most, policy risks embedding the wrong concept of value in investor's minds from the outset, stripping out non-cost elements that we think constitute 'value' more properly conceived: performance, quality of service, economies of scale and the fund's own control over authorised fund costs.

To avoid these pitfalls, we would advocate for two key changes to the RIS' current value for money proposals. Firstly, investors would benefit from a model that encompasses all aspects of value rather than fixating just on cost, and the Commission should widen its definitions of value accordingly. Secondly, as this will require a mixture of both quantitative and qualitative value elements, we also recommend that value assessments remain in the hands of management companies and their boards.

**To empower investors,
retail policy must
measure all aspects
of value rather than
focus on cost.**

Many have observed that this is how value for money is measured and managed in the UK. Here the FCA's supervision is strongly driven by the dictum 'you cannot manage what you cannot measure'. But it is tempered by the understanding that fund management companies alone understand the 'management' that needs 'measuring' in the first instance. And so, while UK model definitively requires quantitative benchmarking of both fund costs and services against peers (crucially also requiring them to justify the same to the supervisor), the model ultimately blends quantitative benchmarking into the qualitatively rich ecosystem that best serves investors in terms of choice and empowerment.

To be sure, the UK model is itself underpinned by safeguards that the

EU system does not possess, such as the Senior Management and Certification Regime (SM&CR) and now Consumer Duty. The Commission might therefore consider a model in which ESMA benchmarks are plugged into each management company's value assessment. This could be done potentially as a fund cost element that sits alongside the non-cost elements in order to assess proper value. Or the ESMA benchmarks provided to national supervisors for approving the fund cost benchmarking could be just one element utilised as part of a wider management company's value assessment framework?

This might be one way of recombining Commissioner McGuinness' points one and two - delivering protected and empowered investors - within the purview of the current RIS proposal all while supporting trust in fund management companies and capital markets.

The other - and we would argue more urgent - task is to widen the purview of the RIS itself as the move towards an inducement ban seems likely to continue.

Simply put, any strategy to 'exit' inducements from the advice channel will, in turn lead to investors themselves 'exiting' advice - becoming so-called advice orphans. The Commission therefore needs an equal and prior strategy to help investors 'enter' the non-advised channel if we are not to lose them to investment altogether - in effective reversal of 'retail participation'.

As hedge fund manager Eddie Lampert said: "the entrance strategy is actually more important than the exit strategy" and we urge the Commission to turn to policy designed to ease - even stimulate - retail participation via online digital access-points and platforms. The likely pause in RIS' legislative timetable should help here, as should the publication of the Commission's excellent Open Finance package. But it will require political will to bring the two together into coherent plan to better protect and empower investors now and in the future - a 'Digital Retail Investment Strategy'.



STÉPHANIE YON-COURTIN

MEP & ECON Coordinator for the Renew Europe Group - European Parliament

What place for the Retail Investment Strategy in bridging the CMU gap?

Shedding light on one of the biggest shortcomings in the European capital markets, a 2022 Eurostat study showed that only 26% Europeans have/had an investment product, compared to 90% which have/had a bank account. The status of our European capital markets has remained the same for many years: highly fragmented, overbanked, underdeveloped compared to other continents and lacking incentives for retail investors to invest. Those inefficiencies go well above the question of inadequate or burdensome legislation, as they are also rooted in cultural and behavioural aspects.

So, what is the answer to increase retail participation in our markets? For change to happen, we need a cross-cutting approach, touching upon many areas while using a “retail investor lens” (e.g., taxation, consumer protection, reporting). There is no one-off solution. This exercise is a never-ending process, that needs to evolve along with retail investors’ behaviour using a step-by-step approach.

The Retail Investment Strategy (RIS), for which I am rapporteur in the European

Parliament, is a great step to start this journey. If truly ambitious, this text not only has the potential to bridge the gap to further achieve the Capital Markets Union, but would also lay the ground for further evolution.

How can the RIS develop the EU capital markets?

On paper, all citizens can be investors but when we look at the numbers, still 70% of consumers in the EU have never invested in financial products. Europe needs to develop its investment culture. Here we need to acknowledge the central role of financial advice, still embedded in many territories, while taking into account new trends, as digitalisation, that form the next generation of investors.

Financial intermediaries still remain the main source of information for citizens when they make an investment. With this proposal, we not only need to guarantee financial inclusion whilst tackling current deficiencies around financial advice, but also ensure financial education for both financial intermediaries and European citizens. Increasing the quality of advice goes hand in hand with ensuring professionals’ financial education.

We need to acknowledge the role of financial advice, taking into account new trends as digitalization.

Looking at major issues addressed by the RIS, digitalisation will play a big part in achieving them. Digital means of financing are engaging new generations to invest and we need to properly frame this new environment to guarantee its safety and attractiveness. We cannot let an event such as the FTX collapse repeat itself. This is particularly relevant with the increasing rise of “Finfluencers”. Consumers rely more and more on social media and influencers instead of traditional financial advice. Younger generations do no longer go to meet their financial adviser at the bank, but instead watch YouTube, Instagram, Facebook, etc. While online marketing through influencers is becoming a growing part of investment firms marketing strategies, consumers are increasingly exposed to misleading marketing practices on social media without adequate transparency, liability and protection. Finfluencers may not have appropriate knowledge on the financial products they are selling to

their wide and young audience. This is why those practices cannot be treated, for instance, as selling shampoo bottles on a TV commercial. Investment firms must be liable for any marketing done on their behalf.

The RIS raises many other meaningful questions: How do we better assess the quality of a financial product? How to ensure that the consumer has all the information at hand while not being overloaded? Based on what criteria will we ensure that financial intermediaries act in the best interest of consumers? How can we use taxation to our advantage to increase retail participation?

The essence of the text is undoubtedly very ambitious, but many questions remain open. It will be up to the legislators in the upcoming months to ensure the clarity, readability, and efficiency of this framework.

How can the RIS be the stepping stone for further developments?

The RIS should be the stepping stone of tomorrow’s Capital Markets Union, when it comes to the green and digital transition and supporting financial literacy. Its success will be a collective responsibility. Developing financial literacy, for instance, will only be the result of EU and Member States’ cooperation.

Implementation will be crucial to see how the effects of the RIS materialise on the markets. Only then, having those elements at hand, should we make further decisions on adapting this framework.

Our political determination will be key to uphold the ambition of this text. I know that the European Parliament will seize this opportunity to engage the next generation of investors in our capital markets. But this ambition must be carried on by all European decision makers, Commission and Council included, as failure is not an option.



ALEKSANDRA MACZYNSKA

Acting Managing Director -
Better Finance

No increased retail investor participation without improved consumer outcomes

Better Finance, the European Federation of Investors and Financial Services Users, welcomed the publication of the Retail Investment Strategy (RIS), as a once in a lifetime opportunity to create a capital markets union that really works for people. The legislative proposal, despite some shortcomings (such as a lack of ban of inducements or failing to tackle serious disclosure issues in the Key Information Document), incorporates certain positive advancements.

What is the ultimate goal of consumers when they invest in capital markets, when they buy packaged retail investment products or insurance-based investment products? Usually, consumers seek to invest long-term, and entrust their money in professional hands to generate decent returns, in order to finance certain projects in the future. Those projects vary from buying a house, paying for the education of their children, or, very simply, avoiding the frightful outlook of ending their days in poverty in a context of ever-decreasing support from public pension schemes. Retail investors buying those products have a long-term outlook, they care

about how much these products will cost and yield in twenty, thirty, forty years.

This long-term outlook is the very reason why trust as well as cost and performance of retail investment products are the core issues that need to be addressed if we want to increase retail investors' participation. And we need first and foremost access to good quality independent advice and value for money, as needless to say without "a fairer consumer experience" we will not manage to boost retail investor participation. In that context, the proposal that the European Commission has put forward may have flaws, but so far I have not heard from the stakeholders criticising it any better suggestions aimed at improving outcomes for individual investors.

First, consumer need access to independent advice delivered in their best interest.

Being an individual investor is not a full-time job. Therefore, consumers should have access to competent financial advisors whose advice is beyond doubt in the interest of their client, the retail investor. Advisors should assess and recommend products based on their quality – that is, their capacity to meet the investor's specific objectives and needs without charging undue cost and in line with the risk profile – and not based on how much money they will make from the sales. Investors want advice, not a sales pitch.

**The EC proposal may
have flaws, but I have
not heard better
suggestions to improve
consumer outcomes.**

Retail investors need to regain the trust in capital markets and their advisors but in reality according to a recent Eurobarometer survey, only 38% of consumers are confident that the investment advice they receive from financial intermediaries "is primarily in their best interest". This has to change if we want consumers to invest. Therefore, Better Finance supported the idea that ban on inducements would resolve the issue of conflicts of interest. We welcomed the proposals to extend the ban on inducements to insurance-based investment products ("IBIPs"), and to ban inducements on "execution-only" (non-advised) sales of investment products, two measures that we strongly advocated for as we hope that they will

improve investors' access to simple cost-efficient products.

Second, there is a dire need for a solid Value for Money framework to ensure that only products that do enable consumers to meet their investment objectives at a fair price are marketed to retail investors.

Are the services and products investors get worth the money they pay for them? Too often they are not. Therefore, Value for Money should be designed as a fundamental safeguard for investor protection and build on the already existing safeguards; rules must lead to significant improvements in terms of the cost-efficiency of the products offered to consumers.

Performance is crucial. As in Better Finance's annual research on the real returns of the long-term pension and investments products, the research by Good Value for Money for the French market or the recent research of the Regensburg University it is clear that being advised by conflicted parties did not provide good outcomes for consumers in the past.

And again in line with Better Finance's independent research carried out in cooperation with academics: cost is equally important. Therefore, I don't agree with critical voices claiming that the RIS is overly cost-focused. Our 2019 findings on the correlation between cost and performance of EU Equity Retail UCITS were clear: "the more you pay, the less you are likely to get". Fees are nearly single-handedly to blame for the disappointing returns of many actively managed funds and the compound effect of charges over an investor's lifetime can be catastrophic. In fact, many including professor John Kay point to the fact that "the least risky method of improving investment returns is to pay less to the financial services industry".

One thing is clear - we cannot continue with the status quo because so far it has served individual investors very poorly.

RETAIL INVESTMENT IN THE DIGITAL AGE



CARLO COMPORTI

Commissioner - Commissione Nazionale per le Società e la Borsa (CONSOB)

Digitalisation in the perspective of the EC policies for the Union

Digitalisation is a game changer for consumers' engagement in the financial sector, triggering innovative developments in capital markets and financial intermediaries operating models. However, at this stage it is difficult to predict time and scope of these changes, and most likely this progress will continue for long.

Policymakers and regulators are striving to keep pace with speed and intensity of digital changes and have undertaken steps in the direction of being better acquainted with these developments, whilst keeping the objectives of financial stability, investor protection and market integrity.

At EU level, the overall consumer protection objective in digital finance is developed in different strategies and acts along horizontal (digital economy) and sector specific axes (in line with the traditional siloed regulatory approach).

The Retail Investment Strategy (RIS) recently adopted by the European Commission (EC) is a piece of this complex puzzle meant to foster data-driven innovation while at the same time stimulating the participation of retail investors in capital markets. Since digitalisation is changing the way in which investors are approached (e.g. through social media and fin-fluencers), the proposal introduces measures allowing a better use of digital means in providing information to clients as well as changes to the existing marketing communications regime. Investor education is also part of the proposal, as a tool to minimise the risk of self-directed investing.

The RIS has been published in parallel with a proposal for a regulation on open finance (FIDA) to ensure data standardisation and portability in the financial sector, while granting customers control over their data.

The RIS with the standardized report on information collected by a firm on its client for the purpose of the suitability or appropriateness assessment, "is expected to facilitate, if the client requests that report, more seamless and cost-effective data sharing and re-use of such information by other firms selected by the client" (explanatory memorandum to the proposal). Such data, together with nearly all financial services data within the open finance scope (related to mortgages, loans, savings, investments, crypto-assets, pensions, and non-life insurance products) will empower consumers to share it in a secure way so that they can get a wider range of better and cheaper financial products and services.

The EC policies aim to foster data-driven innovation and a competitive digital ecosystem paving the way to the development of multi-service digital platforms open to third-party providers of services to end-users.

Current demographic trends exacerbate the need for enhanced financial planning by households with regard to their future financial needs. In this respect, a framework that offers retail investors investing in capital markets a wider range of opportunities is a good step in the direction of more efficient and effective financial planning. While reshaping strategies, business models, and operations in response to the new opportunities, the financial sector could

potentially develop more collaborative business models where different actors work together, exploiting the wide data set available, to address not only investment needs but also offering risk protection (for example ensuring adequate availability of financial resources during retirement). Even though the FIDA proposal envisages tight conditions to access, share and use data that could hamper the potential benefits of open finance, accessing, sharing and using data without making use of the data access obligations established by FIDA is still possible on a purely contractual basis, subject to customer's consent.

This would entail for the financial sector to adhere to a different approach than the traditional one, switching from wealth management to welfare management.

While, as mentioned above, on one hand the RIS could contribute to the achievement of this broad picture, on the other hand, it seems to only foster the development of specific (often traditional) business models.

**Consumer protection
in digital finance
is developed along
horizontal and sector
specific axes.**

One example is the introduction of new rules addressing biases in the advisory process. The EC has introduced targeted changes to the legislation that add to complexity of the already detailed sectoral rules. These rules will ensure enhanced consumer protection only if adequate and effective supervision and enforcement are conducted by supervisors.

Also, the new rules on marketing communications and practices that are applicable only on authorised entities will not address the threat coming from non-licensed individuals and entities operating in the digital space.

Overall, the EC has taken an approach not perfectly fit for the digital era, running the risk of developing a regulatory framework not always aligned to the fast-evolving digital transformation.



FAUSTO PARENTE

Executive Director - European Insurance and Occupational Pensions Authority (EIOPA)

Innovation is crucial to incentivise retail investments

The COVID-19 pandemic accelerated the digitalisation of the insurance sector, resulting in easier delivery of products and services, lower distribution costs, and more tailored offers, thanks to increased interactions between insurers and consumers.

However, digitalisation focused primarily on the distribution of non-life insurance, while the availability of online platforms for insurance-based investment products (IBIPs) remains limited.¹

Digitalisation and innovation can enhance access to retail investments and promote the uptake of retail investment products by enabling consumers to make informed choices that are aligned with their needs. At the same time, behavioural research highlights the challenges of using consumer disclosures as a tool to protect consumers and to promote their decision-making. Indeed, consumers often fail to read the information they receive and can be overwhelmed when presented with too much information. This hinders comparability, making it difficult to make informed decisions. The current regulatory framework, although intended to be technology-

neutral, was designed before the app revolution and without considering digital distribution.

EIOPA is of the view that consumer disclosures need to be presented in a radically simpler and more user-friendly format. Presenting essential information upfront, and offering more in further layers, can facilitate the comparison of key information. And innovation can help in doing so.

Innovative tools, such as simple personal finance aggregator apps, could also enable consumers to access consolidated information on all their investments: from pension entitlements to insurance policies and investment funds, thus improving consumer engagement and decision-making. Virtual agents, chatbots, or oral disclosures could replace traditional paper-based documents, making investment information more appealing and interactive, including on complex concepts such as market risk or biometric risk coverage.

In addition, increased information exchange between insurance undertakings and consumers, including in relation to their demands and needs, is essential to tailor the IBIP design to consumer needs. Innovation can promote well-designed and low-cost methods of meeting the needs of customers with straightforward investment objectives and smaller amounts of money to invest.

A consumer-centric approach will boost retail investments whilst managing risks.

On the other hand, an increase in digitalisation that is not customer-centric can limit retail investments. Two studies carried out by EIOPA in 8 Member States have shown that consumers are more reluctant to buy complex, long-term products (i.e. IBIPs) online, as they commonly require greater consideration and professional advice. Moreover, consumers with limited digital skills can be excluded or discouraged from investing through online tools.

In addition to financial exclusion, data sharing and exchanges pose other risks, not only in relation to data privacy. The more information about individuals that insurance undertakings have and share, the higher the probability that some parameters, or a combination thereof,

can be used as a disqualifier or a proxy for a traditional parameter. Consequently, some consumers may unjustly pay higher costs or not be able to access retail investments which meet their needs. There is also the risk that all the data is held by a few, thus restricting competition. Moreover, digital distribution can include aggressive marketing techniques, such as so-called 'dark patterns' or leveraging on social media. Finally, some consumers may have difficulties discerning whether the advice provided through chatbots is that of adequately registered and qualified advisers.

The current Retail Investment Strategy (RIS) proposes measures to leverage opportunities whilst also addressing emerging risks. It calls for a more digital-by-default approach, allowing the layering of information. It further proposes to present the key information document using an interactive tool and to prevent 'finfluencers' who are not registered or adequately qualified from using social media to promote products.

The legislative proposal on a Framework for Financial Data Access (FIDA) could also improve investment advice for consumers and facilitate their access to a comprehensive overview of their financial and investment situation. However, not all risks of digitalisation are addressed by FIDA, for instance the potentially deceptive insurance practice of combining the sale of financial products with other non-financial goods. There are also opportunities that are not directly addressed by the RIS but that can be developed by the industry, such as personal finance aggregators, providing aggregated information on consumers' financial situation.

The key is to continuously monitor risks to ensure regulation and supervision remain fit for purpose for the digital age.

1. *Consumer Trends Report 2022 (europa.eu) and EIOPA publishes advice on Retail Investor Protection (europa.eu)*



MICHAEL MCGRATH

Assistant Secretary,
Financial Services Division -
Department of Finance

The impact of digitalisation on retail investment

Retail investment strategy (RIS) is a part of the EU's ambitious CMU action plan 'building retail investors trust in capital markets'. Empowering retail investors by adequately responding to new challenges in the market like digitalisation of investment advice and the use of digital distribution channels' will be important while safeguarding the retail investor. Helping to diversify consumer savings, thus allowing consumers to earn better returns while their funds make a greater contribution to the productive capacity of the EU economy. RIS modernises MiFID marketing requirements to take account of digitalised marketing - including the use of social media, influencers and behavioural biases. These steps will be crucial to protect retail investors from added risks of digitalisation e.g., unregulated marketing and social media platforms and 'gamification'.

The advancement of financial technology has reshaped the way people access financial services, from the introduction of Internet-based trading in the 1990s to the growing importance of mobile apps, the rise of robo-advisors and the growing importance of social media. These digital innovations have

removed many of the barriers preventing retail investors from accessing financial markets and this has contributed to retail investors' appetite for investment.

The technological innovation in financial markets is changing and reshaping the existing models of intermediation processes. In recent years, neo-brokers have gained popularity among retail investors in Europe. These brokers offer low-cost services and user-friendly platforms, making investing in financial markets such as Exchange Traded Funds (ETFs) more accessible than ever. Recent studies suggest that in the long-term, they could supplement human financial advisory. Digital advances bring many positives but there are also risks involved, specifically in terms of supervisory challenges dealing with operational risks, cross border digital finance, cyber/data protection and balancing innovation and consumer protection. The emerging models are creating significant governance and regulatory challenges for governments.

As technology keeps on evolving, it brings additional challenges for regulatory authorities to keep up with the pace of digital innovation. In the face of these challenges, regulatory action needs to strike a balance between mitigating potential risks and enabling the development of innovations that can be beneficial for the economy and society as a whole.

Innovation brings opportunities to retail investors while also creating policy challenges and risks.

Another goal of the CMU 2020 action plan is to empower citizens through financial literacy, thus providing them with the knowledge and skills needed to make the right financial decisions. Every day, thousands of people are deciding where to open a bank account, which mortgage to choose, where to invest their money and how to save for retirement². In general, financial literacy of the average retail investor is low across many Member States. There are, however, wide differences across Member States. A recent study on financial literacy in the EU highlights the need for financial education to target in particular those who tend to be on average less financially literate.³ In parallel with the digitalisation of our financial systems and economies, the use of digital technologies offer significant

benefits when used appropriately for delivery of financial education. It can improve access, facilitate and enhance learning process and support positive financial behaviours.

From the perspective of policy makers, digital tools help them reach target audiences, reduce costs and help in monitoring and review. However, these tools such as websites, social media platforms, mobile apps, artificial intelligence and chatbot applications brings additional challenges to address i.e., adapting content to digital or online platforms, training and skills of trainers, addressing the lack of digital skills, data protection and supervisory challenges⁴.

Innovation brings opportunities to retail investors while also creating policy challenges and risks. Digital innovation in finance in particular offers immense opportunities for enhancing efficiency and innovation. However, to fully capitalise on its potential, we must navigate various challenges while safeguarding security, compliance and inclusivity.

1. Source: <https://op.europa.eu/en/publication-detail/-/publication/d83364e5-ab55-11ed-b508-01aa75ed71a1/language-en/>
2. Source: https://finance.ec.europa.eu/capital-markets-union-and-financial-markets/capital-markets-union/capital-markets-union-2020-action-plan/action-7-empowering-citizens-through-financial-literacy_en
3. Source: *Monitoring the level of financial literacy in the EU - July 2023 - Eurobarometer survey (europa.eu)*.
4. Source: <https://www.oecd.org/financial/education/Digital-delivery-of-financial-education-design-and-practice.pdf>



LUÍS LAGINHA DE SOUSA

Chair - Portuguese Securities
Market Commission (CMVM)

Attracting retail investors - more than words and algorithms

This transition to a digitally-intensive environment induces changes in the behavior of investors and financial service providers, profoundly alters communication, both in terms of channels and content, and facilitates cross-border activity and disintermediation. However, only if conducted in an ethical and responsible manner will it benefit investors and society as a whole.

In order to do so, we need to take into consideration that, at the end of every product sold and of every service provided, there is a person, with particular expectations, specific experiences, knowledge, objectives and needs. This is particularly relevant in face of digital tools and mechanisms that have the capacity of reaching a much larger number of people.

Digital platforms, such as fund distribution platforms, robo-advisors and on-line trading platforms, are good examples of this kind of tools. Based on algorithms and provided to customers online, they can potentially choose products from a wider variety of suitable ones, are able to process data faster and in a precise manner, at any time of the

day or night, and avoid behavioral bias. Less reliance on human intervention in the provision of investment services can certainly bring benefits to the end investor, such as lowering the cost, reducing minimum investment amounts, thus democratizing the service.

However, digitalization is not immune to misalignment of incentives. People design the algorithms and these may contain formulae that bias the outcome, even inadvertently. In that case, the same algorithm can impact many more people and its increasing complexity can make it difficult and slow to recognize failures. It may also encounter limitations in old problems, such as access to product quality information, inability of customers to understand software queries or input of the wrong data.

I dare say that it is also very difficult for the algorithm and the structure of the service based in it to address specificities of persons of different regions and cultures. European investor associations have also warned of customer segmentation that can result in the exclusion of some and even discrimination. The challenge of considering the whole person behind the profiling mechanism is not different from that of a human, but the way to address it in an automated service is certainly different. ESAs have been particularly alert in their reports to how digital finance can lead to unfair and discriminatory practices. Here, the supervisory effort has to be on detail.

Despite acknowledging digitalization as a driver of change in the provision of retail investment services, the recently announced retail investment strategy does not propose rules regarding this particular challenge. However, it proposes modernizing the rules on the digital presentation of key information on investment products, whilst establishing a preference towards the electronic format and allowing for a greater degree of personalization and layering in the provision of information via mobile devices or web applications. While the disclosure of information in electronic format is yet to be seen, as ESMA together with EIOPA are mandated to develop specific guidelines, it is paramount that retail investors are not left abandoned in a sea of information. Afterall, it may be just another patchwork of messages that the client does not really pay attention to.

In the case of wrong enticement of clients via web pages, our experience in Portugal has shown that some situations require a quick reaction that is dependent on the intervention of multinational companies that host those contents. In face of some big

tech companies, the supervisory power of a national competent authority may be very limited. In these cases, an effective supervisory answer has to take advantage of the existence of European authorities, with a pivotal position.

In the current technological context, targeted rules on intermediaries are only part of the answer to attracting retail investors. We need a culture of compliance from intermediaries and to equip investors with the knowledge and awareness to, among other things, spot inconsistencies and report them quickly - they will often be the first to realize that something is wrong. We need supervisory alignment in Europe and key strategic messages. Strong political commitment, particularly at national level, is also essential in order to build strong national capital markets, which are a fundamental pillar of a robust CMU.

**At the end of every
product sold there
is a person, with
particular expectations
and specific needs.**

Broadening the base of people accessing capital markets via digital tools can undoubtedly be a major boost to the dynamization of European capital markets. However, if we want to attract and keep retail investors, so that they can take full advantage of the EU's capital markets union, we all need to be committed to this objective.



VICENTE CANCIO GARCIA

Chief Executive Officer -
Zurich Insurance, Spain

EU retail investment strategy: seizing the digital moment

Given the unmatched pace and scale of the transformation of our economies and societies, empowering retail investors is more important than ever. The increased digitalization of financial services and deployment of new technologies have enormous potential to advance the objectives of the EU Retail Investment Strategy (RIS), offering consumers easier access to investments and improved delivery of financial advice. Zurich Insurance strongly supports the objectives of the Retail Investment Strategy and is committed to play its part to foster retail investment. So, how do we make retail investment easier and how do we make best use of digital opportunities?

When it comes to communication with customers, it must be as clear and user-friendly as possible. The Kantar study commissioned by the European Commission highlighted that whilst customer disclosure may be compliant with current regulation, it is not always appealing enough to capture customers' attention. At Zurich Insurance, the customer is at the center of our decision-making. We know that customers are more informed, more connected, and more demanding than ever before. To make sure we are really effective in engaging our customers,

Zurich runs a dedicated customer office which is constantly testing and refining our communications. As such, we strongly believe that any legislative changes that affect retail disclosure should be thoroughly consumer-tested in advance.

Digital disclosure would help to make mandatory disclosure more digestible. An increasing number of customers are asking us to provide more digital options and digital techniques can make complicated information more accessible. For example, via layering, which is frequently used in apps, customers can receive complex information one step at a time, with the possibility of getting more information or an explanation of the terminology used. We have integrated digital tools in the advice process, for example in our business in Austria, where a digital advice tool is used by our advisors in every step of the advice process. It visualizes preferences, options, and choices, with an additional focus on sustainable investment. I am convinced that these digital advice tools will complement rather than replace advisors, enhancing their skills and resulting in a better outcome for customers, who we know value face-to-face advice.

**Empowering retail
investors is more
important than ever.**

We also see RIS embedded in the broader ambition of the European Commission to foster the digital transition. Indeed, we applaud the fact that Europe is embarking on the most ambitious digital regulatory framework in the world, and we call on regulators and policy makers to encourage innovation in financial services allowing consumers and industry to reap the benefits of digitalization. At the same time, more energy should be devoted to identifying inconsistencies amongst the various sources of EU financial legislation. For RIS, a concrete improvement would be aligning provisions on layering and apps across the whole RIS package. In parallel, retail investors' financial literacy needs to expand to include a proper technical understanding of new digital tools and services. We stand ready to offer our insight in financial literacy and protection gaps.

Furthermore, improved delivery of financial advice can be achieved if regulators seize the opportunity to

advance clarity and transparency in the distribution process. Ireland is a good example. As an insurer active in Ireland, we have good experiences with the Irish practice to disclose the amounts of commissions paid for the individual contract (or, if not possible, the methodology). Providing this information in a digital, layered format brings consumer empowerment to yet another level without unintended consequences such as information overload.

Overall, I am convinced that these important measures - clear communication, digital disclosure, and enhanced clarity in the distribution process - help advisors to engage with customers beyond mere transactions, supporting customer understanding and ultimately, a better customer experience. However, for the benefits of these digital opportunities to be realized, care will need to be taken in how the RIS package as a whole is designed to avoid unintended consequences to the advice ecosystem in individual member states.



STEFAN LEHMANN

Chief Executive Officer -
Generali Deutschland AG

Digitalization in the RIS: an enabler, not a substitute, for personal advice

The Retail Investment Strategy (RIS) presented in May 2023 by the EU Commission can play a significant role in boosting the EU's Capital Markets Union. The proposal seeks to encourage more retail customers to take part in Europe's Capital Markets and to facilitate long-term investments and savings across the continent. This is crucial to closing the existing protection gap in pensions throughout the EU. More savings also means improved access to finance for businesses and accelerating the digital and environmental transformation of our economy.

While the public debate has so far focused on a potential commission ban, other elements are just as important to achieve the goals of the RIS. Among the lower-hanging fruits, the increased use of digital opportunities needs to be reflected in the regulatory environment. However, a stronger emphasis on the digital ecosystem is not a substitute for other measures; rather, an integrated approach is required to successfully promote retail investment.

Digital tools complement and enrich the range of services in insurance already available and create new opportunities.

Therefore, we particularly welcome the proposal that "digital-by-default" should become standard for product disclosure as well as for the pre-contractual information for all insurance products. Adapting the IDD and the PRIIPs key information document to the digital age is important to meet customer expectations and improve operational efficiency.

Digitalization also has a role to play when it comes to increased transparency. More transparent information, as set out in the RIS, should be made available to the customer digitally. To make full use of digitalization's potential, it is also important to provide information in a way that is easy to understand. Transparency requirements should be focused on key aspects - those that really matter to the customer, in order to limit the risk of an information overload. At the same time, it should still be possible to obtain more detailed information in a timely manner if requested. Digital instruments such as chatbots and self-service tools could contribute to this.

Insurance distributors are increasingly using digital tools for communication and interaction with customers. However, to date, there is no clear trend for advice-intensive insurance-based investment products to be distributed digitally. According to data from the German Insurance Association, the share of digital sales (via website or app) in new business of life insurance policies in Germany is less than 2 % (in terms of premiums).

Digitalization is central for more transparency and increasing Value for Money.

Pension products must be individually tailored to the needs of the customer in terms of taxes, eligibility, coverage needs, risk and investment preferences as well as personal situations. One size doesn't fit all. For many customers seeking products, digital tools cannot replace the human touch that customers are seeking when it comes to high quality advice. All distribution channels, digital and physical, are important and should be used in a targeted manner, putting the customer first. Regulation must ensure, that private old-age provision is accessible to a large part of society. We therefore welcome the proposal by the EU Commission for now to preserve fee- and commission-based distribution models to avoid the risk of advice gaps.

Digital sales can be useful for standardized products that are easy to understand. In this case, customers should already know their protection needs and investment preferences, and they should also have sound financial knowledge, which should not be taken for granted. Overall, due to different customer preferences, standardized products can only be an option for a very small target group.

This doesn't mean digital tools cannot boost traditional advisors. Where there can be improvements to the underwriting process, taking a first measure of customers priorities and overall process simplification, there can be an improvement in customer satisfaction. This can increase value for money, another objective of the RIS which needs to be reinforced in a holistic sense, by always keeping the interests of customers at the center. Currently, the RIS value for money approach focuses mainly on costs. However, the real value for the customer is also through a personal service provided by the advisor during the whole contract period - also supported by digital tools.

Insurers are taking these steps, embarking on a digital transformation process. EU legislation should support insurers in this journey through an appropriate regulatory environment - including a level playing field among stakeholders - and a focus on streamlining processes and information. Through this path, insurers will be ready with the advice, tailored products and customer experience that customers are looking for.

INVESTMENT PRODUCT: TRENDS AND POLICY NEEDS



MARCO ZWICK

Director - Commission de
Surveillance du Secteur
Financier (CSSF)

Balancing investor needs and protection

The publication of the Retail Investment Strategy paper (RIS) by the European Commission is an important initiative under the Capital Markets Union Action Plan. But does this mean that existing regulations such as UCITS, AIFMD, ELTIF and PEPP have failed to respond to investor needs? This mix of product and investment fund manager (IFM) regulations is being continued by current initiatives: the AIFMD₂ proposal extending its scope to a specific product, loan funds, in addition to being predominantly an IFM regulation. These regulations generally pursue the shared ultimate objective to ensure investor protection, but their scope and focus are different, with product regulations having a direct impact on investment strategies and risk management frameworks and IFM regulations defining the IFM's options, obligations and minimum governance requirements.

But do these rules also consider investor needs, in addition to investor protection? The EU framework

distinguishes between UCITS and alternative investment funds (AIF). UCITS are generally relying on cross-border distribution channels to reach retail investors, whereas AIF passporting is restricted to professional clients. The European Long-Term Investment Fund (ELTIF) regulation is kind of a hybrid between the two and allows marketing with a passport to retail clients under pre-defined conditions. Pan-European Personal Pension Products (PEPP) represent another example of product for retail clients.

The commendable objectives of the RIS to “build retail investor’s trust in capital markets” and to “make the EU an even safer place for individuals to save and invest long-term” are twofold:

- further improve, where needed, investor protection mechanisms,
- widen the investment universe for retail investors by providing access to more diverse products.

The first objective is fundamental and fully anchored in existing regulations, whereas the access for retail clients to alternative products, also referred to as “retailisation of AIF”, aims at providing additional long-term investment and savings options in addition to investments in transferable securities, alike UCITS products.

The principle of commingling private money within an investment fund structure and of having that money managed in line with a pre-agreed investment strategy and risk criteria, including risk diversification and liquidity management, is common to and accepted by all types of investors. But investors’ financial capability and appetite of having less frequent access to their invested money – considering the generally longer-term and less liquid assets held by AIF – or, in a worst case, of losing money, may not be the same for all. This is where the adequate structuring of investment funds is crucial in order to reduce inherent liquidity mismatches between the funds’ assets and liabilities and/or to introduce liquidity management tools that become effective in case of liquidity squeezes.

Retail investors who have been used to buy UCITS products with frequent, often daily, asset pricing and redemption options, will have the possibilities to invest in alternative assets. Investment

fund managers will need to be very transparent when disclosing the nature of alternative assets, the associated valuation processes and risks as well as the applicable redemption frequencies/restrictions.

ELTIF₂ alleviates constraints on the asset side of funds notably by enlarging the range of eligible investments and by reconsidering all current thresholds, including investment and borrowing limits. The flexibility offered by ELTIF₂, both on the asset side and on the level of the structuring of an ELTIF allowing for redemptions during their life, will make it possible to reconcile the objective of channelling private money into long-term finance projects with the need to guarantee an acceptable level of liquidity, particularly for an ELTIF marketed to retail investors.

Regulatory changes cannot exist in isolation and will need to take into account investor needs.

Even though the RIS will hopefully assist in making investment products even better and more accessible to retail investors, most proposed changes focus on enhanced investor protection, and not on creating new investment opportunities and investment fund products at EU level. Whilst these changes relating to – for example – inducement rules, cost disclosures, cost benchmarks, ‘value for money’ and marketing communications are eminently important to foster investor confidence, they cannot exist in isolation and will need to take into account investor needs for two main reasons:

- investors look for investment fund performance, and they are most probably bearing the cost of compliance incurred by the investment funds respectively their actors which risks to negatively impact the performance,
- investors are interested in having access to a variety of investment strategies and in having a full choice in terms of UCITS and alternative products and in terms of traditional versus digital channels and facilities enabling them to buy, monitor and sell these products.



ANNEMIE ROMBOUITS

Deputy Chair - Financial Services and Markets Authority, Belgium (FSMA)

Fostering retail investments: the product range is wide - how to help investors find their way?

To increase retail investors' participation in capital markets, the availability of suitable and competitive investment products is key. The investment product range within the EU is wide. The pan-European investment products par excellence to direct savings towards the real (green) economy are collective investment funds. As early as 1985, the UCITS regulatory framework introduced a product passport that was -and still is- a unique recipe for market integration. UCITS funds have kept growing despite the economic and financial crises and count as a global standard. The framework was refined and revised over the years towards greater investor security. More specific product rules in the fields of real estate (ELTIF), pensions (PEPP) and alternative investments have further completed it. Today, the collective investment frameworks allow for a great variety of products. Funds are moreover the easiest and fastest way to invest, while

direct investment remains inaccessible to most retail investors.

Take the example of Belgium, an open economy with more than 5000 different authorised or registered UCITS investment (sub-) funds, 87% of them foreign. There is no doubt any Belgian retail investor could find suitable and competitive funds within this wide range that, incidentally, has the same tax regime. Belgian retail investors nonetheless tend to have a bias for Belgian funds: although the latter account for only 13% of the retail offer, they attract 60% of Belgian citizens' investments.

Evidence has also shown that, throughout Europe, commercial bank-affiliated funds underperform unaffiliated funds. Despite their inferior performance, bank-affiliated funds hold an important market share because they have a captive investor clientele.

For long-term wealth creation and not considering national tax measures, the challenge at product level does not lie so much in the available product range but rather in helping citizens find their way to the most suitable and competitive products and in continuing to ensure effective supervisory convergence.

For long-term wealth creation, the challenge at product level does not lie so much in the available product range but rather in helping citizens find their way to the most suitable and competitive products and in continuing to ensure effective supervisory convergence.

To boost citizens' awareness about active savings strategies, the RIS enshrines the importance of financial literacy for the first time in European legislation. The objectives of financial education range from financial inclusion and combating excessive indebtedness through learning citizens about the characteristics of financial products and active savings strategies to informing retirees. It is also about teaching consumers to take a critical stance, notably with regard to marketing. Priorities will have to be set at local level. With its Wikifin financial

education programme, the FSMA is a forerunner in the field of contributing to the financial literacy of citizens - in 2011 already, it received the legal mandate to that effect.

However, financial education is not a substitute for information and intrusive supervision. Understandability and comparability of product information, especially with regard to the costs of the investment products, remain a major concern for regulators. As regards the KID for example, consumers struggle to identify the product with the most unpredictable returns, the product with the highest expected return or the product that guarantees a positive return or guarantees them their money back. The revision of the PRIIPS regulation builds on the KID.

Here, the question arises whether there are not limits to simplification. In this respect, regulators will also have their role to play in providing guidance to investors. Publications of the NCA's, such as the FSMA on costs of Belgian funds or as ESMA on costs and performance of EU Retail Investment Products aim at helping investors by prompting producers to justify their level of costs against that of peers. Where the RIS introduces cost and performance benchmarks published by the ESAs, it builds on this kind of initiatives.

Finally yet importantly, passportable retail products need national supervisors who set the bar equally high in terms of passport access and quality of information. Even if collective investment schemes are now an old concept, regulators should continue to invest in convergence of supervisory practices, especially as the products are subject to new evolutions, such as the sustainable finance framework. Common supervisory actions and peer reviews conducted at the initiative of the ESA's should therefore receive the greatest support.

With the current regulatory framework allowing for a broad range of suitable investment products, the RIS will have reached its goal if clients of financial institutions contribute to mobilising bottom-up disciplinary forces in favour of an ever more client-centric attitude of manufacturers and distributors.



CHRISTOPH BERGWELER

Chair of the Board - JPMorgan Asset Management (Europe)

Prioritize helping citizens to become more confident investors

The ongoing economic uncertainty has significantly increased the need to improve the financial literacy of European citizens. Helping more Europeans make the jump from savers to investors can go a long way towards helping them achieve a more secure financial future. This will also have broader benefits e.g. by ensuring a more diversified source of funding for the EU economy. Asset managers have a key role to play, helping direct capital to where it is needed most and creating opportunities for everyday investors to achieve higher returns.

A vast majority of European households still do not invest and continue to have high levels of savings in deposits. In the current inflationary environment, and where the interest rates on deposits offered by banks do not necessarily match the headline rate, this may not be in their best interests. This inefficient allocation of capital may correlate with the low levels of financial literacy across the EU; the European Commission's own statistics indicate only 18% of EU citizens are considered to have a high level of financial literacy¹.

It is important that policy measures to address these issues focus on a positive

vision which serves to empower citizens to invest for their financial future. Policy needs to promote investor choice and transparency, supported by sound financial advice, as a way to help citizens become more confident investors.

The EU benefits from a strong product framework for retail investors, offering an array of investment opportunities while maintaining very high standards of investor protection, achieved both through product-specific and cross-cutting rules. For example, the MiFID II investor protection and transparency rules. Also, the UCITS Directive, which has enabled the exponential growth of the UCITS fund into a widely-recognised gold-standard product globally. These rules are being continuously improved, reflecting market developments and changing investor appetite. For example, we welcome the revised ELTIF Regulation, which will allow for more efficient and effective access to alternative assets by retail investors.

Nevertheless, it is crucial we do not become complacent. The current macroeconomic environment presents an opportune moment to take a more holistic approach to the retail investment landscape and find meaningful ways to promote greater investor participation. It is crucial that the recently proposed Retail Investment Strategy, which seeks to address many of these challenges, focuses on policy solutions which improve the engagement with citizens, the accessibility to advice and the competitiveness of investment funds. At the same time, policymakers must be mindful of potential unintended consequences of ill-thought out or rushed rule-making.

...focus on a positive vision which serves to empower citizens to invest for their financial future.

In this context, we question the narrow focus on cost in the European Commission's legislative proposal. The average ongoing charges for funds, including UCITS, have been declining² over the past decade, both as a result of enhanced transparency requirements under EU legislation and competitive market dynamics. Also, while we agree with the principle of delivering value for investors, a value for money framework which is only informed by costs may not result in optimal investment outcomes. Cost as an almost exclusive

measure of product quality might well be misleading in an environment where added value from active asset management can play a meaningful role. We strongly encourage policymakers to consider value more holistically and to recognize the different costs associated with different levels of service.

In addition, we support measures that ensure easy access to professional advice. Policymakers should be mindful of requirements, such as changes to distribution rules, which could ultimately act as an impediment to accessing advice and create an "advice gap". While we recognise there is scope for improvement, it is unclear whether blunt policy tools will improve investor outcomes. For example, given distribution in the EU remains heavily reliant on banks, a ban on the commission-based model may remove the incentives for distributors to offer third-party products, potentially significantly reducing access to, and choice for, investors.

Instead, we need to ensure more harmonised and consistent rules, so that all investors benefit from the broadest possible choice, while benefitting from the same level of investor protection. We also need to simplify and digitalise disclosures so that transparency serves to enable informed decision-making rather than confuse investors.

As the EU moves forward with its dedicated retail investing framework, policymakers should promote an investment culture which encourages responsibly-managed risk taking. The new rules must prioritise increasing investor confidence without impairing the choice and access for retail investors offered by the existing product framework.

1. *European Commission Monitoring the level of financial literacy in the EU July 2023*
2. *ICI Research Perspective October 2022*



MATTEO ANDREETTO

Head of SPDR ETF
Business, EMEA - State
Street Global Advisors

Retail Investment Strategy: an opportunity to turn Europe into an ETF powerhouse

ETFs have been one of the most significant new product innovations in asset management over the past three decades. Although ETFs have been available in Europe since 2000, they really saw significant growth post the Global Financial Crisis. While the European ETF industry started 2010 with just US\$228Bn of assets¹, they swelled to over US\$1.63Tn² as of June 2023. This growth is projected to continue, with AUM expected to grow at an annual rate of 12% over the next 5 years, reaching in excess of US\$3.1Tn AUM by 2030³.

This extraordinary growth has been propelled by several key attributes of ETFs:

- **Access:** ETFs can offer investors access to niche and difficult to trade exposures, such as emerging market equity and debt or high yield bonds, while investing in a single security on a local and regulated exchange.
- **Liquidity:** The ability to trade intra-day on-exchange at very low cost makes ETFs attractive for investors.

- **Low Fees:** As ETFs are traditionally being passive vehicles, fees are kept to a minimum. Also, due to the on-exchange nature, there is no minimum investment in an ETF share, meaning the management fee applied to all ETF shareholders is the same, irrespective of size.
- **Transparency:** Given ETFs are required to publish their full holdings on a daily basis, this means investors can know exactly what they are buying, and are less likely to get stung by managers holding exotic instruments that may not be appropriate for their portfolios.

All of these attributes make ETFs an appealing investment vehicle for retail investors, as the vehicle has democratized the way investors can access markets.

In this context, retail investors are becoming a distinct distribution channel in what was traditionally a market of wholesale and institutional clients. To date, we have seen Germany be the driving force behind the retail adoption of ETFs in Europe, which has largely been encouraged by the introduction of savings plans in the country. This has increased the ease by which retail investors can become self-directed investors through digital wealth platforms.

The value of ETFs for end investors should remain at the centre of the EU legislative agenda.

The value of ETFs for end investors should remain at the centre of the EU legislative agenda. In this sense, the Retail Investment Strategy could be a great opportunity to build up on these positive developments and replicate them in other markets across Europe, to further facilitate end investors access to simple and transparent products such as ETFs. Digital engagement and distribution is key in this new phase of the EU ETF market and should be adequately supported by regulation.

ETFs have also proven resilient during times of market stress. While many had predicted that in a market sell-off, ETFs could struggle due to the mismatch in liquidity between the ETF shares and the underlying securities in the fund (particularly for less liquid asset classes such as the corporate bond market), the COVID crisis showed this was not the case. ETF shares continued to trade in an orderly manner, and although shares

traded at steep premiums and discounts to NAV, the common consensus was that the ETF prices likely better reflected the fair price of the underlying securities than the NAV or index price, due to prices being stale from a complete lack of trading in the underlying bonds.

While ETFs remain a compelling option for retail investors, changes in market structure and the evolving regulatory landscape can also have a detrimental impact on end investors, which regulators should remain vigilant on.

A good example of this is the planned US move to T+1 settlement in May 2024. This will pose significant challenges to EU ETFs that include US exposures, such as global equity ETFs. The misalignment between the ETF shares and the underlying securities will create problems for Authorized Participants, because it will make managing a creation or a redemption more challenging.

These operational difficulties are further exacerbated by the CSDR regulation, as the operational challenges will lead to an increase in failed trades, which will lead to an increase in fines. APs will be forced to embed these extra costs into the spreads that they charge to the market, ultimately increasing the costs of trading for retail investors.

On the flip side, the recent announcement of a pre and post trade Consolidated Tape is a positive regulatory development for EU investors, as this will help increase transparency on ETF order books and allow end investors to get a better and more precise picture of the way that ETFs are traded.

1. Source: Morningstar Direct.
2. Source: ETFGI June European ETF Report: <https://etfgi.com/news/press-releases/2023/07/etfgi-reports-assets-invested-etfs-industry-europe-reached-record-us163>
3. Source: EY report on European ETF market growth https://www.ey.com/en_gl/news/2023/03/despite-european-etf-market-decline-in-2022-positive-inflows-and-sustained-investor-demand-mean-growth-forecast-from-this-year-onwards



STÉPHANE JANIN

Head of Global Regulatory Developments and Public Affairs - AXA Investment Managers

Are EU retail investors fully benefiting from active fund management strategies?

Up to now, the EU has been very successful regarding the investment fund regulatory framework, in making the UCITS a golden standard, more recently complemented by the AIFs. And the recent political success achieved on 20 July 2023 by the Spanish Presidency, the EP Rapporteur and the EC regarding the AIFM and UCITS Review is just the latest illustration that this EU fund framework can remain stable on its cornerstones while being regularly upgraded and adapted over time in a targeted manner.

But does this EU fund regulatory success fully benefit EU retail investors in practice?

From a CMU perspective, retail investors have been progressively able to get a wider cross-border access to traditional assets (equities, bonds) in collective portfolios represented by the UCITS funds, in particular thanks to the “retail passport” attached to it.

But this cross-border access at pan-EU level by retail investors is not yet possible in practice towards the rest of fund assets (such as infrastructure or real estate).

The interesting case today is that, at national level in many Member States, various local ranges of funds investing in so called private assets (infrastructure, real estate, private equity, private debt) have been successful for years towards retail investors, including mass retail investors. Many retail investors have invested in such domestic private asset funds and remained invested in them (including through open-ended funds).

Therefore, the most important challenge now is to replicate at EU level the success of such domestic private asset retail funds, to ensure that EU retail investors may in the near future benefit from the same Single Market product offer as for UCITS funds.

To that end, the practical modalities of the European Long-Term Investment Fund (ELTIF), through the technical advice of ESMA to be submitted to the EC by the end of this year, will be key for the success – or failure - of the reviewed ELTIF as a complement of UCITS funds for EU retail investors.

Technical advice of ESMA to the EC will be key for the success – or failure - of the reviewed ELTIF.

In addition to that reviewed ELTIF offer, the EC proposal for a Retail Investment Strategy (RIS) seems a way, if rightly calibrated, to facilitate such a wider access and more appropriate choice of investments by EU retail investors.

Which aspects of the RIS should then be clarified to avoid adverse unintended consequences?

First, regarding the Value for Money (VfM) approach and its related benchmarks (at both manufacturer and distributor levels), a race to the cheapest product in strictly absolute terms would have to be avoided. At fund manager’s level, any benchmark related to fund peers should consist of a meaningful underlying sample, for instance not to put funds of different types in the same sample (e.g. mutual funds and ETFs; or actively-managed ETFs and passive ETFs). It is even more important at distributor’s level, where the various MiFID tests to be applied vis-à-vis the investor should ensure that the product

offered in practice to a given individual client is the most appropriate one, which does not necessarily lead to the cheapest product as such.

Second, regarding undue costs, as for the notion of VfM, everyone is of course in favor of avoiding them as being detrimental to the investor. Still, the final provisions will have to be carefully designed in setting the related requirements for fund manufacturers at fund launch and over time, to avoid disproportionate obligations and processes.

Third, regarding PRIIPs, in the same vein the intent to introduce a new section on sustainability is perfectly legitimate, but overloading the content and reading of the currently short document will have to be avoided too.

Finally, whichever piece of EU legislation to be considered and above regulations, the ultimate aim must be to satisfy the needs of retail investors – at pan-EU level - in the best way. Currently, EU retail fund investors have increasing requests and expectations towards fund managers: to be more active in their ESG approaches (either through their fund investments, or actual participations in issuers’ AGMs), to offer longer-term and sustainable investments beyond the mere listed securities, as well as various fund vehicles depending on their needs.

As a long-standing active and ESG fund manager, dealing with the whole range of retail investment funds – UCITS, national Long-Term Investment Fund ranges as well as Active ETFs – and by being strongly involved in the life of our investments, we just want to answer such needs.

We are now expecting that the ELTIF Review will facilitate the Long-Term Investment fund offer to EU retail investors in the near future. And we deeply hope that the RIS will not unintentionally make the EU fund offer more complicated.



GERBEN EVERTS

Executive Director - European Investors' Association

Value for money requires client centricity + effective pan-EU shareholder rights

In the CMU, retail investment strategy and subsequent regulatory proposals, a lot has been shared about investors and the investor perspective. The interest of investors is mainly voiced and protected by others. Consequently, investors hardly have any flexibility in choosing the most adequate distribution channels. Furthermore, protection against wrongdoing in the governance and pan-EU distribution of financial products is suboptimal.

As long as industry is in the position to convince policy makers that inducement models have added value, the value for money and equity culture will not develop. The ECMI-CEPS report as well as Prof. Dr. Steffen Sebastian's recent academic work on the effect of inducements has three clear take-aways: a ban on inducements has a positive effect on household returns on investments, no negative effect on savings and a ban is also positive for poorer households.

Many retail investors are not aware that incentive structures are not in their interest and eat away large parts of their future revenues. The most important advice retail investors deserve is the

advice to save on unnecessary costs they have to pay every year for a one-off advice in a distant past.

To truly increase retail investor participation, we need fair and efficient capital markets, where diversification and returns are important. Investors want (qualitative) value for money, preferably with simple products. Pan-EU pension products should be allowed a second chance. Financial literacy and financial education are important, but one should caution for biases (education by intermediaries). The important concept of client centricity should be incorporated in the law and the role of supervisors enhanced. The introduction of pan-EU collective redress is crucial to attract cross-border retail investments and the essential rights of shareholders should be kept intact.

Against this background, the CMU and retail investment strategy are important stepping stones. The AIFM and UCITS directives have delivered successful brands, recognized as the golden standard. We all know that pooling investments is helpful as professional portfolio management is stimulated, standardization is delivered and investors' and consumers' interests are served. However, further clarification and harmonization of delegation structures and liquidity management tools in the AIFMD and UCITS are still required.

Citizens of Europe, whether they invest directly or indirectly, need to be the true CMU champions.

A preliminary observation on ELTIF is that less than 100 ELTIFs have been created altogether. We still have difficulty in accepting that to stimulate retail investment, the EU has resorted to lowering investor protection. For this reason, the intention to enable open-end ELTIFs can be criticized. Access to infrastructural products enables diversification and more optimal portfolio management. However, the characteristics of illiquid assets are significantly different. Investors need to be well informed to be able to make a careful decision.

We've entered an era where we see more pan-EU financial flexibility, comprehensive digitalization, demographics requiring self-discipline and a higher educated population. The main issue is not that investors don't understand

financial products. Overly complex information creates barriers for people to start investing. Investors don't trust products, nor the 'independent' intermediaries. Consequently, huge amounts of consumers' savings are dead wood on a savings account washed away by inflation. A further review on existing regulation is important.

If you compare Europe with the US, the fragmentation in the fund sector is a key difference. We have too many funds. Also, all distributors have their own funds and an incentive to advise those. Consequently, funds are too small, liquidity is poor and costs are too high. We are stuck with a non-competitive situation.

In an ideal world, seamless cross-border distribution of investment products would be the default. However, we all know that the home/host supervisory arrangements are not interpreted from a European angle, but from a national perspective and an attempt to protect 'national champions' on the sell-side. The rigidity of supervision is different if you compare Member States with a large domestic market with those where a domestic market is essentially absent. The latter have no incentive to protect consumers and investors. The dodgier entrants from third countries decide on their registration accordingly. Consequently, marketing and investor protection rules will remain fragmented to protect local consumers and investors and to restore the level playing field with domestic players.

An effective CMU cannot be delivered without strengthening supervisory convergence. Flexibility to opt for the lowest hurdle needs to be curbed and the ESA's be given the right to decide where third-country issuers and intermediaries are to be regulated. As the silent majority, the citizens of Europe, whether they invest directly or indirectly, need to be the true champions of the CMU.

CONSOLIDATED TAPE PROPOSALS



HANZO VAN BEUSEKOM

Member of the Executive Board - Dutch Authority for the Financial Markets

Consolidated tape, now what for the bond CT?

At Eurofi in Paris in February 2022 I concluded the CT panel that I moderated with the phrase: Let's see in Santiago de Compostela what has come out of the trilogue negotiations. With the principal agreement reached on the MiFIR review, it is now time to consider the practical establishment of a viable and effective consolidated tape solution.

Although the technical trilogues have not been completely finalized yet at the time of writing, a positive outcome seems clear. There will be a CT that will add significantly to transparency and execution quality, reducing fragmentation in EU capital markets, increasing visibility, comparability, funding opportunities and improve market resilience.

This does mean that real work starts now. From AFM's perspective, we have continuously strived for the rapid establishment of a bond CT as we believe

this would have the most significant impact on transparency. Now that the outlines are clear, we need to make sure that a viable CT proof of concept can be delivered soon.

There are number of considerations that would need to be addressed as part of these next steps, and most importantly, the tender and award process by ESMA.

- In our view, the bond CT should provide for real-time, subject to applicable deferrals, post-trade data feeds based on mandatory contributions from market data contributors as defined in MiFIR. Core market data should be made available to the Consolidated Tape Provider (CTP) in standardised formats. These formats should leverage, to the extent possible, existing MiFIR reporting methodologies and industry practices.
- The main task of a CT provider will be to ensure a solid and secure technical platform for processing, (cloud)storing, and harmonizing data contributions for consumption, combined with adequate capabilities for administration, access, dissemination, distribution licensing and subscription management for CT data consumption.
- CT data should be made as widely available as practically possible to different types of end-users, differentiating between display data aimed at non-professional usage and wholesale non-display data for automated processing, redistribution or to support the creation of value-added services.
- A CT provider should establish a solid governance framework, ensuring fair representation of all stakeholders including data contributors and users. Governance and avoidance of conflicts of interests should become an essential element of the selection and award procedure for CT providers by ESMA.

It is now key that all stakeholders involved should work together to get the CT working in practice and to seek a provider that is able to operationalize the CT effectively.

Together with the industry and supported by ESMA and the European

Commission in observer capacity, the AFM has already drafted a number of high-level technical principles on the core attributes of a bond CT in May 2022 that address the above.

These principles were the result of a process facilitating the generation of ideas, business models and proofs of concept by way of our Regulatory Sandbox that includes technology providers, industry representatives from the buy- and sell-side, trading venues and liquidity providers. This allowed for rapid progress to be made and for market based, practical guidance to be developed into an agreement on high-level technical principles for a corporate bond CTP.

In our view, these principles are still a perfect blueprint to address the many practical elements around data delivery, data quality, scoping and governance. Some of the data quality and reporting recommendations have meanwhile been taken onboard in the amendments of MiFIR RTS 2 and the new comprehensive ESMA reporting guidelines.

Having an operational CT in place will be a great boost to enhance real meaningful transparency in a manner that is useful to all market participants. In particular a correct and flexible calibration of an EU wide deferral regime for bonds is essential for the establishment of a bond CT, which will eventually be up to ESMA.

Last, but not least, ensuring the right level of data quality and consistency is paramount. Much progress has been made with better guidance and best practices on correct and consistent ways of reporting. We further believe in strengthening ESMA's role in handling and enhancing data quality and reporting consistency. Another key element is to form an industry expert group to advise on some of the key issues in reporting market data and CT governance.

We all agree on the timely implementation of a CT for bonds as an integral element of the Capital Markets Union and that now is the time to deliver. Already looking forward to 2025's Eurofi in Poland to see where we landed!



NIELS BRAB

Head of Group Regulatory Strategy & Chief Regulatory Officer - Deutsche Börse Group

EU consolidated tapes on the horizon – let’s go CMU!

Following tough negotiations, the EU has finally reached political consensus on the Review of MiFID II/ MiFIR and the establishment of consolidated tapes (CTs). While future will tell how the different CTs may enhance the investment climate and improve overall transparency, the agreement marks an important step into the right direction as it is symbolic of the EU’s strong commitment to advance the Capital Markets Union (CMU) during a critical time marked by geopolitical tensions and significant economic challenges.

After a lot of discussions on the concrete details, it is now time to look forward and to embrace the compromise found – also bearing in mind the importance of a swift and effective implementation. It has been long established that CTs may provide valuable instruments by supporting a more integrated trading view across EU markets, enhancing the general investment climate by boosting transparency and broader visibility. Furthermore, they may provide more standardized high-quality data across different execution realities, thereby improving effective best execution verification while also strengthening investor protection within the EU.

Especially when it comes to the equity and ETF dimensions, European exchanges

remain committed to delivering in the EU’s interest through their Joint Venture. Leveraging on exchanges’ expertise and long-standing history as the powerhouses of high-quality market data, their bid for the delivery of an efficient and effective implementation is footed on a comprehensive and professional business set-up that is well equipped to master complex operational challenges while creating an environment conducive to innovation and growth.

Regarding the concrete details of the equity CT, it is therefore good news that ESMA has been entrusted with a significant role over the coming years. This will facilitate a smooth implementation, avoiding market disruption and unintended consequences while maximising the positive impact and effectiveness.

This does not only include the running of the tender process but notably also concerns the core of any viable equity CT with a significant added value for the market, i.e. high quality market data from various sources as the backbone and starting point. ESMA’s joint responsibility with NCAs to enforce accurate, complete, and timely data submissions is especially key when it comes to alternative execution venues – as the market failure around high-quality data from this segment had an important impact on the non-emergence of a viable equity CT under MiFID II/ MiFIR over the last years.

European exchanges remain committed to delivering in the EU’s interest through their Joint Venture.

While a lot of progress has already been made in certain regards (see e.g. latest ESMA data on SIs indicating that about 90% of post-trade data is available within 30 seconds), it is of essence that ESMA’s efforts and expertise is further leveraged in the context of the expert stakeholder group which is to be set-up by the European Commission

Beyond the necessity to ensure high quality data as a starting point to any integer and reliable CT, it will also be critical to ensure that the details around the revenue distribution scheme reflect the needs of EU equity markets and current empirical realities. Exchanges play a key role for the EU’s CMU endeavour embedded in an

open strategic autonomy – they are indispensable when it comes to price formation and accurate reference data as the backbone of any sound investment decision-making.

The compromise reached by the EU acknowledges this importance and aims to limit any unintended consequences on their viability. This should help to avoid a CT set-up that only comprises parts of the EU’s equity markets, noting that an uncomprehensive coverage would lead the whole project ad absurdum as a partial and fragmented coverage would not signal the much-needed unity across the internal market at this critical juncture.

Overall, it is clear that the implementation of the equity CT presents challenges for both regulators and the industry. This is not only due to the narrow implementation timeline but also triggered by additional uncertainties surrounding the upcoming review of the regulation, potentially affecting the CT’s attractiveness and commercial viability. Striking the right balance between political and market expectations is therefore vital for the success of the EU’s equity CT. But it also requires all stakeholders around the table to constructively work together, supporting the political deal found and embedding the CT discussion in the broader picture of EU capital markets.

Let’s embrace the opportunities the accord presents and collaborate on an effective implementation, supporting a deeper EU capital markets integration and boosting the famous CMU endeavour in the sustainable interest of future generations.

Based on the experience the EU will gain over the next years, the scope of the equity CT could then be reviewed and adapted in symbiosis with market needs and a profound future vision of the underlying market structure.



NICHOLAS BEAN

Chief Executive Officer -
Bloomberg Trading Facility BV

Dare we say the finishing line is in sight for a bond consolidated tape?

A European consolidated tape (CT) for bonds may finally be achievable after EU legislators reached a trilogue breakthrough on the MiFIR review. While this represents a significant milestone, there is still some way to go before a viable CT for fixed income markets actually emerges. Moreover, we have been here before; a CT was first envisaged when MiFID II was agreed back in 2014 yet none emerged. The MiFIR review must ensure this time will be different.

Given the lengthy period that has passed since MiFID II was agreed and the MiFIR review was proposed, it is worth re-examining the underlying rationale for a bond CT. The objective of the Capital Markets Union initiative is a single financial market across the Union to stimulate growth, provide greater funding opportunities and facilitate investment in Europe. The introduction of a bond CT can concretely support these important objectives by providing a single stream of data, which affords market participants a more transparent and reliable overview as to where liquidity lies and how best execution can be achieved. Clearly, the rationale for a bond CT remains as compelling today as it was in 2014.

However, whether a CT actually emerges this time around depends on the extent to which the lessons of the last nine years have been heeded. Einstein famously quipped that insanity is doing the same thing over and over again and expecting different results. With a CT for bonds failing to emerge under MiFID II, it was very clear that a 'one more go' approach would not deliver results and that a fundamental change in approach was required to address two key impediments to a bond CT.

The first impediment to a viable CT was the commercial model. MiFID II created insurmountable regulatory barriers by legislating for multiple competing CTs, which would have to give their product away for free after 15 minutes, while having to secure data from trading venues and APAs. It was good to see policymakers seeking to improve the commercial incentives for a potential CT provider by changing to a one-tape-per-asset class approach and removing the 15 minutes requirement.

A second impediment has been MiFID II's complex and unwieldy deferral and transparency regime, which has resulted in trades being withheld from publication often until after any usable time. A key lesson has been that the consolidation of trading and volume data is only useful if it is timely and of good quality. Fortunately, legislators have recognized the importance of improving the regime and have taken the first steps to simplifying and harmonizing maximum deferral periods. However, the devil will be in the detail as ESMA develops detailed implementing rules and this calibration will be 'make or break' for the success of a bond CT.

**It is essential to remain
sensitive to the feedback
of the bond markets.**

A related issue, as it is not actually a CT provider service, has been the fixation of a sort on MiFID II's pre-trade transparency regime for bonds. This does not reflect the practicalities of trading in this asset class. Specifically, the Request For Quote trading system (protocol) inherently affords investors with highly relevant liquidity identification in the pre-execution phase. As such, it was good to see legislators reconsidering the fixed income pre-trade transparency regime and seeking to target it around central limit order book and periodic auctions systems. This course of action boosts the prospects for a bond CT as it will enable ESMA to focus its resources and

firepower on the simplification of the post-trade transparency regime, which is critical for the success of the bond CT.

Regarding asset class sequencing, the approach of prioritizing the CT in the bond market ahead of equity markets is ostensibly to address the greater need for transparency in the former over the latter. This contrasts with other considerations for such a decision - for example the more challenging nature of political agreement in matters concerning equity markets. Irrespective of the driver, members of the bond market community are broadly keen to demonstrate leadership in this area and contribute, in any relevant way, to bringing about a bond CT. Nonetheless it is essential that policymakers and all stakeholders remain sensitive to the feedback of the bond market community throughout the CT tender and supervisory process.

Ultimately, the MiFIR review represents significant progress in terms of important lessons being learnt and it paves the way for a bond CT to finally come into existence. However, there is still a lot of work to do. ESMA's level 2 choices will be critical, not secondary to the success or failure of a bond CT. European fixed income markets have a pivotal role to play as the EU navigates the economic challenges of this decade. When we look back in nine years' time, we need to be able to say that the MiFIR review was truly different.

We thank **the partner institutions**
for their support to the organisation
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SECURITIES TRADING: MARKET STRUCTURE AND TRANSPARENCY EVOLUTIONS



CARLO COMPORTI

Commissioner - Commissione Nazionale per le Società e la Borsa (CONSOB)

MiFIR review: the final judgement

The process for the review of MiFIR was long and cumbersome, with some announced overarching goals, on top of which the realisation of the long-awaited consolidated tape (CT), and much resistance from different categories of stakeholders for a variety of interests.

The current political agreement is characterised by a CT for shares and ETFs based on post-trade data but also including limited pre-trade data based on the Council compromise proposal, whereas the CT for bonds remains focused on post-trade data but will be the first to be launched after the entry into force of the MiFIR recast.

For the equity CT it is worth mentioning that: i) it is set to be voluntary for small venues fulfilling some specific conditions, ii) the revenue sharing mechanism for market data contributors to the CT foresees a preferential treatment for small venues, as well as for data related to shares and ETFs which the trading venue admitted to trading

less than five years prior to the entry into force of the amending regulation.

Whilst it is understandable that small trading venues are to be incentivised to contribute to the CT, it is less clear why financial instruments with a shorter life should be rewarded and thus valued more than older ones.

Regarding waivers to pre-trade transparency and limits to dark trading, a single volume cap of 7% will apply only for reference price waivers. No limits will instead apply to negotiated trades, differently than before, potentially running counter the objective of expanding lit trading, which was at the heart of the review.

Pre-trade transparency on non-equity instruments is removed for systems other than a central limit order book or periodic auction systems. Additionally, transparency for derivatives is limited only to exchange-traded derivatives and transactions in OTC derivatives denominated in euro, Japanese yen, US dollar or pound sterling, subject to additional conditions, which means that not all derivatives traded on an EU trading venue, especially on organised trading facilities, will be fully transparent. In other words, the non-equity space will end up in less transparent grounds than currently.

The objective of greater harmonisation in the deferrals for non-equity has been finally achieved, taking into account the liquidity of the instrument and the size of the transaction concerned, but according to second level measures to be adopted by ESMA. The sole flexibility allowed is for the competent authority of a Member State to grant additional deferrals for an extended period of time, not exceeding six months, with regard to transactions in sovereign debt instruments issued by that Member State.

The systematic internalisers (SIs) regime is simplified for both equity and non-equity. The amount of minimum quoting threshold for equity, which has been highly debated, will need to be specified by ESMA (now it is twice the standard market size). Finally, SIs will be allowed to match at midpoint without complying with the tick size regime, differently from what is applicable to transactions executed on trading venues.

The expected set up of both non-equity and equity CTs is the best outcome of

the lengthy negotiations. Regarding the other measures meant to boost transparency, we need to consider who will benefit from these changes and who will bear the costs.

When considering the details of the measures briefly mentioned above, as result of negotiations, it seems that the non-equity space will continue benefiting of a more favourable treatment in terms of requested transparency, probably in connection with a lower degree of liquidity when compared with equity. However, in countries where transparency requirements for non-equity instruments have been applied rigorously (almost up to the equity level), no such negative consequences on the market liquidity have been experienced. For this reason, the above said outcome does not seem to be ambitious enough, also in comparison with the situation in the US. Additionally, it potentially prejudices further expansion of the equity instruments, in addition to the existing debt-equity tax bias.

Who will benefit from the MiFIR changes and who will bear the costs?

As anticipated, another goal that was announced but seems not having been pursued coherently is levelling the playing field between trading venues and systematic internalisers (of which the possibility for SIs to match at midpoint is a prominent example).

In sum, the revenues of trading venues, especially the larger ones, risk being eroded by the mandatory contribution to the consolidated tape, while at the same time operators in the dark space may have an advantage by having access to enhanced transparency and not bearing its costs.



HANZO VAN BEUSEKOM

Member of the Executive Board - Dutch Authority for the Financial Markets

Will the MiFIR review lead to more competitive EU capital markets?

Now that a political agreement has finally been reached on the MiFIR review (with further technical details to be worked out), it is important to look at the expected impact on European capital markets. A key question for us to evaluate the political agreement on the MiFIR review is whether it will benefit the competitiveness of EU capital markets. As Brexit has dealt a severe blow to the aspirations of the EU to become a leading capital market in the world (with London as a major financial center now operating outside the EU), it is even more important that major adjustments to the market structure in the EU are beneficial to the competitiveness of the EU markets.

Our assessment is that the MiFIR review is a major step forward, probably even the best feasible advancement in terms of achieving transparent markets but there is some room for further improvement.

As my separate article on the bond CT in this Eurofi magazine argues, we consider the establishment of a CT for bonds an important success: there will be a CT that will add significantly

to transparency and execution quality, reducing fragmentation in EU capital markets, increasing visibility, comparability, funding opportunities and improve market resilience. We believe the CT for bonds can play an important role in setting examples for other asset classes.

The CT for equity is next in line. There has been much opposition to the establishment of an equity CT, but the agreement on the MiFIR review endorses the importance of the consolidation of (near to) real-time post-trade transparency for equity. This is by itself already a major achievement and very good news for enhancing transparency in the EU. For the equity CT, we don't believe it will compete with proprietary market data franchises: this business model for trading venues remains unaffected. In return, better visibility and revenue-sharing models could provide a tangible benefit for smaller and less interconnected venues.

Aside from the CT for bonds and shares, there are other encouraging results of the MiFIR review like the measures to enhance pre- and post-trade transparency (e.g., waiver and deferral requirements, rules on systematic internalizers and amendments to the share and derivative trading obligations). These measures on transparency and market structure are each of them strong contributors to meaningful transparency.

The most important additional result from our perspective is however the ban on Payment for Order Flow (PFOF), including only a very limited time for national discretion to opt out of this regime. The agreement should be seen as a ban to buy off competition in the liquidity provision. Retail orders should be able to flow freely to exchanges with full transparency of costs for investors. Retail orders are the "bread and butter" to the whole of the order and trading chain, and they form an essential basis for price formation in the market. It is encouraging that the EU, like other trading centers around the world, is taking the right turn in this.

Taken all together, the establishment of a CT for bonds and equity, the ban on PFOF and measures to enhance transparency are important steps forward for the MiFID II/MiFIR framework to operate successfully and to improve the competitiveness of EU capital markets.

Let us zoom in a bit more in detail. The establishment of the CT speaks for itself. In simple words its establishment will strongly improve transparency and non-discriminatory access to market information and will thereby

contribute to the competitiveness of EU capital markets. We expect that the ban on PFOF and measures to increase transparency will also contribute significantly to the EU capital markets operating in a competitive way.

Does the principal agreement on the MiFIR review leave nothing to wish for? Although we are very positive on the outcome of the negotiations, we think there is still some room for further improvement. The most tangible example of that is the consolidation of pre-trade transparency information for equity. The political agreement allows for the inclusion of only very limited pre-trade information in the equity CT.

An enhanced operational MiFID/MiFIR framework is key to competitive EU capital markets.

In our view, investors would be better off with the inclusion of more extended pre-trade information. This would enhance the price formation process and in that way be beneficial to the competitiveness of EU capital markets. We recognize however that this was not feasible, and, in that sense, the current agreement can be considered the best result that could be achieved. The next step is to make it workable and in that respect there is a big role for ESMA in terms of drafting level 2 regulations and the selection and authorization of the CT's for bonds and equity.



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Competitiveness is about more than local companies listing abroad

High-profile cases where successful European companies have decided to float in the US have prompted soul-searching around one question in both the EU and in London: why are we not competitive enough?

This is an important issue to consider – the flow of companies going from the EU to the US is significantly larger than that in the opposite direction. It is understandable that European countries want successful companies to list locally, and that would require more competitive capital markets. This ambition lies at the heart of the capital markets union project. Yet, thinking only in terms of “competitiveness”, especially with US markets, risks focusing only on the most visible part of the problem. Putting a magnifying glass on high-profile EU companies listing outside of the Union can obscure a deeper issue lurking underneath the headlines: it is not just that some of the best European companies are going elsewhere, but that there are too

many companies in the EU that do not use capital markets at all.

Instead, they rely on bank financing or internal funds. The ratio between debt securities and bank loans for non-financial companies in the US is more than tenfold that in the Euro area. US companies also use equity financing to a greater extent, giving them better access to long-term capital to finance uncertain, possible high-impact ventures. In addition to the likely detrimental effects on economic growth from a dearth of risk-willing funds, the loan-heavy European corporate funding mix reduces economic resilience. The eurozone debt crisis is a striking example of how overdependence on bank loans can exacerbate and prolong downturns. Even if one prefers to think of capital markets in terms of competitiveness, it is difficult to be competitive if you cannot weather a crisis.

There is clearly no conflict between the policies that would attract national success cases to list within the EU and those that would improve capital market access for all companies. On the contrary, the overlap is significant. But it is important to remember that the cost of uncompetitive European capital markets is not just the prestige loss of big names floating abroad, but more importantly a widespread lack of market-based funding. The EU shares in global activity on both equity and debt markets are consistently smaller than the size of its economy would suggest.

**The more important cost
of uncompetitive capital
markets is a widespread
lack of funding.**

But identifying symptoms is not very difficult. The more daunting task is to diagnose the cause. There is the usual suspect: fragmentation in EU markets, notably caused by a mosaic of different insolvency and tax systems. Lack of harmonisation is a critical issue, but EU-wide measures are not the only tools available to improve market functioning. Much can be done nationally as well.

One notable example is the asset allocation of pension funds. There are large differences within the EU, but on aggregate European pension funds' allocation to equities is much lower than it could be. Pension funds shifting some of their capital from fixed income towards equities, while maintaining prudent investment strategies, would make a significant pool of capital

available to companies and help improve capital market dynamism as well as the financial sustainability of the funds themselves.

Another is household exposure to capital markets. Reflecting the dominance of banks, EU households allocate around a third of their financial assets to simple currency and deposits, more than twice the US number. In some EU countries, the share is more than fifty percent. This has the twin impact of reducing both companies' access to finance and households' returns on their savings.

More broadly, the EU economy is not structured primarily around high-growth industries. This is not conducive to capital market growth, especially in a low-interest rate environment like that of recent years, where growth at times seemed to be the only game in town. When considering aggregate IPO proceeds since 2008, the EU's top industry is consumer cyclicals, whereas the US' is technology. The share of tech companies in US IPO proceeds is almost three times that of the EU, and for other high-tech industries like healthcare it is well over twice as large. The figures are even less flattering when looking at absolute amounts – US proceeds in these industries outside the EU's by seven and six times, respectively. The only sectors where EU proceeds exceed US ones are utilities and telecom.

These are high-level economic and financial issues that require significant political commitment and broad buy-in to address. They will not be solved by fine-tuning at the edges. That does not mean that technical measures related to, for example, a consolidated tape are unimportant – on the contrary, technical improvements are critical to building well-functioning markets. But they make a difference at the margin.

Successful European capital markets require broader and bolder initiatives as well, a focus on the forest and not just the trees.



BEATRIZ ALONSO-MAJAGRANZAS

Head of Exchanges
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MiFIR: what is still needed for the ultimate project for the EU Capital Markets

The entry into force of MiFID II and MiFIR in 2018 was a response to an economic reality very different from the one we are living in today. Since then, significant changes have altered the dynamics of our financial ecosystem. These include the pandemic and the boost in technologies like cryptoassets, DLT, and blockchain, which have become an important variable affecting how participants in capital markets interact. Thus, the review of MiFIR is of utmost importance, as it is the opportunity to assess new circumstances and address the challenges that have arisen.

It is important to highlight that despite the political agreement reached in June 2023, the technical aspects of the regulation are part of a discussion that can and will extend over the subsequent months, and that must not be considered concluded until a solid compromise is reached. In fact, many of the details that fall under the second part of negotiations are just as crucial as the formal political arrangement.

Transparency and proportionality must be the lighthouse of the discussions for policy makers and for industry stakeholders. As the bandwidth of the discussions has lightened now of political tendencies, it is the right time to target the imbalances that appeared as a by-product of MiFIR, and to provide a much more attractive ground for investments and capital to flow into the EU.

Despite its controversy, the ban on Payment for Order Flow (PFOF) is a milestone in achieving a consistent and harmonized trading landscape throughout the EU that can allow us to compete with other jurisdictions that move fast and adapt quickly to new realities. Ultimately, this will translate into better protection for the end client, by offering a fair and clear price, and promoting competition.

Moreover, a fit-for-purpose threshold for SIs, where they fulfil their role without harming an efficient price formation process is indispensable for targeting fragmentation among trading venues in the EU and allowing the end client to achieve the best execution. It is crucial to ensure that the thresholds that determine SIs activity are realistic and do not overflow beyond the scope envisaged in the directive. Otherwise, fragmentation will only increase – leading to a less-optimal performance of markets overall, harming price formation, and resulting in a distorted view of trading occurring in the EU.

Exchanges are an integral part of the financial ecosystem contributing to raising capital and growth.

Furthermore, the application to the SIs of the transparency requirements for the consolidated tape is a guarantee to ensure functionality and usefulness of the tape itself and its role as a tool for permitting distribution of information, and not just a mere dataflow that can only be exploited by a few. This is particularly relevant when considering the overarching objectives of CMU and the goal of increasing access to capital markets to all stakeholders and not just of those who have more technical means.

Other elements, such as waivers, will play a crucial role in ensuring transparency: ESMA is now tasked with determining thresholds for pre-trade transparency, and it is critical that this be done in a carefully considered manner. More

precisely, the reference price waiver should not be fed from the output of the consolidated tape, but should remain a threshold on its own.

It is also very pertinent to note the changes proposed to the share trading obligation that have finally reached a compromise where either local or non-EEA currencies are considered in the exemption, which are fundamental to maintaining a solid integration of the EU markets with its third-country counterparties in the region.

Among these open questions, there is one important factor to highlight: Exchanges are an integral part of the financial ecosystem, contributing in a transparent and orderly manner to raising capital and allowing for growth and consolidation of the economy. As such, the qualities of robustness and resilience, proven over periods of distress, have the capacity to add value to the decision-making process. Moreover, the experience provided by long-standing presence in the industry makes Exchanges great partners to supply expertise, technology and reliability when shaping the future of finance in the European Union.

As new horizons draw near for the capital markets, new challenges arise as well: better integration of markets, reducing fragmentation, and fostering fair competition must remain driving forces to improve our markets. While leveraging from new tools shaped with knowledge, technical expertise and assessment from authorities is needed to sustain long-term viable capital markets that permit growth and protect their players: customers, companies, and venues – as it is the path for maintaining and increasing relevance in an increasingly changing and competitive scenario. Thus, the next and final stage of the MiFIR Review is a golden opportunity that must be addressed with proportionality and rationale to provide the EU with a solid project that can attract and retain companies and capital.

ENHANCING CENTRAL CLEARING IN THE EU



KLAUS LÖBER

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The case for central clearing supervision

Cleared markets are not as static as often portrayed. Since the end of the EMIR 2.2 negotiations in March 2019, the clearing landscape in the Union has undergone major changes and has been exposed to important challenges, with EU CCPs expanding their services across markets, currencies and owners.

In less than five years, the number of EU CCPs has risen to 14 with a new CCP established in Croatia, 15 new clearing services have been launched and could be offered EU-wide as a consequence of EMIR, and 3 EU CCPs have gone through acquisitions, including two from non-EU groups. More importantly, 2 cleared markets that are essential for the Union's financial stability, namely euro-denominated repo and CDS markets, have moved or are currently moving at least in part to the continent – and more can be expected to come as a result of the EMIR 3 discussions.

These developments have contributed to a significant increase in notional amounts cleared and in margins

collected at EU CCPs, with an increasing concentration of some products at certain CCPs, serving clearing members and clients from all of the EU and beyond. The increasing size of exposures and their concentration have implications for the stability of the EU as a whole and raises necessary questions as to the suitability of our CCP supervisory framework.

A first consideration stems from the design and the role of CCPs. CCPs have multiple connections with key financial market infrastructures and users ranging from large investment banks to corporates and pension funds. All these entities answer to supervisors with different mandates which currently lack a central coordination function to ensure that supervisory responses complement one another and do not diverge. This is true in particular in times of stress, where national supervisors of CCPs will likely focus on maintaining CCP operations at all costs, whereas the competent authorities of clearing members and clients may prioritize the stability of their supervised entities – possibly at the expense of the broader interest of financial stability overall.

A correlate to this resides in the cross-border nature of these cleared exposures, as the said investment bank or pension fund may not be established in the same country as the CCP. This degree of interconnection implies that a disruption at a CCP established in one Member State will necessarily impact multiple key financial and corporate counterparties across the Union. In certain cases, especially among the largest and most systemic ones, EU CCPs may even service more clearing members and clients in other Member States than in the one where they are established, as can be seen with the UK based Tier 2 CCPs. It should also be recalled that 15 EU Member States currently do not have CCPs and are in this sense completely dependent on the supervision of competent authorities in other Member States where CCPs are established.

Based on the above considerations, it is essential that we break away from the misconception that a CCP disruption only has a bearing on the CCP and the Member State where it is established. CCPs cannot be looked at and supervised in isolation. They are deeply interconnected through their clearing members, which can be called

on for additional resources and thereby have a bearing on the financial stability of another Member State. The reverse is also true: it is futile to believe that one understands the risk linked to the exposure of a CCP to a bank, if the supervisor of the CCP is not fully aware of the connections that that bank has with other CCPs.

This is why it is essential that we move on from a CCP-centric view of supervision to a more coordinated and integrated view on central clearing and its participants. Strong and effective coordination and integration between all relevant authorities is key to ensure that risks concentrated in EU CCPs are adequately monitored and managed, in order to minimise spill-over effects across Member States.

In addition, a stronger EU view would help reduce occurrences of divergent interpretations of EMIR by NCAs, which may result in different conditions for authorisation of CCPs and supervisory approvals, or worse in regulatory competition to attract clearing activity between Member States. A more unified approach would also increase the predictability and reliability of supervisory decisions for EU CCPs, thereby reducing the administrative burden on CCPs and increasing their attractiveness.

From a CCP-centric view of supervision to a more coordinated and integrated view on central clearing.

The European Commission proposal to review the EMIR framework goes in the right direction, notably with the creation of a Joint Monitoring Mechanism supporting a more horizontal view on central clearing, but does not yet achieve a true EU supervisory perspective on the central clearing ecosystem. While the European Parliament seems to be favourable to a more integrated approach to central clearing supervision, it remains to be seen whether the Council is ready to follow suit – at least for the most systemic and cross-border relevant CCPs.



PIERO CIPOLLONE

Deputy Governor -
Banca d'Italia

Liquidity of financial markets and central clearing in times of stress

Financial turmoil episodes occurred in the last years have confirmed that central counterparties (CCP) margin requirements can become a source of liquidity pressure for participants; the potential vicious circle between market liquidity and CCP margining practices is a significant concern of public authorities. A related key feature is the access of CCPs to central bank liquidity in times of stress. In this context, supervision and regulation play a key role.

Margins can be procyclical, and this is an extremely delicate issue. Margins should increase with risk, which is perceived as higher in times of stress. But, as liquidity conditions tighten, participants may find it difficult to provide additional collateral at short notice; their tendency to refrain from engaging in trades due to margin costs could amplify the liquidity crisis. Furthermore CCPs may be tempted to strengthen their competitive position, adopting models with weaker counter-cyclical tools and lower margin levels.

To avoid negative feedback loops on market liquidity, CCP regulators and supervisors have to ensure a level

playing field among CCPs in terms of risk management models, avoiding a race to the bottom which could have disruptive effects on financial stability.

While risk models play a key role in calculating the forward-looking component of margins, in times of stress the primary driver of large calls are often their intraday component, the 'variation margins' (VMs), which are inherently deterministic. Even though VMs do not represent a source of liquidity drain, being only the redistribution of resources across members, the failure of timely execution of this process can lead to liquidity strains; time-lag in the collection and redistribution of VMs - whereby CCPs call intraday VM and dispatch them only the next morning - should be limited to the largest extent possible.

Another facet of these issues relates to collateral availability. Clearing participants may face difficulties in accessing highly liquid collateral to promptly meet CCP margin calls, especially during stress periods. These difficulties emerged during the recent turmoil in commodities markets, where a number of clearing participants, in particular non-financials, strived to increase their credit lines with commercial banks and even asked for direct liquidity support from central banks. Looking ahead, the issue could become more acute, should new strains materialize in a context of monetary policy tightening. A solution could be to widen the list of eligible collateral, limiting the enlargement to non-financial counterparties where appropriate, but it must be assessed against the potential risks it would entail for CCPs and the wider financial system.

Finally, attention must be paid to the conditions under which CCPs can access central bank liquidity in times of stress. Back in 2018, when assessing the euro-area financial sector, the IMF emphasized that access to central bank facilities provides a safety net in times of market tensions, which is of paramount importance for financial stability. This issue is also crucial for establishing a robust framework for the recovery and resolution of CCPs and for developing clearing capacity in the EU.

Importantly, all these issues are already being tackled. The FSB and the international standard setting bodies are working on CCP margin practices. At EU level, EMIR is being reviewed. The Eurosystem is also progressing well with its work on CCPs' access to central bank liquidity. It is important not to lose momentum.

In this context, let me underline the importance that the monitoring activity is up to the challenges the supervisory authorities are called to face. As CCPs are required to review margin levels on an ongoing basis and intraday liquidity flows become more and more relevant, authorities must adopt monitoring tools allowing for high-frequency information on the clearing system functioning.

**Mitigate procyclicality,
ensure access to central
bank money, strengthen
cross-border supervision.**

At the Bank of Italy, we have been following such an approach for many years, including for settlement systems and trading venues supervised by the Bank; in crisis times it proved to be a valuable tool for gathering information on a timely basis, allowing the Bank to make promptly the relevant decisions, when needed.

In a monetary and capital market union, an adequate role of CCPs in times of stress also requires strong cross-border supervision. In this sense, the Bank of Italy welcomes the strengthening of the role of ESMA called for by the revision of EMIR. It has to be pursued through an appropriate combination of the responsibilities between the national authorities, in charge of supervision, and the ESMA, in charge of supervisory convergence at EU level.



FIONA VAN ECHELPOEL

Deputy Director General -
European Central Bank (ECB)

Striking the right balance for the active account requirement

The degree of overreliance on third-country central counterparties (CCPs) has been a long-standing debate. Authorities of the European Union, including the European Central Bank (ECB), have repeatedly called for EU market participants to reduce their exposures especially to UK CCPs. Looking at the clearing landscape as of June 2023: about 80% of the total notional outstanding of euro-denominated interest rate swaps is still cleared outside the EU; about 50% of EU clients active in this market do not clear any trades in the EU, and among those clients, 47% clear euro-only portfolios outside the EU despite viable alternative clearing options existing in the EU. At this point, it is worth revisiting why this situation could be problematic.

The main concern relates to stressed market scenarios and in particular, the possibility that a third-country CCP may take discretionary actions which could have adverse effects on the EU financial system. The type of adverse effects in this respect include, among others, increased margin requirements or collateral haircuts on financial instruments critical for the financial stability of the EU or certain default

management decisions. These actions are part of the typical CCP risk and default management toolkit and hence not problematic in themselves - but they can raise sensitive issues in default scenarios if taken on a scale or within a timeframe that may lead to market stress or deepen difficulties at an EU financial institution or even an EU Member State.

In addition, they may have implications for the implementation of monetary policy and the smooth functioning of payment systems within the EU. While CCPs and their authorities across the globe aim to set out rules-based default management and recovery and resolution procedures, there will always be a degree of discretion for decision-taking. In a tail-risk scenario, crisis management objectives and priorities of a third-country jurisdiction may not be aligned with those of the EU. This potential mismatch of interests can only be resolved by addressing overreliance at the core and thus moving a meaningful portion of clearing exposures to EU CCPs, subject to the supervision of an EU competent authority. The existence of a common market and currency, the interdependencies between EU financial institutions and the framework of cooperation established among EU authorities ensure that interests within the EU are better aligned than they would be vis-à-vis a third country.

A thorough analysis is essential before concluding on the key features of the active account

The requirement to hold an “active account” at an EU CCP, as set out in the legislative proposal to review the European Market Infrastructure Regulation (“EMIR 3”) proposal, constitutes an important and necessary first step towards a more balanced clearing landscape, effecting both a reduction in excessive exposures and a building up of EU-based clearing activities. While overreliance can be addressed over the medium-term, cost and competitiveness issues arise in the short-term making it difficult for policymakers to strike the right balance.

However, focusing on short-term aspects only runs the risk of losing sight of the overall objectives of the active account. For example, it has been argued that commercially critical activities like market making should be exempt from the scope of the active account.

Considering that a substantial portion of EU market participants’ clearing activity is in market making, such exemption may render the active account essentially ineffective in reducing overreliance and adversely weigh on the possibility of building up liquidity pools at EU CCPs.

Several approaches can be deployed when implementing the active account depending on the priorities assigned to the various objectives, but a common understanding of the underlying quantities, metrics, assumptions, and definitions is crucial. A thorough analysis is essential before concluding on the key features of the active account to ensure this novel tool is brought forward in an effective, proportionate and prudent manner. In this vein, the calibration of the active account should leverage on the technical expertise of European Securities and Markets Authority (ESMA) in cooperation with other EU authorities.

After years of debate, it is time that the dynamics in European clearing markets change. The market has repeatedly proven that it can adapt to and optimise along new macroeconomic and regulatory circumstances. Market participants should consider EMIR 3 an opportunity to help shape and enhance the EU clearing landscape and actively participate in a constructive dialogue with the relevant authorities during the transition phase.

After all, the building up of an active and resilient EU-based clearing market is an essential element of the development of the Capital Markets Union which will benefit EU financial markets as a whole.



EVA WIMMER

Director General - Federal
Ministry of Finance, Germany

Active Accounts in the EU must be made effective

The discussion on the clearing of euro-denominated interest rate swaps – the so-called Euroclearing – has come a long way. Since the early days more than a decade ago the EU has pursued the goal to effectively address the financial stability risks that over-the-counter derivatives clearing and in particular Euroclearing entails. Since the United Kingdom's withdrawal from the EU the clearing of substantial parts of euro-denominated interest rate swap business takes place outside the EU. In view of the substantial systemic importance of Euroclearing to the EU this situation entails serious risks for the preservation of EU financial stability.

The European Commission has held a series of roundtable discussions with stakeholders to discuss potential measures to address the financial stability risks. Whereas some of the proposed measures such as requiring immediate relocation would create cliff-edge risks and would therefore have negative implications for financial stability in the EU themselves, other measures such as capital add-ons or liquidity buffers would be harmful to EU market participants only and would thus create an unlevel playing-field vis-à-vis non-EU competitors.

As a result, the European Commission has come forward with a new

approach – the so-called Active Account – which would require EU market participants to establish and actively use an account for Euroclearing instruments at a clearing house/CCP located in the EU. ESMA would have the possibility to set a minimum quantitative level of activity if this is required to safeguard financial stability. According to the European Commission this approach would strengthen the clearing at EU CCPs and reduce the overreliance of EU market participants on clearing at CCPs that are of substantial systemic importance to the Union, but are located in third countries.

However, it should be noted that despite various initiatives undertaken by EU CCPs in recent years to build a liquid Euroclearing market in the EU, for the time being, the bulk of Euroclearing has remained outside of the EU and the overreliance of EU market participants on offshore clearing is ongoing. If one wants to take this more into account, then targeted adjustments to the Commission proposal can be considered.

However, these adjustments should not jeopardize the goal of bringing more Euroclearing activities to the EU. As a first step and to create the necessary momentum for changing the status quo so as to further strengthen clearing activities in the Union, it is necessary that Active Accounts are fully operational from the outset and that they provide for a minimum level of activity of at least 10% in new contracts. As a second step, in order to keep the momentum created with the introduction of the Active Account and in order to progressively reduce financial stability risks to the Union, the European Commission should be mandated to adjust the calibration of the quantitative requirements over time without further recourse to the legislators being required.

**Active Accounts in the EU
must be an exemption
for client clearing
services provided to
third-country clients
and be further
specified by ESMA.**

The adjustments should be undertaken by the European Commission on a regular basis and be based upon recurring assessments by ESMA of the clearing activities undertaken by EU market participants in relevant

instruments. In its assessments ESMA should take into account the reduction in clearing of relevant derivative contracts at third-country CCPs by EU market participants and should consider the costs, risks and burden of increasing the required proportion of activity for those participants.

In order to ensure a level-playing field and to avoid competitive disadvantages for EU market participants vis-à-vis non-EU operators targeted exemptions, for example an exemption for client clearing services provided to third-country clients could be introduced and be further specified by ESMA.

At the same time, the regulatory framework and the supervisory processes regarding the extension of authorization and validation of risk models should be streamlined so as to make clearing in the EU more attractive and to reduce the time to market of new products and services for EU CCPs. In this process, one should pay close attention not to introduce new procedures and not to increase the number of ex-ante assessments by the various supervisory bodies such as the national competent authorities, the colleges and ESMA. Otherwise the intended effect of streamlining might not materialize or might even turn into the opposite.

In any case, a further strengthening of ESMA role in the supervisory process should not compromise the existing final supervisory responsibility of the national competent authority since this could lead to a decoupling of the supervisory responsibility and the fiscal responsibility of the Member State where the CCP is located.



JULIEN JARDELOT

Head of Europe, Government Relations & Regulatory Strategy - London Stock Exchange Group (LSEG)

Adapted standards and level playing are essential for clearing competitiveness

LSEG operates two leading multi-asset class clearing houses (CCPs): LCH Limited – in London – and LCH SA – in Paris. Both provide risk management capabilities across a range of asset classes, including OTC interest rates, fixed income, FX, CDS, equities, and commodities. LCH Group’s CCPs offer clearing services to members and clients across the globe and as such are subject to the supervision and regulation of numerous jurisdictions.

Specifically, LCH Limited is directly subject to UK and EU EMIR frameworks, and those in the US, Canada, Australia, and Japan, to name a few. Both LCH Limited and LCH SA are subject to the direct supervision of a wide range of authorities including the Bank of England, ESMA, and the CFTC in the case of LCH Ltd. We operate globally systemic CCPs and as such welcome both the cross-border supervisory scrutiny and stringent rules we are subject to. Our customers thus not only get access to a large and diversified

clearing community but also robust risk management standards, subject to the requirements set by the most demanding jurisdictions in the world.

Looking at the ongoing review of EMIR, the European Commission has proposed several measures that have the potential to significantly improve the EU clearing ecosystem.

Chief among them is the streamlining of the supervisory processes. The supervisory structure outlined above has an additional layer for EU CCPs – such as LCH SA – due to the role of national competent authorities, CCP College and ESMA. This affects both EU CCPs’ efficiency and their time-to-market for new products and services. Because of the current multi-layered and open-ended supervisory timelines, EU CCPs can take years to launch new products and services responding to market needs. However, in other jurisdictions, competing CCPs count their approval processes in a matter of weeks (in the case of non-objections). Addressing this is key to the competitiveness of EU CCPs, which is why we support the proposals of the European Commission and European Parliament to increase the role of ESMA to simplify the supervision of EU CCPs.

We also suggest that EU CCPs of systemic importance to the Union be directly supervised by EU authorities. This simplification would help to ensure a more harmonised supervision and implementation of EU rules.

Rules must improve the attractiveness of EU CCPs rather than define their market share.

Another crucial component of the European Commission’s proposal seeks to facilitate buy-side access to central clearing. These measures aimed at pension funds, insurance companies, and other market players financing the real economy are essential to guarantee a diversified and resilient membership of EU clearing houses. We need to address inconsistencies in the EU regulatory framework that impede access to clearing. This would not only broaden access to CCPs but also achieve a more stable, shock-resistant EU clearing ecosystem with deeper liquidity pools.

Measures that would constrain EU firms’ decision of where to clear would do just the opposite. It would affect their competitiveness and ability to

manage their risks efficiently. It is not a ‘one-off’ issue. Artificial market fragmentation, in the form of active account requirements, would have a lasting effect on the costs and risks to EU firms, especially if those are applied widely, with a minimum level of activity required in the EU. In practice, this would not only entail recurring costs for every transaction, but also increased risk, illustrated by greater margins needs. Looking at the numbers, EU firms only represented circa 27% of the notional registered on euro IRS in 2022.

For SwapClear, this represents less than 9% of overall cleared volumes. Such an artificially created captive market would therefore be a fraction of the current, competitive market which also raises questions from a financial stability perspective. A captive market formed by EU firms clearing in euros and subject to the same economic cycle would increase both wrong-way risk and potentially act as an impediment to safe and efficient default management.

Rules must improve the attractiveness of EU CCPs rather than define their market share. This is essential to maintain trust and financial stability. Any measure aimed at defining the market share of a specific CCP will result not only in an unlevel playing field but can also lead to increased financial risk, the opposite of what policymakers are trying to achieve.

CCPs are the anchors of a stable global financial system. This and any future review of their operating framework should always facilitate their risk management role, through simplified and agile regulatory procedures and access to best-in-class technology providers, regardless of their location.



ERIK TIM MÜLLER

Chief Executive Officer -
Eurex Clearing AG

A well-balanced approach to reduce systemic risks and foster EU clearing

EU financial markets and infrastructures play a key role in ensuring resilience and driving economic growth. A strong and attractive clearing landscape is therefore essential for deepening the EU's single market on the 30th anniversary of its creation and strengthening the international role of the Euro, underpinning the political objectives around the Capital Markets Union, financial stability, and an open strategic autonomy. The EU institutions seem united in their approach not to compromise on those objectives amidst the prevailing challenging economic and geopolitical macro-environment.

EU regulators are strongly committed to fostering financial stability and clearing activities in the Union, therefore calling on market participants to help reshape the European capital markets. EMIR 3.0 is an important milestone in this endeavor, making EU central counterparties (CCPs) and the broader EU clearing ecosystem more globally competitive as well as resilient, especially by reducing systemic risks arising from excessive exposures towards third-country infrastructures.

The ECB recently pointed out our joint responsibility for a robust clearing

framework. Notably, there is the need to address the monetary policy and financial stability concerns associated with off-shore clearing of systemically relevant Euro products. EMIR 2.2 ensured that EU authorities have some insights into systemically relevant third country CCPs. However, in a crisis event, their ability to intervene and safeguard the stability of the Euro, the Eurozone and ultimately taxpayer money remains limited. While it is good to see that EMIR 3.0 aims to increase the EU authorities' insights into Tier 2 CCPs' resolution planning, the Commission, ECB, ESRB and ESMA made it very clear that this alone will not suffice.

Rather, they advocate for an appropriate level of relevant Euro clearing activities taking place in the Union. This is where the active account requirement comes in: Taking a targeted and proportionate approach, it only applies to EU market participants that are subject to the clearing obligation and to those products that have been identified as systemically relevant, i.e., Euro OTC IRD, CDS and STIR. It aims at gradually rebalancing only a part of those activities to the EU to reduce systemic risks and build a sustainable domestic clearing ecosystem, while still allowing the flexibility to clear at Tier 2 CCPs. Compared to other policy options, such as derecognition or capital add-ons, the active account shows a spirit of compromise, carefully balancing regulatory objectives and market participants' competitiveness concerns.

Transition into a market structure with more competition and substantially reduced systemic risks.

Of course, EMIR 3.0 may require market participants to adapt if they haven't done so already. However, there is ample evidence that markets can adjust to new realities, for example as evidenced by the G20 reforms after the financial crisis or the IBOR transition. Both huge undertakings that the global community was initially skeptical on but in hindsight mastered flawlessly.

Eurex Clearing's aim is to help the industry transition into a market structure with more competition and substantially reduced systemic risks, while keeping any transition impact to a minimum. This is why we introduced our OTC IRD Partnership Program and recently expanded it to STIR. Our OTC IRD market share has grown to 20 per

cent and we have onboarded more than 600 market participants. They can clear at virtually the same terms, with no account fees, and optimize their netting efficiencies as well as funding costs. We continue to provide additional incentives schemes to facilitate the industry's transition, mitigating transitional costs and stimulating deeper liquidity in the EU.

However, if we miss the opportunity to make the best of the active account proposal, we risk compromising the access to Tier 2 CCPs under the current terms. Despite the EU-UK political relations fortunately improving recently, there seems to be little appetite to prolong the temporary equivalence for Tier 2 CCPs in the absence of a joint rebalancing effort. Therefore, the Commission continues to encourage market participants to use the time until mid-2025 for reducing their overreliance on Tier 2 CCPs.

Any other measure but the active account requirement risks having more severe implications for the industry and the financial system. So, we should consider the active account proposal as a well-balanced solution to the current chicken-and-egg situation: If appropriately calibrated, the ideal outcome will be a market structure where activities are rebalanced to the extent that Tier 2 CCPs are not considered a risk to the EU's financial stability anymore. This would allow for maintaining access to Tier 2 CCPs and resolve the cliff-edge risks around the quickly approaching expiry of the temporary equivalence.



STÉPHANE GIORDANO

Deputy Head of Public Affairs - Responsible for Wholesale and Financial Markets Activities - Société Générale

An open strategic autonomy for clearing

As a leading financial institution with a global presence and a deeply rooted investment banking & financial markets DNA, Société Générale has welcomed the strategic shift of the Commission to promote, together with financial stability, the concept of “open strategic autonomy” as an objective of its CCP reform.

Over the past 15 years, the EU has undergone many severe and formative crises - from the 2008 Great Financial Crisis and the 2012 Eurozone debt crisis to the most recent Covid crisis in 2020 and the invasion of Ukraine in 2022. All these crises, notably the most recent ones, have demonstrated that, to reinforce its resilience, the EU must reinforce its autonomy and onshore value chains in all strategic domains, from semiconductors to pharmaceuticals. I fully subscribe to that idea. I would add that the financial industry is one such strategic domain, and that the debate on CCP regulation cannot escape these considerations.

This brings me to two critical points. First, the review of EMIR aims to address systemic risk, but it must also contribute to a credible EU industrial policy for

clearing. Second, EU authorities must consider the impacts of their proposal all along the value chain, i.e., on the local clearing ecosystem but also on the upstream global trading ecosystem. Without sufficient concern for these two dimensions, the reform underway will fall short of its objectives, and risks increasing, instead of reducing, the dependency of the EU vis-a-vis third country players.

Achieving financial stability does not require quantitative constraints on EU clearing

If EU policy makers are genuinely interested in addressing systemic risk, the worst-case scenario is that market participants are shut out from third country CCPs, because they would lose access to clearing (mostly managed by UK CCPs). Aware of such risk, the Commission has identified the need for a progressive and proportionate approach, hence its proposal to require an “active account” for EU market participants in an EU CCP. To avoid disruption, the qualification of whether “active” or not need not be quantitative at all: the only requirement should be that EU CCPs are scalable enough to clear a significantly larger number of transactions if such a fall-back scenario arises.

Preventing systemic risk does not specifically require that EU CCPs have a large market share. Other instruments, such as shared supervisory measures, stronger powers to the ESMA, or leverage on collateral are far-more-reaching measures. An illustration of this is that the US authorities are not worried that dollar swaps are mostly cleared by LCH.

We need to improve the attractiveness of EU CCPs and of the whole EU financial system.

History shows that success will be achieved if CCPs and their participants transfer their activities to the EU voluntarily. Since 2019, the repo-clearing of euro sovereign debt - the most immediate financial instrument to channel the EU’s monetary policy- takes place in the EU, following the decision of LCH to move this activity to Paris, and CDS-clearing takes place in either the US or the EU due to ICE’s unilateral decision to leave the UK.

The question should be: how can we make the transfer of activities from third countries to EU CCPs economically

sound, from a business and competition point of view?

A quantitative approach to clearing is a self-inflicted damage to our competitiveness

On top of not addressing systemic risk per se, a quantitative account would severely harm our competitiveness.

The CCP reform proposed by the EU, just as any industrial policy, should not ignore its side effects. If we try to go too fast or if we are too restrictive, we will not only fail, but we will also create dependencies vis-à-vis players from third countries. We will regrettably isolate ourselves and deteriorate our capacity to finance ourselves. For example, as 75% of IRS in euro do not involve any EU counterparty, there will continue to be a significant offshore clearing market, with a potential risk of a strong asymmetry of flows in EU CCPs, causing a costly difference in equilibrium price for EU market participants. This would dramatically affect cross-border banks with offshore clients who will lack a compelling motivation to clear in the onshore CCP.

On the contrary, a qualitative approach has its virtues and brings us half-way. Currently, a significant proportion of EU customers clear their euro transactions only with LCH. Ensuring that they open a qualitative active EU account would be a significant step!

To achieve our goals, there is simply more work to do to improve the attractiveness of EU CCPs, and of the whole ecosystem of EU financial markets

The comparative advantage of third-country players lays in favorable conditions for financial activities, excellent infrastructure, suitable human resources, strong culture, and pragmatic regulation. Because there are strong economic arguments for the concentration of activity in a small number of CCPs, hindering market access for reasons of economic orthodoxy will only further jeopardize our competitiveness.



PATRICIA BOGARD

Head of Public Affairs
and Regulatory Watch -
Crédit Agricole Corporate
& Investment Bank

An operational Active Account to support the relocation of clearing in Europe

The European Commission has released in December 2022 a proposal to review the EMIR regulation, in the wake of the Brexit, and in the context of the upcoming end of equivalence that was granted to UK CCPs by June of 2025.

The proposal is set to address two main long term objectives; managing systemic risk arising from excessive exposure to third-country systemic CCPs for the financial stability of the Union and ensuring strategic autonomy of the clearing ecosystem of the Union.

The key measure introduced by the Commission's proposal in this respect is the active account requirement. The active account is intended to host the part of the clearing flows that will be relocated to Europe.

All counterparties subject to the clearing obligation will have to open and maintain an account at a European CCP, and to feed this account with a regular flow of transactions, so as to ensure

that this account and the associated processes are operational. Thus, in the event of a crisis on a non-European CCP, this would allow new clearing flows to be redirected to a European CCP immediately, to ensure operational resilience, which meets the stake of financial stability.

Moreover, the development of clearing flows in Europe and the gradual increase in volumes should make the offer more attractive and competitive; the emergence of a true clearing capacity in Europe is a key challenge in terms of strategic autonomy. To achieve this objective of strategic autonomy, it is also crucial to preserve the competitiveness of financial institutions that are members of European CCPs, while the market remains currently mainly outside Europe and the relocation of the clearing will entail additional costs:

- Currently, LCH Ltd's market share in euro swaps is 95% (Q1 2023); and 75% of euro swaps do not involve EU counterparties; as a consequence, the market liquidity is mainly outside Europe.
- the split of clearing over several CCPs (EU / non-EU) will alter netting benefits for clients that are multi-products and particularly multi-currency.
- the resulting increase in margin calls will trigger additional liquidity needs and costs.
- Due to lower liquidity, clearing at Eurex rather than LCH induces a market basis, resulting in higher costs for EU clearing members and their clients (average 0,85 bp for 10Y € swaps since 2019 with an increase around 3 bp in the last months and a maximum of 4 bp).

A too fast relocation of clearing would harm EU competitiveness without meeting the objective sought.

For all the reasons above, a relocation of clearing activity in Europe that would go too fast would harm EU clearing members' competitiveness without meeting the objectives sought, as entities not subject to the clearing obligation as well as non-EU entities might choose to maintain their clearing activities at LCH with clearing members not subject to mandatory thresholds (i.e. non-EU banks).

For client-driven activity, dealers do not have any control over the choice of

CCP; trying to clear a trade at a CCP that does not match clients' pricing expectations would either lead to losing trades and clients franchise or exposing dealers to an unsound basis risk, harming the ability to conduct market-making activities in these products, and ultimately providing competitive pricing to the clients.

While EU authorities wish to push for further commitment from clearing members to achieve a faster pace of relocation, we would recommend the introduction of a two-phased active account requirement for entities subject to the clearing obligation, in order to enable a progressive relocation, and secure the development of a strong and resilient clearing ecosystem in the EU.

In the first phase, the active account opened by entities subject to EMIR would be managed through setting qualitative criteria. One could imagine to request at minimum one transaction to be cleared for each maturity bucket at every semester, the purpose being to ensure the operational efficiency of this active account.

This first phase would not result in a status quo, and could drive a significant move to EU CCPs, as there is a significant share of EU-clients subject to EMIR, dealing mainly or exclusively EUR IRS, and clearing exclusively at LCH.

In order to assess the efforts made during this first phase, ESMA could conduct a general assessment 36 months later, to determine whether it is necessary, and relevant in regard of cost/benefit ratio, to propose minimum quantitative thresholds to be met to increase the pace of relocation as a second phase of this reform.

Finally, public entities could help increase the attractiveness of EU CCPs by clearing part of their transactions at EU CCPs by clearing part of their transactions in the EU; this move would drive significant volumes, providing more liquidity in the European clearing landscape; or at least they could ask for Eurex swap level reference in case of bilateral transactions, which would allow their dealers to hedge with EUREX cleared swaps.

The development of a wider product offer by Eurex could as well be a game changer in the medium term.

SECURITIES POST-TRADING INFRASTRUCTURES: EFFICIENCY AND RESILIENCE



DENIS BEAU

First Deputy Governor -
Banque de France

Digitalisation, securities settlement efficiency and the role of central banks

Exactly one year ago, I wrote an article for Eurofi titled “Competitiveness and resilience of EU infrastructures”. One year later, I am delighted to elaborate in these columns on several important achievements which will contribute to make securities settlement in the EU safer and more efficient.

First, in March 2023, the Eurosystem successfully launched the TARGET2 - T2-Securities consolidation, allowing European participants to optimise their liquidity management across all TARGET Services. And we now look ahead to the launch of the European Collateral Management System in April 2024. Second, the recently completed review of the CSDR regulation has led to some important developments in regulatory provisions to enhance settlement efficiency and discipline, such as the reporting obligations on settlement fails or the mandatory buy-in rules. Finally, the Regulation on a Pilot Regime for

market infrastructures based on DLT² entered into force in March 2023. For a 3-year period, renewable once, the Pilot Regime will allow existing and new CSDs and multilateral trading facilities to use DLT in post-trade activities within a derogatory framework. This concrete, real-life test will enable the identification of the necessary regulatory developments, while guaranteeing investor protection, market integrity and financial stability. It will make it possible to clearly identify DLT’s advantages in post-trading, in particular for the efficiency of the settlement process.

Let me now turn to what I see as a key ingredient for the future of the post-trading landscape, namely digitalisation, and to the role that central banks can play in this field.

Digitalisation will be a game-changer for securities infrastructures, in the same way that it has impacted our daily lives, and this is only the beginning. Besides the immediate direct changes stemming from digitalisation of processes – such as faster access to information or lower operational costs – digitalisation will drive market players’ growing interest for new forms of financial instruments and technologies, such as tokenised assets and DLT, and their potential to enhance settlement efficiency – including of complex operations.

Digitalisation will also pave the way to meet the customers and financial intermediaries’ demand for immediacy. For instance, while most securities transactions are currently settled at T+2 (i.e. two days after the date of execution), some countries are pushing to reduce the expected settlement date in conventional settlement systems to T+1³. This medium-term strategy complements a longer-term perspective, in which DLT infrastructures should play an increasingly important role in reducing settlement cycles.

Tokenisation indeed offers the possibility of atomic settlement, with delivery-versus-payment taking place instantaneously, at T+0. While shorter settlement cycles could help the industry better mitigate counterparty risk and lead to operational efficiencies (e.g. by lowering margin requirements and therefore costs), this reduction will be gradual as it will require significant adaptations throughout the settlement chain to ensure proper reconciliations⁴.

Central banks have a key role to play to help reap the benefits of digitalisation for the

efficiency and resilience of securities post-trading infrastructures, while limiting their risks. This role encompasses a variety of actions, from facilitating an active dialogue with financial market stakeholders to being a leading actor of innovation. In the case of the Eurosystem, for instance, the AMI-SeCo⁵ is a forum allowing central banks to collect industry feedback and insights on issues related to the clearing and settlement of securities, including on the potential of DLT for wholesale settlement. Beyond promoting market dialogue, the Eurosystem has launched exploratory work on the settlement of tokenised assets using wholesale central bank money (wCBDC), with the input of a dedicated Market Contact Group.

Digitalisation will be a game-changer for securities infrastructures, and this is only the beginning.

The Banque de France looks forward to accompanying market initiatives to experiment potential solutions using wCBDC⁶ in this remit and in the context of the Pilot Regime.

And of course, in their role as service providers, central banks will have to keep their own post-trading infrastructures up-to-date with the latest technologies and functionalities tuned towards market demand and evolving practices and risks.

1. Denis Beau (2022), *Competitiveness and resilience of EU infrastructures*, *The EUROFI Magazine*.
2. *Regulation (EU) 2022/858 on a pilot regime for market infrastructures based on distributed ledger technology (DLT)*.
3. *India already uses T+1 for the settlement of equities, while the US and Canada recently confirmed the launch of T+1 settlement in May 2024. In Europe, discussions about T+1 securities settlement are still ongoing*, see *Association for Financial Markets in Europe (AFME)*, September 2022.
4. *In this regard, DLT can play a facilitating role, as demonstrated by DTCC’s project Ion, which used DLT to enable operators to carry out reconciliations among parties more efficiently*.
5. *Advisory Group on Market Infrastructures for Securities and Collateral*.
6. *Wholesale CBDC experiments with the Banque de France*, July 2023.



FIONA VAN ECHELPOEL

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AMI-SeCo's role continues to be critical for post-trade harmonisation in Europe

Safe and efficient financial market infrastructures and post-trade arrangements are essential for the transfer of payments and assets, smooth monetary policy implementation and financial stability. Fostering harmonisation of post-trade processes, including collateral management, is a key objective for the Eurosystem in the pursuit of financial market integration in Europe.

The Eurosystem keeps an active and open dialogue with all relevant financial market stakeholders. It uses its Advisory Group on Market Infrastructures for Securities and Collateral (AMI-SeCo) as the forum for discussing with central securities depositories (CSDs), central counterparties (CCPs), banks, Eurosystem central banks, issuers and industry associations.

AMI-SeCo defines and maintains pan-European standards and market practices related to securities settlement, collateral management and corporate events. It monitors their consistent implementation across the so called AMI-SeCo markets (including

the European Union, Switzerland and the United Kingdom) and regularly publishes, on the website of the ECB, the results of monitoring exercises, thereby creating a certain degree of peer pressure towards harmonisation.

AMI-SeCo's 13th T2S Harmonisation Progress Report on the harmonisation of European securities settlement shows an overall very high level of compliance with the T2S harmonisation standards, even though some challenges remain in the corporate actions area. The report also includes a readiness assessment of markets preparing to join the T2S platform, namely Euroclear Bank (BE), Euroclear Finland (FI) and SKDD (HR). Although there is still work to be done, these markets are expected to comply with the majority of the T2S standards by the time of their migration to T2S in autumn 2023 - start of migration in the case of Euroclear Bank.

Regarding collateral management harmonisation, in the past, AMI-SeCo identified ten areas in which further action would be needed by relevant stakeholders to achieve a Single Collateral Management Rulebook for Europe (SCoRE). SCoRE defines common rules for managing collateral that replace the fragmented legacy standards and market practices existing across Europe today. AMI-SeCo has already endorsed harmonised standards in the areas of Corporate Actions, Billing Processes and Triparty Collateral Management, the implementation of which is foreseen by April 2024. The Sixth Compliance and Progress Report (SCoREBOARD) confirms the commitment of market stakeholders: although slight delays in current implementation milestones were reported, the majority of the markets are expected to comply with the agreed SCoRE standards on time. Efforts are now focused on the markets (including three euro-area markets for Corporate Actions Standards) that are lagging behind their adaptation plans and on the standards for which implementation requires adoption across the whole intermediary chain.

To address remaining and potential new harmonisation challenges in the most effective way, AMI-SeCo has recently reviewed its mandate to adopt a leaner, flatter and more transparent governance structure that provides clarity about responsibilities and scope of action. A survey has been launched within AMI-SeCo's membership to identify the remaining barriers to financial market integration that hinder efficient cross-border settlement, asset servicing and market access in the AMI-SeCo markets. To complement the already known gaps, the survey tries to expose practical, technical and administrative barriers at

detailed level. Additionally, AMI-SeCo is developing a strategy and roadmap for ISO 20022 adoption in Europe. A potential end date for the use of legacy messaging standards is currently under discussion: Corporate Actions could rely solely on ISO 20022 by November 2028, and coexistence with current standards could cease in all AMI-SeCo markets by November 2030.

Besides AMI-SeCo which advises the Eurosystem on post-trading matters, the Eurosystem has recently established a new market contact group, the New Technologies for Wholesale settlement Contact Group (NTW-CG). The NTW-CG will provide expert input on the potential use of new technologies, for example DLT, for settling wholesale financial transactions in central bank money. This helps ensure that developments in central bank money keep pace with digital innovation in wholesale and retail payments, and that central bank money remains a monetary anchor that supports the stability and integration of the European financial system and payments system. The Eurosystem's exploratory work in this field is planned to start in 2024.

AMI-SeCo has become a key forum for interaction, contributing to post-trade harmonisation.

Overall, AMI-SeCo is recognised as a key forum for interaction between the market and the Eurosystem in the post trade landscape in Europe, contributing to financial integration promoting post-trade harmonisation. The optimised governance and the ongoing mapping exercise on remaining barriers will contribute to the pivotal role AMI-SeCo is playing in the European efforts towards financial market integration now and in the future.



JULIAN REISCHLE

Director General Payments and Settlement Systems - Deutsche Bundesbank

EU post-trade in search of salvation?

Preparing for the Eurofi Financial Forum in Santiago de Compostela more than 20 years after the publication of the notorious Giovannini reports on EU clearing and settlement, one thought almost suggests itself: aiming at integrated, efficient and resilient EU post-trade markets sends you on a long pilgrimage.

As outlined in the Giovannini reports, major steps towards such an EU post-trade ecosystem have since collectively been taken by governments, regulators and market participants. The Eurosystem played a crucial role here, and the Deutsche Bundesbank is not only a member of it, but also part of a smaller group of central banks that developed T2S, run this integrated settlement platform smoothly and further improved it by consolidating it with the Eurosystem's new-generation RTGS system T2. One of the next steps in fostering the integration of EU post-trade markets will be the go live of the European Collateral Management System (ECMS) and the accompanying harmonisation initiative to create a Single Collateral Management Rulebook for Europe (SCoRE) in 2024, simplifying the European cross-border collateral handling. And yet another incisive change for EU financial markets is looming on the horizon: a wholesale

central bank digital currency (CBDC) could establish a truly European means of payment for multiple use cases.

To enhance settlement of digital or crypto securities, the Eurosystem already now explores how wholesale transactions on DLT platforms could be settled in central bank money, including by potentially issuing a wholesale version of CBDC or setting up an interaction with existing TARGET services.

All of the Eurosystem projects need to be supported by harmonisation or legislative initiatives, with legislators ideally not only forcing market actors to adapt, but rather seeking their input for the sake of safe, efficient and forward-looking solutions. For instance, the Eurosystem explorations on how DLT based financial transactions could be settled in central bank money may build up on the new EU DLT Pilot Regime, which as a regulatory sandbox aims at promoting DLT in securities trading and settlement, including via the combination of trading and post-trading activities within a single entity. A further imminent step on the regulatory agenda is the adoption of the CSDR Refit, under which the objectives of CSDR shall be met more efficiently and proportionately, as previously advocated in the 2020 final report of the High Level Forum on the CMU. For CSDs' banking-type services, access conditions, including through other CSDs, will be adjusted in order to facilitate cross border services for various currencies. In addition, a revised passporting regime will reduce barriers to cross-border settlement and ease administrative and financial burden on CSDs.

Aiming at integrated, efficient and resilient EU post-trade markets sends you on a long pilgrimage.

Moreover, EU convergence of CSD supervision will be improved, whereby colleges could play a more important role. Not surprisingly, this point is subject to discussion, as it touches on basic principles, particularly that responsibility and liability should be harmonised, or put in other words: being in charge of a decision and at the same time being liable for the consequences are two sides of the same coin. In addition, it should be noted here that the predominantly national supervision of CSDs has worked quite well so far.

In contrast to this, the settlement discipline regime established under CSDR only entered into force after considerable delays and has not yet brought about the desired improvements. Settlement efficiency rates in the EU are still lower than in other developed capital markets and a clear upward trend cannot be observed. As a mandatory buy-in regime would, with good reason, only be a measure of last resort under the provisional agreement on the CSDR Refit, it is likely that legislators will have to review the penalties system, including the penalty rates that are currently enshrined in the Level 2 measures under CSDR.

When discussing post-trade developments in other capital markets, it is impossible to overlook the shift to T+1 settlement around the world, particularly the changeover in the USA scheduled for 28 May 2024, and in fact, such evolution of market structures appears to be the next logical step in the common search for efficiencies and risk reduction. Nevertheless, it should be noted that this step requires careful preparation in order to avoid setbacks, including a potential drop in settlement efficiency. This may not go against the natural assumption that the UK and the EU will follow suit, but it will not be a short-term or haphazard move and happen only after due consideration has been given to market characteristics, which particularly in the EU tend to be highly complex.

So, whoever reaches Eurofi in Santiago de Compostela will be unlikely to find immediate salvation for the challenges of the unique EU post-trade ecosystem there. Instead, they will realise that the journey towards safety, efficiency and integration is not ending here.



PIERO CIPOLLONE

Deputy Governor - Banca d'Italia

Enhancing efficiency and resilience of securities post-trading infrastructures

Digitalization of finance and the innovation brought by distributed ledger technologies (DLTs) are favoring the development of new business models, services and user experience, with a great potential for its adoption by financial markets infrastructures (FMIs) along the whole lifecycle of securities. Like in other domains, DLTs are expected to bring significant efficiency gains, thanks to process simplifications, extension of operating times, reduction of costs and the removal of most of the barriers to same day settlement (T+0).

Greater transparency and traceability may also improve supervisory activities and reduce counterparty risk, as well as operational risk due to fewer manual activities and the decentralized storage of information.

However, the adoption of DLTs inevitably raises a number of key concerns for public authorities, related to the massive exposure to cyber risks, the downsizing of the role of financial intermediaries, the greater dependence on external providers and the higher liquidity risks until business volumes on DLT platforms consolidate.

A fundamental role is played by the establishment of common standards, to pursue integration with legacy systems and overcome interoperability issues and fragmentation, so as not to defeat the harmonization efforts undertaken so far, as happened with the launch of T2S, a fundamental milestone in the post-trading services.

Governance aspects are also key, because accountable entities must be identified for regulatory and supervisory actions to be enforceable and effective. An active dialogue with the market is also crucial, as transition to DLTs requires rethinking all processes in order to fully exploit its advantages.

In order to allow financial institutions to keep pace with technological innovation, it is necessary to adapt the regulatory framework. An important step has been made in the EU with the DLT Pilot Regime Regulation, which allows FMIs to experiment the use of DLTs in the supply of securities trading and settlement in a secure technological environment. The Pilot Regime has been recently transposed into the Italian framework, enabling the issuance and circulation of native digital securities. In addition to what strictly set out by the EU Regulation, the Italian law has introduced the role of ledger officer at national level. Ledger officers are in charge of the issuance and circulation of digital financial instruments over the counter (OTC), i.e. outside a trading venue.

Digitalization of finance is expected to increase efficiency of the whole securities lifecycle.

From an operational standpoint, the availability of a wholesale Central Bank Digital Currency (CBDC) could facilitate the use of a comprehensive Delivery vs Payment (DvP) approach in the DLT framework. In the absence of a Eurosystem service to settle the cash leg of DLT transactions in central bank money (CeBM), market players could resort to commercial bank money or stablecoins. In this regard, the Eurosystem is seeking how to ensure that developments in CeBM keep pace with and contribute to digital innovation, while remaining a monetary anchor that supports the stability, integration and efficiency of the European financial system.

This approach includes Eurosystem-led exploratory work, which will take

place in 2024, to investigate how central bank money settlement in euro could take place in the presence of new technologies such as DLT. As part of this work, the Eurosystem intends to engage in experiments and trials (involving limited settlement of real payments and assets) to gain practical insights into different solutions together with the market players, for the use of DLT in large value payments and securities settlement. Furthermore, we have the opportunity to meet market demand for CeBM solutions during the DLT Pilot Regime thus avoiding DLT ecosystems being built around other means of payment from the onset.

Banca d'Italia is willing to contribute to this work by proposing a solution centred on the Eurosystem's TIPS instant payments platform and DLT-agnostic API to synchronize the asset-leg and the cash-leg, making an instantaneous DvP transaction possible on a 24/7 basis.

Another possible way to improve the efficiency of securities settlement is to halve the duration of the settlement cycle from two (T+2) to one (T+1) day. Such a major change has already been implemented in some markets (India) and planned in others (US and Canada, with expected go-live in May 2024). Its impact on the resilience of settlement systems is far from obvious, as T+1 settlement reduces the time available to settle trades and therefore may increase operational risks.

Looking ahead, technological advances should make it possible to reap the benefits of a shorter settlement lag without compromising the resilience of post-trading infrastructures. An accelerating factor could be the competitive pressure from DLT-based trading platforms. In any case, an appropriate adjustment period should be foreseen to allow market operators to put in place the necessary implementing measures.



HAROUN BOUCHETA

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The regulatory road to a more integrated EU post-trading ecosystem

CMU objectives and the more recent regulatory agenda have contributed to the goal of reducing fragmentation and promoting a more integrated post-trading ecosystem. It is a fact that the EU made significant progress in this area.

But there is still room for improvement. The EU post-trading market is still more fragmented than in other jurisdictions, and in order to work towards a higher level of integration, the EU should move forward on some important pieces of the regulatory puzzle which are still missing.

On the digital front, legislative initiatives are progressing well at EU but also international level. Many of them should positively affect the post-trading ecosystem notably those promoting a new framework for the provision of custody services. Nonetheless, some developments would probably need more consensus to move forward.

Another key issue relates to the move to T+1 in some key jurisdictions such

as the US and how it impacts the EU. In a context of interconnected global financial markets, EU policy makers should pursue a tangible cost/benefit analysis taking into account the differences between US and EU markets.

This regulatory road to a more integrated EU post-trading ecosystem will surely be a priority for the new Commission and the new European Parliament to come in less than one year from now.

Some improvements have recently been made to the EU securities post-trading integration (CSDR and ECB)

The EU recently reached an agreement on a compromise text for CSDR Refit. This is an important step.

CSDR has been substantially improved compared to its initial version. It is made easier for CSDs to offer cross border services through a new passporting regime and an improved cooperation mechanism between supervisory authorities. In terms of settlement discipline, penalties have been decoupled from mandatory buy-ins and these latter can only be implemented in limited circumstances. In addition, CSDR encourages settlement efficiency.

Besides CSDR, we have also recently seen useful developments in the ECB governance (AMI-SeCo) designed as a forum with market stakeholders in order to facilitate the further integration of financial markets in Europe and to oversee FMIs operating in the euro area.

On T+1, EU policy makers should pursue a tangible cost/benefit analysis markets before any considerations are made.

But some important pieces of the regulatory agenda are still missing (SRD II and WHT)

The second shareholder rights directive imposes a minimum standard to further facilitate the exercise of shareholder rights, particularly in a cross-border context, and encourages long-term shareholder engagement. Some weaknesses have been identified and ESMA as well as the EBA recently published a report on its implementation and effectiveness.

Paving the way to a review of the directive, the European supervisory authorities made some recommendations such as: considering a regulation rather than a directive; explore the possibility of

introducing an EU-wide harmonized definition of shareholder; and improve the harmonization of the documentation required for the entitlement of shareholders to exercise their rights.

Complementing the review of SRD II, a directive on withholding tax is currently considered by the European Commission. A consultation has been launched to gather feedback on tax barriers that have been identified for decades. Developing a harmonized quick refund withholding tax process that would rely on custodians and issuer's paying agents should deliver significant value for investors and tax authorities.

Too many initiatives on the digital assets front?

The EU is moving in the right direction with a digital finance strategy that includes new regulations like the markets in crypto-assets regulation (MICA), the DLT pilot regime and the digital operational resilience act (DORA). One of the main objectives is to protect consumers against some of the risks associated with the investment in digital assets. Custody services and the segregation of client assets are a key element of these provisions.

On this specific topic of custody, draft recommendations made at international level may not perfectly fit with the EU framework. Policy recommendations by IOSCO or the digital asset and private law principles of UNIDROIT are some examples. The IOSCO principles, which have been defined without a proper impact analysis and which do not contain a precise definition of digital assets, introduce a new definition of control used for custody services that is likely to trigger multiple inconsistencies in the EU context.

Other challenges are still ahead of us notably through recent proposals on open data and digital euro.

T+1 is a major trend, but some jurisdictions are not ready

T+1 is an opportunity for increased standardization, harmonization of practices and potential reduction of margin costs.

Nonetheless, there are benefits of remaining at T+2 and the US move does not necessarily force the EU to follow the same path. Such a change would carry important transition costs in front of limited benefits.

EU policy makers should pursue a tangible cost/benefit analysis taking into account the full extent of the legal, structural and organizational differences between US and EU markets before any considerations are made.



ILSE PEETERS

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How to reconcile the “old” and the “new” post-trading focus to benefit the CMU?

EU securities post-trading is confronted with numerous challenges, some of which are known for many years, even decades; other topics are relatively new. Yet, defining the better way to reconcile or even combine the “old” and the “new” is a challenge for all players in this ecosystem, ranging from securities issuers, investors, intermediaries, to Financial Market Infrastructures (FMIs) such as CCPs and CSDs. While both “old” and “new” are extremely important, they are competing for priority and resources across the ecosystem. And the overall outcome is important as it will be one of the key success factors for achieving the objectives of the Capital Markets Union and the EU Open Strategic Autonomy.

The “old” focus points on EU post trade are well-known:

First and foremost, the importance of ensuring business and operational resilience has always been the Number One focus and one on which CSDs have greatly delivered as demonstrated over recent crisis periods. The implementation of the Digital Operational Resilience Act (DORA) is

a further step in ensuring resilience of the financial ecosystem.

Secondly, a lot has been written and said since the publication of the Giovannini reports more than 20 years ago regarding the EU securities post-trade landscape and the need to better support cross-border investments. More recently, the CSDR REFIT is helpfully cutting some red tape and providing a more suitable approach to the mandatory buy-in. It also includes the clear objective to increase settlement efficiency. The recent European Commission’s proposal FASTER (for better withholding tax procedures) is a very welcome initiative for which we hope the Council will take swift decisions, as action in this domain is urgent and timely. A common digital certificate of residence, a harmonised Relief at Source and Quick Refund procedure, and a single standardised reporting format are good steps to unlock new flows of cross-border activities, while reducing the risk of tax malpractices.

The “new” focus points relate to the digitalisation and shortening of the settlement cycle:

On digitalisation, the DLT Pilot Regime and the related discussions on the cash leg for securities settlement have drawn most attention.

With the DLT Pilot Regime, the EU wants to position itself as a key player in the development of DLT. While this initiative will bring necessary learnings, it may not be sufficient to make the adoption of DLT a success. DLT, like any technology, will not solve the existing barriers to further integration post-trade service, nor has the technology sufficiently proven to be resilient for large scale operations. DLT will need to meet the expectations of the “old” focus mentioned above to be considered as a license to operate. One of the key questions is also the need for and availability of a wholesale CBDC (wCBDC) for the settlement of the cash leg in a DLT environment.

After gauging the market’s interest in 2022, the ECB announced the launch of an exploratory phase for the development of a wCBDC in April. Within this frame, a new market contact group, that includes Euroclear, has been set up. The first trials and experiments of this task force are expected to start already in the first half of 2024. It is interesting to note that the market DLT platforms can be licensed under the DLT Pilot Regime or under the full legislative framework. With this, the ECB acknowledges that CSDR can be considered as technology

neutral and allows the use of DLT for the provision of core CSD services.

The discussion about shortening the settlement cycle (often referred to as T+1) in the EU is a new and important focus point, especially after the decision in the US and Canada to accelerate the settlement cycle to T+1 in May 2024. With CSDR Refit, ESMA will be tasked to draft a report on shortening the settlement cycle in the EU by the end of 2024. As neutral FMIs, CSDs will participate in the discussions on the opportunity to move forward with such change of settlement cycle.

The “new” focus points relate to the digitalisation and shortening of the settlement cycle.

We should ask ourselves if the introduction of new technologies such as DLT is a pre-requisite for shortening the settlement cycle or if it is better to adapt the legacy ecosystem. This unanswered question is fundamental, and we hope that the upcoming report by ESMA will contain the necessary elements to make a sound cost-benefit analysis and subsequent recommendation to the EU Commission.

A continuous dialogue between the EU post trade ecosystem players and public authorities is necessary to determine how the industry can evolve to combine the “old” and “new” focus to the benefit of the EU capital markets.



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Towards an EU T+1? Opportunities for post-trade automation and standardization

To date, Capital Markets Union (CMU) initiatives have focused on reinforcing the EU's global competitiveness and strategic autonomy, rather than efforts around harmonization and efficiency in the post-trade space. However, with the forthcoming implementation of T+1 in the U.S. in May 2024, a discussion around Europe's market infrastructure and settlement efficiency could be thrust into the spotlight.

The main driver behind the implementation of T+1 in the U.S. has been the benefits that accelerated settlement and increased settlement efficiency will deliver, including reduced risk, lowered clearing fund requirements, improved capital, and liquidity utilization, and increased operational efficiency. These drivers have become even more significant given the increased focus on settlement risk and margin usage during the 2020 and 2021 market volatility events.

Importantly, to achieve the intended industry-wide benefits of a move to T+1, there is a need to evaluate and potentially increase automation in trade processes which take place prior to settlement, therefore reducing operational risk and improving operational efficiency – all wins for firms.

When considering settlement efficiency across the EU, it is likely that the region could also benefit from increased levels of standardization and automation of post-trade processes and messaging. In fact, ECB T2S data shows a 1% decline in trade settlement rates year-on-year from 2019 to 2022 which could suggest that T2S may not be achieving the efficiencies that were intended through the initiative.

The good news is that automated post-trade solutions that enable timely settlement are already available. One example is central trade matching, a best practice which provides automation and standardization within the trade allocation, confirmation, and matching process. By successfully completing these processes on trade date, also known as Same Day Affirmation (SDA) in the U.S., matched and agreed transactions can be moved to settlement in time to meet T+1 timeframes. Central matching also allows identifiers to be generated and included in post-trade messaging, such as a unique transaction identifier (UTI), which are critical in traceability and transparency of transactions.

The EU could benefit from increased levels of standardization and automation of post-trade processes.

Another example is accurate settlement instructions, a key driver to reducing fails and increasing settlement finality. Accurate standing settlement instructions (SSIs) guarantee that trade settlements, margin and payments are sent to the correct accounts. And, because SSIs can change frequently and securities can settle different locations, automation and strong controls in this area ensures that account instructions are up-to-date and accurate, which facilitates timely confirmations and therefore a higher chance of timely settlement. As a best practice, SSIs should be stored in a controlled fashion, within a single repository in which all participants have access to, decreasing the reliance on multiple internal data stores.

Finally, a move to a 1-day settlement cycle provides the opportunity to implement data initiatives that have benefitted derivatives markets. The use of UTIs and the electronification of post-trade workflows from trade capture to settlement can help eliminate manual processes that contribute to trade failure as well as improve overall market inefficiencies. T+1 ultimately provides the opportunity to create and drive efficiencies for securities markets.

There is no doubt that the industry is rapidly evolving, with new technologies, new assets, and a move towards T+1 gaining momentum each day. Against this backdrop, the EU has an opportunity to capitalize on market developments in other jurisdictions which could enable increased competitiveness in market infrastructure while delivering many enhanced benefits for the industry.

Post-trade automation and standardization can be the enabler of this, increasing efficiencies and control, while decreasing the potential for settlement fails. Although undoubtedly complex in the changes it would require, the benefits of an accelerated settlement cycle in the EU are tangible and would deliver great benefits.

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FINANCIAL STABILITY RISKS IN EUROPE



FERNANDO RESTOY

Chair - Financial Stability Institute (FSI)

Recent bank failures, deposit stability and the role of supervision

Over the years, an evolving policy framework composed of partial deposit insurance coverage, a prudential regulatory and supervisory regime and a banks' failure management system have been used to contain the risks associated to destabilising bank runs. Recent bank failures may point to a structurally less stable banks' deposit base as a consequence of technological developments. That might eventually justify the consideration of some reforms on different aspects of the policy framework aiming at further protecting financial stability. Those reforms should in any case be grounded on compelling evidence and, crucially, on a rigorous cost-benefit analysis.

For the time being, though, those episodes already constitute a good case for speeding up a full implementation of the Basel standards in all jurisdictions. Moreover, they support the need to put in place or further develop pragmatic bank failure management regimes -such as the one contained on EC's CMDI proposal - that sufficiently acknowledge the need to provide non-insured deposits with a sensible degree of protection when banks fail.

But, even more importantly, supervision should be further strengthened to address the root causes of bank failures. Indeed, while the case for radical regulatory reforms still remains quite uncertain, there are already clear arguments for reviewing supervisory practices and seeking ways to strengthen them. For example, the materialisation of interest rate risks triggered several bank failures. But banks' vulnerabilities unveiled by those failures went beyond specific exposures or funding sources. This included excessively risky balance sheet structure, deficient risk management and unsound growth strategies. In other words, the root cause of the weaknesses of failing banks was a flawed business model and poor governance.

Of course, the large amount of non-insured deposits accelerated the failure, but this was not the main vulnerability of the failing banks. Put differently, the assumption that non-insured deposits are now less stable than in the past should primarily lead to the conclusion that more and earlier policy action is needed to promote sustainable business models and sound governance practices.

Importantly, the ability of standard prudential rules to address this type of weakness is limited. There is simply no feasible amount of capital and liquidity requirements than can compensate for banks with poor governance or

business models. To the contrary, an attempt by authorities to compensate for a bank's structural deficiencies with more capital and liquidity could well exacerbate problems and further undermine the viability of the institution.

Actually, the prompt identification and correction of those deficiencies is the core business of supervision. The European banking union is a good example of a jurisdiction which has developed a well-structured supervisory review and evaluation process (the SREP) which supports the application of Basel's pillar 2. In particular, unlike other jurisdictions, together with capital and liquidity adequacy, the ECB's SREP evaluates the governance and business model sustainability of all banks under its remit. On the basis of that evaluation, it regularly conveys recommendations or requirements to banks in order for them to address their weak points. In a recent report commissioned by the ECB, a group of experts have praised this structure, although we have also recommended that the approaches followed when deploying qualitative measures be further improved by refining their formulation, prioritisation, and monitoring.¹

Before considering far-reaching regulatory reforms, give supervision a chance.

More broadly, supervision can become more effective with a more forward-looking and intrusive approach. Authorities should have the means, powers and culture to challenge more forcefully banks' business plans, internal organisations and decision-making processes without, obviously, alleviating any management responsibility. Before we even think of introducing far-reaching changes in prudential rules or in the scope for deposit guarantees, we should first give supervision another chance.

1. Dahlgren S, R Himino, F Restoy and C Rogers (2023). "Independent Expert Group Report on the SREP", ECB, April.



YANNIS STOURNARAS

Governor - Bank of Greece

Cutting the Gordian Knot: financial stability in turbulent times

Issues around financial stability and the interplay with monetary policy came into the spotlight, following the recent banking turmoil. In fact, many analysts claim that today authorities are facing a new economic trilemma, as we cannot achieve price stability, maintain economic growth, and have financial stability at the same time.

Over the past few years, we experienced several fat-tail events or adverse shocks, such as the pandemic, the Russian invasion of Ukraine, the energy crisis, the turmoil in the UK Gilt market and in the US banking sector. The EU banking system managed to weather all these adverse events on the back of solid financial fundamentals that were gradually built up after the Global Financial Crisis.

At the same time, EU banks do not share the vulnerabilities of some failed US banks. These cases were rather idiosyncratic and related to significant weaknesses in the risk management (especially regarding interest rate and liquidity risks) as well as the inadequate internal control systems of these banks, which were exposed by the tightening of the monetary policy.

Nevertheless, risks to financial stability have been rising over the past few months due to uncertain macroeconomic outlook amid high geopolitical risks, the sharp increase in interest rates and the persistently high inflation which could amplify pre-existing vulnerabilities in the financial sector. Strains on balance sheet of non-financial corporates and households could impair asset quality of EU lenders. Prospects for banks could also deteriorate, as the reassessment of economic growth prospects alongside with rising interest rates will probably weigh negatively on the demand for new loans, the cost of funding and the implementation of banks' business plans. Risks stemming from exposures in the non-bank financial sector (NBFI) and the CRE market could also materialize.

Finally, other cross-cutting risks such as the climate change risk and the risks stemming from cyber-attacks have recently gained importance.

The recent episodes in the US banking sector, was a powerful reminder that a crisis can unravel very fast upon the loss of market and depositors' confidence. Therefore, there is no room for complacency. So how will policy makers ensure the preservation of financial stability amid tightening monetary policy? Some high-level proposals could include a) the improvement of the regulatory framework for the non-bank financial sector, b) the use of macroprudential policy with the aim to increase resilience in the system, c) the implementation of top-quality supervisory standards, leveraging on the lessons learnt from the recent turmoil, and d) the improvement of our crisis management framework and the completion of the Banking Union.

There is an Ancient Greek legend associated with Alexander the Great in Gordium of Phrygia, regarding a complex knot that tied an oxcart. Reputedly, whoever could untie it would be destined to rule all of Asia. In 333 BC Alexander was challenged to untie the knot. Instead of untangling it laboriously as expected, he dramatically cut through it with his sword^[1]. Today, policy makers do face an equivalent challenge in the form of the 'new economic trilemma'. However, we know that authorities cannot address such a trilemma with one tool alone, like Alexander the Great did with his sword; instead, there is a role to play for all stakeholders, i.e., monetary (and fiscal) authorities, as well as banking supervisors and macroprudential authorities.

Financial stability in turbulent times: what are the implications for policy makers.

Even though the monetary policy and financial stability tools are used on a standalone basis to address different purposes, they both have an impact on the economy and the economic agents and are interconnected. Therefore, monetary authorities should continue to pursue their goal and take well-informed decisions to address the inflation problem while supervisory authorities (and banks' management) should ensure the resilience of the financial sector. At the same time, we should follow Alexander's example and take bold and decisive actions to address the structural challenges we are currently facing. In the euro-area, on top of our list with actions should be the completion of the Banking Union and the further integration within our fragmented banking sector.

The completion of the Banking Union will remove for good the bank-sovereign nexus and shield the European banking sector from many external and domestic shocks.

1. https://en.wikipedia.org/wiki/Gordian_Knot



ANDY BLOCKER

Global Public Policy - Invesco

The framework for liquidity risk management in OEFs must be robust yet flexible

Over the last few years, there has been a flurry of activity from policymakers globally seeking to map and address potential risks stemming from the so-called ‘non-bank’ sector and, though some of the debate has suffered from a lack of precision regarding the scope of the sector and, as a result, evidence of globally systemic risks that may materialise therein, the progress which has been made by the FSB and IOSCO in publishing their respective recommendations on liquidity risk management (LRM) in OEFs should be acknowledged.

It is also important to acknowledge the principles on which the recommendations are made including ensuring that the dealing profile of a fund reflects the liquidity profile of the underlying assets; that the cost of liquidity is borne by subscribing or redeeming investors; that existing or remaining investors in the fund are protected from material dilution; and that disclosures appropriately inform investors about liquidity risks and the framework in place to protect them.

It is critical that the broad principles-based framework for LRM in OEFs, while robust, is sufficiently flexible so as to be reflective of the practical realities of managing such funds in different jurisdictions. Indeed, it must be able to accommodate diverse market practices, operating, distribution, and dealing models. As an example, this means that while swing pricing might be relevant for Europe, it is not appropriate for the U.S. given inherent differences in both markets. In this regard, we welcome the recommendation that local regulators make a broad LRM toolkit available for use by asset managers as most appropriate for their respective markets.

This need for flexibility reflects authorities’ shared belief with industry that there is no “one-size-fits-all” approach to LRM, and that asset managers are best placed to manage liquidity within their portfolios in the best interests of their investors. In its proposal related to liquidity bucketing, the FSB, in our view, risks undermining this key policymaking tenet by being overly prescriptive in seeking to ascribe particular dealing structures to specific asset classes based on their perceived liquidity which, as we know, is dynamic and reflective of market conditions. The calibration of such a policy, if pursued, should not preclude end-investors from accessing investment opportunities in specific assets classes deemed ‘less liquid’ via OEFs where appropriate LRM mechanisms are in place.

This, of course, relies on effective governance and oversight from fund boards and other relevant governing bodies tasked with implementing and overseeing OEFs’ LRM activities, as well as disclosing to investors the protections they are afforded by the LRM framework.

While governance and disclosure are well covered in the recommendations, it is unfortunate that, in the case of

authorised OEFs, neither authority sufficiently takes account of the work undertaken by asset managers in relation to a fund’s LRM framework leading up to and at the point of authorisation which involves agreeing with their local regulator the appropriateness of a proposed fund structure, the investment and distribution strategies to be pursued, and the LRM framework to be implemented. Indeed, liquidity risk analysis also forms part of managers’ fundamental investment processes, and this should at least be acknowledged as part of an OEF’s broader LRM activities.

Additionally, it is vital that policymakers give due consideration to practical barriers to the implementation of certain LRM tools, and we welcome IOSCO’s attempt to provide solutions to issues relating to the reliability of market data, and the role of third parties in operationalising such tools. Overcoming such barriers will be key to enhancing OEFs’ already well-developed investor protection and LRM frameworks.

The framework must accommodate diverse market practices, operating, distribution, and dealing models.

Finally, authorities must better address the cost of their recommendations, to local regulators, firms, and end-investors, by undertaking robust cost benefit and impact analyses. OEFs, and non-bank financial products more broadly, are critical to wealth creation. They are highly regulated and transparent, and policymakers must acknowledge that it is neither prudent nor feasible to seek to regulate risk out of the market entirely, unless the policy objective is to see end-investors’ opportunities diminish.

Our role as an asset manager is, first and foremost, as a fiduciary to our clients, but it is incumbent on all stakeholders, including policymakers and regulators, to ensure that the regulatory and supervisory environment in which we operate is robust but also conducive to creating value for investors.

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Sustainable Finance

Sustainability risk
Sustainability disclosure challenges



Digitalisation and payments

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Artificial intelligence (AI) Act
Digital Operational and Cyber-Resilience
Cryptoassets
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Economic and stability challenges

Covid crisis: impacts and responses
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Payments and AML

Payments and AML

CLIMATE AND ENVIRONMENTAL RISKS IN THE BANKING SECTOR



JOSE MANUEL CAMPA

Chairperson - European Banking Authority (EBA)

Environmental risks and the role of banking regulation

The banking sector has a key role to play, both in terms of allocating capital to support the transition and managing financial risks stemming from environmental factors. Only a robust banking sector can effectively fund the transition. Hence, banks must keep taking steps to manage environmental risks.

On the bright side, climate related impacts are now better understood and acknowledged. Governance and internal control frameworks have progressed substantially, while risk management practices are evolving in the right direction. Collecting granular and reliable data remains a challenge. However, some banks are proactively addressing it by relying on targeted questionnaires to their clients or engaging with external data providers.

Banks however need to continue to strengthen their organisational, risk management and quantitative capabilities in the ESG area. Examples include ICAAP, scenario analysis, risk

metrics and indicators. Furthermore, current practices suggest uneven progress on the incorporation of environmental drivers of risk types other than credit. Consideration of nature related physical risks and biodiversity impact remains limited.

For climate stress testing, past initiatives by both banks and supervisory authorities provide useful guidance for next steps.

It is clear that critical challenges lie ahead. These include how to overcome the limited data availability as well as methodological limitations. This was clearly reflected in the results of the May 2021 EBA pilot exercise on climate risks. Moreover, there is a need to develop more comprehensive and forward-looking models and scenarios, covering all specific transmission channels, as well as the potential compounding of risks. This was one of the key findings of the 2022 SSM climate risk stress test.

I have no doubt that equally important insights will be derived from the forthcoming One-off Fit-for-55 climate risk scenario analysis which is being conducted by the EBA in collaboration with ESMA, EIOPA as well as the ECB and ESRB. ¹ The value added of this analysis is its cross-sectoral and system-wide nature, as opposed to standard solvency stress tests which focus on specific sectors only. The primary aim will be to assess the resilience of the financial sector in line with the Fit-for-55 package, while gaining insights into the capacity of the financial system to support the transition even under stressed conditions. We will investigate how stress propagates through the financial system and how financial institutions' reactions might magnify it. The exercise will be launched by the end of 2023, with results to be published by Q1 2025.

Looking further ahead, I am also convinced that there is a need for regular climate stress tests. These can be expected to strengthen the collective capacity of both banks and supervisors in this field.

The incorporation of environmental risks in the regulatory framework remains a challenge. In response, EBA published its new roadmap on sustainable finance in December 2022, covering all three pillars of the banking framework and outlining key objectives

and timeline for delivering on our mandates in sustainable finance.

In 2023 banks began disclosing quantitative and qualitative information following the requirements in the EBA Pillar 3 package. This will surely contribute to the availability of ESG data – the quality of which is expected to progressively increase – for the benefit of all market participants.

Going forward, we expect banks to continue to strengthen their risk management systems to better identify, manage and report ESG risks. The EBA has initiated work to update several EBA Guidelines to include ESG risks. The guidelines include those on loan origination, internal governance, remuneration and the SREP. The EBA CRD6 mandate on ESG risk management guidelines will allow us to set requirements as to how institutions should account for ESG risks. This includes aspects such as risk appetite, internal controls, ICAAP, management of different financial risk types as well as requirements on transition plans.

Banks have a unique position to finance the transition to a more sustainable European economy.

Finally, when it comes to Pillar 1, our approach will remain grounded on risk-based considerations, aiming at accelerating the integration of E&S risks across the Pillar 1 framework, while preserving its integrity and purpose. Our Pillar 1 report set for publication later this year will lay the foundations for further reports to come in line with CRR3 mandates and propose targeted enhancements to the Pillar 1 framework, which – together with initiatives under Pillar 2 and Pillar 3 – will contribute to better incorporating ESG risks across the framework.

I look forward to working together with all stakeholders to meet this important societal challenge.



MERCEDES OLANO LIBRAN

Director General - Banco de España

Current state of the climate risks in the banking sector

Banks, regulators and supervisors have worked hard in recent years to ensure that climate risks are adequately integrated into banks' strategies, business models, corporate governance, risk management and disclosure of their exposures.

We know that identifying, measuring and managing climate risks continue to pose major challenges and difficulties for banks, including:

- The difficulty in obtaining data of sufficient quality, and the problems in interpreting these data from a financial standpoint.
- The forward-looking nature of these risks makes it very difficult for banks to include them in their risk management frameworks, that consider the medium term with a time horizon of 3 years, whereas these risks need to be managed over a much longer time horizon, 10 - 20 years.
- When developing and reviewing transition plans, banks have to base themselves on their counterparties' transition plans which, are not yet very developed

In terms of regulatory developments, we have seen the following progress:

- Work continued on progressively incorporating ESG matters into the

prudential regulations, both in the CRR and in the CRD.

- The CSRD was approved in November, and tries to gradually align sustainability reporting with financial reporting. Once implemented, it is expected to help banks gather data on the ESG aspects of their counterparties.
- The EBA has published its roadmap, which includes numerous climate risk-related aspects, focused on the progressive incorporation of ESG risk into the three pillars of prudential regulations (regulation, supervision and disclosure).
- The Basel Committee has incorporated climate risks into its work programme, taking a holistic approach.

From the supervisory standpoint, the activities that have been carried out over the last year were:

- Climate risk stress test, which main conclusions were:
 1. General improvement in the quality of the climate-risk related data available to banks, but around 60% of them do not have robust climate risk stress-testing frameworks, nor have sufficient data available in this respect.
 2. The importance of ensuring an orderly transition, as the losses under such a scenario would be significantly lower than those that banks would have if action were delayed.
 3. Most banks do not include climate risk in their credit risk models, and just 20% consider climate risk as a variable when granting loans.
 4. Almost two-thirds of banks' income from non-financial corporate customers stems from greenhouse gas-intensive industries, and is also concentrated in a small number of large counterparties, which increases their exposure to transition risks.
 5. In the part of the test assessing the projections of losses in extreme weather events (floods and droughts / heatwaves) and under transition scenarios with different time horizons, the results highlight the heterogeneity of the impacts across European banks, and that these impacts are highly dependent on the sectors and the geographical location of their exposures.

- Thematic review on climate-related risks

This review sought to gain a clear picture of where banks stood in terms of complying with the supervisory expectations.

The most important findings were:

1. There is greater recognition of the importance of physical and

transition risks for banks, with over 80% concluding that such risks have a material impact on their risk profile and strategy, and 70% considering that the risk is material within their business planning.

2. Progress has been made in terms of the institutional architecture for addressing climate risks. More than 85% of the banks have basic practices in most of the areas covered by the ECB's expectations. Nonetheless, significant shortcomings remain, and around 10% of banks are lagging behind, without having made any material progress over the last year.
3. While some banks have started using transition planning tools to improve the long-term resilience of their business models, a "wait-and-see" approach still prevails.
4. Less than 10% of the banks use granular, forward-looking information to manage climate risks.
5. It is also essential that the banks work to improve their capacity to execute their own plans and processes. 55% of the institutions have devised practices but failed to implement them effectively.

In short, this review shows that banks are not yet properly managing climate risks and that, although improvements and some good practices have been identified, there is much still to be done.

Banks, regulators and supervisors have worked hard to ensure that climate risks are integrated.

I would like to finish by noting that, while we are aware of the current difficulties in prudently managing the climate risks, we believe that we must continue working hard to overcome these obstacles.

With this in mind, the commitment and awareness of all parties – regulators supervisors and financial institutions – is essential to ensure that the organisations have in place the necessary human and technological resources to gradually integrate climate risks into their strategies, business models, corporate governance, risk management and reporting.



NATHALIE AUFAUVRE

Secretary General -
Autorité de Contrôle Prudentiel
et de Résolution (ACPR)

Measure, foresee, act: a supervisor's perspective on climate stress-tests

Environmental, social and governance (ESG) factors can affect banks' credit, market, operational and reputational risks, and can cause a general increase of the risk in the system if the policies to transition to a greener economy are delayed or insufficient. This could lead to sudden and large shocks on asset prices and financing conditions, negatively affecting the solvency and liquidity of financial institutions, triggering contagion and systemic instability, as well as social and political unrest.

We recently observed a growing awareness and demand from stakeholders for banks to integrate sustainability risks into their strategies and governance, risk management and disclosures. It coincides with the recognition of the urgency and magnitude of the global challenges posed by climate change, biodiversity losses, social inequalities and human rights violations. However, we are still facing a lack of harmonized and consistent standards, methodologies and data for measuring and mitigating sustainability risks.

Despite these difficulties, European banks have been developing their own

sustainability strategies, aligned with their business models, risk appetites and stakeholder expectations. They also enhanced their sustainability reporting and disclosure practices. Finally, they engaged with their clients and counterparties to assess their sustainability risks and opportunities and provide them with sustainable finance solutions.

Among the tools that banks and supervisors may use, climate stress testing is a relatively new and evolving practice. The unique and complex features of climate risks, with their potential tipping points and non-linearities, represent a major challenge in terms of accurately capturing their impact on the financial system. However, climate stress testing exercises (such as those conducted by the ACPR in 2021, the BoE in 2022 or the ECB in 2022) have provided valuable insights for financial stability analysis and policy making. Supervisors have concluded on the benefit of adopting a forward-looking perspective for assessing the potential effects of climate change on the financial system.

Vintage after vintage, significant progress has been made in the definition of scenarios and climate stress testing methodologies. Scenarios are now more granular, consistent and cover different drivers of climate change risk (such as temperature increase, carbon price, policy actions, technological innovation) and different time horizons. Methodologies and models have improved to estimate the direct and indirect impacts of climate change on the financial system, taking into account both physical and transition risks, as well as their interdependencies and spillovers. The scope and coverage of climate stress testing has expanded to include different types of financial institutions, different sectors and regions, different asset classes and different transmission channels.

Regarding data availability and comparability, disclosures related to sustainability risks are the focus of an ambitious work plan at international and European level. Indeed, the Basel Committee plans to issue a consultation paper on the Pillar 3 disclosure framework for climate-related financial risks by the end of 2023. The European Union is one step ahead with the setting up of a progressive approach. As of 2023, large and listed European banks are required to publish quantitative and qualitative information regarding their exposures to ESG risks as part of their Pillar 3 reports. While this first exercise emphasizes the challenges related to data collection and harmonized methodologies, it mobilizes and

channels the European banking sector's efforts towards the net-zero transition.

Works on integrating ESG risks into banks' risk management but also into regulatory framework and supervisory practices have grown exponentially in the last couple of years. The above-mentioned data, conceptual and methodological hurdles have so far hindered well grounded pillar 1 treatment proposals for ESG risks, but this may change in the future. Meanwhile, current supervisors' efforts focus on ensuring a proper capture of ESG risks under pillar 2. In particular, transition plans will become a key element of the supervisor's toolkit and need to be operationalized at short term, keeping in mind they should be considered along with other supervisory tools, such as ICAAP. Further, they also raise a number of issues such as the need to ensure their credibility and that of banks' counterparties own transitions.

**Significant progress
has been made in
the definition of
scenarios and climate
stress testing.**

I have good faith that difficulties will be overcome without affecting transition financing. Regulators and supervisors are fully committed, and Basel Committee has a very ambitious roadmap in this respect.

I also know that banks do progress in a timely fashion.

So let's keep the momentum.



HIROYOSHI KOIZUMI

General Manager of
Sustainability Risk Management
Office - Mizuho Financial Group,
Inc. / Mizuho Bank, Ltd.

Client transition supports enhanced by stronger climate-related risk management

As decarbonisation efforts have accelerated throughout the world in the recent years, financial institutions are increasingly expected to contribute to the transitions of the real economy, in other words, to support the clients to develop and implement transition plans through engagement, and to provide financial support for this purpose.

While this trend creates business opportunities for financial institutions, this also requires enhancement of risk management systems that could accurately capture social and economic changes related to climate change. In climate-related risk management, material risks need to be identified, monitored and managed. Mizuho has established the following process.

In order to identify material risks, we first identify the financial and operational risks posed by climate change, assuming various channels of transmission for each risk category, such as credit, market, and liquidity. Then, we examine the

events that could be anticipated in the short and medium to long time horizons for transition risk and both acute and chronic physical risks. The materiality of each risk is assessed qualitatively from two perspectives: impact and controllability. Credit risk is identified as the most significant in this process, and thus assessed by sector as well.

With regard to risk monitoring and management, based on the results of the qualitative sector assessment described above, a framework for “Risk Control in Carbon-Related Sectors” was introduced in 2021. This framework will identify and control risk in high risk areas among sectors recognized as facing transition risk at particularly high levels (Electric power, coal, oil and gas, steel and cement sectors, as of July 2023).

These high-risk areas are identified by evaluating risk along two axes:

1. our clients’ sectors based on the largest component in the sales/energy mix of their business activities, and
2. our clients’ measures to address transition risk. Their responses to transition risks are based on their formulation of transition strategies and targets, level of their targets, and the progress on their strategy.

Additionally, we engage our clients and work with them for shifting their business structure to lower carbon-related risk areas and sectors, and for promoting their response to transition risks. Through this process, we monitor the progress of transitions in order to control risks that may emerge in the future.

**Mizuho’s robust
climate-related risk
management provides
powerful support for
client transitions.**

As large investments are required when our clients are proceeding with transitions, it is essential for financial institutions to provide financial support. Mizuho has established a process to confirm the reliability and transparency of clients’ transition strategies in accordance with several criteria such as the Climate Transition Finance Handbook of the International Capital Markets Association. Mizuho is actively providing financial support to the clients who have transition strategies in line with those criteria. Support for the transition could lead to a temporary

increase in Financed Emissions for financial institutions, and we recognise the importance of establishing such process especially when we try to explain our efforts to respond to climate change to our stakeholders.

As mentioned above, Mizuho has gradually developed a system to identify, monitor and manage climate-related risks. Quantitative risk analysis is important for more advanced risk management, and scenario analysis is effective for this purpose. Mizuho has been working on this for seven industries (Electricity utilities, oil and gas, coal, steel, automotive, shipping, aviation) to grasp the quantitative impact.

On the other hand, scenario analysis methods are still developing and are currently not accurate enough to be used directly for risk management. One of the keys to sophistication is to improve the analytical methods by selecting or creating better scenarios to use, and by improving financial analysis models. Such improvements are supported by a deep understanding of the business, industrial structure, and transition plans of our clients, which could be obtained through our engagement with clients. Then, we believe we will be able to obtain analytical results that are in line with real economy and can be utilized for risk management in the future.

It is important for financial institutions to develop the ability to appropriately manage climate-related risks not only from the perspective of protecting their own management but also from the perspective of strategic risk-taking to provide financial support to enhance the transition of their clients.

Mizuho aims to maintain management stability that can withstand environmental changes such as stricter financial regulations in the future through advanced climate-related risk management, while supporting the transition of our clients and becoming a partner that can continue to share risks over the medium to long term.



BERTRAND LUSSIGNY

Deputy Secretary General -
La Banque Postale

Challenges for proper assessment of climate risk measurement and management

Once the question of defining climate risks achieves a general consensus (around physical, transition and reputational risks, which add aggravating factor to existing risks), the debates now focus on the two other pillars of sound risk management, namely the measurement of these risks and the means to manage them within the framework of risk appetite and robust governance.

Beyond the primary responsibility of bank management, it is important to highlight the essential contribution of regulation, particularly in risk measurement. However, historically, this regulation has always emerged in response to past crises, from the creation of the Basel Concordat in 1975 to Basel III. It is clear that the financial materialisation of climate risks in bank balance sheets, still extremely limited, does not allow for empirical evidence of ex-post risk differentials or the use of usual back-testing methods to feed prospective risk metrics.

What are the lessons learned from the former stress testings (EU, NGFS, ...) and related feedbacks?

The Stress Test exercise conducted by the ECB in 2021 is quite illustrative of the imperfection of tools and the still very exploratory nature of certain methods. Unfortunately, ultimately, it proved difficult to produce detailed and insightful analyses because:

- Different institutions used highly divergent methodologies, in terms of balance sheet projection and risk calculation, both for physical and transition risks, with approaches varying from granular to aggregated and with different assumptions (notably on the use of carbon prices)...
- The very long-time horizons required in these exercises lead to dysfunctions in traditional models.
- There was a lack of consideration for business impacts (revenues, commissions, and expenses).
- The difficulty in obtaining high-quality and available data to produce relevant results.

These feedbacks demonstrate that, as it stands, relying on a single tool like stress tests for evaluating sound climate risk management would not be appropriate. Similarly, recent political discussions in the European Parliament regarding bank transition plans show the lack of common definition and objectives, reflecting different and sometimes divergent uses of the subject in prudential contexts.

Alignment of stress test results, transition plan, commercial offers and governance is fundamental.

What are the main challenges posed by the incorporation of sustainability factors in the evaluation of bank climate risk exposure and proper risk mitigation?

At the time of the operational implementation of the climate topic, while seeking to integrate it as much as possible into existing frameworks, and beyond the constraints that force banks to make considerable investments in adapting their processes and desiring to do so with the right reference directly, the question arises about the relevance of evaluating their exposure to risk and their capacity to manage it. In line with the latest stock-take of the NGFS, we believe that this risk assessment and understanding of the capacity to manage it involves aligning the results of the

stress tests, transition plans, business offerings, and banks' governance.

In that respect, La Banque Postale became in 2021 the first European bank and one of the first financial institutions in the world to have decarbonization trajectories validated by the SBTi. Besides, as a mission-led company since 2022 committed to a just transition, we are also strongly committed to phase out fossil fuels (coal, oil and gas) by 2030. We are progressively integrating climate risk into our credit granting and provisioning policies, our stress tests in the ICAAP. Simultaneously, we are deploying a range of products and services that will decarbonize our balance sheet and those of our counterparts (e.g., impact real estate loans based on a Global Impact Indicator which will be reviewed by WWF and implemented by the end of 2023, green and social loans for local authorities and companies in addition to green bonds, and the SRI label for 100% of eligible funds managed by our asset manager LBP AM).

This consistent strategy allows us to build an international leadership which is acknowledged in terms of ESG, as evidenced by being ranked the world's top bank in terms of ESG by Moody's and receiving an A rating from CDP, the international reference organization for evaluating corporate climate strategies.

Thus, as raised by the NGFS, we encourage supervisors, in their actions of evaluating the management of climate risk by banking institutions under Pillar 2, to rely on the expertise of the entire ecosystem (credit rating agencies, NGOs, etc.) to allow for the most holistic and realistic evaluation possible while preserving the indispensable idiosyncratic vision required for an orderly transition.



MAYA HENNERKES

Director for Green Financial Systems - European Bank for Reconstruction and Development (EBRD)

Pathways to Paris – How to green the financial system with transition plans

Climate change is one of the greatest challenges facing our generation. The Paris Agreement has committed the world to limit global warming to well below 2°C, ideally 1.5°C above preindustrial levels. The Intergovernmental Panel on Climate Change (IPCC) has demonstrated that to achieve this, global greenhouse gas (GHG) emissions need to reach “net zero” around mid-century – thus necessitating urgent action to reduce them.

More needs to be done. Based on current national commitments we are on track towards warming of 3-4°C – which will bring about major and irreversible climatic changes severely impacting human welfare. We are seeing the adverse impacts already: the summer of 2023 has been marked by extreme heat and rain, with wild fires and floods hitting large parts of the Northern hemisphere. Is this the new normal? Meanwhile, global emissions are still on the rise.

If we are still to limit global warming to tolerable levels, national and private

sector commitments are critical. Companies and financial institutions are increasingly doing so by establishing their own net zero pledges. The financial sector in particular can be an important agent of change and achieve considerable leverage by being green, inclusive and climate friendly.

So how does a bank transform its business and contribute to global net zero efforts? A so-called “transition plan” is emerging as the central tool to do so. Informed by recent work by institutions such as the United Nations, the Network of Central Banks and Supervisors for Greening the Financial System (NGFS), and the Transition Plan Taskforce in the UK, a few critical areas are central for Banks to ensure such plans are robust:

- 1. Emission targets:** Banks need to shift their thinking from considering only their own emissions as a company, such as those from its buildings, business travel and personnel commute. Even more importantly, they need to start capturing financed emissions, namely those of the economic activities they are supporting through loans and investments. Once this baseline is established, they can identify realistic but ambitious GHG emission reduction targets, both for their own and their financed emissions. These targets need to be clearly formulated and committed to.
- 2. Climate finance targets:** Financial players have the power to channel their funding towards green and socially sound activities, or transition activities that support the transformation to green. As we have found at EBRD, setting targets to gradually increase such financing can help achieve this. We have committed to dedicating more than 50% of our financing every year to green activities by 2025, and have already reached this target.
- 3. Fossil fuel policies:** Committing to the goals of the Paris Agreement cannot be done without putting a stop to supporting new coal. Other fossil fuel exposures need to be carefully assessed and managed to make sure that they are in line with low carbon pathways.
- 4. Climate corporate governance:** Banks need to build a strong internal governance for climate and other ESG issues. Does the Board have formally assigned responsibilities around climate change? Are sustainability matters mainstreamed into strategy, business development, risk management and other processes? Without a strong “G”, the “E” and the “S” will not succeed.

- 5. Managing impact from own operations:** While the impact of the financed activities is exponentially higher, a financial institution should not neglect what can be achieved in-house, such as lowering electricity consumption and switching to renewable energy sources, sustainable buildings management, and reviewing travel and procurement policies.

As the financial sector collectively acquires the “art of transition planning”, a number of areas require our focus. Firstly, there is a need for further harmonization around the form and substance of the transition plan. With both the recently published international reporting standard ISSB and emerging EU legislation referencing transition plans, agreement is needed around what makes a transition plan credible and good.

The financial sector in particular can be an important agent of change and achieve considerable leverage by being green, inclusive and climate friendly.

Secondly, it is important to fend off “paper decarbonization” – decarbonizing one’s portfolio without actually reducing emissions in the atmosphere. There is a risk that some of the net zero target setting may lead to this. Thirdly, emerging market private sector players need support. If they cannot provide the data expected of those bound by emerging EU legislation, or they cannot demonstrate credible plans at the entity level, they risk losing access to foreign direct investment.

Collaborating with investors like EBRD can help. As a fully Paris-aligned institution, the EBRD not only scrutinizes all of its financing to ensure it is consistent with the low carbon pathway, it also actively supports partner financial institutions with transition planning, helping them to become the sustainable forces needed to transform our existing economic systems.

CLIMATE AND ENVIRONMENTAL RISKS IN THE INSURANCE SECTOR



FAUSTO PARENTE

Executive Director - European Insurance and Occupational Pensions Authority (EIOPA)

Growing recognition of sustainability risks in the insurance and IORP sectors

Sustainability risks are increasingly recognized by the European insurance sector, as they can materially affect the business activities of insurance undertakings, for example, through investment losses related to stranded assets or increased insured losses caused by more frequent and extreme weather conditions.

EIOPA's assessments started in 2018 with the EU-wide insurance nat-cat stress test exercise. Besides enhancing its stress test framework on climate change related risks,¹ EIOPA recently published a sensitivity analysis on transition risks² and several studies focusing on physical risks related to climate change.

The expected increase in frequency, severity and correlation of weather-related events will put significant pressure on non-life insurers, particularly regarding property-related lines of

business.³ Consequently, premium levels are expected to increase, thereby exacerbating the already substantial climate insurance protection gap and its potential macro-economic implications.⁴

Climate change adaptation is key to maintaining the future availability and affordability of non-life insurance products that provide coverage against natural catastrophes.⁵ EIOPA's report on impact underwriting shows that while insurance undertakings are making progress in implementing climate-related adaptation measures in their insurance products, the European insurance market overall appears to be at a relatively early stage in this regard.⁶

One of the main challenges for supervisors and the insurance industry to assess and manage sustainability risks relates to the availability of data and loss models. Comprehensive open-source data is needed to improve the accuracy of the risk assessments, in conjunction with open-source models integrating forward-looking climate considerations. In this context, EIOPA developed the "CLIMADA-app", a user interface to facilitate the use of the CLIMADA open-source catastrophe model.⁷ A thematic article published in the June Financial Stability Report discusses the key findings obtained using this tool. If no adaptation or mitigation measures are taken, climate change could significantly increase river flood risk across Europe over the coming decades, with larger losses expected in northern Europe than in southern regions.⁸

The European Commission mandated the ESAs to conduct a one-off climate risk scenario analysis in cooperation with the ECB and the ESRB, aiming to assess the resilience of the EU financial system and its ability to fund the transition towards EU targets on greenhouse gas emissions. The cross-sectoral exercise will be based on end-2022 balance sheet data, and will include two adverse but plausible scenarios that could affect the financial system over the period up to 2030.

EIOPA recently conducted its first climate stress test for the European occupational pensions sector. The results showed a sizeable drop in the value of assets (12.9%) in the context of a disorderly transition scenario, indicating that IORPs have a material exposure to transition risks.

Solvency II, as a forward-looking risk-based framework, can effectively enable insurers

to manage sustainability risks alongside other prudential risks. Many of the existing prudential tools for risk measurement and mitigation can be applied to address sustainability risks as well. For instance, EIOPA's application guidance on climate change materiality assessments and climate change scenarios in the ORSA illustrates how climate-related materiality assessments and scenario analysis of climate risks can be incorporated in this existing prudential tool, not only in the short term, but also in the long-term.⁹ EIOPA is currently evaluating the potential for a dedicated prudential treatment of sustainability risks,¹⁰ and is initiating the re-assessment of the standard formula for natural catastrophe risk in Solvency II.

The regulatory landscape is continuously evolving to effectively address sustainability risks.

Supervisors and the insurance sector in the EU have shifted their focus to sustainability risks. It remains essential that the insurance sector continues to evolve ensuring that future challenges are appropriately addressed.

1. EIOPA (2022): *Methodological principles of Insurance stress testing – Climate change component.*
2. EIOPA (2020): *Sensitivity analysis of climate-change related transition risks.*
3. EIOPA (2022): *European insurers' exposure to physical climate change risk and (2022): FINANCIAL STABILITY REPORT.*
4. ECB and EIOPA (2023): *Staff Paper on Policy options to reduce the climate insurance protection gap.*
5. EIOPA (2022): *EIOPA's dashboard identifies the European natural catastrophe insurance protection gap.*
6. EIOPA (2023): *Pilot Exercise on Impact Underwriting.*
7. EIOPA: *Open-source tools for the modelling and management of climate change risks.*
8. EIOPA (2023): *FINANCIAL STABILITY REPORT.*
9. EIOPA (2022): *Application guidance on climate change materiality assessments and climate change scenarios in ORSA.*
10. EIOPA (2022): *Discussion Paper on the Prudential Treatment of Sustainability Risks.*



SACHA SADAN

Director, ESG - Financial
Conduct Authority (FCA)

UK Financial Conduct Authority is taking action on ESG

The financial sector has a vital role to play in helping the economy adapt to a more sustainable long-term future. The UK Government has called out the important role the Financial Conduct Authority (FCA) has in achieving their vision for the UK to be the world's first net zero aligned financial centre. We take this role very seriously and are proud that financial services have been front and centre in helping to drive positive, sustainable change. Within this, we are committed to international alignment, and we have been doing a lot of work to make sure that we are developing global solutions to global problems.

We were delighted to see IOSCO endorsement of the International Sustainability Standards Board (ISSB) standards in July. We have worked with the ISSB since the start and are hugely supportive of its mission to create a common, global language for companies around the world to communicate their sustainability stories in a consistent and comparable way. It is great to see ISSB and the European Finance Reporting Advisory Group (EFRAG) working hard on interoperability to help build global standards. The UK Government has also signalled its support for ISSB and once available for use in the UK, we will update our rules to reference the ISSB standards.

In parallel, we have been working very closely with the UK's Transition Plan Taskforce (TPT) to develop a framework for credible net zero transition plan disclosures, which complements ISSB standards. While the TPT was launched in the UK, it has a truly international focus. We know there is no 'one size fits all' approach here – every business model is different and what works for one might not work for another. But what is important is that we get started, get it wrong, make mistakes and then learn from them. Small iterative steps that are started tomorrow are better than achieving a perfect solution in 10 years' time.

Timely, complete, and consistent global adoption of the ISSB standards, combined with high-quality, forward-looking transition plan disclosures, can give investors the confidence to invest in a sustainable future and help the market for sustainable finance scale with integrity. As part of the FCA's commitment to 'walk the walk', we published our own Net Zero Transition Plan in July, which we have developed using the TPT's framework.

We are also working to build a world-leading and competitive sustainability disclosures and labelling regime that will help the UK's asset management sector thrive by setting standards that improve the sustainability information consumers have access to. Our Sustainability Disclosure Requirements and Investment Labels consultation set out a package of measures to build confidence and help consumers navigate the market and make better informed decisions. We are working with the EU and are making sure our requirements are consistent with the EU's Sustainable Finance Disclosure Regime (SFDR). We just have different starting points – consumers are at the heart of our proposals.

To create a UK market that functions competitively and effectively for the benefit of consumers, they must be able to trust sustainable investment products. Investors have a really important role as stewards of capital to make sure the economy rapidly becomes more sustainable. Our proposed sustainable improver label for example, is designed to legitimise investment in firms that, while not sustainable today, are on a credible path to becoming more sustainable over time.

We have said for some time there is a clear rationale for a globally consistent regulatory approach for certain ESG data and ratings providers. So, we welcomed the Government's consultation, which closed in June, on whether and how to bring ESG ratings into the FCA's regulatory perimeter. Should the

Government decide to extend our perimeter, setting up a new regulatory regime would take time. That is why, last November, we announced the formation of an industry group to develop a voluntary Code of Conduct, which is currently being consulted on. It is grounded in IOSCO's recommendations and is considering developments in other jurisdictions.

Looking back on recent years, we have made significant progress – as a regulator and as industry – but there is lots more to do.

What is important is that we get started, get it wrong, make mistakes and then learn from them.

Creating positive, sustainable change isn't just about climate change. It's about looking beyond and considering wider environmental issues, such as biodiversity and nature, as well as social and governance issues, such as diversity and inclusion, the living wage, fair taxation, and supply chains. As firms adapt to this changing world, their governance arrangements, incentive structures and capabilities must keep pace. We all know that what gets measured and incentivised, gets done.

To deliver the transition to net zero, we will need a transformation of unprecedented pace and scale. We know that many firms in the market are already on their transition journey, but we want to work with industry to make sure firms are able to do this well and are doing it consistently.



ANDREA NOVELLI

Chief Executive Officer - PosteVita

Sustainability and adaption in the insurance business: from insurantal imaginary to stark reality

In his 1991 book, *The Foucault Effect*¹, Francois Ewald, a French philosopher, described the insurance business as an abstract technology of statistical combinations. Ewald defined the complexity of those combinations as an 'insurantal imaginary'. According to his views, the insurance business was about extracting potential scenarios from those combinations, assigning them probabilities, but without the capacity to mirror that imaginary in full.

As a result, according to Ewald, in the practice of insurance, it was possible² to separate different classes of risks that could impact us and define different branches or business lines of our own insurance activities.

Each risk, still quoting Ewald, is insured as to protect oneself from an accident, or 'like a roulette number, a card pulled out of the pack'. Companies and regulators have discreet approaches to the matter. That period of discreet insurance activities is up for change.

The series of extreme events we witnessed in the last 3 years heralded a wider concept of risk and of insurance: the Covid-19 pandemic, followed by the war in Ukraine and the solid manifestation of extreme weather in Europe are examples of global and pervasive trends, with the capacity to impact not only on a class of assets or insured items or people, but at multiple levels.

The summer of 2023, one of the hottest recorded in Europe, shows clear signs of this: we are witnessing its impact on agricultural production, morbidity rates health claims, ranging from respiratory to mental health issues and damages to assets like homes and cars.

2023 is becoming our year zero: it is not only about hotter weather, but about uncertainty and potential disruptive 'peak' events, as we witnessed in Italy this year so far.

The insurance sector in Europe will have to be at the forefront of analyzing current impacts, as to build a heatmap of critical points and adaptiveness.

Our imperative will be to treasure the information these events are providing us and modelling around 2023 as benchmark. Understanding extreme events and subsequent adaptation is the first step towards a long-term sustainable model. Before any of the investments on greening our economies and activities will start to have some substantive effect, we will need keep managing emerging extreme events.

The insurance business, quoting again Francois Ewald, is about 'controlling the hazard of contingency'. Some ideas on how to keep sustainability at the centre:

- *Model climate and society change into our own forecasts* – Recent reports (i.e. the UK Institute and Faculty of Actuaries, 2023) questioned how economists assess the impact of climate change on scenarios for financial services, including pensions and life insurance. As reported by Carbon Tracker, while temperature increases up to 5 Celsius degree by 2100 is expected to reduce the Global GDP by 10% - as claimed by a series of economic papers – we know that this would be an existential threat. We all need to consider the full extent of climate

change and adaptation needs across the spectrum of risks we all manage.

- *Include adaptation risks into the premia* – Whatever risk we ensure our clients against, we need to have adaptive pricing: over time, we should be able to include impact components, translating them into different premia according to the transition quality of the solution offered to our customers. This is valid for damage and loss insurance and for life products.
- *Build long term sustainability into your investment* – The long-term play for the insurance business is to be sure that our portfolios transition into sustainable-linked and ESG-rated investments. This requires additional transparency and clarity on how assets are defined in relation to different taxonomies.
- *Redefine the transferability of some risks* – Climate global externalities need a substantial rethinking of transferability, including what a risk is and how it can be mitigated by the market through reinsurance or other means, or what the risks are that we are facing requiring collective action and policy choices. As highlighted by the UN Environment Programme on a 2021 Report ("Insuring the climate transition"), the transformation to our ecosystems requires major interventions, including being mindful of where transferring a risk is only compounding its effect.

The insurance sector in Europe will have to be at the forefront of analyzing current impacts, as to build a heatmap of critical points and adaptiveness. Our aim is to reduce risks before reaching a point where they will not only difficult to transfer, but, as explained by the IMF in 2020³, the impact will be perceived at any level of the financial markets, including sovereign issuers, the backbone of our life insurance businesses.

1. *'Insurance and Risk' in "The Foucault Effect: Studies in Governmentality", 1991, London.*
2. *And it is happening today, showing the deep influence that Ewald and his master, Foucault had on the actuarial sciences in France.*
3. *IMF Working Paper 20/79 – 2020 - This Changes Everything: Climate shocks and sovereign bonds, by Serhan Cevik and Joao Tovar Jalles.*



HIDEHIKO SOGANO

Chief Sustainability Officer -
Dai-ichi Life Holdings, Inc.

The importance and challenges of formulating the “transition plan”

Financial institutions around the world, not just in Japan, are tackling sustainability risks with a strong awareness of the issue. Especially with regard to climate change, GFANZ and Net Zero Alliances are functioning as a base for accumulating the best practices of private financial institutions. This spring, GFANZ established its first country chapter here in Japan, which would surely accelerate a positive momentum in the whole Japanese financial sector to achieve net zero. As an example of recent momentum, a small number of banks and insurance companies have started announcing transition plans for climate change in line with the GFANZ framework this year. Dai-ichi Life Insurance will also announce its transition plan for the first time this August.

This has three positive effects.

First, the plan provides an opportunity to broaden our understanding of what the transition means for us and the actions we are taking to support decarbonization in the real economy. of stakeholders.

Second, by publishing a plan, members of the Executive Committee and Board

of Directors of the financial institutions, can comprehensively review the approach and clarify what additional efforts are needed to continue on the path to net zero.

Finally, our net-zero transition depends on our clients taking action toward decarbonization and business transformation. Unfortunately, there is still no clear indication of how much each industrial sector will decarbonize in every five-years-term toward the ultimate goal of decarbonization in 2050. Still, the transition plan provides a means to involve our clients in their own transition planning.

At the same time, when formulating the transition plan, it is necessary to find the right balance between uncertainty and our commitment, since we need to recognize the changes beyond our control, such as developments of technology, various changes in policies, and geopolitical risk.

In particular, I would like to share issues related to “hard-to-abate sectors” from the perspective of Asia, including Japan.

First, the definition of transition finance is not yet shared among stakeholders. The G7 Hiroshima Summit communiqué mentions the importance of transition finance. This is good news, but in order to integrate transition finance into transition planning, more consensus needs to be reached on what kind of finance should be trusted as transition finance. In general, the energy composition of Asian countries, including Japan, is highly dependent on coal-fired power generation. Temporarily increasing financing for the brown sector, such as high-efficiency gas-fired power plants, is inevitable in order to secure stable and affordable alternatives to coal-fired power. In order for such finance to be recognized as transitional finance, it is necessary to build a consensus to enhance mutual understanding.

Clear definition of transition finance, national level of roadmap, and just transition are needed.

Second, there is a need for concrete green energy transition roadmaps at the national level. For example, we must clarify whether and how we will accept gas and nuclear power as temporary alternatives. Currently, private financial institutions such as GFANZ are making

efforts to draw a pathway for each industry’s transition, but I would like the government to clarify the major direction that will serve as a premise.

Moreover, it must be a “just transition plan” so that no one is left behind by the transition. This contains some social dimensions such as labor mobility, reskilling of people who have engaged in the abated sectors, and rebirth of the community with governmental support.

This challenge in Asian coal-fired power generation is also applicable to other hard-to-abate sectors. How to deal with sectors that are particularly difficult to reduce, and how to provide them the transition finance, are the areas that have not yet been sufficiently discussed, and are considered to be one of the major themes for COP28.

Financial institutions, including insurance companies, have high hopes for the development of new technologies to realize decarbonization and are in a position to provide them with the necessary finance, which means they see this as an opportunity. It is certain that the awareness of risks and opportunities around sustainability is steadily spreading, we should recognize at the same time that the deadline for addressing decarbonization is fast approaching.

As we have made great progress with respect to disclosure standards such as the TCFD, we hope that the importance of a transition plan will also be shared with regulators so that it will be understood and promoted in markets around the world.

AML: KEY SUCCESS FACTORS



MARCUS PLEYER

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The key to successful AML regulation: a risk-based and proportionate approach

With the European legislative package, we are on the verge of a breakthrough in the fight against money laundering and terrorist financing. A comprehensive package of rules and an ambitious AML watchdog will be crucial factors in lifting the EU to best-in-class in terms of AML prevention. In the ongoing trilogues, it is important for legislators to keep a firm eye on the ultimate objective of regulation: the requirements must be well thought out, risk-based and proportionate. In short, we need to strike the right balance!

Why is it important to emphasise this so explicitly? Anti-money laundering regulation consists to a large extent of relying on the collaboration of the

private sector in the (public) task of combating money laundering, whether by requiring private actors to act as gatekeepers or by requiring legal entities to identify their beneficial owners and enter them in beneficial ownership registers, to name just a few examples. Against this background, both a risk-based approach and the principle of proportionality must be observed with particular vigilance in building a targeted and effective framework.

At the same time, it is crucial to complete the AML package and establish the European anti-money laundering authority (AMLA) swiftly now that there have already been significant delays in the negotiations. But we would be well-advised not to introduce excessive and non-risk-based requirements now, which we might have to revise in an AML package 2.0.

The guiding question for legislators and regulators must therefore always be: Is additional regulation justified in terms of risk? This applies primarily to standards targeting obliged entities and partially also to standards targeting supervisory and other competent authorities. It is essential to be equipped with the necessary facts when making far-reaching regulatory decisions. Without a solid factual basis, it is not assured that regulation will be as targeted as intended. The Commission's impact assessment, together with the supranational risk assessment and the national risk assessments, are very good starting points for this. We need to find out, as accurately as possible, where the actual risks lie.

Let me illustrate these considerations with two examples:

1. The provisions on transparency – which are widely considered by the industry to impose significant administrative burdens for all legal arrangements and obliged entities, irrespective of their specific business activities and risk profiles – will be expanded under the new package and should be examined thoroughly in terms of their suitability and proportionality. Among other things, the proposed provisions (a) require all legal entities in third countries to be entered in a beneficial ownership register when a business relationship is established in the European Union and (b) reduce the percentage threshold above which a person is

considered a beneficial owner. In this context, we must pay particular attention to the European Court of Justice's case law, which requires our considerations of proportionate regulation to include legal interests such as those of the person affected by transparency rules.

2. In connection with the future EU anti-money laundering authority, there is the concern we might overstretch our good intentions. It is tempting to give AMLA a broad range of tasks and powers, including in the area of sanctions enforcement for example. This is all the more understandable given the growing importance of preventing sanctions evasion over the past year and a half. At the same time, we must ask ourselves whether the intended synergy effects are actually likely to be achieved and what this means for AMLA's overall functioning. Newly established authorities often experience growing pains in their first few years, and assigning AMLA too many tasks could prevent a successful start.

Effective AML regulation must be based on targeted, proportionate and risk-based rules.

With the right combination of targeted, proportionate and risk-based rules and operations, we will maximise the success of the new EU-AML framework and organisational structure. To combat financial crime effectively, all stakeholders must join forces and pursue a common goal. It is crucial for the general public, the private sector and competent authorities to share the confidence of legal experts that the AML package will bring added value and not only added work.

Let us therefore strengthen the dialogue between policymakers and civil society to our mutual benefit, so that we can implement the new framework from day one in a risk-sensitive and thoroughly effective manner.



KENNETH FARRUGIA

Chief Executive Officer -
Malta Financial Services
Authority (MFSA)

Strengthening Europe's AML/ CFT Supervision

After several years of legislative processes, the Anti-Money Laundering Package, comprising three regulations and a directive is nearing its final stages.

The creation of a supranational AML/CFT authority (AMLA) is one of the major developments being proposed, and is intended to improve supervision across all sectors, by coordinating and directly supervising high-risk entities, particularly credit and financial institutions operating in multiple Member States. A driving factor behind the setting up of AMLA was the variation in the level, quality, and effectiveness of supervisory practices across Europe, leading to money laundering scandals involving European credit institutions.

While the AML package offers promising solutions, the eventual establishment of AMLA does present its own challenges. Its role is undergoing somewhat of a metamorphosis with each successive review of the Commission's proposal. The number of selected entities possibly subject to direct supervision has been increased by both Council and Parliament, and so has its mandate when it comes to restrictive measures. There have been repeated warnings that this

will require AMLA to have an ever more substantial budget to, amongst others, recruit additional staff and bolster its technological capabilities.

Financial implications apart, can AMLA find the necessary human resources to effectively and efficiently execute its mandate? Technology will only go so far- ultimately you will need qualified, experienced and creative people to take decisions, and those are in short supply. Recruiting and retaining staff in this area has always been challenging, with authorities having to compete with one another for a limited pool of talent. AMLA's responsibilities will require additional skilled professionals which may potentially strain the human resources capabilities of national authorities as they lose their skilled regulators to the supranational body. AMLA must also tackle cross-cultural and language barriers to foster effective communication and collaboration among its staff and with the various national supervisory authorities.

Technology will also feature high on the agenda, be it as a means to facilitate the compliance by entities, or as a medium that creates new vulnerabilities within the AML/CFT system. The European Banking Authority has already been active in this area but with the AML Rulebook Regulation casting a wider net when it comes to CASPs, while also seeking to address uncertainties surrounding Virtual IBANs, AMLA will need to keep up the momentum in the technological sphere. It might also need to consider the reconciling of products, like instant payments, within the overall AML/CFT framework, but especially, transaction monitoring and reporting obligations, as well as possible new threats such as NFTs and the metaverse.

To ensure transparency and prevent illicit activities, advanced technological solutions must be deployed to verify beneficial ownership information and safeguard against the misuse of corporate structures and robust monitoring. Tracing solutions will also be necessary in the realm of cryptocurrency, demanding innovative technological approaches. AI and Machine Learning Compliance represent a significant opportunity for enhancing AML/CFT efforts while information sharing and collaboration platforms, such as the EU AML database EuReCA, play a pivotal role in fostering greater cooperation among financial institutions and supervisory authorities.

The other main building block of the AML Package is the AML Rulebook Regulation which sets out the AML/CFT obligations for entities. Moving away from a directive to a regulation as the instrument of choice will limit as

much as possible any arbitrage between Member States while also ensuring as uniform as possible an application of the same AML/CFT obligations in each one.

From a European perspective, one could say that the creation of single rulebook and a single supra-national authority with direct supervisory powers was only a question of time. Money knows no border and neither does crime, and in an area created to facilitate and incentivise cross-border activity it was necessary to set overarching rules that do not allow for national influences. The project has suffered some delays, albeit this was to be expected due to its highly sensitive nature one and everyone wanting to contribute to develop the best possible solution.

Moving away from a directive to a regulation as the instrument of choice will limit as much as possible any arbitrage between Member States while also ensuring as uniform as possible an application of the same AML/CFT obligations in each one.

Regulatory uncertainty may arise during AMLA's initial stages, as it navigates scope, powers, and interactions with existing supervisory bodies and national authorities. Addressing the technological and human resource challenges will be critical for its success. By overcoming these challenges, leading by example and fostering greater cooperation and consistency, the EU can bolster its financial system's integrity and enhance its credibility in the global fight against financial crime.



ANTE ŽIGMAN

President of the Board –
Croatian Financial Services
Supervisory Agency (HANFA)

Need for planned AML/CFT specialized supervisory training

EBA's recent findings indicate that all EU competent authorities could be doing more to supervise the financial sector effectively. Failure to manage ML/TF risks in this area can impact the integrity of the entire EU's financial system. As the financial industry encompasses entities of various sizes and business models, ML/TF risk factors fluctuate significantly by type and intensity. As competent authorities already identified three additional emerging risks in the sector - 'white labeling', virtual IBANs, and third-party acquirers, all connected with geographical risks and cross-border transactions, we are aware of the new gaps that need additional effort and response.

As the higher ML/TF risk is linked to the use of new technologies and remote customer onboarding, SupTech solutions, in particular when it comes to trading with crypto assets, the use of AI solutions, etc., will be required, competent authorities will need to have well-trained, educated and specialized experts to be able to „lead this battle“.

For example, the business models of FinTech companies vary as much as their offerings. The business model of white label FinTech companies focuses on offering business-to-business (B2B) services, and some white label FinTech

companies have also consumer-facing and handling offerings. Supervisors will need to understand these business models to be able to supervise effectively.

Will this new concept of direct supervision led by AMLA also help national supervisory authorities to, along the way, strengthen their internal knowledge and capacities and increase national AML/CFT effectiveness related to new ML/TF risk factors? Will Joint supervisory teams build on the existing capacities, knowledge, and practices of national supervisory authorities?

The discussion on eligibility criteria and the selection process for direct supervision are still ongoing and we need to look at this new mechanism in a broader context, not only as an ML/TF operational supervisory tool but also as a form of additional supervisory convergence and an opportunity to develop practical case study templates for national lead efforts.

AMLA is meant to provide mutual assistance in the AML/CFT supervisory system, as well as practical tools and methods for mutual assistance. that the hope is that AMLA will ensure sectoral and cross-sectoral training programs, including technological innovation; exchanges of staff and the use of secondment schemes, twinning and short-term visits, and exchanges of supervisory practices between supervisory authorities when one authority has developed expertise in a specific area of AML/CFT supervisory practices. This is a necessary and positive development but let's not forget that specialized training and education are needed right now. It may be argued that we are significantly behind schedule. As new ML/TF risks arise, a supervisor's readiness and capacity must follow such changes.

**Supranational
roundtables and
operational training
should become
our day-to-day
supervisory routine.**

We must be aware that the ML/TF risk landscape has changed. Environmental crime, including illegal waste trafficking, illegal trade with endangered species, illegal gold mining, and the violation of environmental regulation, is a predicate offense to ML. The EBA Report from July this year shows that 83% of the competent authorities responding to the questionnaire indicated that no

authority in their jurisdiction assessed risks arising from the laundering of proceeds of environmental crimes. EBA advised competent authorities to take the steps necessary to understand the risk that institutions in their sector might be laundering the proceeds from environmental crime. The new AML Package will expand the list of obliged entities to other sectors, including CASPs and crowdfunding platforms. In parallel, the types and methods of ML/TF crime are rapidly increasing.

We are already running late with common supervisory specialization for some specific ML/TF risks. Cross-border/supranational cooperation and a robust and structured exchange of practices between supervisors are important to keep up with new technologies, and new business models.

The ambition that went into preparing the new AML/CFT legislative package should be accompanied by an equally ambitious and structured plan for specialized and continuous training of our operational AML/CFT experts to be ready to follow all current and ongoing changes. Supranational organized roundtables and operational specialized training should become our day-to-day supervisory routine to be ready for existing and new ML/TF threats. We should bear this in mind while waiting implementation of the new EU AML rules.

Special attention, therefore, needs to be paid to ensuring timely, comprehensive, and targeted AML/CFT specialized supervisory training. That is the still missing piece needed to close the potential gaps in the new AML/CFT package.



RIKKE-LOUISE ØRUM PETERSEN

Deputy Director General -
Danish Financial
Supervisory Authority

Main building blocks for the AML/ CFT framework of the future

The fight against financial crime has moved to the forefront of the supervisory agenda in recent years. As discussions continue on how to design the foundations of future efforts to combat money laundering and terrorist financing in Europe, it is important to keep the eye on the ball. First and foremost, AML/CFT should not be seen or used as a panacea. In our endeavor to hinder criminals in making use of the profit of their crime, we should not lose focus on combating and investigating the predicate crime – which is often worse than the following economic crime and often entails far worse human suffering. From that starting point, I think there are four key areas that we need to focus on to ensure success in this very important task: a risk-based approach, cooperation, the need for well-designed legislation and harnessing the power of technology.

Let us start from the basics: in Europe alone, there might be around 200,000 obliged entities. Therefore, the task for the supervisors is tremendous – and

AML/CTF supervisors must start from a risk-based approach.

Planning of supervisory activities is inherently based on incomplete information. AML/CFT risks do not necessarily relate to size or any other obvious metric. Hence, there is a need for accurate, timely information on obliged entities to allow supervisors to focus efforts where they count the most.

A key element to success is cooperation; supervisors must cooperate closely with law enforcement, the FIU intelligence services and tax authorities. Authorities involved must exchange information and learn from each other. Public private partnerships (PPPs) are an important add-on to this cooperation. Information gathered from the source will always be superior to second hand information. Early experience, starting with the JMLIT in the UK, are very promising as to the potential gains of such endeavors.

Secondly, AML/CFT supervisors should cooperate with prudential supervisors. Prudential supervisors' knowledge of supervised entities which will be of great value to AML/CFT supervisors – and vice versa: input from AML/CTF supervisors is important for the risk assessment by prudential supervisors. In the Danish FSA, AML/CTF supervisors are sitting close to prudential supervisors – much to the benefit of both.

Thirdly, supervisors must cooperate across borders. Crime is becoming more and more international. In Denmark, e.g., a very large part of un-covered money laundering has threads to other

**In close cooperation
with Germany and The
Netherlands, Denmark
has pushed for increased
room for cooperation
and data sharing in the
AML package.**

countries. In the Nordic Baltic area, AML/CFT supervisors have formed a permanent working group a few years ago. This working group continues to bring value and its activities are widening and deepening. In Europe, we are also step-ping up through the work in supervisory colleges.

The need for cooperation is no less relevant for the coming European AML Authority, the AMLA. The AMLA will supervise financial institutions which have the highest AML/CTF risk – and

the AMLA will need to cooperate with law enforcement, prudential supervisors and national AML/CFT supervisors to succeed. If we do not get this cooperation right, there is a risk that the AMLA will not be the positive force that we are looking for – but will mostly add complexity and administrative burdens.

As the creases on the EU AML package are still being ironed out, we need to keep the broad picture in mind. We must aim for high minimum standards. But setting high minimum standards is not the same as setting out very detailed provisions. The reasons for this are obvious. Combating and preventing financial crime is a moving and often also a somewhat blurred target. This calls for flexibility in regulation. There is a risk of formulating too detailed rules, which might well result in both obliged entities spending scarce resources on what is inherently low risk – resources which should have been spent elsewhere – and supervisors getting caught up in “checking the box” rather than trying to see and understand the everchanging landscape of AML/CTF risks.

Hence, we are back with a need to focus on the risk-based approach – in the effort of obliged entities and in supervision. We need a regulatory framework that supports this – not one which ends up deflecting efforts by being too detailed and prescriptive.

And this brings me to my final point: information alone cannot do it – we need to harness the power of technology to succeed here.

In close cooperation with Germany and The Netherlands, Denmark has pushed for increased room for cooperation and data sharing in the AML package. Current rules restrict obliged entities to arrange their preventive efforts in silos. It is difficult to follow money trails when criminals launder their proceeds through networks of accounts across financial institutions.

The aim is a framework which creates room for new and innovative approaches without specifying the recipe, based on the possibility for national discretion to develop initiatives on data sharing and cooperation, with all due safeguards. We still find it imperative that this remains a part of the package. And in due time maybe the ambitions for data-sharing can have international dimensions; maybe led by the work and expertise of the AMLA.



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Ongoing negotiations on the AML Package: what is at stake for AMLA and FIUs

Faced with diverging texts with different levels of ambition, European co-legislators are working in the trilogues to forge a suitable compromise for the AML Package. Reforms should be feasible, for a smooth implementation across the bloc with no excessive costs and unduly lengthy timeframe, to avoid that the inception of AMLA and the rulebook be pushed too far into the future. These are all usual hurdles in EU negotiations; they become more pressing here due to looming elections next year and a context of not fully mitigated risks. The procedure for deciding where AMLA will sit is also lagging behind, due to political struggles on criteria. Ambitions and realism should find a balance soon.

Proposals by the Parliament aim to expand the role of AMLA as the FIUs' Mechanism and enhance FIUs' responsibilities, in response to long standing calls for more convergent and effective approaches. Right motivations must be translated into feasible solutions.

The reporting of suspicious transactions should be fostered and simplified. However, the proposal to set up a unified EU procedure available to all for disclosing to any FIU "of choice" is neither appropriate nor feasible. Rather than a swift "one stop shop" solution, this would entail a "one size fits all" system, requiring an overhaul of national and EU IT platforms, increasing public and private expenses and lowering the quality of disclosures. The Council approach, centred on AMLA providing uniform though flexible reporting standards, is preferable.

Effective joint analysis on cases that FIUs cannot tackle effectively in a national perspective is one of the goals of the reform. The Parliament intends to provide AMLA with a more incisive coordination role and powers to launch joint exercises; FIUs would be required to participate, with little room for refusing. This step toward a truly supranational approach would be more effective but more demanding for FIUs, in terms of casting priorities and mobilizing resources.

Parliament's amendments explicitly vest FIUs with a supranational status and mandate in their roles in the governance of AMLA. National laws would have to reflect that, balancing FIUs' prerogatives with a duty to serve AMLA's and EU interests (which do not necessarily coincide in full with domestic agendas). This is a momentous change which comes with a cost envelope. It also brings new responsibilities: the Parliament insists that, similar to supervisors, FIUs should be made subject to "peer reviews" and "recommendations" for remedying inadequacies.

**With negotiations' end
not yet in sight, also on
AMLA's location, ML risks
remain outstanding.**

Other, non-FIU, agencies could be admitted to joint analyses and to the FIUs' and AMLA's "data room". These agencies could also receive disseminations and would be observer members of the General Board. While inter-agency cooperation is key, these proposals would commingle separate areas of competence and lead up to multi-purpose processing of sensible information and a defective coordination with domestic arrangements.

AMLA would also gain competences for the implementation of targeted financial sanctions. This area has

received a boost following the invasion of Ukraine and would benefit from a better EU coordination. However, notwithstanding connections with supervision and FIUs' matters, the role envisaged for AMLA would expand, and perhaps shift, its mandate.

A lot may be at stake in co-legislators' balancing act. Designing and implementing competences for AMLA in the TFS area require time; with an already overdue legislative process and EU elections looming, credibility can be eroded. A more incisive role for the FIUs' Mechanism will enhance effectiveness but also raise feasibility concerns. The interplay between national prerogatives and supranational constraints is also an important variable: more room for AMLA in joint analyses or peer reviews will reduce FIUs' legroom, touching on highly valued national arrangements. Changes to STR reporting procedures would require a sustained multi-annual commitment by EU and national authorities, as well as by the reporting sector; an unviable "one stop shop" idea may stifle the transition.

Less visible or tangible factors (for now) are also exposed. Risks are not duly mitigated: the new AML system, and the FIUs' Mechanism in it, have been designed to prevent major ML cases similar to those that occurred before 2020; a few years have passed and we may yet be far from that objective. Also, AML activities rely on information processing, within the public and the private sector and across the two, domestically and cross-border; to keep the pace of innovations (e.g. on AI), AML actors should be given indications on "dos" and "don'ts" to safeguard sensible data.

At stake are credibility and trust, essential for a system that is not harmonised and relies on national stakeholders (and taxpayers).



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For a new, fully operational and efficient, AML/CFT framework

In order to make sure that the new framework will be in the best position to fulfill expectations several building blocks need to be there.

1. The new framework must rely on a comprehensive and harmonized set of legislation: in particular AMLA will need a robust set of legislative measures that clearly defines its powers, responsibilities, and the punishments for money laundering offenses. These measures should be aligned across all member states.
2. This legislative framework must be reinforced by clear policies that also must apply in all member states. Those policies must be well known in all countries, consistently applied by all national supervisors and regularly adapted to follow the changing methods of money laundering. It should also apply at all stages of the “life” of financial institutions. As recently highlighted in the EBA report on ML/TF risks associated with payment institutions, given that currently “supervisory practices at authorization vary significantly, AML/CFT components are not consistently assessed. As a result, payment institutions

with weak AML/CFT controls... may establish themselves in MS where the authorization process is perceived as less stringent to passport their activities cross border afterwards”. Intra EU cooperation and international collaboration must be there to reinforce the new framework efficiency.

3. The new authority will need adequate resource allocation. As one of the SSM Board member recently pointed out without this, the new framework will miss its objective (Elizabeth MacCaul at Leaders in Finance AML event June 2023). Regarding financial resources, adequate funding is needed to ensure the smooth operation of AMLA. This includes salaries for employees, operational expenses, purchasing necessary software and hardware, and funding investigations. As far as human resources are concerned, hiring skilled professionals with expertise in financial crime, forensic accounting, law enforcement, legal services, and IT is necessary. Also enough staff is needed to handle the volume of cases and to ensure swift action. This staff will need to be continuously trained to keep up to date with the progress of money launderers themselves. Adequate infrastructures and partnerships will also be needed to ensure collaboration with other organizations, both domestic and international ones. This can involve training initiative, data sharing agreements, joint operations.

The new AML scheme will need strong leadership, effective coordination and capacity building.

4. Advanced technology: Modern anti-money laundering efforts require sophisticated technologies. This can include advance software for detecting suspicious transactions, data analysis tools, secure databases for storing and retrieving information, and cybersecurity measures to protect sensitive data. In this field leveraging cutting-edge technology such as artificial intelligence and machine learning can help detect suspicious transactions more accurately and swiftly. Indeed, as Elizabeth MacCaul was highlighting in her previously mentioned speech “ AI is exceptionally good at analysis vast amounts of financial data and

identifying patterns, making it much easier to identify suspicious transactions or money laundering activities which can be flagged for further investigations...AI can help to identify hidden links and connections, uncovering complex networks and relationships...”

5. Clear data management rules and relationships with data protection framework are also key. Balancing effective AML data management with data protection can be challenging, but it is essential to ensure both the integrity of financial systems and the privacy rights of individuals. To do so requires careful planning, robust systems and ongoing monitoring and compliance efforts to make sure that collection of data, data storage, data processing and analysis or data sharing, are done in a manner consistent with data protection regulation to protect individual s privacy and prevent misuse of personal data.
6. Adequate transparency should enhance its efficiency/ reputation. It should maintain public trust, enhance cooperation with other entities and ensure accountability. In order to foster this transparency, regular reporting on the activities, achievements and challenges of AMLA can ensure that stakeholders and the public at large understand its work. This covers in particular statistics on cases handled, convictions obtained, funds recovered and sanctions imposed. AMLA s governance will also benefit from being transparent; lastly regular audits and oversight can also ensure that AMLA is acting responsibly, effectively and in accordance with its mandate.

All the above mentioned building blocks seem necessary to improve the efficiency and reputation of the new AML scheme. To sum up it will need strong leadership, effective coordination and capacity building, swift and effective action means, strong public engagement and continuous improvement to keep pace with changing circumstances and threats.



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Filling AMLA with life: partnership and pragmatism

Two years have now passed since the anti-money laundering and counter terrorism financing (AML/CTF) package was presented by the European Commission. The European Union is now entering the final stage of negotiations, with co-legislators likely to reach agreement on a final common text later this year. However, reaching an agreement on the legislative text is only one of three key elements needed to finalize the EU AML framework. Equally, during this delicate phase, it is important that the discussions on the technical requirements affecting the industry are not overshadowed by political decisions on the future location of the AML Authority (AMLA).

The second element is to ensure that the handover of responsibilities from the EBA to the AMLA is done in a planned manner, so that financial institutions do not face a regulatory or supervisory gap in meeting their AML/CTF obligations. Coordination and collaboration with public and private partners will be key in the first years of AMLA.

The third element is to achieve a careful balance when the AMLA finally develops its technical standards under the new AML rules. Many of the specific requirements that financial institutions will have to comply with will still need to be developed. This gives the

AMLA a truly unique opportunity to create a robust framework, partnering closely with the industry. The smooth transition also requires that the AMLA build the necessary in-house expertise with EU regulatory framework and that it is integrated into the EU's supervisory ecosystem. In developing its technical standards, the AMLA should not rush and adopt a risk-based approach that reflects the unique business model of the financial institutions to which the future AML rules will apply.

The recent report from the EBA on the ML/TF risks in the payments sector shows the urgency for the implementation of the AML/CTF Package, both from an industry and a supervisory perspective. A key takeaway from the report is that the industry and the respective supervisors need to enhance their cooperation and dialogue, so as to ensure a better understanding of the sector and the supervisory expectations placed on payment institutions. For example, the remittances sector has a thorough understanding of its inherent risks, built over many decades. To that effect, Western Union, and the broader industry, have developed a series of processes and controls to mitigate that risk, and ensure the safe use of their platforms. Enhanced cooperation and sharing of information between the industry and the supervisors will then be beneficial for both parties and the AMLA can play an important role in this regard.

**Better cooperation
helps regulators,
supervisors and industry
to overcome many of the
AML/CFT challenges.**

The changes in the AML/CTF framework should also reflect the increasing adoption of new technologies in the fight against financial crime. Technology can greatly help companies deliver on their AML/CTF obligations and make the implementation of a risk-based approach a reality. It can also facilitate data sharing for AML/CFT purposes.

Developing new EU regulations should not hamper innovation in areas such as, for example, customer onboarding and post-onboarding controls. A positive development in this regard is the European Parliament's proposal to introduce a new technology tool that connects all relevant obliged entities, supervisors and FIUs ("one-stop-shop"). This tool has the potential to significantly reduce data fragmentation of data

reported by entities to different Member States, allowing for the different players to be brought together in a centralized manner. Moreover, it could also improve the data reporting efficiency, allowing for better identification, for both obliged entities and relevant authorities.

One important consideration when data sharing technology is used is the application of EU data privacy rules. This trade-off between data privacy and data sharing remains a constant challenge for all parties involved. The new legislation formally recognizes the public interest mandate for sharing AML data. Solving this trade-off will ultimately depend on political will.

Western Union has consistently supported the creation of AMLA, especially when it comes to the supervision of entities with large cross-border operations. The AMLA can add efficiency to the EU's supervisory process, especially for financial institutions with cross-border activity within the EU. More importantly, we believe that it can have a truly positive effect on how the fight against financial crime evolves to confront a rapidly changing landscape.

EU23

We thank the **Spanish EU Council Presidency** and **the partner institutions** for their support to the organisation of the Eurofi Santiago Forum



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THE EUROFI HIGH LEVEL SEMINAR 2024

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THE **EUROFI** FINANCIAL FORUM **2024**

BUDAPEST - HUNGARY
SEPTEMBER 2024

ABOUT EUROFI

The European think tank dedicated to financial services

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

OUR OBJECTIVES

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

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

OUR APPROACH

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

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

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

OUR ORGANISATION AND MEMBERSHIP

Eurofi works on a membership basis and comprises a diverse range of more than 70 European and international firms, covering all sectors of the financial services industry and all steps of the value chain: banks, insurance companies, asset managers, stock exchanges, market infrastructures, service providers... The members support the activities of Eurofi both financially and in terms of content.

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

OUR EVENTS AND MEETINGS

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

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

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

OUR RESEARCH ACTIVITIES AND PUBLICATIONS

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

- **Regulatory update:** background notes and policy papers on the latest developments in financial policy
- **Views Magazine:** over 190 contributions on current regulatory topics and trends from a wide and diversified group of European and international public and private sector representatives
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