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Foreword

The Eurofi Financial Forum took place in Santiago de Compostela on the eve of the informal Ecofin meeting and was organised in association with the Spanish EU Council Presidency. More than 1000 participants from the public and private sectors followed the 40 sessions of this Forum and the interventions of key representatives from the public and private sectors and the civil society.

The macro-economic challenges facing Europe and the main regulatory and supervisory developments in the financial sector at the European and global levels were discussed during this Forum, as well as the main vulnerabilities in the financial sector and the EU policy initiatives aiming to support the digitalisation of financial services and the development of sustainable finance. With the European elections due to take place in June 2024, a discussion was also initiated during this Forum about the priorities for the incoming European Commission in the financial area.

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

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

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Fighting inflation and addressing low growth

The EU faces a difficult trilemma: containing inflation, improving public finances and generating sustainable growth.

The Chair welcomed attendees and noted that the current environment increases the need for clear policy choices and proper instruments to have a soft landing an to increase long-term growth drivers. Tackling inflation is imperative; high inflation disproportionally affects the less affluent parts of society. A proper monetary-fiscal policy mix is needed, and short-term, energy-related support measures can be phased out. Fiscal space shrinks due to higher interest rate costs and room for future investment needs has to be found. Quality of public expenses, reforms improving the economic functioning and private financing are the additional growth mobilisers which need to be activated to address long-term challenges.

Questions on how that landing can be managed, how soft it will be and what it means have become more prevailing, because some expectations on the growth momentum of international economy have not materialised. The question of how persistent inflation is, how it can be brought down, and its impact are more prevailing. The issue of stagflationary risks is has come more to the forefront. The question is what policy tools Europe has to properly manage that.

1. Slower growth in Europe amid a moderate fall in inflation expected

1.1 A reduced growth momentum

An official explained that on 11 September the European Commission released its summer economic interim forecast, which is an update of its fully-fledged spring forecast. A soft landing for the euro area economy is on the cards, but it is not out of the danger zone. The euro area showed remarkable resilience and the outlook is now for a very modest growth. Weakness in economic demand, in particular consumption, shows that high and still increasing consumer prices in most goods and services are taking a heavier toll than expected. For 2023 as a whole the projection is a real GDP growth of 0.8% for the euro area and 1.3% for 2024. That is a sharp deceleration compared to the strong recovery growth of 3.3% in 2022. Momentum in 2023 is even weaker, when considering that around 0.5 percentage points of the growth rate in 2023 is owed to carry over effects from 2022. There are stark differences of growth performance across countries. Germany has a contraction of 0.4%, whereas Spain is growing at 2.2%. 2024 will see more convergence.

1.2 Inflation to further decline

An official stated that inflation is set to continue to come down while employment remains strong. Inflation continued easing in the first half of 2023 as a result of declining energy prices and moderating inflationary pressures from industrial goods. The baseline scenario for the euro area headline inflation is projected to come in at 5.6% in 2023 and reach 2.9% in 2024. Continued wage increases are gradually restoring household purchasing power, while the expectation is for unit profits to normalise and fiscal support to be phased out. The corporate sector is expected to absorb most of the increased wage bill. The fiscal stance is more contractionary, and the inflation process remains on track, both in the labour market and the financial sector. Both avoid major disruptions, and the latest July European Banking Authority (EBA) stress tests provide support for that.

The slowdown of growth is primarily the result of monetary policy working its way through the economy, but also of a weak global environment. While the US and other advanced economies are holding up, China's post pandemic reopening rebound was very short-lived. The widespread confidence problems in China are deeper-rooted than expected.

1.3 An outlook challenged by risks and uncertainty

An official explained that uncertainty remains high and the baseline projections are surrounded by important risks. The war in Europe and wider geopolitical tensions could deteriorate and further compound the outlook. Inflation could turn out to be stickier, prompting interest rates to stay higher for longer, with negative repercussions on financial stability, investment, employment and consumption. There are forceful factors challenging the European economy on a longer term basis, notably the ongoing demographic change, the imperative green transition, the fragmentation of the geopolitical landscape and high levels of public debt, not only in Europe.

The Chair noted the description of minimal growth forces in 2023, but that inflation is still very high and far above what the ECB sees as compatible with the inflation objective.

2. Tackling inflation is imperative

2.1 High and persistent inflation would be costly in terms of output and investment

An official explained that Europe is in a period of sluggish growth. In October 2022 the IMF forecasted a projection for 2023 of growth of 0.5%, which was upgraded to 0.9%. In the third quarter manufacturing is decelerating and services growth is slowing down, but there is also a strong labour market. The drivers in the future are expected to be nominal wage growth and real income recovery, which is going to be the underlying push on growth. Inflation is the issue. High inflation hurts private investment and has distributional consequences which hurt the poorer segments of society the most. An expected decrease in headline inflation occurred, which reflected lower energy prices and an undoing of the supply chain disruptions faced. Core inflation is more persistent than expected, excluding the volatile parts of headline inflation, showing that the feedthrough of energy increases and costs is slower. In the future it should be expected that nominal wage increases are going to feed into core inflation.

The ECB is predicted to hit the inflation target of 2% by mid-2025. Supply shocks are usually persistent. In successful cases, 60% of the time it takes central banks at least three years to deal with bringing down inflation. 40% will not have brought down inflation after five years. This risks a de anchoring of inflation expectation, so a restrictive monetary policy is needed for a considerable period. It is important to err on the side of overtightening, as costs in dealing with inflation shock with overtightening is far lower than dealing with de-anchored inflation expectation. The current path of interest rates of 3.75% in the eurozone and with the ECB is expected to deliver on the inflation target by mid 2025.

An industry representative noted that inflation itself is the worst number to look at, and what needs to be examined is the evidence around the inflation number such as the price surveys, the activity surveys, the markets and the inflation expectations. Activity is slowing dramatically. All supply chain tensions, expansionary fiscal policy and the elements that contributed to the current inflation surge are now in the past. The ECB bank lending survey shows a substantial slowing of both the credit demand and the credit supply side. The labour market remains tight, but when looking at the forward-looking indicators there are signs of softening. Unemployment has been exceptionally low; bankruptcies were exceptionally low due to the fantastic fiscal support, but they are now increasing.

Many corporates need to go out and refinance. Fiscal policy is tightening, and quantitative tightening (QT) is taking place. Corporates will absorb some wage increases but there needs to be some wage gain to rebalance the wage profit split and to ensure a soft-landing scenario. If inflation problems are structural and linked to an insufficient supply side then investment is needed.

Inflation is decreasing, and with a forecast of 3.0% for 2024 it will be heading towards 2.5% by the second half of the year. The danger is currently more on the growth side than on the inflation side, but the worry for the euro area is if there is insufficient investment, because energy supply is becoming more inelastic. Significantly more price volatility could then take place. The danger on the inflation side is if governments respond with untargeted, untailored and untemporary measures.

2.2 Eastern European countries face higher inflation than eurozone countries

An official explained that the real issue is inflation, and that central Europe experienced a dramatic inflation situation after the Communist era. After the pandemic central Europe immediately started tightening and undertaking rate hikes, one year before the ECB. Central Europe was also much more intensively hit by the war and the energy crisis, the inflation was much higher and the interest rate was also much higher than the ECB rate. In Poland headline inflation is set to reach 11.4% in 2023. High interest rates hit the economy hard, resulting in an immediate shock for the credit markets, growth figures and prospects. The 2023 growth figures in the Czech Republic and Hungary show that both countries are in technical recession. Poland is also very negatively hit in terms of GDP growth, but the outlook for 2024 is much more positive.

Central Europe is trying to ease monetary policy by the second half of 2023. Central European central banks are applying a forward looking approach, while ECB decisions are data driven. The easing and decreasing of interest rates have already started and the outlook is now much better, with 3-4% growth expected for 2024.

The Chair agreed that central and eastern European economies were hit harder by the conflict but there is hope for a faster recovery. Some people feared that if monetary policy was slowed down it meant the same for fiscal policy.

2.3 Avoid nominal wage growth outstripping inflation and productivity growth

An official stated that peak rate has almost been reached on the monetary policy side, and there are currently signals on maintaining that stance for an extended period of time. It is important that wage increases take place, but the worry is if nominal wage growth is larger than inflation and productivity increases. If nominal wages grow by 5% in 2023, 3% in 2024 and profit shares then fall back to the levels of 2015 to 2019 the inflation target would be achieved. The increase in nominal wage is important because a recovery in real incomes is needed to reduce the purchasing power losses and to support growth.

On the monetary side the situation is appropriate and the situation on the fiscal side is adequate. That fiscal stance needs to continue, but for the medium term it has to be stepped up because the creation of a fiscal space is needed. Efforts are also required on the supply side, such as structural reforms ranging from re skilling the workforce with an emphasis on digital skills, to integrating immigrants. Improving the flexibility of the labour market and promoting innovation are essential. Investments are also vital, particularly to facilitate the transition to renewable energy and green technology.

2.4 Changes in interest rates are like tectonic shifts in financial markets

An official emphasised that high and persistent inflation is a problem. However, since monetary policy has implications not just on real economy price levels but on all parts of the financial system, it is important to avoid one dimensional analysis, especially in a high-debt environment with monetary policy tightening at record pace. Since the 2008 financial crisis and the start of highly expansionary monetary policy, there has been a significant increase in borrowing from capital markets, both by sovereigns and corporates. These dynamics increased further following fiscal and monetary expansion in the face of Covid. In inflation adjusted terms, the outstanding amount of corporate bonds in the EU has increased by almost 75% since 2008. For non-investment grade issuers the figure is almost 170%. While the aggregate development is similar to that of the US, the EU's growth has been more concentrated in higher-risk segments.

Europe also stands out when it comes to central bank involvement in corporate bond markets. The Eurosystem's corporate bond holdings stand at just below 3% of eurozone GDP, or almost 6% of the domestic market, much more significant than markets like the US and UK, where central banks have unwound their corporate bond positions. In a vulnerable situation like this, monetary policy needs to proceed cautiously and with financial stability risks in mind. It also cannot be left alone in this fight – it is vital that fiscal policy and prudential supervision help address high inflation while maintaining financial stability.

Delivering the capital markets union (CMU) would help reduce the financial stability uncertainty associated with rapid monetary policy tightening. Monetary policy functions through financial markets, meaning that the better functioning and the more liquid these markets are, the more efficiently monetary policy can be implemented. More efficient transmission makes it easier to gauge the impact, and thereby reduces the risk of sharply restrictive policies triggering financial instability.

3. The appropriate response to past shocks and to structural challenges facing European economies is to implement structural reforms, fiscal consolidation and investments that promote growth

3.1 Governments face pressure to consolidate their debts while creating fiscal space for appropriate investments in the green and digital transitions

A policy-maker noted that the Eyjafjallajökull volcano eruption in 2010, which happened during the previous EUROFI in Spain, was a good exercise in finding an alternative supply side. Four crises have been weathered: the great financial crisis, the euro area crisis, Covid and the war in Ukraine. The fifth crisis is the first we know it in advance: the environment and climate crisis. Covid, war and the environmental crisis are so complex that they cannot be solved with one or two instruments. Unconventional supply side instruments need to be used.

The two fundamental things a policymaker should do when going to the market is understand why and how. Europe did a world class job when it went to the market and asked for money for green, digital and social, and was very clear in all its communication that those were the three things that mattered. Every month the EU gives €1.5 billion of macro financial assistance to Ukraine, a non investment grade country, because it is looking at the design of a larger and safer Europe.

The response of member states has been excellent. With the agreement of Council and Parliament, minimum spending requirements for the Recovery and Resilience Facility (RRF) were put in, with green at 37% and digital at 20%. Member states had green at 40% and digital at 26% because the targets made sense in the market. Work has been done with member states on spending reviews and performance based budgeting, as well as increasing the quality of public administration.

The Chair agreed on the EU's world class response. It is important to the money that flows from NextGenerationEU (NGEU) on the ground and get investments done.

3.2 The implementation of NGEU is spurring a wave of ambitious reforms across Europe

An official stated that inflation expectations are overall well anchored, including in European Commission surveys. Wages are behaving well so far. The interest rate cycle is posing a big policy dilemma. The green transition requires a significant amount of investment. Europe's response to the pandemic has put the RRF in place, which is a powerful tool that leverages investment and reforms in key areas.

3.3 Experiences with the RRF and NGEU are mixed and controversial

An official noted that the RRF is a success story to some extent. Member states are responsibly overcommitting themselves and focusing on green transition and digitalisation, but in terms of execution it is not a success story; a survey was conducted between the member states and only 23% of them were satisfied with the progress of the RRF. The NGEU turned out to be an extremely bureaucratic tool that put heavy burden on national administrations. The implementation requirements of the national recovery plans remained rigid, with substantial delays in transferring payments to member states. Five member states still have no access to those funds more than two years after the pandemic, and against the background of the high interest rate environment it has become much more costly.

An official stated that the vast majority of countries are on track with the implementation of their recovery and resilience plans. More than €150 billion of grants have been distributed, and several countries are in the process of transmitting their third if not fourth payment request. The process of protecting and ensuring that the European taxpayer's money is well spent required the setup of audit and control mechanisms in a completely new performance based model.

A policy-maker observed that the fact that only 25% of the RRF has been spent is good news, because with 25% there has been a rebound. The rebound will be even bigger when 100% is spent.

The Chair added that with the requests that had been made for loans, the utilization of the RRF would be running up to at least 75%.

3.4 A tight fiscal stance in 2023/24 will help avoid additional inflation pressures and rebuild space; it is imperative that fiscal policy contributes to an improvement in the economy's supply side

An official explained that fiscally there is alignment with monetary policy in order to support the disinflation effort, but more needs to be done to create that fiscal space for the future. One of the weaknesses of European fiscal policy has always been procyclicality, as it can spend and support the economy during a crisis but cannot consolidate when times are good. There needs to be fiscal space for investment for the future on the public side, which will require hard choices and a 'rejigging' of spending. Revenue measures will be needed in order to do the required fiscal consolidation. NGEU was an excellent instrument, as it was performance based, focused on structured reforms and did not just provide money for future investment. The IMF has estimated that NGEU can lift potential GDP by 1.5% by the end of the programme in 2026.

On the European side a fund for countercyclical fiscal policy could be set up so that investment does not need to be cut. The second aspect is to think about a climate fund, as climate is a public good. Investment is needed across Europe. A European instrument would be useful for member states, but also in creating the fiscal cohesion required for good macroeconomic management.

3.5 The current state of the reform of the Stability and Growth Pact (SGP)

An official underlined that challenges and trade offs for fiscal policies are becoming tougher. The European Commission has come forward with proposals for a reform of fiscal rules in Europe. One of the design elements is to keep room for public investment and to have incentives in place that allow member states to continue doing that, and to avoid the errors that happened during the financial crisis and the follow-up where public investment cuts were the first victim of consolidation strategies.

The European Commission will hopefully be smarter after the informal Economic and Financial Affairs Council (ECOFIN) meetings on 15 and 16 September. The Spanish presidency is working intensively with member states, including in bilateral talks, to make progress. There are three difficult areas of discussion. The first is the overall balance of the governance of the proposals, the role and the responsibilities assigned to the Commission, the Council and possibly the European Fiscal Board. The second is the role of investment and whether the incentives in the Commission proposal are sufficient. The third is centred on the safeguards and benchmarks; the Commission proposal is centred on a medium-term debt sustainability analysis, but some member states would feel more comfortable if there were a greater amount of hard benchmarks to clearly monitor every year.

3.6 Towards an NGEU 2?

An industry representative noted that the ideal next step was NGEU 2, and highlighted Mario Draghi's recent editorial in The Economist outlining that a fiscal union was unrealistic when looking inside EU member states and understanding their social dynamics, but that the alternatives are also unrealistic. Mario Draghi also highlighted that the ECB had informed the markets that the euro system could redo quantitative easing (QE), and that the Outright Monetary Transactions (OMT) and the Transition Pathway Initiative (TPI) would be important in creating fiscal rules and fiscal room for national governments.

The ECB is engaging an operational framework review and the results will be seen towards the end of 2023. The operational review is important for what the future looks like regarding fiscal room. It is not ideal to link the monetary side and the fiscal side, but markets need to understand that unwarranted spread widening in Europe is something that will not be tolerated.

The Chair summarised that speakers recognised the macroeconomically tighter situation regarding inflation and growth. There are different appreciations of how the crisis may be exited in terms of how fast inflation may decelerate and how monetary policy may react going forward. Broad agreement was reached on the fact that the quality of public finances and investment are important. Europe has launched important initiatives and a world class NGEU, even though panellists have different views on implementation. There remains an element of worry if inflation stays higher. Markets have not yet priced in fully a scenario of "higher-for-longer" interest rates.

Normalising monetary policy: way forward

1. The outlook for inflation and growth in the euro area

1.1 Inflation is falling, but it remains well above the 2% target

A Central Bank official considered that progress has been made towards the objective of reducing inflation to 2% in the medium term. In October 2022, Euro area annual headline inflation was 10.6%. In July and August 2023, it was 5.3%. For the first time, core inflation is coming down. However, some of this fall is due to the drop in energy prices. It is not easy to determine the degree to which it is related to the change in interest rates. The impact of higher rates is yet to be felt. Households and businesses have been using up savings accumulated during the pandemic, but these savings will eventually run out. Until now, the EU banking industry has shown resilient. It has accommodated the weakening growth and continued high inflation without an increase in non performing loans (NPLs), for example. At some point, this will change. There has been sluggish growth during this period of rising interest rates. There are some signs that a turning point has been reached, but it remains to be seen whether this is the peak of interest rates.

A Central Bank official observed that the EU economy is in a good position despite the high levels of uncertainty. It is not at all certain that the EU has reached the peak interest rates. The estimate of r star is slightly positive in real terms. As inflation falls, policy will become increasingly restrictive. The eurozone is projected to reach 2% inflation in 2025. For the first time, the realisation of core inflation has aligned with projections. If inflation falls at this pace, the current rate is likely to be the peak. If inflation falls more slowly than projected, it will be necessary to take further action via signalling through interest rates. It is unlikely that the rate will be increased in October. By December, there will be three further readings of inflation. If they align with the projection, immediate action will likely be unnecessary. If core inflation remains persistent, however, further rate hikes must be considered.

1.2 The economy has proved more resilient than feared

1.2.1 The labour market remains resilient despite the deceleration in the economy

A Central Bank official observed that the current situation also reflects the monetary policy decisions taken during the pandemic and Russia's invasion of Ukraine. These measures were unconventional and untested, and their consequences are not yet fully understood. Due to fiscal policy support, many EU economies have been very resilient. The situation in the labour market is also unconventional. In comparison with the same stage of the last business cycle, there is unusual resilience in the labour market. In any event, headline inflation has been decreasing. It is finally in line with expectations. The current level of restriction is helping to bring inflation down. The next decision on rates will need to remain data driven. The main concern is that higher wage growth could fuel inflation. Indeed, employees demanding compensation for the loss in purchasing power amid tight labour markets has resulted in high wage growth. When considering the next step to take, it will be important to remember that currently transmission is mostly working on the lending side of banks' balance sheets.

1.2.2 Balancing resilience in the labour market with inflation reduction

A Central Bank official suggested that the key question in 2024 will be whether the resilience in the labour market is consistent with inflation returning to 2%. If inflation stalls above the target, it will be necessary to take further action.

1.2.3 As input costs reduce, profit shares will come down and labour shares will increase

A Central Bank official noted that there has been extensive discussion across Europe about profit shares, which have increased substantially in the last year. This should not have been a surprise to anyone, however. When margins remain flat and input costs rise, profit shares rise. At the peak of inflation, profit shares are at their highest. As input costs have fallen while wage demands have picked up, we already profit shares going down, as expected. This will solve the political issue regarding profit shares.

2. The monetary policy stance of the European Central Bank (ECB)

2.1 Negative interest rates were a mistake, and the ECB's response to inflation came too late

A public representative commented that Christine Lagarde was entirely right to call inflation a 'monster'. If this monster is not faced now, it will return in a more dangerous form. While the increase in policy rate seems impressive, it is worth remembering that the starting point was -1%. It was probably a mistake for rates to be this low. Secondly, the ECB's response to inflation came too late. The Federal Reserve raised interest rates in March; the ECB started in July. Over the last few months, euro area core inflation has been 5.2%, 5.7%, 5.3%, 5.6% and 5.3%. The statistical relevance of the difference between these numbers is practically zero. Core inflation is stuck at 5%. A Central Bank official noted that this is why the Governing Council takes account of momentum. Taking account of momentum, average three month core inflation was around 4% in September.

A Central Bank official disagreed with the suggestion that negative rates were a mistake. For a long period of time, inflation remained low while rates were around that level. Negative or nominally extremely low rates could not and should not have lasted forever, but there was a rationale for making these decisions.

A public representative agreed that it is easy to say with hindsight that things should have been done differently. However, the financial system is now extremely overleveraged as a direct consequence of that policy.

A Central Bank official stated that the negative externalities of negative rates are clear. In the future, central bankers will be much more cautious about using negative rates due to these unwanted consequences.

2.2 The ECB is committed to reducing inflation to 2%

A Central Bank official highlighted the importance of anchoring expectations. The 2% target is very clear, and the market understands the firm commitment to it. At a certain point, however, the focus on 2% can become an obsession. The anchoring of expectations is about creating stability in the real economy. It is about ensuring that companies are not obsessed with costs, price increases and margins. The objective of the 2% target is not to keep inflation at exactly 2.0%. It is to stabilise inflation around 2%. Monetary policy makers need to continue to demonstrate their determination to reach 2% and communicate the successes they have achieved so far. They will continue to follow a data-dependent approach to determining the appropriate level and duration of restriction.

2.3 At current interest rates, the 2% target should be reached in the second half of 2025

A Central Bank official noted that the eurozone is on track to bring inflation to 2% towards the end of 2025. However, uncertainty is very high. It is by no means certain that the present policy rate is the peak. The Governing Council will keep an open mind about further action. The yield curve reflects the changing market perception about the duration of the higher interest rate period. The markets must understand that central bankers are resolute about the 2% target. At present, the policy is in a reasonable place. Indeed, there is no need to be extremely hawkish or extremely dovish. As the economy softens, the easing of profit margins should enable wage growth to be less inflationary. However, this is yet to be seen in the data. The policy rate should only be reduced when the inflation outlook is about to consistently (say, from year and a half into the forecast) undershoot the target. If the path is leading smoothly to 2% over the forecast horizon, there is no reason to cut rates. Cutting rates too early would also reduce future policy space and push inflation up.

The Chair suggested that the key word in the discussion was ‘resolute’. The Governing Council has signalled its resolve to remain restrictive for as long as necessary.

2.4 The IMF’s research suggests that the policy stance should have a tightening bias

An official explained that the IMF’s baseline projection is that the ECB will achieve its inflation target in Q3 2025. The IMF’s research on episodes of inflation has shown that 40% of central banks do not successfully bring inflation under control after five years. The remaining 60% take an average of three years to reduce inflation to target. The IMF’s research also indicates that some of these negative outcomes were caused by countries prematurely declaring victory. The currently high levels of uncertainty make it difficult to determine what the right policy stance is. The inflation data will affect the inflation outlook. The IMF’s research suggests that the policy stance should have a tightening bias. If there is a requirement to carry out a second tightening cycle after inflation expectations have been de anchored, it will be extremely costly for the economy.

The development of wages and profits will be a key factor in future policy decisions. Clearly, nominal wages need to recover. The projection of recovery in 2024 is based on a recovery in real incomes. Currently, the IMF projects that nominal wage growth could be 5% for 2023 and 3% for 2024. This projection assumes that input prices substantially align with the forecast, productivity growth is flat and profit shares decrease to pre 2019 levels. Profit shares need to be compressed to allow wage growth to take place to achieve the inflation target. However, the door should be left open to further policy action on interest rates. It is encouraging to hear that there seems to be a consensus on this. The future cannot be predicted perfectly. The only choice is to react to events, which always requires some preparation.

2.5 Markets are pricing in the inflation forecast, but there is still significant uncertainty

A Central Bank official commented that markets were pricing rate cuts too early - if central bank inflation forecast materialises, rates will be cut later than markets anticipate. This cut might need to happen faster than projected only if the economy softens dramatically, if transmission is faster and stronger than forecast, if the external environment worsens or if the pass through of the decline of commodity prices into retail prices happens faster than projected. Equally, further supply side shocks could be caused by geopolitical factors, the consequences of climate change on food prices or changes in firms’ pricing behaviour.

3. The challenge of addressing excess liquidity in the euro area

A public representative stated that there is considerable excess liquidity in the market. More will have to be done to reduce the balance sheet. Eurofi’s monetary scoreboard also suggests that excess liquidity is a significant issue. A Central Bank official emphasised that excess liquidity must be removed in a way that does not damage the financial system, and this will take time.

3.1 The implementation of QT must be gradual and cautious

3.1.1 Testing the market with asset purchase programme (APP) sales

A Central Bank official stated that the solution to excess liquidity is quantitative tightening (QT). The Chair highlighted the recent announcement about flexible reinvestment and fragmentation risk in relation to the pandemic emergency purchase programme (PEPP).

A Central Bank official agreed that testing the market with outright APP sales could be beneficial. The ECB is already in the process of shrinking its balance sheet. Targeted Long Term Refinancing Operations (TLTRO) redemptions have contributed significantly to the reduction in the balance sheet. After so many years of expansion, any reductions could have structural consequences for the economy, the financial market and the banking sector. When there is less attention on interest rates, there will be time to discuss whether the ECB should work more proactively in this regard.

3.1.2 The excess liquidity will need to be mopped up, but there is no urgency

The Chair noted that the EU is in uncharted territory. Negative rates, quantitative easing and excess liquidity are all unprecedented phenomena.

An official agreed that QE has impacted the operation and workings of the financial market. The transmission of monetary policy through interest rates is working, however, which means that central bankers will have the time to learn how to drain this excess liquidity properly.

3.1.3 QT must be implemented cautiously

A public representative remarked that an overly abrupt implementation of QT will result in financial instability. Caution is the price that must be paid for the actions of the past. This will be a task for regulatory authorities as well as central banks. The system has become excessively leveraged over the last 10 years. The shadow banking system is a major problem that is often discussed but rarely addressed.

3.1.4 The efforts to reverse QE have been successful

A Central Bank official noted that it is too early to commit to outright sales. It does not make sense to discuss sales while central banks are still using interest rate instruments to bring inflation to 2%. Everything that has been done to reverse quantitative easing has been successful. The TLTROs, early redemption and the reduction in reinvestment have all been successful. At some point, the market needs to work with less direction from the ECB.

A Central Bank official agreed that QT should proceed gradually. QT will take time to implement and will need to be sequenced correctly. Before cutting rates, central banks should have stopped reinvesting and perhaps moved into outright sales.

3.1.5 The reserve requirement can be a useful tool to sterilise liquidity

The Chair commented that raising reserve requirements could also help address excess liquidity. In July, there was a shift to unremunerated reserve requirements. It has been suggested that this might impact profit and loss (P&L) as well as liquidity.

A Central Bank official observed that all monetary policy instruments affect P&L. The reserve requirement has been around for 200 years. As a prudential tool, it has been superseded by measures such as the liquidity coverage ratio (LCR) or the net stable funding ratio (NSFR). Monetary policy makers reached the lower bound of interest rates and expanded their balance sheets, but they have not reduced them before raising rates. In this sense, the reserve requirement is a useful tool not to drain liquidity but to sterilise it. Increasing the reserve requirement sterilises part of the excess liquidity until it can be safely drained. This affects P&L because mandatory reserve requirements are unremunerated.

A Central Bank official considered reserve requirements to be a simple tool, rather than a crude one. Simplicity is often preferable to complication. For example, the question of reverse tiering creates an entirely new set of problems.

3.2 Excess profits should be used to increase resilience in the banking system

The Chair highlighted the fact that deposit rates have not risen in line with increases in the policy rate. There have been different responses to this across the eurozone. Lithuania has imposed a windfall tax on banks, for example. The excess liquidity in the system seems to be suppressing competition on deposits, which is one channel of transmission.

A Central Bank official agreed that the transmission of monetary policy has been strong in terms of its impact on bank lending growth. However, there is considerable variation between countries. Unfortunately, banks have not been keen to share their profits. Profitability in the banking sector is extremely high. Populist thinking about what to do with these excess profits can lead to short term politically motivated decisions that ultimately damage the economy. These excess profits also have negative implications for the transmission of monetary policy. In that regard, banks must use these profits wisely. In the past, the European banking sector has had low profitability and competitiveness issues. Banks should use their excess profits to improve their services, invest in digitalisation and strengthen the banking system against further shocks.

A Central Bank official stated that banks have been slow to increase deposit rates. This is not due to reserves; it is because their results are getting better. In fact, this is a political issue. It can be solved by taxing banks, but this could have significant macroeconomic effects. It could negatively impact the climate transition, for example. It will also be difficult to do QE in the future if the banks are aware they are going to be taxed if the process is loss making for member states.

A Central Bank official highlighted the importance of taking account of the pace at which transmission is felt in deposit rates. QE, negative interest rates and the low interest rate environment were the results of a crisis caused by serious deficiencies in the business models of many banks. Central banks should not over remunerate simply because interest rates are higher. In a competitive environment, there should be pressure to increase deposit rates. Banks should want deposits because they want to do something with them that helps the real economy. This is why this is concerning. There has been a deceleration of credit, which will have important consequences for the real economy. In that sense, it will be important to closely monitor the loan to deposit ratios of banks.

A Central Bank official agreed that the banking industry must use the present situation wisely. The banking system needs resilience and efficiency. Weak banks are prone to failure, which weakens the system. Banks need to use the time and funding available to make the industry more resilient and drive economic growth. On the macroprudential side, these profits could also be used to strengthen countercyclical buffers, say introduce positive neutral CCyB. This moment of profitability should be used to make the system more efficient and resilient.

The Chair suggested that the PEPP flexible reinvestment and the Transmission Protection Instrument (TPI) could help protect against fragmentation risk, which Charles Goodhart had recently characterised as 'the dog that has not barked'. A Central Bank official noted that the EU banking industry is in a better position than it was in when 'the dog first barked' during the eurozone debt crisis. A Central Bank official emphasised that central bankers now have the right instruments to intervene if there is any unwarranted fragmentation.

Open strategic autonomy and EU economic security

Introduction

The objectives of strategic autonomy in the financial sector are clear, but implementation remains challenging. Deepening banking union (BU) and the capital markets union (CMU) is the right way forward, but it is difficult to make progress on those shared priorities.

The EU banking sector remains fragmented in part due to a sub-optimal capital and liquidity allocation between the parents and subsidiaries of pan-European banking groups, low profitability levels, different legal systems and so on. 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 BU.

For a CMU to emerge, it seems necessary to set up a bottom-up approach by meeting the needs expressed by many countries, where the economy is financed almost exclusively by banks, to develop local capital markets and share equity financing. At the same time, it is essential to establish a single European rulebook and single supervision for cross-border activities and pan-European financing players to eliminate undue complexity, level the playing field with foreign third-parties and facilitate European consolidation of financial players. Combining these two approaches remains challenging and all the more so as many member states often favour national strategic autonomy at the expense of European autonomy.

The Chair stated that the objective of 'open strategic autonomy' in financial services is to avoid excessive reliance on any single external service provider or jurisdiction. By developing an adequate domestic capacity and diversifying exposures externally, it should be possible to increase the EU's resilience in a world of growing uncertainty, while remaining integrated in a global financial system. For him, two questions arise in this regard. The first question is whether it is more feasible to to be open, strategic and autonomous as an integrated EU market than it is as 27 national markets. The next question is whether being open, being strategic and being autonomous are complements or substitutes.

1. Objectives and ways forward

1.1 The objectives are well defined

1.1.1 Strategic autonomy's increased significance

An official highlighted that ambitious conclusions on European financial strategic autonomy were adopted in April 2022. These conclusions remain valid in front of the Covid pandemic and the war in Ukraine, which were wake-up calls on the need to work further towards strategic autonomy of the EU. In the field of financial services, Strategic autonomy relies on three main aspects: a strong and internationally recognised currency, a resilient and competitive financial sector, and autonomous rule-making with respect to setting new standards and norms.

On the first aspect, there has been progress on the international role of the euro and 20% of international reserves are now labelled in euro but there is a need to be mindful of the impact of fragmentation on the international role of the euro. On the second topic, the financial sector has shown its resiliency despite turmoil in the US and in Switzerland. However, there is still some work to do to deepen the capital markets and have an integrated single market for banking and financial services.

On the last aspect and the creation of norms, Europeans have played a key role, in particular, on sustainable finance. There is now a framework that brings more clarity and transparency over the environmental, social and governance (ESG) characteristics of companies and financial products, though it can be improved. Building on this work, there is also a proposal on the regulation, transparency and integrity of ESG rating agencies currently under discussion.

1.1.2 Defining autonomy

An official stated that strategic autonomy is neither protectionism nor separatism. It is about making own decisions and own alliances. It is about working together with like-minded partners that share the same values and want to protect those common values. It is mainly about increasing the EU's capacity to act strategically on the global stage or in the global market. It is also about increasing competitiveness and building resilience.

The concept of strategic autonomy includes financial autonomy. The financial sector is a key area where open strategic autonomy (OSA) can be ensured. Brexit raised the question and highlighted a key dilemma about whether the EU's economy can be satisfied by being mainly an importer of financial services developed in third countries. The financial sector and the real economic sector go hand-in-hand, and without fostering autonomy, resilience and strengthening macroeconomic stability the resilience of the EU cannot be ensured.

The EU has great ambitions for the green transition, climate change investment and new technologies. They all need a great deal of fresh money, which should come from capital markets. The financial sector should not be seen solely as a bundle of risks that have to be regulated and supervised. Its core function is to intermediate financing from private people to investors and thereby enable growth.

1.1.3 The openness of the EU financial system

An industry representative remarked that Europe is the most open bloc in the planet. The question is whether to be more open. BRICS want to challenge Europe and the economic equilibrium. They have a plan to fundamentally transform the way the rest of the world operates. Before the competitiveness test, there should be an evaluation of what the unintended consequences could be. It should be asked whether it makes European producers and makers stronger or weaker.

The EU consists of 450 million people and has $16,000 billion of economic output, which is third in the world after the US and China. It had $1,450 billion of foreign direct investment between 2019 and 2022. Europe is as strong as its single market is. The only reason the rest of the world respects it is because of the strength of the single market.

1.1.4 Stability, competitiveness and customer confidence are three key aspects of strategic autonomy

An official indicated that strategic autonomy in finance means being stable, competitive and having the complete confidence of customers. OSA should be centred on those three aspects. Financial services are the backbone of the economy and economic security. The vulnerabilities should be mapped to interdependencies, for example, which could be handled either through diversification or cooperation, even with third countries.

One good definition of OSA is the ability to cope alone but to cooperate whenever possible. The financial sector can only support the economy if it is competitive. A substantial share of the knowledge and technology necessary for a successful digital and green transition resides outside of the EU, so there should be caution about placing unnecessary barriers that can slow down the EU's green transition.

The confidence of all consumers should be kept, while ensuring that banking groups are strong on all levels, and that supervisors know the entities and the market specificities. Customer protection is crucial, and even more so when it comes to digitalisation. As electronic payments gain momentum, new types of fraud are increasing. Customer awareness should be strengthened, and attention paid to managing cyber risks.

1.1.5 Europe 's competitiveness and growth needs competitive banks

An industry representative remarked that in 2008 the EU's economy was larger than the US's, but now the US economy is a third larger than the EU plus UK. At the beginning of 2008, the market cap of the top eurozone bank was very similar to that of the top American bank. At the beginning of this year, the top American bank represented more than the first 10 eurozone banks combined. European banking sector's competitiveness has eroded to be much lower than the other international players. Since 2008, EU banks have been weakened by poor growth, lasting negative interest rates, market fragmentation and lack of scale.

1.1.6 The participation of global firms in the EU system adds competition and market depth to the benefits of EU citizens

An industry representative suggested that strategic autonomy is about being competitive, resilient and globally relevant. That means having a financial sector that is able to provide a complete set of services to the economy under any circumstances.

In Europe, perhaps because of the trauma of the great financial crisis, much of the focus has been on being prudentially resilient, which has been achieved very well. The worry that foreign banks – US ones in particular – just want to take advantage of their effective internal market and then leave Europe in case of a crisis is no longer accurate. During Covid, for example, the foreign banks' share of the market did not change from 33%. Financial market resilience is not about how strong a single institution is. It is about the financial network. The financial network cannot be autonomous and has to be global.

1.2 Ways forward are well known

1.2.1 Completion of the CMU is crucial

An official emphasised that when creating the CMU there should be focus on local initiatives to build the depth of the market from the bottom up. The diversity of member states should not be seen as an obstacle, but as an opportunity for safety and increasing the competitiveness and resilience of the EU.

An official highlighted that some concrete legislative proposals and topics should be prioritised in order to make additional progress on the CMU agenda. First, the Listing Act should be a priority in order to reverse the trend of decline in public markets in Europe. Second, there is the need to increase investor culture with better information and further market transparency, including through the review of MiFIR. Third priority should be securitisation, which needs to be revitalised. Fourth key topic is credible and manageable sustainable finance requirements. Finally, Europe should increase financing opportunities for start-ups and scale-up companies.

1.2.2 Making the EU banking sector more competitive and resilient

An industry representative remarked that there is a need for a strong, competitive financial system that can finance the economy to achieve the goals of security, social equity and transition. However, it is difficult to see the light at the end of the tunnel in terms of the single market and the service passport due to the wide array of national rules on insolvency, consumer protection and deposit insurance. The lack of a BU is one of Europe's biggest missed opportunities. A European Parliament study estimated that the completed economic and monetary union can add €320 billion a year to the economy until 2032.

An official reminded the audience that size matters: all foreign or non- European banks are welcome on the single market but there is a need to ensure the rise of bigger actors and further consolidation of the banking sector. A great deal of progress has been made towards a more resilient and better supervised banking sector, but we are still far away from a true single market for banking. There has to be consideration of what is preventing cross-border exposure and integration. To find the right solutions, there is a need to re-engage the industry to better understand the impediments to more cross-border exposure and to look at the different ring-fencing practices to determine which distort the most and try to lift them.

An industry representative stated that good progress has been achieved on BU, 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 welcome. CMU and BU are the fundamental drivers of financial resilience in the EU.

2. Priorities for progressing towards open strategic autonomy

The Chair summarised that strategic autonomy is a relatively new concept to finance, being more familiar in political science. So, a question is whether it is a natural concept for finance. It is about building and using domestic capacity but also being willing to cooperate where possible. The question then is whether to build that domestic capacity as a complement to the rest of the world or if there are substitution effects between building domestic capacity and the willingness to interact with the rest of the world.

'Open', 'Strategic' and 'Autonomy' have to be balanced, but the question is which to stress more, and whether the balance is the same in the financial sector, given the network effects, as in the real economy where there is greater traction for the concerts such as strategic autonomy.

2.1 Combining bottom-up and top-down approaches

2.1.1 Identical rules, single supervision and European equity

An industry representative commented that a single rulebook is necessary. When rules are only similar, they are different. Identical rules are needed. The Listing Act is a unique opportunity to create a proper S1 with the EU flag on it and a European Securities and Markets Agency (ESMA) logo so the rest of the world understands that it is the output of European regulation.

There is a need to move radically to single supervision for pan European players. There are plenty of pros and cons to single supervision, but there is too much asymmetry between local supervisors and too much unpredictability around gold-plating. Single supervision is needed for harmonisation purposes.

Fragmentation of producers and makers is never going to be the right tool to compete against giant companies. Consolidation has to be facilitated and creative ways found to ensure competition. Size is a prerequisite to being able to buy other assets and to influence other's decisions.

The world has changed, as more people in Europe will be voting for populist and nationalist right-wing parties. Those votes must be respected, but they do not provide a mandate to continue with the narrative of the happy globalisation days of the CMU. There is a need to find a way to reconnect with the fundamental values of the European project. The way to continue integration while resonating with citizens' expectations is to make sure a set of measures is delivered so European money is going to owning European assets, and where equitization is an avenue to provide the migration of the pool of European savings towards ownership of European companies.

2.1.2 Strengthening the securitisation to connect capital markets to the real economy

An industry representative stated that the EU's CMU is underdeveloped, limiting financing choices for large companies and small and medium-sized enterprises. A weak securitisation market and market fragmentation hampers investment within the EU and also dampens funding from outside. One of the priorities should be strengthening Europe's securitization market.

2.1.3 A competitiveness test in order o to assess systematically unwanted consequences of any piece of EU financial regulation

An industry representative noted that if Europe does not own assets, and Europeans do not manage European players, it is not autonomous. Europe has to not just be a continent of consumers of finance but also of makers of finance. There should be a pause to try to realise, when it comes to competitiveness tests, that there are two types of players in the industry. There are those who sell services in Europe, who benefit from all of the money injected into the system for stability purposes, and those who treat this part of the world as a division called Europe, Middle East and Africa (EMEA).

2.1.4 The use of domestic resources to preserve diversity

An official remarked that the CMU under consideration is multi-centred and should take into consideration market and corporate specificities. The main opportunity of CMU is its diversity. Accelerating the green and digital transitions plays a key role, and with the CMU the right direction is being taken. There should be a move toward strengthening the resilience of the non-banking sector, while also ensuring the cooperation of regional centres. ESG is also a critical aspect. ESG ratings, for example, will have an important impact on capital markets in trying to strengthen investors' confidence in sustainable products.

2.1.5 CMU does not mean centralisation

An official emphasised that there should be learnings from the approach taken so far on CMU. There has been a focus on creating a pan-European capital market with unified regulations and centralised institutions large enough to serve all member states and to compete on a global scale. Over the past 15 years much of local capital market capacity has been lost due to this approach and due to regulatory and technological changes that have favoured centralisation. Instead, the CMU should be based on the best practices from the regions that have successfully developed their markets and be closer to medium-sized companies. The CMU should consist of closely interconnected international, regional and local EU financial hubs.

Local ecosystems should be rebuilt through regulation that is better adapted to the size of companies and markets. Private capital markets and alternative ways of financing should be developed. An equity culture should be built in Europe. Prudential regulation should be reviewed to prevent it from handicapping the sector's capacity to finance the economy.

2.2 Improving the BU remains difficult

2.2.1 Integrating bank supervision in Europe vertically and horizontally

An industry representative noted that bank supervision is carried out in a much fairer way compared to the US. It is vertically integrated, independently of the size of the bank. There are the same criteria, although there might be a different supervisor. The biggest enemy is market fragmentation. There is no single market to talk about for financial services. The culprit is not yet achieving a true BU. Supervision is vertically integrated, but horizontally, geographically, it is not, so European institutions cannot capitalise with the huge economies of scale there are in Europe. That is one of the most important improvements that can be introduced to the market.

2.2.2 The home-host issue is difficult to solve

An official stated that fragmentation of the EU banking sector should be avoided by ensure that consumers can be confident in the resilience of local subsidiaries of banking groups. The home-host question is very difficult. Banks use different business models in different countries. As long as there are various financial cultures and market situations, local supervisors are needed. The supervisors know the local entity and its environment, with sensitivity to local and regional trends, and can act quickly and efficiently.

An official noted that the home-host issue is also due to the banking systems and the differing levels of development of European countries. It is not possible to think that host countries will have a sufficient level of prudential regulation requirements and will allow the banking groups to transfer meaningful financial resources from the subsidiaries to the parent entity, with of all the costs that will arise. The costs associated with bank failure are still largely assumed at the national level. There can be discussion of how to create a mechanism that will provide an outflow of capital to the home countries and not affect negatively the depositors and clients in smaller countries, and how to make the market more unified and open. All member states should be considered.

An industry representative called for dispensing of home-hosting because it is politically loaded. Even if there is the European Deposit Insurance Scheme (EDIS), if the system still has the home-host situation there will not be a BU, and there cannot be a CMU without a BU or a fully developed securitisation market.

An official noted that when creating new concepts, like the CMU or BU, there is a focus on the regulation but, rather than looking for new rules, the existing rules should be evaluated to identify how they could be simplified.

The Chair summarised that OSA is not an obvious concept in an international financial system that has been characterised by globalisation. It is a question of balance between the O, S and A, and it has to be decided whether they are complementary, or partially substitutable or not. As a collection of 27 national financial systems, they cannot be complementary because there will always be a feeling of threat from the outside. There is a better chance as an EU 27 single financial system which would be large enough to compete globally and so less likely to be about openness. Supporters of globalisation must accept that the world has changed and that the commitment to openness has weakened. One concern is that if the emphasis on openness is reduced, the pressure for integration of national markets within the EU will be reduced and the EU will stay fragmented and never become strategically autonomous. Openness is part of what delivers a strategically autonomous Europe.

Priorities for the next Commission

Introduction

The Chair welcomed the attendees to the panel reviewing the priorities for the next European political cycle, first in terms of macro issues, then Capital Markets Union (CMU) and banking union. The discussion showed that the key policy objective for the years to come is to restore the EU's competitiveness. The EU is not a single country, but to build a true banking and capital markets union, national egos should be put aside to lay a common, European-oriented foundation.

1. Restoring EU competitiveness is the key policy objective for the coming years

1.1 Addressing economic and fiscal divergence between EU member states to catch up Europe's lag in competitiveness

A public representative stated that the key word in discussions about the next European Commission will be competitiveness, specifically loss of competitiveness in the face of China and the USA. Europe lacks the capacity to mobilise resources on focused objectives and lags behind the US economically, technologically and militarily. Europe has a weaker risk-taking culture and should consider CMU as a chance to strengthen it.

Internal competitiveness within the EU must also be considered. The main structural weakness of the EU is economic and fiscal divergence or heterogeneity between member states. The reform of the Stability and Growth Pact (SGP) holds relevance. Cosmetic changes have been proposed which will not deal efficiently with the structural issues of the EU. The EU must deal with the lack of fiscal discipline and the lack of flexibility, meaning that the proposed policies are procyclical.

A European fiscal framework should be built based on two pillars. There should be simple expenditure rules. The simpler the rule is, the more difficult it is to circumvent. On the other hand, a fiscal instrument is required like that used for NextGenerationEU (NGEU), which should be permanent, and should be strictly controlled by the European Commission or the Council and used in the event of asymmetric shocks suffered by different countries.

An official agreed that competitiveness will be on top of the agenda. The Commission has neglected the idea of an agenda in the past few years. There is need to decarbonise and to get rid of fossil fuels. This will require a transition period, the meaning and consequences of which have been neglected. The lack of attentiveness has resulted in a need to catch up. The international community must be on board. If the EU decarbonises to the extent the Commission is proposing, 7% of CO2 emissions will disappear. This does not mean much at world level.

The Commission has said it will be a geopolitical commission and needs to get others on board with its efforts in the current international context with China and the US very active, especially with the American Inflation Reduction Act.

The Office of Management and Budget in the United States says that there is about $1,000 billion in tax breaks. There will be many American companies that will not pay any taxes for the foreseeable future, which gives them huge investment opportunities. The longer-term consequences of this have been underestimated. The EU must not be behind the curve. It should get in front to safeguard competitiveness, jobs and welfare.

The political decision-making process within the EU is quite complicated. Enlargement should not complicate that political process even more. There will be two things that will need to be efficiently taken care of, which are the enlargement and the impact on the political decision-making process.

1.2 Increasing productivity and reinforcing competition policy to reignite the Union's competitive flame

A public representative agreed that competitiveness and productivity are crucial. Prices can be lowered to drive competitiveness, but that is not a goal, so the focus shifts to productivity. There are concerns in that regard.

Average productivity growth is weaker than other large economies. R&D investment intensity in the EU falls behind the US, at 2.3% of GDP compared to 3.5%. The EU will not reach its 3% target in 2030. 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.

The US has overtaken Europe in terms of productivity which shows that Europe must invest more. European funds are needed for investments in essential industries like green hydrogen and batteries. Interest rates have gone down since the mid-1990s and investment rates are flatlining. If rates are flatlining, productivity, whether public or private, will not grow.

There needs to be more public and private investment. Sustainable finance should ensure that private and public investments are aligned. There should be a focus on transition. There has been too much focus on green transition through the taxonomy. It is not about being green but becoming green. There should be a sustainable finance framework so that all corporates can make the transition towards sustainability.

The other part is that investment must be financed alongside rising healthcare expenditure in the Europe. The EU might want to maintain or reduce its debt. Capital has been undertaxed, and labour has been overtaxed, and there should be national and international efforts to remedy this. The mobility of capital has increased such that there has been a lowering burden of capital, which cannot be afforded with the goal of investment and higher productivity.

When talking about competitiveness, the competition policy and lack of it in Europe must be addressed. 70% of profits of the top 50 IT firms goes to America, 23% goes to China and Southeast Asia, and 3% through the EU, including ASML in the Netherlands. The large earners and large corporates are Google, Facebook and Amazon, which have taken hold of the economy without a competition policy in place in the EU. There should be more competition in the market to allow interoperability.

The Chair commented that there are not enough fast-growing companies in Europe and those companies have nowhere to go to get capital. They instead go to the US, which is a serious problem.

1.3 Pursuing the strengthening of the single market

An official observed that the best way to increase productivity is to increase the consolidation of the single market.

In terms of regulation, if new environmental rules are to be passed, there are some problems in the Parliament and in the Council. To advance the single market, it is mostly agreed that there should be a real European single market, and banking and capital markets are far from this. One objective to focus on for the next few years is to advance faster in the single market in banking and capital markets, as well as in other sectors.

There is a need for the EU to increase resilience and autonomy in the global market. There should be an advance in the industrial policy. Globalisation has started in a new process. The EU may be approaching regionalisation more than globalisation, but most of the new measures and new norms to increase autonomy will also increase inflation in the short term. It is unclear whether the means that the Commission introduced in some proposals will be successful. In the meantime, inflation will be higher and public expenditure will be higher, and public money will be moved from other objectives to review the industrial policy with a potentially questionable impact.

There is a debate on the budget and own resources. New European debt was issued during the mandate which must be repaid. There is political agreement between the Parliament, the Council and the Commission to put in place new own resources to repay the debt, but this is a faraway objective. The own resources are key for the future.

If there is any kind of fiscal stabiliser where the objective is different from the convergence policies, there are two debates: one on convergence and the other on anti-cyclical elements.

The Chair stated that there is the question of whether Europe needs to speed up the decision-making process. The second issue is whether institutional changes are to deepen the single market or build a permanent institution, or NGEU, and give more responsibilities to it.

A public decision maker commented that the notion of competitiveness should not be moved away from, and it has been neglected in past years. Long-term strategy documents in the EU refer to smart, sustainable social growth, yet rarely mention competitiveness, so lack of focus on competitiveness should not come as a surprise.

Productivity has been decreasing for two decades in quality and in comparison, with the US. The labour force in the US has grown by tens of millions and productivity is growing. It is shrinking in Europe. Europe is facing structural problems, in terms of labour and skills.

The issue of regulation must also be mentioned. There were promises on the reduction of the administrative burden and that there will be a proposal from the Commission. This is a good step forward but the approach to this should always be horizontal. The Net-Zero Industry Act shows an interesting pathway for the future as it promotes labour and skills. It is also about the reduction of administrative burdens, especially for sustainable technologies, and about investment in industry which has been underestimated in the past years.

Most of the key successful companies will grow based on mobilised private investments, in which there are still issues, similar to capital markets. Capital markets in Europe are shrinking and at the same time there is a CMU initiative. Europe is failing in this regard. The last half year saw the least IPOs in Europe since 2008, indicating that there is something wrong. Without having enough funds built on own resources, it would be difficult to deliver successfully on climate and other goals. There must be a massive mobilisation of capital within Europe and from the outside.

1.4 Without a single market, nothing Europe does will work

A public representative stated that the question on the interference power of Brussels to member states has not been established in the future or present.

Europe needs a clear, transparent and democratic framework because it is unacceptable when the Commission, without any control from the European Parliament, takes decisions on member states. This must be fixed. It is a difficult debate, but to achieve an internal single market and increase competitiveness, a stable market is needed for the eurozone. An important step during the last few years was taken with NGEU, but there has not been any new own resources to repay the debt. If there are own resources on the table, decisions will be easier to take in the face of an important crisis in the future.

On competitiveness and the administrative burden, there is a need for more private and public investment, but the problem is who finances it. In Europe, it is banks. 70% of Europe's SMEs and companies are financed directly by banks, but there are national markets. There are thousands of national regulations and European regulations which give some powers to national governments and national supervisors to reduce the consolidation of the single market.

To increase competitiveness, reducing national regulations but keeping national borders will not work. Without a single market, nothing will work.

1.5 Mobilising four types of resources (labour force, Green Deal, regulatory framework and finance) to restore EU competitiveness

An official commented that mobilising resources is one of the key features to achieve competitiveness. The EU's key strategic resources must be determined. There are five key resources and each comes with challenges that must be tackled.

The first resource is people. The EU has a labour force, but there is not enough high-qualified labour. This must be addressed.

The second is forward-looking policies and the right targets. The Green Deal must be maintained until the end. The EU should be pragmatic and realistic but remain ambitious.

The third is the regulatory framework. The EU usually sets the regulatory framework ahead of everyone including competitors. There is a challenge with the implementation of that proper regulatory framework, which can play the opposite role and drive the gap between the south and the north, the east and the west.

Fourth is finance. The Recovery and Resilience Facility (RRF) has been by far one of the very successful policies of the EU in the last few years. However, only about 30% has been used and time is almost at an end, suggesting lack of efficiency. The EU does not know how to invest. Money must be used in the most efficient and effective manner for the benefit of industry and people.

Fifth, Europe has always been a driving force for innovation and ideas. This is Europe's key strategic advantage and should be boosted using all the other four resources.

2. To improve the Banking Union and Capital Markets Union, a European-oriented foundation must be laid

2.1 A functioning capital market in Europe would be helpful

A public representative commented that sustainable finance has a crucial role to play in aligning public and private investment. The Sustainable Finance Disclosure Regulation (SFDR) is a chance to align better with a taxonomy framework that has been developing in parallel. Better alignment is required to relieve unnecessary burden.

Finance needs to go to corporates for the change towards sustainability. This will help not just the corporate but the political debate as it will broaden the base and thus the support for sustainable finance. Only recommendations on transition finance have been made in this mandate and legislative initiatives are now required.

R&D is lower in Europe than in the US on the macroeconomic scoreboard. This is partly the result of aggressive takeovers by Google and Facebook. The US is turned to because it has deep pockets in comparison to Europe. The deep pockets of tech companies are as much of a problem as competition.

Christian Lindner and Bruno Le Maire wished for a revival of the CMU. This comes from the countries that shut down Debt-Equity Bias Reduction Allowance (DEBRA), which removes the debt bias from corporate taxation, and countries that take aim at the inducement ban or value for money.

While looking at alternative investment funds, there are shocking differences across countries in fees for investment funds, which is hampering the European market. In the UK or the Netherlands, the fees are low on average, but in Poland and Portugal, fees are incredibly high. If there is to be a European capital market, it must be noted that the market is not functioning at some points.

2.2 Active private investors or retail investors will not be interested in market financings without the proper tools and right framework

A public decision maker stated that domestic investors must engage before those outside, which is where certain challenges are faced.

In terms of acceleration, risk aversion cannot be changed. The driving force of the European economy is the SMEs or start-ups. The initiative on European legislation and start-ups is one of the last initiatives in the Parliament from the Committee on Industry, Research and Energy (ITRE) perspective.

One of the problems described by the start-up sector is the inability to fit into any regulatory framework without proper definition. It is difficult for start-ups to access funding as investors are not willing to take the risk of something that is not part of regulatory framework. The industry is working actively to ensure receipt of that stamp to get proper access to liquidity and financing.

The EU's environment is unique and requires internal work before thinking about attracting from the outside. The Retail Investment Strategy is also important as it goes back to the financial literacy of the society. Active private investors or retail investors will not be interested without the proper tools and right framework.

2.3 CMU should be approached in terms of a broader strategy and not as a set of single specific measures

A public representative stated that there is a need to properly mobilise private funding. A truly European cross-border culture must be built and cannot be done by one piece of regulation. There is a problem of how to approach the entire CMU initiative.

Funding is already available but is lying in different instruments or savings accounts. The idea is not to turn Europeans into Americans, but to adapt the US framework to the needs of Europeans. The amount of available funding can then be used both for financing the economy in growing SMEs and financing the climate policy targets and all the others.

This past year, the EU is losing on Foreign Direct Investment (FDI) compared to the US, indicating a problem in attractiveness. Making Europe greener and more sustainable was the right decision but this needs to be dressed up in an attractive way. There does not necessarily need to be more regulation as there are many rules and policies in place.

The discussion about sovereignty might not be needed in this context. The right thing on the best suitable level should be done using the currently available tools.

2.4 When a crisis comes, Europe knows how common its interests are. If the situation normalises, this means that the politics is still local. This is the main problem in the EU

A public representative observed that bank supervision is not the main challenge. The problems are on dynamics rather than security. It is not a real banking union if there is not a major cross-border takeover of banks in the EU.

What is at stake is sovereignty or a perception of it. CMU is about deepening the capital market in Europe. Huge progress was made by building the euro which is forgotten already. The problem with CMU is that it is a myriad of small and big changes that are very intrusive in national systems and the countries are very reluctant to give up on those interests or traditions.

When a crisis comes, Europe knows how common its interests are. If the situation normalises, this means that the politics is still local. For the EU to come back to being something more than a group of wealthy countries, it first needs to put aside national egos.

The Chair commented that as Europe has tried to build a banking union, CMU, sustainable finance and so forth, it has not used la méthode Delors. Europe has not been rigorous enough to show intellectually, with unimpeachable or academic evidence for all member states, that these things are beneficial.

A public representative noted that, if European capitals are ready to accept that at the European level their budget proposals are not only criticised but changed, fiscal union could work. If there is doubt about this, there will be a huge political discussion with tensions increased to a never-seen-before degree.

It is about sovereignty. The big problem for banking regulation is the execution. Europe has gone very far in following up and in having the data and analysis. When there must be action and potential elimination of one bank in one country, sovereignty and national sensitivities come into the equation. If the answer to those questions on sovereignty remain in a grey area, there will be problems with competitiveness, productivity and even climate policies for the foreseeable future.

2.5 A permanent fund is necessary

An official stated that Europe wanted a single monetary union and a single currency. There are no other sovereignty decisions that give back the sovereignty on monetary policy. A true fiscal union like the US is not necessary. The debate on convergence, how to move the money from north to south or south to north and how to increase or reduce inequalities is another debate. Reducing the burden on the European Central Bank (ECB) with a small fund could be useful. This fund could directly finance Germany which needs more investment. It is not a debate between north and south, but about how to build an efficient monetary union.

A public representative added that the question of subsidiarity is relevant in the European public debate but a discussion is required on the functioning of the EU and the need to extend membership to the western Balkans and to include Ukraine. There is a need to discuss what to do together and separately.

People already have a very good concept of subsidiarity. All the euro barometers long ago showed that people thought a common foreign policy is fine because people understand the concept of acting together in a big world. On other issues like taxation or climate change and energy policy, people perfectly understand that that is a natural role for Europe to have.

The Chair thanked the panel for their participation and wished the members success in their future elections.

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II

BANKING AND INSURANCE REGULATION PRIORITIES

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Lessons learned from the banking turmoil

Introduction: Back to basics: sound risk management and strong supervision

The Chair commented that the banking turmoil in March and April was a disturbing reminder of the speed with which underlying financial system vulnerabilities can be exposed. There is a general consensus that deficiencies in banks' risk management and governance were primary drivers of the turbulence, especially in the United States. Supervisors have also identified some weaknesses in the implementation of the supervisory framework. The growing influence of digitalisation and social media can trigger sudden financial outflows.

During this session panel it was highlighted that it is not the right time to think of new regulation, but rather to define and improve any piece of the current framework that proved it was not working. Moreover, regulation cannot be a substitute for supervision. Priorities for ensuring that supervision is intrusive, proactive and effective forward looking without entering into the management of institutions were discussed.

1. Now is not the right time to create new regulation, but rather to define parts of the current framework found to be insufficient

1.1 Without the Basel framework, the banking turmoil contagion would have been much worse

A Central Bank official commented that the financial system had maintained its stability, largely due to Basel III reform, which has strengthened capital and liquidity requirements. In Japan, even with the unexpected shift from the low for longer to the higher for longer interest rates environment, not only the global active banks but also the regional banks have maintained sufficiently higher capital than required. The banking turmoil was idiosyncratic to the relevant financial institutions' business model, governance and risk management. Full, timely and consistent Basel III implementation should be prioritised over revision. Furthermore, the effectiveness of supervision by pillar 2 must be improved, including monitoring, onsite examination, dialogue with top executives and stress testing in more stringent scenarios.

An industry representative stated that the existing global regulatory framework has proven effective and has demonstrated that resilience since the GFC has increased substantially. With regard to capital, implementation of the existing Basel framework is key. Transparency of supervisory rulings should be reviewed. Whether transitional prudential measures are in place, this should be understood and made transparent to the market. The same applies to forward-looking stress tests, which are not disclosed in every country.

1.2 A loss of confidence in financial institutions leads to a sudden shift from the book value to mark-to-market value to resolution value

The Chair commented that, during the banking turmoil, there was a shift by investors and markets from a balance sheet point of view to an entirely mark-to-market view, in which capital and liquidity does not matter. This can be counterintuitive in some cases, because assets are not supposed to be in the market.

An industry representative stated that these dynamics are not counterintuitive, because all investors are aware that banks are engaged in maturity transformation, which creates a natural mismatch between assets and liabilities. Particularly, the quantum of liquid assets is not calibrated to sustain a mass simultaneous withdrawal of all liabilities. Banking relies on confidence that the institution will continue as a going concern. If that confidence is lost, the market pivots from a going concern view to a liquidation view of the balance sheet, assuming that some assets will not be realised at their book values. This has a disproportionate effect on shareholders, leading to a fall in the share price. This is not particular to the financial industry. The share price of Eastman Kodak dropped as it was downgraded. On the day that it announced that it was going to file for bankruptcy, the share price dropped a further 28%. This is rational behaviour by the market because the liquidation value is expected to be less than the going concern value.

Banks are private enterprises and should be allowed to fail, but they need to fail safely. Confidence support mechanisms, such as liquidity provision by central banks, should be harmonised. A clear understanding of the mechanisms to support the confidence that is necessary for a business to remain a going concern is vital. The mechanisms of the European Central Bank (ECB) should be considered more closely. In particular, the emergency liquidity assistance (ELA) programme is quite opaque.

A Central Bank official observed that a loss of confidence in financial institutions leads to a sudden shift from the book value valuation to mark-to-market value to resolution value. As financial intermediation intrinsically involves maturity and liquidity transformation, it is not surprising that this happens in turmoil. Similar occurrences were observed during the financial crisis in Japan in the 1990s.

1.3 The velocity of deposit withdrawal raises questions, but a revision of liquidity ratios to address the outflows seen in reality might have material effects on credit provision and intermediation

A Central Bank official observed that social media and digital banking has dramatically increased the contagion speed of loss of confidence and thus the speed and volumes of deposit withdrawal. To address this, the macro and micro-prudential policy at an ordinary time will be key in appropriately conducting supervision, for example onsite examination, offsite monitoring and stress testing. At a time of stress, a supervisor's announcement, nimble liquidity provision by central banks and public backstop as necessary should play key roles. The moral hazard issue must also be addressed.

An industry representative emphasised that the liquidity framework must be credible. It is not self-evident that a debate should be opened on the liquidity coverage ratio (LCR) and net stable funding ratio (NSFR), which were not applicable to the US banks involved in the turbulence.

A Central Bank official commented that the turmoil has highlighted some new lessons. For example, the speed of runs has increased. Silicon Valley Bank (SVB) lost $40bn of deposits on one day and was expecting to lose $100bn of deposits the next day a combined total of two thirds of its balance sheet and 85% of its deposits in 2 days. During the global financial crisis (GFC), Northern Rock only lost 20% of its deposits in 4 days because people had to queue up to remove their money and there was the social media channels were not what they are today. The outflow rates in the LCR and the NSFR were calibrated against the scenario experienced during the GFC, which is a wholesale funding run and retail deposits being relatively stickier. Supervisors and banks are supposed to consider operational readiness and the importance of being able to monetise the high-quality liquid assets (HQLA), but it is not something that supervisors in the international community have focused on.

A revision of ratios to deal with the actual outflows and a requirement of readiness to monetise on day zero, which would likely require a bigger mix of reserves in the HQLA, might have material effects on credit provision and intermediation. This could shift banks towards a model of narrow banking, which would not be desirable. An old alternative proposal by Mervyn King was that the central bank becomes a pawnbroker of all times and stands ready to provide liquidity against pre-pledgd collateral. LCRs and NSFRs would not be needed, just an ex-ante pre-pledge of haircutted assets to meet all deposit withdrawals for all deposits up to 12 months. There is a spectrum between these two views. One lesson from Credit Suisse is that intraday liquidity is needed, which is included in pillar 2.

An industry representative emphasised that how the new digital scenario impacts the established LCR and NSFR parameters must be considered.

1.4 Rather than creating new regulation, any parts of the current framework that are not working should be redefined

An industry representative noted that there is general agreement that the crisis was not caused by a traditional banking model and a failure in regulation but was specifically due to particular business models with poor management of risks. A risk that is different from the traditional financial risks may lead to a bank run because of reputational issues. This cannot be addressed with traditional measures of regulation. The risks must be understood, and issues managed before they happen. Once issues arise, a contagion effect is possible. The report recently produced by the expert group for the single supervisory mechanism (SSM) points whether some issues may be addressed by increasing requirements or qualitative measures. The benchmarking initiative is a positive development, but there is a risk that benchmarking could be used to promote preconceived ideas or models that have not been tested. Supervision should not become too intrusive in a bank that is well managed.

1.5 The regulatory response should not be rushed. The focus is still very much on implementing Basel III

An official noted that there are lessons for supervisors, but also for banks. Banks in the US failed with more than a trillion dollars of assets and there was a forced integration of two GSIBs. The speed of the bank runs was extremely fast. This was ultimately related to a lack of confidence, but capital should not be totally discounted. The global spread of events, despite the events being very different, was fast and interconnected. Journalists, market analysts and investors were all thinking of 2008, even though it was not a repeat. The Basel Committee on Banking Supervision (BCBS) met in March 2023 and agreed that the resilience due to reforms had helped enormously. There was enough confidence. However, it must be remembered that there was widescale Government intervention, liquidity support and deposit guarantees. It had been hoped that this would not happen so quickly again.

2. Remedying weaknesses in supervision

2.1 Lessons for supervision from the emergency takeover of Credit Suisse

2.1.1 The list of missteps at Credit Suisse up to the incident six months ago demonstrates the need to balance supervisory powers

A regulator stated that, if a supervisor has the power to manage a bank to set the strategy, the result will be a weaker banking system. However, a supervisor that is not able to influence the management of a bank effectively will also lead to a weaker banking system and provide for a loss of confidence. It is clear that the numerous enforcement proceedings against Credit Suisse by FINMA did not result in a timely change in the risk culture of the company. FINMA is therefore considering three potential new measures. The first measure is the introduction of a senior manager regime to more closely link responsibilities and risk takers. The second measure is the possibility of FINMA fining banks. The last measure is the possibility of having a looser and more offensive communication around enforcement policy. In the end, the question of whether supervisory instruments and competencies should be further expanded is a political one.

2.1.2 The Credit Suisse case demonstrated how authorities worldwide are able to prepare and coordinate for a single point of entry bail-in

A regulator underlined that the too big to fail specific capital and liquidity requirements rescued Credit Suisse in October 2022. During that month there was a huge digital and global bank run on the global systemically important banks (G-SIBs), something unseen even in the GFC. The too big to fail package was decisive in preserving financial stability in the crisis. The single point of entry bail-in package was ready to be implemented, so was a very credible option for the Swiss authorities. The option that was chosen was the UBS-Credit Suisse integration, but the availability of the other option made an old-style bailout very unlikely. The single point of entry bail-in was ready to be implemented because the global regulatory community was involved.

The too big to fail framework will likely be improved after this crisis. Two elements will be central. One is the development of more optionality in the resolution planning. Secondly, the reliance on a public liquidity backstop, which was crucial to restore financial stability. A further lesson to be drawn from this crisis is that liquidity is a key metric in the too big to fail environment as well.

2.2 Supervisors need the ability and the legal framework to take early action when necessary

An industry representative stated that deficiencies in banks' internal governance frameworks and risk control practices cannot be remediated by requiring compliance with more demanding prudential standards. Supervisors oversee, control and challenge the appropriateness of the risk management and governance and intervene if it does not meet the required standard. Effective early intervention powers might be necessary, even when the prudential metric is still adhered to comfortably. In Switzerland, UBS supports the suggested introduction of an individual accountability regime, based on experiences in the UK and the APAC region. The request for defining competences is also supported. Early intervention powers should be clearly defined and based on objective criteria. Indicators could include the number of enforcement actions, the failure to remediate effectively identified control weaknesses and continued and long-lasting weak profitability or stock price/book value and CDS spreads performance compared to peers.

2.3 International cooperation must be combined with cooperation between supervisors and resolution authorities

A resolution authority official commented that the turmoil derived from a confidence crisis. Building confidence requires appropriate risk management, governance and adequate supervision. If all these lines of defence prove insufficient, then, at the end of this continuum, stands the resolution framework. Confidence can be fostered by being transparent about how the framework works. Credit Suisse's AT1s write-off is a good example. The eventuality of what happened was foreseen in those securities' prospectuses and should not have been a surprise. However, immediately after the publication of the decision taken by the Swiss authorities, the SRB, with the SSM and the European Banking Authority (EBA), had to state that the process would be different in the European context. In fact, European AT1 contracts, in case of need, would be written off following the usual creditor hierarchy.

It is not possible to be transparent ex-ante about exactly what will be done at the moment of failure, because some flexibility in implementing the framework must be retained. However, it is important to spell out in advance what could be done. Instead of complaining that AT1s are not working, probably we should focus on explaining how they actually work. This is just an example of how to increase confidence in the framework – including in the banks, supervisors and finally in the resolution authorities.

Good communication, between authorities and with the public, is especially important at a moment of crisis.

An industry representative noted that the Saudi National Bank shareholders on 15 March stated that they would not buy more Credit Suisse shares 'for many reasons outside the simplest reason, which is regulatory and statutory.' People wondered what the 'many reasons' were and the stock price plummeted another 31%. In addition, the acronym SNB, Saudi National Bank, was misconstrued by some to be the Swiss National Bank. People stated that the 'SNB' was not going to support Credit Suisse.

The Chair commented that, although transparency must be increased, this does not necessitate revising the framework. Clarity is crucial to increase and maintain confidence.

2.4 Resolution tools must be ready to use in Europe

An industry representative stated that resolution should remain the base case in the too big to fail framework, but the framework should also be prepared for the superior option of an avoidance of resolution. This would require appropriate data rooms and a third-party assessor to review the valuation of illiquid assets.

A resolution authority official cautioned on blurring the lines between resolution and liquidation. There are two solutions in Europe: resolution and liquidation. Resolution works! Again, trust in the system is key.

An industry representative stated that the question in Europe is whether the power needed in a crisis is available. Once a crisis starts, the contagion effect will be present. The key is to stop the situation in the company that has the problem. To what extent the market is being given clear messages must be reviewed. In addition, second-round effects mean that the impact can be huge when a lack of confidence in the banking system starts. A great deal of time is invested into recovery plans, but whether these plans will address the problems of the bank is unknown. The risk is that institutions are forced to invest a significant amount of time in preparing and are asked to sell the profitable assets that were essential to make the institution viable.

A resolution authority official explained that resolution tools must be operationalised. It is not enough to just raise a total loss absorbing capacity (TLAC) or develop resolution or recovery plans. These must be tested to ensure that, at a moment of crisis, it is possible to act quickly. Another key lesson learnt from the recent turmoil is the importance of liquidity in resolution. In the Banking Union, banks are being requested to be able to identify collateral immediately and provide the relevant data. Additional solutions can then be found to provide support via the Single Resolution Fund (SRF) and the European Stability Mechanism (ESM) - once the treaty will be ratified. However, the liquidity needs of a global bank – a clear tail-risk - may go even beyond the means of SRF and ESM. The SRF is ready to find a solution for these extreme scenarios. Having a liquidity line in place ex-ante will likely reduce the need to actually draw on it.

2.5 Liquidity in resolution is vital to restore stability

An industry representative stated that it is important to distinguish between a crisis that leads to resolution or liquidation and a crisis that can be recovered from due to a temporary lack of liquidity. Emergency liquidity assistance is provided by the national central banks, under the supervision of the ECB, and more examination of how it is delivered is merited. While there is a broad acceptance of the general collateral framework by ECB, the idea of the central bank potentially acting as a repo counterparty for other collateral needs to be investigated. The central bank can provide liquidity in emergency situations. Standardising this would increase the transparency, reliability and confidence in the system.

Managing risks in the banking sector

The Chair stated that the EU banking sector faces significant challenges, including weak economic growth, high levels of public and private debt, persistently high inflation and rising interest rates. The European Banking Authority (EBA) stress test in July demonstrated its resilience, but this is not a cause for complacency.

The panel focused on the main risks faced by the EU banking sector in the current macroeconomic context. Structural issues were also considered. The second round of discussion focused on interactions with Non-Bank Financial Institutions (NBFIs).

1. Main risks and vulnerabilities in the EU banking sector in the current macroeconomic context

1.1 Despite a challenging environment, EU banks have confirmed their resilience

1.1.1 The results of the 2023 EU-wide stress test 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

A regulator observed that the stress test, published in July 2023, had included 75% of the EU banking sector.The scenarios used include higher inflation for longer, leading to higher interest rates, deterioration in the economy and increasing unemployment as a result of industry-wide declining credit and asset quality. The scenarios, while criticised as implausible, tested the right qualitative factors.

The outcome of the stress test is reassuring. There had been a total depletion of around 460 basis points of core equity tier 1 (CET1), resulting in average CET1 of the sample about 10%, higher than the banking sector's starting level in previous EBA stress tests. Banks started the exercise with high CET1 and high profitability, but levels of asset quality at all-time lows. The high interest rate scenario meant banks generated more net-interest income, compensating for losses cause by depleted credit quality. The EU banking sector is well positioned to support the economy in times of severe stress given that, despite combined losses of €496 billion, EU banks remain sufficiently capitalised.

The stress test considered a solvency scenario, contrary to many of the liquidity-related concerns of the past six months. To this end, a transparency exercise was carried out on the held-to-maturity portfolios of European banks. There was reassurance, as so-far unrealised losses might exist in such portfolios.

The scenario also sought to provide useful information for banks and supervisors considering capital planning, as well as an understanding of pillar II prudential requirements. Capital projections and potential capital distributions were additional considerations. Asset quality concerns will be a key issue in future.

1.1.2 The turmoil of March and April 2023 showed that European banks are resilient to shocks

An industry representative noted that banks have been resilient in the context of war in Europe and rising energy prices and interest rates. The Silicon Valley Bank (SVB) event in Q1 was testament to how quickly the market's natural defence mechanisms need to adapt. Stress testing demonstrates that banks are resilient, with risks mitigated by a diversified deposit base, robust liquidity ratios and contained unrealised losses.

Commercial Real Estate (CRE) is impacted affected by a number of elements, including digitalisation. Occupancy rates and circular trends make the market challenging. Most big banks have a modest proportion of CRE investment and are managing exposure well. The leveraged lending market has been challenged throughout the year, with no new transactions. De-risking inventory has been a successful strategy, but refinancing has yet to happen and clients are trying to extend.

An economic slowdown, a rise in default rates and tighter lending are all needed to aid the success of monetary policy. Banks are able to absorb the slower growth and higher defaults needed to counter inflation.

1.1.3 For banks present in eastern and southern Europe, the situation is currently still manageable from a risk perspective

An industry representative explained that political and credit risk might jeopardise banks' P&L, but not its existence. In terms of political risk, banks' clients are voters. Populistic measures in certain markets might create unmanageable artificial interest environment. Rising populism is evident in several countries, resulting in measures like ad-hoc bank taxes and regulations harmful to credit growth.

In terms of counterparty credit risk, central bank measures are starting to have an impact and interest rates are increasing, but the environment is still inflationary. Raw material and energy prices are increasing due to the war in Ukraine, the effects of which are particularly seen in industrial economies such as Germany and Czechia. If this situation continues, the service sector, employment rates and the retail portfolio will likely be affected, too. This is not yet a significant concern, as the situation is currently one of a market shake-out. Companies are disappearing from the market. Many of them are so-called 'zombie' companies, that managed to survive only in a very favourable economic environment. Higher NPLs or risk costs are expected, but the current favourable risk costs in the market are not natural.

Banks in eastern and southern Europe responded to the financial crisis by implementing lending guidelines, designed for bad times. It is too late to start re-tightening such guidelines. Once contracts are concluded and the money is spent, it is gone. Supervisors postulate the risk-based approach while on-site teams focus on rule-based credit lending. The latter is not useful for large corporate businesses. There is no simple rulebook to follow and the creation of one would pose a major systematic, model risk.

1.2 Asset price corrections may give rise to asset quality concerns

A Central Bank official stated that there are three risk trends. First is persistently high inflation, unprecedented monetary policy tightening and the difficult geopolitical situation.

Second is digital transformation, occurring in the financial services sector at a fast pace. Banks' business models are being challenged and strong governance is key to navigate such rapid change. There is growing reliance on third-party providers in a context of increased cyber risk.

Third is the increasing potency of climate risk. Europe must make energy secure, affordable and sustainable.

Each of these risks can lead to both asset price corrections and asset quality concerns. The former is evident in the real estate sector as interest rates rise. Mortgage lending and house price growth have slowed significantly in recent time and CRE markets are showing signs of downturn. Higher interest rates might create more downward pressure on house prices, causing the debt servicing capacity of households to become a concern, particularly in countries where valuations are stretched, debt levels are elevated, and the individual household debt has a higher proportion of variable rate loans.

In the July ECB bank lending survey, banks reported a net tightening of credit standards for housing loans, which can be seen in the loan dynamics in the market. The annual growth rate of house purchase loans declined from 1.8% to 1.3% in June and there were 40% fewer transactions in the CRE market in Q4 2022 compared to 2021.

1.3 The current transition to a tighter monetary environment is affecting banks' balance sheets in different ways, depending on whether the banking book or the trading book are considered

A Central Bank official observed that levels of indebtedness were projected to rise, but remaining below historic peaks. Liquidity tightening has crystalised interest rate risk in the banking book in some jurisdictions. The CRE sector, while always cyclical is now facing the unprecedented structural challenge of digital transformation. How the transition takes place will be important, especially in China where an uneven transition might have global ramifications.

Business models more based on trading books do not have the benefit of offsetting net interest income to compensate for impairments. Many wholesale clients faced with higher borrowing costs have moved away from banks and turned towards private credit and equity. Many banks' clients and employees are now with their competitors. The reality is that size and scale might be a primary way for banks to mitigate this and safeguard profitability, making it a challenging environment for smaller players globally.

There were useful lessons from events in the gilts market during the liability-driven investment episode or the US treasury market in the run-up to debt ceiling concerns. Market players must prepare for a market of unprecedented volatility, including implications for repo operations or leveraged lending operations in sovereign bond markets.

1.4 Banks' connection with non-financial leveraged institutions can be a source of risk

An industry representative noted that, while banks underwrite bridges, the appetite for this will decrease alongside valuations. The availability of bank capital decreases in turn while underwriting standards increase, and the CRE sector is less supported. The previous decade's leveraged finance activity has ended, partially due to it being a rate-sensitive topic. A Dear CEO letter also forced SSM banks to revisit leveraged finance operations.

Leveraged finance is the provision of risk capital supporting European innovation. Tighter underwriting standards allow the banking sector to provide higher yielding capital. Regulators are well aware of banks' activities, but understanding of the non-bank financial services sector will take time.

Sanctions risk and operational risk management have grown, and the implementation of such sanctions is not like in the past. Indeed, the speed of implementation currently is of a different dimension. Banks incur substantial reputational risks for non-compliance. Sanctions must be implemented reasonably, so that banks are not afraid to fail.

A Central Bank official stated that focus should be shifted beyond traditional risks to recent events, like the rise in interest rates and energy and commodity prices. There is clearly a focus on liquidity and banks' funding plans. Structural challenges, like climate risk, digital operation risk, IT and cyber are additional priorities.

1.5 Managing risks in this new uncertain environment has become a complicated task for institutions and poses a significant challenge for regulators and supervisors

1.5.1 A sound and well-established governance and risk management framework is a cornerstone for business sustainability

A Central Bank official remarked on the importance of robust governance and risk management frameworks for banks stability. Banking business models with poor governance of credit risk, asset liability management, IT or risk data aggregation and reporting are especially exposed in the current environment.

There are also structural challenges, like the growing impact of digitalisation. Climate-related risks are a relatively new area of supervisory focus but are nonetheless relevant. Non-bank financial intermediation is rising since the global financial crisis (GFC), creating interlinkage risks. Managing risk is becoming a complicated task for banks, regulators and supervisors alike. Recent Commission projections revised forecasts for 2023 down by 0.3 percentage points and there is evidence of a slowdown in European growth across manufacturing and services.

There are good examples of bank adjusting their models to mitigate credit risks. Banks proactively manage the potential accumulation of non-performing loans (NPLs) and need to adapt their strategies accordingly. Banks must also prepare for possible second-round effects of inflation. While net-interest income is increasing, this will not last forever. There will be additional NPLs, a deterioration in asset quality and an associate need for greater provisions. Banks must be vigilant.

1.5.2 The three main areas of focus of micro supervisors

A Central Bank official identified three main areas of focus for micro supervisors. First, banks should strengthen their provisioning and capital planning by considering the overall risk environment. Second, banks should review the resilience of their mortgage portfolios banks' mortgage portfolios taking into account idiosyncratic vulnerabilities created by jurisdiction and lending. Banks must acknowledge where their customers are exposed to interest rate rise risk, inflation or house price deterioration. Finally, banks need to engage with distressed portfolios early in the CRE loan process and do the appropriate classifications.

1.5.3 More attention is needed to strengthen funding capacity of European banks and their global competitiveness

An industry representative stated that their organisation is deploying capital to help Europe address challenges across digitalisation and sustainability. European banks remain the main source of private funding. European banks have been resilient since Covid, but they should be part of the solution and not part of the problem. Attention should therefore be paid to the competitiveness of European capital markets. Their share has fallen globally from 19% in 2006 to 10% in 2020 and to 9% in 2022. Larger national players should problem-solve in their home markets, but a European solution is needed. Indeed, market fragmentation and a lack of deep capital markets in Europe are two key challenges to be addressed. Concrete measures like securitisation are necessary for European capital markets to develop and catch up.

Regulation drives resilience but also but the added costs and barriers to competitiveness of any new regulations must be considered by European policy makers. If not, they will make even more challenging European banks to perform their key function of financing the economy.

2. Assessing and addressing systemic risk in Non-Bank Financial Institutions (NBFI)

2.1 What is at stake

2.1.1 The size of the NBFI sector has grown significantly during the past 15 years

The Chair highlighted that the NBFI sector has grown to 50% of global financial assets since 2008. This sector plays a larger role in liquidity, credit and maturity transformation. EU banks' asset exposure to NBFI entities is on average 9%, which is high even though some associated credit risk is offset by collateral exchange.

The sector challenges financial stability because it is less strictly regulated. For instance, NBFIs play a role in the short-term funding of banks, representing more than half of repo funding to EU banks in Q4 2022. These entities are significant investors in bank debt securities, but the deposits placed can be volatile. Withdrawal of NBFI liquidity might jeopardise banks' ability to fund operations during a crisis.

A Central Bank official stated that the recent letter of the Financial Stability Board (FSB) to the G20 rightly identifies the build-up of leverage in the NBFI market. The total assets held by NBFIs in Europe has tripled to around €49 trillion in Q4 2022, representing almost half of the financial system.

2.1.2 Non-Bank Financial Institutions are both competitors of and borrowers from banks

An industry representative observed that NBFIs might be seen as both competitors and potential borrowers. In terms of the latter, credit risk becomes relevant. Banks can understand the business and risks associated with lending money to leasing, factory or large trading companies. It is more difficult to review the assets and investment policies of an investment fund or family office. It might be argued, as a result, that a limit should be set, but this does not help in case the business model is not well understood. In addition, NBFIs are also depositors and therefore a source of refinancing. It is challenging to manage liquidity risk in a business model relying on institutional depositors.

2.1.3 Banks and NBFIs are interconnected, which exposes banks to liquidity, market and credit risks

A Central Bank official identified four main areas of interconnection between banks and NBFIs: loans, securities, funding and derivatives. Indirect links are also a concern, as there is correlation of risk between common exposures without visibility. For example, there are Euro area real estate investment funds with large footprints in several Euro area countries where the CRE market outlook is deteriorating. The convergence of such exposures in the banking sector with NBFIs with the same downturn is a concern. Links to the NBFI sector expose banks to liquidity, market and credit risk.

NBFIs primarily maintain liquidity buffers as deposits and short-term repo transactions. They are also an important source of funding for European banks, making risk spillovers possible. Additionally, derivative exposures must be closely monitored for counterparty risk. The SSM, after its target review, has published a public consultation on counterparty credit risk. Areas for improvement include customer due diligence, defining risk appetite and default management processes.

2.2 Over the past 18 months to two years, there have been numerous examples of banks sleepwalking into large concentrations of counterparties

A Central Bank official noted that balance sheets have shifted into counterparty risk as a direct risk-taking move from banks' balance sheets to those of non-banks. Many have failed to learn the lessons of the GFC and there have been many examples of banks sleepwalking into large counterparty risk concentrations. Private equity funds are a specific area of interest. Repo-matched books are another area where such concentrations can emerge; indeed, by their nature, they operate with large notionals in order to meet returns targets.

Also of interest are exposures to commodity derivatives, where there are often insufficient initial margin levels. This can result in sudden and late increases in margins, which can be destabilising for counterparties and the market. More ex-ante assessment of the potential future liquidity needs of counterparties – some of whom might be impacted by the sparser liquidity environment – is required, alongside more risk sensitive (rather than purely commercially-driven) initial margin terms and pricing.

Supervisors can help in terms of visibility and data collection. This is in the interests of all parties, and key to identifying and understanding system-wide dynamics and potential threats to financial stability. Risk culture is also fundamental. While capital and liquidity are essential, they might not avert a firm's downfall. Early seeds of future failures are to be found in unsound risk culture and incentives.

2.3 More transparency is needed in NBFIs

A Central Bank official stated that more transparency is needed. It must be asked whether the growth in lower-rates issuances is attributable to the growing NBFI sector or the banking sector. More visibility around default rates in each sector, where credit originates, the source of exposures and convergence of common exposures would be valuable.

The Chair asked if the private sector shared concerns about a lack of transparency. An industry representative agreed that more NBFI visibility is needed. The FSB's taxonomy work can be used when engaging with bank analysts, but the numbers produced can be very different to the reality. Hedge funds, private credit and real-money funds all have concentrations, but hedge funds are stress tested every day.

NBFIs are well managed but bank analysts struggle to understand their operations, as the accepted taxonomy is not always used in disclosure. More transparency would help assess the aggregate effect of banks' exposures. The private sector wants to add value for clients by continuing to lend in the leveraged lending market.

2.4 Addressing the fair value gap in the banking book is a priority

An industry representative identified interest rate risks in the banking book and the fair value gap as two areas of focus. Q1 events had demonstrated that banks lend in the long term. A sudden rate increase would create fair value gaps in the lending book with unexpected consequences. For example, merging and consolidation might be prevented. Cerberus Capital's bid to acquire HSBC France was prevented by the latter's fair value gap on its mortgage book. In the case of Credit Suisse and UBS, the fair value gap was phased in over time to facilitate consolidation.

2.5 Fair prudential rules for banks and non-banks

An industry representative explained that there are three categories of lenders: banks, non-banks and central banks. The latter are reducing exposure to corporates. In a market where a significant liquidity provider is retrenching, it is uncertain whether the banking and non-banking sectors will be able to absorb the related lack of high-risk capital. They likely can but with different underwriting standards. Since the GFC, banks have doubled their capital to €1.3 trillion and have the capacity to lend for the right transactions. They are more conservative because regulatory oversight is also more conservative.

There must be a level playing field to ensure that risk capital is made available, and a clarification of the scope of leveraged finance clarified. For instance, there is a need to distinguish between a fallen angel that you want to support during a down cycle versus a true leveraged finance transaction with financial sponsors and private equity firms, etc, where the leverage from day one is simply higher. Lastly, the higher interest rate environment will impact leveraged finance and the availability of risk capital in the future.

2.6 Improving regulatory oversight of NBFIs

A regulator noted that the EBA's mandate makes it challenging to discuss non-banking regulations. There are financial stability concerns: leverage, liquidity-linked maturity transformation, interconnectedness, and complexity. Any of these factors in NBFIs must be carefully overseen. Furthermore, history suggests that, when there are problems, issues that were believed not be in the banks appear in the banks. More visibility is therefore needed on NBFIs. For example, there is a large amount of non-bank lending to CRE, which is fine. However, if the large amount of non-bank lending to CRE becomes less available and liquidity dries up, banks might be picking up such lending at the worst part of the cycle. What does not seem to be in the banks would be present at the worst moment.

The Chair summarised that the evident resilience of the EU banking industry is a result of a great deal of work since 2008. The risks going forward have been identified. Transparency, liquidity, interconnectedness and leverage are key when considering NBFIs.

Future of the Banking Union

1. Closing Pandora's Box by ensuring progress for the internal market remains challenging

1.1 Political debates about controversial topics have restarted, aiming to strengthen the internal market by finalising the banking union in the upcoming legislative cycle and stablecoin trends

The Chair stated that the topic of banking union has been discussed for a long time. The situation in the European Union has improved significantly over the last 10 years, as proven by the resilience of the banking sector during the pandemic and the banking turmoil earlier this year. Nevertheless, banking union progress is stuck. There are many problems. There are discussions about sovereign exposures in banks' balance sheets. There is the request of a EU safe asset. There is the issue of the European deposit insurance scheme (EDIS), national insolvency rules, and the interlink. This is a complex mix of difficult topics. The home-host conflict is also connected to the banking union and is based on a lack of confidence in the responsible behaviour of the banking sector and politicians from other member states in times of crisis.

The purpose of the session is to find out whether there is any possibility of progress, whether there is something that has been overlooked, and whether there are gaps to be filled in the framework. Historically, the single market in Europe has never been pushed forward by politics. All major steps forward were helped or undertaken by the European Court of Justice (ECJ).

1.2 The benefits of the Banking Union and the CMU are not sufficiently highlighted and both host, home countries and the banking industry should refresh their views

An official stated that it is important to fulfil the potential that the banking union offers. It is not just about ticking a box and finishing the project. It is worth taking some time to reconsider the key objectives when relaunching the discussions on banking union after the European elections next year.

The resilience of the banking sector has been proven so far with the new Basel IV package and should be set for quite some time, so now is the time to shift the focus to the needs of the real economy. Huge amounts of money will be needed for private financing for decarbonation of the real economy and for the digital transition, ownership and adapting to the technological revolution. Also, the rebalancing of the financing of the European economy from a bank-focused financing of corporates and SMEs to more of a direct market financing has not yet been delivered. Banking union and capital markets union are two parallel but consistent projects. On capital markets union, the op-ed published in the Financial Times on 13 September 2023 by Bruno Le Maire and Christian Lindner is the first effort to say that there is a need to restart the agenda, starting from the next Commission. There is a need for a mindset shift, starting more from a bottom-up approach and the needs of the corporates.

Another point relates to the integration of the market. The fact that there is not yet a full banking union is not just the fault of host supervisors ringfencing as much as they can. There is a question to be asked to the industry about why it has not organised as third-country bankers have post-Brexit. They have had a constraint from the outside that has forced them to reorganise to service the corporates and SMEs in the internal markets. It is a positive sign that banks from outside the EU have tried to take better advantage of what exists in the internal market. Experience should be drawn from that.

From the point of view of the host countries, there might be a better way of starting the political discussion next year. If the discussion starts from where it was in 2022, it will probably fail again. There is a need for both host and home countries to refresh their views. It is about ensuring that corporates and SMEs have the financing they need. If they do not have it from one bank, they will get it from another. This is an issue of liquidity. The discussion should start from the way ministers of finance in various countries see the needs of the real economy, rather than an institutional set-up that is about who is deciding to give waivers. That is a critical or secondary issue. The key political objective is financing the SMEs and corporates.

The Chair asked how the importance of liquidity translates into a political proposal on banking union.

An official answered that there is a need to take some time, because the banking union is not currently a major topic. It is worth reconvening once everybody has ideas about how it fits within the general scheme. It is not just about focusing on the institutional set-up and whether or not to give waivers. That discussion has taken place numerous times without solving the problem, so it is best to circumvent it and return to it later.

1.3 Regulatory fragmentation creates the wrong incentives and undermines trust

A resolution authority official explained that the Banking Union has come a long way since the great financial crisis. In fact, now we have a resolution framework, the Single Supervisory Mechanism and the Single Resolution Mechanism (SRM). However, recently this progress has slowed down perhaps due to a lack of trust. For instance, ringfencing remains topical. 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. Ringfencing decisions are not only affecting prudential areas. For instance, banks aiming to convert a subsidiary into a branch may face problems for the treatment of the contributions to the local Deposit Guarantee Schemes (DGSs). There is no "portability" of contributions between DGSs. This may represent a technical roadblock to convert a subsidiary in a branch. This is a technical issue that could be addressed.

The Chair commented that it also requires a proposal by the Commission.

1.4 There is also a lack of sufficient trust in the crisis management framework itself

A resolution authority official stated the lack of trust translates into a reduced effort of removing national barriers. With barriers between Member States, the Banking Union remains incomplete. There are different ways to break the vicious circle mentioned before. One is the institutional set-up. For example, the presence of central and independent supervision and resolution authorities should already foster trust. It is hard to see why there should be any distrust within the Banking Union.

Unfortunately, at times we also see insufficient trust in the framework itself. It is no secret that, during the recent turmoil, comments have been made publicly on the impossibility of implementing certain resolutions tools. Again, it is clear that trust is needed to improve the framework. The framework needs to be complete and flexible (so to adapt to any situation) and agile enough to make the right decisions.

SRB has taken two resolution decisions: one for Banco Popular and one for Sberbank. In both cases, the decisions were taken for the good of the Banking Union and for maintaining financial stability. There was no home or the host bias. Within the Banking Union the home / host issue is difficult to justify.

Clearly, legislative safeguards help to build trust too, for instance a clearly prepositioned internal MREL. BRRD2 sets a requirement for the level of prepositioned internal MREL counterbalanced by the possibility to grant waivers. Waivers were granted when the conditions were met. Once the principle is set, the authorities should be trusted to implement it in a way that is not driven by national considerations.

On the regulatory side, the macro tools are largely controlled by Member States and the national insolvency laws are still not harmonized. This, of course, poses a challenge when comparing resolution with liquidation. In fact, there is a harmonised system for resolution, but not for liquidation and this can pose level playing field problems.

Finally, also the authorities naturally need to work to build trust in the system. The SRB is working on a strategic review to foster trust and a renewed common approach with stakeholders on ongoing topics.

2. Why there is little cross-border branching in the EU

The Chair commented that one of the issues with home-host is the waivers for liquidity and capital and possible ringfencing. One way out that has been suggested many times is for banking corporations to branchify, but not many institutions have done so.

2.1 Branchification offers real benefits

An industry representative stated that Nordea is one of the only major European banks that has moved from subsidiaries to branches. This was done a couple of years ago when Nordea joined the Single Supervisory Mechanism (SSM), moving its headquarters to Helsinki. This has proven to be a very good decision with clear benefits, including simpler and more effective balance sheet and liquidity management, clearer governance and accountabilities, the avoidance of many duplicated requirements on subsidiaries, the ability to cater for large financing needs and a reduced reporting burden.

2.2 But there are still many obstacles which can prevent banks from embarking on this transformation

An industry representative explained that the process of branchification remains complex and cumbersome, even in the Nordic region. The challenges include transition costs and the operational burden taking the focus away from regular banking business. The main problem is that branchification has no legally defined turnaround time or long-stop date for decision in the EU. Banks face broad and unprecise requirements as to the content of applications and the scope of examination. Crucially, there is no blueprint in Europe for branchification. Furthermore, there is a need to apply for all approvals and permissions when moving domicile even when valid approvals exist. Further challenges are brought by divergent national implementations of options and discretions under the Capital Requirements Regulation (CRR). It is complex even without the question of home-host and the ongoing lack of trust in European supervision and resolution. In addition, AML and conduct supervision is still national and not sufficiently coordinated, and there is varying non-prudential regulation.

Overall, it has been a positive experience and Europe is missing an opportunity by not supporting this. This structure supports profitable growth and the economy. Nordea has managed to complete many acquisitions of portfolios, and it is the only bank in the Nordics that has been growing. This is also important for the economies and the green transition.

2.3 Branchification needs a different environment to deliver its best outcomes

An industry representative stated that there has not been enough progress on the banking union due to market and collective action failures. There is not yet an EDIS because countries prefer not to move instead of exploiting the benefits. Another collective action failure, which is more connected with markets, relates to giving up the cross-border mergers and consolidation of the banking sector and level playing field. UniCredit is present in 13 countries, but it is not yet a pan-European bank; rather, it is a collection of national banks. It is not that branchification does not work; rather, branchification needs a different environment to achieve its best outcomes. There is reason to be optimistic. UniCredit has considered branchification, but there is not just one way to diversify a business. There are different ways to diversify that take into account the local features. Businesses can be diversified while belonging to the same group and responding to the same strategy.

3. Increased efficiency driven by innovation could reduce the gap with global competitors and build momentum for progress in Banking Union

An industry representative explained that it is worth looking at other experiments with integration such as the single market and to consider how this translates into the financial industry. The solution is innovation. There have been many recent innovations in the financial system, from digital currency to artificial intelligence. This is relevant because each one of these innovations may have an impact on how business is conducted in the single market. This is clear from looking at the experience of other innovation waves where, because of technological breakthroughs, it was in the interests of the private sector to push towards further integration. All the recent technological innovations will have an impact but, as a basket of innovations interacting with each other, this impact may be much faster than expected. Early results from the application of artificial intelligence suggest that this is the case. This is supported by the analysis of market interactions and the impact of innovations. Soon, productivity will be measured in a more appropriate way because of innovation in the financial sector.

General innovation developments such as the diffusion of digital technologies, particularly AI, provide the basic factors to carry out the structural transformation brought about by the environmental, security and 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. A more dynamic and productivity-driven banking industry can revamp banking union while short-term measures provide facilitation effects.

4. Further harmonised regulation and supervisory practices across jurisdictions and rebuilding trust among member States are needed

4.1 Harmonizing the macro prudential requirements and more generally improving the allocation of capital in a banking group

Another important topic is the lack of consistency in capital requirements. An industry representative stated that the biggest issue is the consistency of the requirements. If capital is trapped in certain countries because of higher subsidiary or branch requirements as macroprudential requirements are reciprocated, banks see higher capital costs and lower returns. Therefore, when the capital is allocated inside a banking group, there is likely to be less expansion and a reduction in lending in that country. The issue is about how to finance the economy. There are two conflicting objectives. When the requirements differ across countries, there is a distortion in the capital allocation. Host countries then see less activity by cross-border banks and do not achieve the aim of trapping capital in the system.

There is also a difference between small and large banks in the SSM, and then much bigger differences between the EU banks that are not part of the SSM. It is difficult to explain to investors why these capital requirements do not correspond to the risk. This inconsistency is hampering the ability to raise capital and conduct cross-border consolidation, which is significant as there may not be many consolidation opportunities in single countries in the future.

Moreover, the macroprudential requirements are set by national authorities and are not coordinated. More than half of the capital requirements come from the macroprudential requirements, which are high in the Nordic countries. Nordea has the highest overall capital requirement (OCR) in the SSM. This does not correspond to the risk profile, creating an inconsistency. The Basel III implementation should be the place to discuss the macroprudential framework and European coordination, and also to look at tools that are no longer needed, such as risk-weighted floors.

4.2 Following a holistic approach to rebuild trust among Member States

4.2.1 The Statement of the Eurogroup of 16 June 2022 should serve as a guiding principle in the negotiations

An official observed that, from the host perspective, nobody is questioning the benefits of economy of scale, the need for further market integration or the need to increase the competitiveness of European banks on the global stage. The political question is not about whether the banking union is needed, but rather how to achieve it. Currently, the situation is like a prisoners' dilemma, and it is resulting in suboptimal settings and solutions. There is no need to start again from zero. The roadmap and the statement agreed in the Eurogroup in June is a good starting point. It outlines four workstreams: deposit protection, crisis management, diversification of bond holdings, and market integration. From the host perspective, the workstream on diversification of bond holdings is relevant so that relevant member states can overcome the so-called home bias. At the end of the banking union project, Slovakia would like to be seen as a home country for European banks.

Overall, there are two principles to follow. Firstly, there is a need to build trust. There is a lack of confidence in responsible behaviour, and not only among member states, but also between member states, institutions and market participants. In the host member states, there have also been some negative experiences with how banking failure has been fixed. Sometimes, the way the regulation is negotiated and how the Commission make their proposals is seen from the host perspective as a provocation. Looking at recent events with the banking package and the output floor, it is unlikely that the home-host issue can be fixed via the backdoor. It needs to be clearly and openly discussed. There is also a need to approach all elements or workstreams holistically and with the same speed. The reasons for this are twofold. Firstly, it is important in terms of building trust. Secondly, it is very important that all participants are interested in the banking union project until the end. A symmetrical approach is needed. According to a famous African proverb, 'If you want to go fast, go alone; but if you want to go far, go together.' This is something that applies to the banking union.

The Chair asked whether the Federal Deposit Insurance Corporation (FDIC) in the US is a good system for Europe as it does not require a system to restrict sovereign exposures or liquidity and capital waivers between states.

An official responded that the banking union discussions are not as interconnected as they could be with other projects, such as fiscal union. It is still a long way from being a federal setting with a common backstop. The FDIC is backed by the Treasury, which is not the case for EU institutions, so the position is more complicated. Secondly, due to the lack of trust, institutions have very complicated mandates. This is the case for both host member states and home member states. In the US, the FDIC has a much easier mandate and task.

The Chair commented that some of the workstreams that have been created should not be an issue for the banking union. The sad point about banking union is that it is technically quite easy to achieve, but it has become difficult because the issue is so politicised.

An official noted that UniCredit is operating in Slovakia as a branch and is quite a significant bank in Slovakia. The Nordea case is also encouraging. There are two important Austrian banks, Raiffeisen and Erste, that are not making use of branches in their operations in central Europe. Some fear that this is so they will be able to exit the Slovakian market more easily.

The Chair stated that, according to second-hand information from banks, there is strong pressure from host authorities not to branchify.

4.2.2 Trust need to be pursued by each stakeholder

An industry representative stated that trust has to be seen from three points of view. Trust is needed in Europe, and not just for banking union. It is about the whole policy set, starting from fiscal policy. Secondly, building trust is a process that requires repeated interactions among stakeholders. Trust needs to be pursued by everybody, not only by some stakeholders. Thirdly, there might be different speeds in this process. Some stakeholders may be quicker when it comes to delivering trust and having that trust reciprocated. Others may take more time, but it is not a race. What is important is that everyone reaches the final goal.

An official noted that one issue should not be prioritised over another. Trust is a process, so it is important to continue applying a holistic approach. The focus should be on building on achievements that have already been made rather than starting again from zero. Lastly, the benefits of single markets are not only linked to prudential regulation. There is also the non-prudential side. The Commission has come up with a proposal on insolvency, but there are other areas that are very difficult, including consumer protection or company law. Work is also needed on interconnectedness with the register.

4.3 A stable, clear and flexible regulatory landscape that recognises the diversity of business models is necessary to encourage cross-border activity within the EU

An industry representative explained that SMBC has a global approach to banking. SMBC has had a presence in the EU market for decades, and the EU represents one of its important operating theatres. It is important to be able to work with EU parties and corporates, serving international clients in corporate and investment banking via a single market. SMBC sees itself as both a Japanese and a European bank. Many of its customers are large EU-headquartered corporates and financial institutions. After Brexit, a subsidiary was created, establishing a headquarters in Frankfurt with six branches across the EU region in order to continue operating smoothly. In this respect, there has already been branchification, albeit on a different scale.

At the same time, there are branches of SMBC's Japan headquarters in the EU. Historically, this has been an important way to operate in the region. It is important to maintain this duality between a subsidiary with EU passporting rights and branches of Tokyo in the region. This enables free movement of capital and liquidity and allows SMBC to benefit from the single market. It also enables the drawing of liquidity and capital from Japan, where needed for certain operations. It is important to maintain this and to ensure that SMBC can freely operate with this dual regime in the region.

As a third-country operator in the EU, what matters most for progressing towards a genuine banking union is making sure that there is clarity, flexibility and stability in the regulations that are proposed. EDIS is not viewed as particularly important. What matters is ensuring continued operation with clarity and transparency as liquidity is moved across the region. Any obstacles to liquidity would be an issue. SMBC does not want to be forced into different approaches because of regulatory evolutions, such as having to put liquidity outside the EU region.

4.4 Improving the governance of the SRB

An official commented that the Sberbank decision has been viewed differently in the host member states. There were lessons learned about how to improve the governance of the SRB. More Europeanisation is needed in the SRB and SSM. The Sberbank case does not show that the SRB needs no governance improvements.

A resolution authority official commented that the SRB is constantly trying to improve, which is why the strategic review has been launched. However, in terms of results, the Sberbank resolution was a success. Financial stability was maintained without any public support. The issue of governance can be discussed further but the results were positive.

The Chair added that, while some host countries may have an issue with how the Sberbank case was resolved, the problem related to Single Point of Entry (SPE) and Multiple Point of Entry (MPE) strategies. It was not a stability issue. The distrust comes from the combination of the resolution framework and the lack of clarity as to when cases are shifted to national insolvency laws. The SRB should be able to ease the fears of host countries and push matters forward.

4.5 The banks' desire to build a BU must be more strongly asserted

The Chair commented that France has been a great promoter of banking union from the beginning, seeing it as a European project.

An official stated that the most important pillar, which has been lacking in recent years, is a push by the market and the banks. While Nordea has made an important step, this is in a specific sub-region of Europe where branchification is easier than it is elsewhere. Sberbank was a specific case that related to the war in Ukraine and sanctions against Russia, but there was a concrete result. It has been done pragmatically and it works. In building trust, it is not a question of how much is in the workstream or the roadmap of the banking union. Trust is built on concrete results in the market. The financial industry is taking action because one supervisor was pragmatic in implementing the rules. That should help build trust in the central supervisors and between supervisors also. It is an example to build on and something that has been missing so far. It has also been missing from discussions between technocrats in recent years. Overall, it is about focusing on the results of the concrete steps rather than on institutions and governance. The last few years show that focusing first on institutions and governance leads to failure, so it is time to try a new method.

The Chair added that a swift agreement on crisis management and deposit insurance (CMDI) has not been mentioned by the panellists as an important step in achieving banking union.

Improving the EU bank crisis management framework

1. Enhancing the EU's crisis management toolkit

On 18 April 2023 the European Commission published its legislative proposal concerning the review of the BRRD, SRMR, DGSD and Daisy Chain Directive, which is currently debated by the European Institutions. The Chair observed that the ECB views progress on the crisis management and deposit insurance (CMDI) framework as essential to European integration. If there is no progress on this topic, the prospects for progress on banking union look very dire.

1.1 The current framework is 'handcuffed' by contradictions, but the CMDI proposal seeks to provide the beginning of a solution

A resolution authority official stated that the expansion of Public Interest Assessment (PIA) should come with funding solutions for those banks that will become resolution entities. An expanded PIA without additional funding would be suboptimal with respect to the status quo. Indeed, switching new banks from liquidation to resolution without adequate funding options may be detrimental to the credibility of the system. The CMDI proposal provides us with a valid toolkit to deal with the banks that would enter in the resolution sphere.

The Chair noted that the ECB is extremely supportive of the discussion. Widening the scope of the European harmonised resolution framework is the most cost efficient way to facilitate an orderly market exit for banks that meet the test of failing or likely to fail (FOLTF). The proposed amendments would also minimise struggling banks' net asset losses, contribute to stabilising deposits in the system and require less funding to be mobilised than is necessary with depositor pay outs. The ECB is also happy to engage on the important issue of cost. It will be important to find an arrangement that reassures the industry that the benefits are greater than the costs.

1.2 The scope of resolution can be enlarged if the rules ensure financial stability

An official considered that there are three key elements to the proposals. First, the question of resolution versus national insolvency should not be an ideological debate. The default should be national insolvency. The key factor should be whether resolution delivers better results on financial stability. The scope of resolution can be enlarged if the rules guarantee financial stability. Secondly, some constraint is important to curb the moral hazard, but there is also a requirement for flexibility in order to address exceptional cases. Deposit guarantee schemes (DGSs) should be used in exceptional cases where funding resolution would endanger financial stability. Finally, Minimum Requirement for Own Funds and Eligible Liabilities (MREL) is not the only means to achieve resolvability. Technology and preparation are also important contributing factors. MREL should not be the same for all banks: proportionality is key. For a resolution strategy involving full recapitalisation, MREL could easily reach 16% or 18% of risk weighted assets or being even higher. If small banks are asked to set aside this amount, it will drive them out of the market.

An industry speaker reacted to the idea that enhancing financial stability should reduce the funding gap for small and mid sized banks: this can be true only if two conditions are met. First, MREL requirements have to be imposed on much more small & mid-sized banks, and second the authorities have to intervene early much more often. On the first point, some say that medium sized bank cannot issue MREL instruments: this is not true, as there are other solutions such as longer transitional periods, relying on a higher share of retained earnings or the creation of an escrow account to access in resolution. On the second point, in its current form, the CMDI reform could reinforce the other preventive actions that exist: this is a key issue to foster consolidation of the banking sector in Europe.

1.3 A public liquidity in resolution backstop is essential for successful crisis management

The banking turmoil earlier this year has highlighted the importance of being able to access funded public backstop facilities in resolution; they are essential to restore confidence. This is still an open issue in the current EU framework.

1.3.1 Liquidity in resolution: a missing piece in the EU framework

An official stated that liquidity is not a topic that should be addressed through the CMDI review; rather, it should be addressed through the completion of the banking union. Liquidity is key for the maintenance of financial stability in the event of resolution. There will be a liquidity problem in a bank resolution, no matter what the cause of the crisis. If the bank has met the FOLTF test, there will be a liquidity stress. Even though the bank has been resolved and recapitalised, the market will need reassurance. There will always be a need for bridge financing while the markets are being reassured.

Therefore, there must be a credible and transparent liquidity backstop which is easily understood by market participants and depositors. This mechanism should be subject to strict conditionalities, such as the existence of a viable business plan. The related legal regime should also be transparent and clarify – for instance – how to recover any losses. The European Stability Mechanism (ESM) backstop is a move in the right direction, but the resolution of a very significant bank (like a G-SIB) or the unfold of a systemic crisis will likely require hundreds of billions of euros. In such a case, where the mutualized funds are not enough, there is ground for the public authorities to intervene and provide the resources. Any resolved bank that has been fully recapitalised should be able to access a public backstop. This could be similar to emergency liquidity assistance (ELA), appropriately amended and translated for the resolution framework.

1.3.2 Prerequisites for an operational liquidity in resolution tool

An industry representative emphasised that the most important task is to ensure that the framework works when needed. A liquidity in resolution tool will be required to resolve medium sized banks. It will also be necessary in the event of a liquidity constraint across multiple banks. However, it should be a contingent liquidity in resolution tool. The ECB is the natural candidate to create this tool, given its experience in providing collateralised funding to the market. However, there will be a need for a public guarantee, which will require the involvement of the member states. The experience in the US provides some insight into how to structure the tool. In the US, the Federal Reserve granted loans to bridge banks and loaned money to banks with beneficial collateral treatment. These are the types of ideas that should be explored.

1.3.3 The SRB's resolution toolkit is strong, but it must have effective liquidity provisions

A resolution authority official explained that CMDI caters for mid sized or regional banks that could also present a systemic risk. On liquidity, it is key to recall that there are over 75 billion in the Single Resolution Fund (SRF) – plenty of resources. However, we should find a solution for the tail-risk cases. For the bigger banks, it is currently not easy to find enough money at the right time. The question of liquidity in resolution is always discussed in terms of finding a lender of last resort. However, being the lender of last resort does not automatically mean losing money. In the case of Credit Suisse, the Swiss government provided a guarantee of 100 billion Swiss francs to the liquidity line provided by the central bank. This line was certainly not drawn up and, in any case, everything was fully reimbursed with interest in a few weeks and provided a lot of stability to the transaction. Nor the central bank nor the government lost any money in the credit line transaction.

The Chair agreed that the recent cases of resolution all involve the sale of the bank. In the case of Switzerland, the sale was a resolution in all but name. The CMDI reforms are aimed at reducing the cost of managing failing banks. The aim is not to make the process more costly for the good banks; it is about trying to find the least costly way to deal with mid sized banks. Ultimately, it will be important to reassure DGSs that this will diminish their burden rather than increasing it.

1.4 Strengthening contingent liability will improve the sale of business resolution tool

An industry representative suggested that the best way to minimise cost is to avoid disruption and contagion. So far, contagion and disruption have been largely avoided by using a sale of business strategy. The effectiveness of this strategy could be enhanced by providing acquirers with better protection against contingent and hidden liabilities. Contingent liability is a calculation of potential losses that are unlikely to materialise in the future or losses that cannot easily be estimated. This is a cost for an acquiring bank. Under the existing framework, the acquirer of a failing bank is exposed to a broad range of contingent and hidden liabilities. The proposal makes some progress in this regard. At the moment of resolution, an independent valuer will consider the contingent liability. This is a step forward, but there are some concrete ideas that could further strengthen it.

1.5 Preventing the so called 'limbo effect' and reforming insolvency law

A regulator queried whether future regulations should address the so called 'limbo' effect, which relates to entities that meet the FOLTF test but do not meet the insolvency or resolution criteria. Supervisors, as well as resolution authorities, find these entities difficult to deal with. When some banks in Poland went through resolution, the discussion revolved around the philosophical question of whether insolvency should be the default solution. Different countries have very diverse legal regimes for the insolvency of banks. The traditional understanding is that insolvency is the standard solution and resolution is an exception. The experience in Poland suggested that it might be preferable for resolution to be the default procedure. At some point in time, there could also be a harmonised pan European legal regime for the insolvency of banks, which would harmonise the law for entities that have no ability to access the SRF.

2. Should DGSs address the funding gap in the resolution of mid sized banks?

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

2.1 It may be beneficial to use DGS funds to bridge the gap required to meet the 8% total liabilities and own funds (TLOF) threshold, especially in case of small or medium sized entities

A resolution authority official explained that the proposed intervention on DGSs has a key aim: to protect financial stability without using taxpayers' money. The possibility of using DGS resources (industry funds) in resolution should reduce the need to use them in liquidation. For customers, resolution is always a preferable option as it avoids the interruption of functions. However, resolution in some cases, even if preferable, is hard to execute because of a funding gap.

For small and medium sized banks, this gap may be due to two practical reasons. First, it will take a significant amount of time and effort for the "CMDI switching banks" to transition to MREL compliance. EU biggest banks have had an eight year transition period to reach MREL compliance. Second, a crisis may be more severe than expected. If the losses that the bank took are very large, it may be necessary to bail in deposits. A deposit bail in is politically very difficult. DGSs should intervene to fill these kind of financing gaps. Since the DGS intervention is only up to the level of the 8% TLOF and since MREL remains the first line of defence, according to our estimations, the amounts being targeted will not be significant. Needless to say that the banks that are targeted for resolution have to be resolvable.

It should be clear. To be resolvable, means more than waiting for interventions from a DGS or the SRF. All the work that the SRM and the banks have been doing in the past years is a testament to this fact. When the national resolution authorities and the SRB earmark a bank for resolution, the bank needs to work to become resolvable. This requires issuing MREL, putting in place IT systems capable of delivering the right information the right time, a bail in playbook, valuation capabilities and so on. CMDI is just a practical solution. It is key to recall that the CMDI proposal, besides the DGS bridge and expanding the scope of PIA, will simplify and clarify several parts of the framework (e.g. the withdrawal of the licence for the failing bank and the daisy chain requirements). These improvements should not be lost.

A regulator noted that Poland has an institutional structure where the resolution authority is also the deposit guarantor. This means the resolution fund and the DGS fund exist 'under one roof'. The advantages and disadvantages of this structure should be discussed more widely. In the panellist view, it may be beneficial to use DGS funds to bridge the gap required to meet the 8% threshold, especially in case of small or medium sized entities. Indeed, there is a requirement for pragmatic and practical cooperation between DGSs and resolution authorities. In cases where these funds are managed separately, there are benefits to involving the DGS at an early stage of the process.

2.2 Eliminating the DGS super priority could lead to turmoil in the markets

2.2.1 Strict burden sharing must remain the cornerstone of resolution, excluding a DGS bridge

An industry speaker emphasised that the recent US crisis has shown that the failure of small and mid sized banks can trigger widespread contagion. The reform of the EU crisis management framework should first seek to enlarge the Public Interest Assessment (PIA). Ultimately, the same risk should be governed by the same rules. Safeguards to ensure the harmonised application of the revised PIA should be put in place. The application of the PIA by national authorities could be made more consistent by disclosing a summary of any PIA outcome that concludes in favour of liquidation. This would foster transparency and enlarge the scope of resolution. Nevertheless, the enlargement of resolution must not distort healthy competition or maintain excess capacity in the European market.

2.2.2 The 8% TLOF requirement should remain intact

An industry speaker considered that the MREL buffer, which is necessary to reach the 8% TLOF bail in requirement, should be used to access the Single Resolution Fund (SRF). This is consistent with the post crisis principle that shareholders and creditors should pay more of the costs of resolution. It is not correct that small and mid sized banks cannot issue MREL. These institutions can and do issue MREL, especially when ordered to do so by resolution authorities. If these banks cannot shoulder the cost, they should exit the market. Finally, supervisors should act early enough to handle bank distress without undue cost. This is allowed by article 27 of the BRRD. To reinforce these powers, there should be inducements for the authorities to act in a timely manner. If the reform is in line with these principles, it would foster the necessary consolidation of the banking sector in the EU and reduce overcapacity.

2.2.3 The protection offered by DGSs would be negatively impacted by a requirement to finance the resolution of small and mid sized banks

An industry speaker stated that deposit insurance is a core element of the entire CMDI framework. Deposit insurance offers one product: protection. From that perspective, the key question is how to protect the protectors. The benchmark for the framework will be whether it improves upon the high level of confidence in the current system. The CMDI proposal can be divided into two different parts. The first part aims to improve the existing framework and is based on several European Banking Authority (EBA) opinions on the variation in depositor protection, which suggest further harmonisation as a way to ensure equal protection for all depositors in the event of insolvency. This suggestion is a positive step forward. However, the second part of the proposal is a fundamental shift towards resolution as the standard procedure. This protection for the protectors would come at a steep price. To make resolution available to most banks, the current protection offered by DGSs would be reduced.

Indeed, the shift to resolution is based on the idea that DGSs should finance resolution tools. This would require DGSs to lose their super preference in insolvency proceedings. The super preference gives the DGS a preferred position in the creditor hierarchy. In a depositor pay out, a DGS will usually be entirely reimbursed. Removing the super preference will significantly increase a DGS's losses and reduce its financial firepower, its capability to safeguard deposits and consequently its capability to ensure trust in the system. Using DGS to finance resolution would make it more difficult to recover funds paid for depositor compensation and would indirectly result in further financial burdens for credit institutions. The use of DGS funds for resolution combined with the loss of the super-preference would lead to frequent additional funding obligations. During a crisis, these obligations could result in a domino effect.

Furthermore, the role of DGSs and Institutional Protection Schemes (IPSs) would also be reduced to mere payboxes instead of risk minimisers. As stated in their joint declaration and call to action, the preventive measures of IPSs will be made more difficult or even impossible by the new extensive requirements, which are not in line with the obligations on IPSs pursuant to article 113(7) of the Capital Requirements Regulation (CRR). Take the example of someone buying a new car. A potential buyer might be happy to learn that a car is equipped with a state of the art AI autopilot system, but, if the choice is between an AI autopilot system that works in most cases and an airbag that is proven to work in all cases, the decision for the buyer is clear. Nobody would choose a new IT system if it meant not having an airbag. Customers want to rely on the most basic safety feature that offers reliable protection. The discussions over the last years have been around the credibility and financial firepower of DGSs, yet the Commission is proposing to take away the core element of that credibility.

2.3 DGS funds can play a key role in resolution under a robust and harmonised Least Cost Test (LCT)

An industry speaker stated that the key question is about the least cost solution. The current proposal makes the solution impressively expensive for DGSs. Indeed, there is no contradiction between protecting the protectors and protecting financial stability. Deposit insurance schemes play a significant role in financial stability. The idea of protecting customers should not mean that all customers are protected in all cases. Currently, deposit insurance schemes strike the right balance between providing protection for those who need it and a 100% guarantee for all customers. The latter would cause significant moral hazard, facilitate less market discipline and make the scheme much more costly.

A regulator observed that the least cost test can only be properly performed with the involvement of the national resolution authority and the DGS. The determination of cost has to be holistic. The resolution authority and the DGS should come to a joint determination. Additionally, there is question about the competition consequences of smaller or medium sized institutions being unable to meet the criteria yet nonetheless receiving the benefit of the DGS. Ultimately, the goal is to protect financial stability. It may be necessary to balance competition and financial stability.

Indeed, it is important to consider the interaction between the protection of financial stability and the protection of competition. The smaller banks will receive the benefit of resolvability at a lower cost than the larger banks, which have been paying this higher cost for the last eight years. In this regard, the least cost test could even become the leading test perhaps at the cost of the PIA. Harmonisation will be a challenge, especially for non eurozone resolution authorities. There should be further discussion of enhancing the transparency of the PIA, which could involve the publication of PIA outcomes.

An official explained that to allow for a wider recourse to industry funded safety nets to manage crises and foster value preserving transfer strategies, two adjustments are imperative: the elimination of the DGS super priority and the inclusion of indirect costs in the least cost test. DGSs should be unleashed to serve a public purpose. Cost is the most relevant factor in this discussion. The opposing argument is that the removal of super priority would mean that DGSs would pay much more in piecemeal liquidation scenarios. However, it is the intention of the proposal to try to avoid piecemeal liquidation scenarios. By allowing authorities to pursue the least costly solution (through DGS preventive and alternative measures, as well as DGS intervention in resolution), DGSs are used preventatively and the likelihood of these very costly and impactful situations occurring will be close to zero. It is important to protect DGSs, but it is possible to do that while serving the higher purpose of financial stability. Furthermore, including indirect costs in the LCT would allow a proper identification of the real costs borne by the DGS and the whole financial system and unleash the effective deployment of efficient and value preserving bank crisis management tools.

Bank diversity in Europe: what evolutions?

The Chair stated that diversity is a way to become more resilient. The question is how to take diversity seriously on regulation and supervision, which raises the question of proportionality. There are also new kinds of aggregation and articulation between entities mainly pushed by digitalisation, and there is a question whether all business models are prepared for the challenges ahead in an equally efficient way.

Three main points emerged from the discussion: (i) European bank diversity is an asset and must be considered under the prerequisite of stability; (ii) The 2024 SREP review and proportionality are essential for the preservation of banking diversity in Europe; (iii) All bank business models need to be prepared for digitalisation challenges.

1. European bank diversity is an asset and must be considered under the prerequisite of stability

1.1 Banking model diversity is a European asset

An industry representative commented that diversity in the banking sector is extremely beneficial for the economy and customers. It leads to a highly competitive banking market, tailor-made financial solutions, and ensures systematic stability. Europe needs national and international champions taking higher risk and executing complex mergers, as well as smaller, locally rooted institutions who are natural partners for private households. The EU financial industry will lead with green, digital and social for at least the next decade.

The Chair noted that the banking union (BU) has sound banks that have proved capable of ensuring that economic agents have access to financing when it is most needed. During the pandemic it was possible to avoid excluding certain groups of economic agents by meeting different financing needs.

1.2 Stability is the cornerstone of bank diversity in Europe

A public representative outlined that after becoming a politician in a national parliament during the financial crisis in 2008, they had come to value diversity when seeing that different models had different chances of surviving. Diversity is valued because the world is uncertain. Developed methods are needed in order to see how resilient banks are in different crises. Resilience should be much more central in regulation and supervision. When making regulation laws the key focus is proportionality. Diversity is essential for resilience but cannot be an excuse for conservatism. Supervisors need to be empowered to be wise and brave at the same time.

The ongoing climate change crisis has not been sudden. A societal and economical change towards sustainability is needed, as well as a vast amount of public and private investment. The return on this investment is highly uncertain, particularly in terms of the date it will pay off. Supervisors do not think the markets work; therefore, market data cannot be used to assess. Climate change is a crisis where a resilient banking sector is needed. The banking stress test shows a concentration of risk among 10% of banks for climate change policies.

2. The 2024 SREP review is key for the preservation of banking diversity in Europe

2.1 The SREP process needs to take diversity more into account

An industry representative observed that more cooperation is needed between supervisors and banks, as banks cannot stick to benchmarks, which are often inappropriate. More consistency and transparency is needed around the sample, as well as the timing of the Supervisory Review and Evaluation Process (SREP). There is a need to enter phase two of supervision to avoid putting the diversity of the business model at stake. The SREP in 2024 should encapsulate the concerns. According to the Wise Persons Group report, the aim of the SREP should be to give more time to the joint supervisory teams (JST) to ensure proper supervision. The SREP assessment should be done every four years, which gives sufficient time for the JST to take the consequences of their recommendations on the diversity of the business model into account.

An industry representative agreed that the SREP process needs to take diversity more into account. It is an assumption by the SSM that a benchmark approach is needed in order to create a level playing field.

2.2 The SREP review in 2024 should be an opportunity to adapt its procedures and processes, and further take specific indicators and quality measures into account

An industry representative noted that on profitability it does not make sense to compare their company to a listed company with a paired ratio of 50%, as their company is not listed and does not have shareholders. An appropriate indicator for cooperative banks could be the residual income after distribution, and the actual capacity to create Common Equity Tier 1 (CET1). The SREP should also focus on qualitative measures, such as the ability to serve customers and small companies.

The Single Supervisory Mechanism (SSM) should elaborate a 'business model adequacy test' that could apply to JST recommendations. A bank should be able to raise an issue regarding the integrity of its business model to JSTs, who would then have to assess the issue. The actual process should be further defined by the SSM in close coordination with the representatives of cooperative banks.

The Chair added that the way ahead for the work of the SREP will be decided before the end of 2023 and develop in 2024.

2.3 The SREP should be adapted and take the stakeholder value model and country institutional specificities into account

An industry representative explained that their company is a cooperative bank and has one banking licence. Its business model is different to other business models. The retail banking and leasing part could be compared, but the third significant pilar, being the international Banking for Food strategy, is a niche. The SREP process is currently a one-size-fits-all. If a significant part of the bank is more niche then the SREP process needs to recognise that those banks have a sufficient amount of knowledge about these markets, clients and activities which should be looked at as a risk mitigant. The SREP is currently not taking this on board.

The SREP also needs to be more balanced for cooperative banks. Some cooperative banks are listed on a stock exchange and have issued shares, but most are not, as they are not focusing on the short term. The culture is different for cooperative banks as they are focusing more on the long term, which differentiates them from listed banks within the EU.

The shareholder value model can be characterised by highly innovative use of internal models, complex legal structures, risk taking, and strong profits. In contrast, stakeholder value institutions that 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 community they serve. The SREP process also needs to take countryinstitutional specificities into account as this drives to a significant part the retail products a bank offers.

A Central Bank official stated that their organisation has tried to align the supervisory methodologies that it applies to significant institutions and less-significant institutions (LSIs) as much as possible, but that does not mean that the same assessment and the same judgment is applied. The horizontal assessment helps the analysts and the JST, but also the banks, because horizontal supervision helps avoid the risk of discrimination towards one specific bank.

2.4 ECB supervision, with its continued focus on governance, will keep examining and challenging the way in which individual banks assess the risks they take

The Chair commented that everybody values diversity, but the issue is how to take it into account. Supervisors are paid to measure the risk of failure. Prudential supervisors try and assess the risk of failure of the institution and the risk of spillovers to other parts of the financial system in a fair and balanced manner. Specificities need to be taken into account. One important aspect of the cooperative is the personal interface; a future question will be whether to keep that or go to the digital interface.

It is important is to have concrete proposals to see how banks can deal with the benchmark. A comparison of the appropriate benchmark is needed to compare all banks in Europe and to ensure the same level of resilience. It is unclear whether using AI in the customer interface has a different impact.

3. Proportionality is essential to maintain bank diversity

3.1 Proportional application of homogeneous banking rules that apply to all supervised entities is important for maintaining bank diversity in Europe

A regulator stated that a process of dramatic change is ongoing. When looking at the numbers of LSIs supervised in the eurozone there has been a 33% decrease since 2015, from more than 3,000 LSIs in 2015 to around 2,000 in 2021. The consolidation process is especially concentrated in Italy, Germany and Austria. In recent years the issue of enhancing proportionality is at the centre of regulatory considerations; after the last amendment of the European Supervisory Authority (ESA) regulations, all ESAs had to mandatorily establish advisory committees on proportionality. The European Banking Authority (EBA) Advisory 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.

The Wise Persons Group has given orientation for a reform of the SREP process, which will also give room for new ideas and how proportionality can be introduced in the daily SREP process. The current framework already pays consideration to proportionality, and in close collaboration with the SSM a basic SREP has been developed for the cooperative sector in the regulator's country. The internal governance of the sector is relevant. Checks and balances must be in place at all times. Governance makes a big difference, and a functioning institutional protection scheme (IPS) is essential.

An industry representative commented that small actors will not be onboarded without preserving the cooperative model. Their company is the leading bank for small and medium-sized enterprises SMEs in their country; preserving diversity means ensuring a fair transition everywhere. Proportionality is needed around different business models.

3.2 A diverse banking sector needs truly proportionate banking and regulatory rules as well as proper functioning IPSs

An industry representative observed that over the last 10- or 20-years rulemaking development has become extremely complex and there are many reporting lines. A diverse banking sector needs truly proportionate banking and regulatory rules, especially when it comes to compliance and reporting. Smaller banks are facing fixed-cost disadvantages associated with the ongoing wave of compliance and reporting requirements. The agreement reached on the EU banking package will lead to additional requirements and burdens that disproportionately affect smaller banks.

A balance between harmonised banking rules and the diversity of business models is lacking in the EU Commission's proposals for a review of the crisis management and deposit insurance framework. IPSs have been highly efficient for decentralised, relationship based banking models in a number of member states, but changes proposed within the crisis management and deposit insurance (CMDI) review would significantly impair the abilities of IPSs that are recognised as a Deposit Guarantee Scheme (DGS).

A practical solution for the BU is needed that will allow IPSs to continue to function properly Choosing an IPS is a cost-efficient way to protect depositors and member banks.

3.3 There is a prudential limit to proportionality

A Central Bank official stated that their country has two cooperative groups that have become significant and 117 LSIs that have different business models. Traditional banks can also run businesses with digital processes. There are marketplace lending (MPL) managers, as well as asset managers with a banking licence. In Europe, proportionality has always been driven based on the size as a proxy of proportionality. There is now a definition of a small and non-complex institution; given the digitalisation and the adaptation of the cooperative banks, the question is whether they also become interconnected.

Supervision should be driven by risks and be risk-based. The proportionality regulation sometimes does not match the risk assessment. LSIs are sometimes very significant locally. There is a prudential limit to proportionality, but if a small bank is risky then more intrusion is needed in supervisory terms. An argument could be made that small banks are riskier from a liquidity perspective because they might have less access to the market, which might imply the use of supervisory tools that try to frontload or anticipate negative market development. There is also a business limit to proportionality, because of the importance of data governance. In addition to all the risks that a poor data governance might imply for the customers' relationship, if the reporting system keeps being simplified then the board would not get the information that they need for business purposes, not only for prudential purposes. The discussion needs much more granularity.

A public representative stated that diversity and proportionality are crucial. The business model does not always make a difference. Their country has three large banks, one which is commercial, one which is state owned and one which is cooperative. All three came very short on anti-money laundering (AML) methods. Digitalisation is one of the key developments. A distinction needs to be made between the customers, the clients and the SMEs, as it will lead to more mobility of bank deposits. Introducing the digital euro as a competitor for banks is desired. Cooperative banking still has very close relations with SMEs, which is a strength and should be maintained.

4. All bank business models need to be prepared for digitalisation challenges

4.1 A business model is sustainable if its governance can adapt to new circumstances

A regulator explained that in their country the cooperative sector was previously profitable compared to other sectors. Cooperative banks had a local banking monopoly through their relationships, but that local monopoly is being eroded due to the fact that people in rural areas now have access to digital banking. Banks are currently trying to pool functions much more and outsource towards centralised institutions within their associations, which is acceptable from a supervisory point of view. The question remains whether it is sufficient to deal with the cost pressure via digitalisation as well as the pressure on the market in rural areas.

A regulator added that digitalisation is a central factor in maintaining access to bank financing and avoiding exclusion. However, digitalisation could eventually exclude digital-averse individuals and is a major challenge for smaller institutions that are only able to keep up if they are prepared to undergo permanent modernisation.

An industry representative stated that digitalisation is one of their group's core strategic objectives. It has one IT provider, which increases the level of information security and cyber resilience. All available channels are provided to get in touch with customers, in line with a fair and non discriminatory access to digital financial services. The EU digital identity and wallet should be introduced very soon, and the digital euro needs to be examined.

An industry representative highlighted that their company is located in the Netherlands, a highly dense country with a very strong digital infrastructure, which helps it to be a frontrunner regarding digital. Digitalisation is coming in waves and Covid has created a significant increase in video calling.

4.2 The increased reliance on outsourcing exposes the banking sector to higher levels of interconnectedness and concentration risk when multiple intermediaries rely on a limited number of service providers

A Central Bank official stated that proportionality is important particularly for LSIs (e.g. the SREP could be applied every two years for LSIs that do not have any problem), but the most important thing is that the reliance on digitalisation reduces differences between significant institutions and LSIs.

Cooperative banks are accessing digital payment systems through a lot of strategic agreement with other parts of the system. or are relying on providers to handle various functions such as cloud, IT and critical functions. This might expose small banks to the risk of interconnectedness, similarly to Significant institutions.

There has been a concentration of outsourcers; given that the outsourcing does not reduce the responsibility of small and big banks, there is a need to assess the interconnectedness, as well as the ICT and digitalisation-related issues. There should be much more focus on interconnectedness rather than size.

Running a traditional business with digitalisation implies a great deal of innovation and many structural changes in the P&L composition, that needs to be examined much more, as well as the risk that digitalisation might imply.

Global and Solvency II insurance frameworks

The Chair stated that Europe is reviewing Solvency II and that the three pillars of the framework will be reviewed. At the global level the International Association of Insurance Supervisors (IAIS) is finalising the global capital standard for insurance. The UK is also working on its own review of the prudential framework. An additional aspect is the interrelation between European Solvency II, UK Solvency, and the Insurance Capital Standard (ICS) at a global level.

1. The Solvency II framework requires critical adjustments to remain faithful to its initial objectives and take on board emerging sustainability related risk

An industry representative stated that extensive discussions have already taken place on Solvency II. The main aspect for insurers is to provide security and trust to policyholders with good service. The secure and fair markets target sometimes may not imply security and/or best service to policyholders. The market should do well for consumers and citizens.

On the Solvency II review the expectations are for fitness to initial purpose and to address the new context, new environment and new risks. Realistic approaches in the proactive prudential framework are paramount and will only be achieved while remaining risk based. The two main threats in the risk-based valuations are sustainability issues and long-term guarantees that sometimes clash with short-term bias in the regulation. Care is needed to avoid disproportionate capital charges between asset classes. Sustainability issues are the second major threat.

Insurers need to be able to pursue managing their risks, with the monitoring of their exposures being the liabilities or the investment and observing the transition that occurs every day. There is a concrete aspect in sustainability with physical risks, but the transition could result in costly and inappropriate work that could bring new risks. The wish is for regulators, particularly supervisors, to strengthen the debate in quality. It would be welcome for supervisors to challenge and bring more science based evidence.

2. The review of the Solvency framework for insurance undertakings in the EU is expected to reinforce the role and efficiency of the sector in the economy, financial stability, and the cooperation among supervisors

2.1 European Parliament, Council and the European Commission are close to completing the review of Solvency II

An official stated that the Solvency II review is reaching a pivotal moment as the trialogue meetings are about to commence. The Council and the European Parliament are close and will hopefully converge with the European Commission by the end of 2023. The review is essential for the insurance sector and the European economy.

A regulator noted that Parliament had reached an agreement and there are now three stable texts. The hope is that the trialogues manage to conclude before the elections start. Solvency II is a robust fundament of the industry. A second point is to examine how often Solvency II is reviewed, as there is a significant time and cost from the industry in impact assessments. The hope is that the trialogues will result in an outcome that is planned in coordination with all the other regulatory files such as the Insurance Recovery and Resolution Directive (IRRD) and the Digital Operational Resilience Act (DORA).

The Chair agreed that stability of regulation and coordination with other workstreams are key.

A regulator added that the trialogues can further develop the enhancement of cross-border cooperation at a time when there is more home-host instead of group subsidiary. If there is an issue then a platform can be helpful, but care is needed if someone wants a platform for every home-host situation.

2.2 Critical reinforcements

An official stated that the review is a unique lever to better protect policyholders and adapt to emerging risks. It enhanced cross-border activity supervision, and increased collaboration between supervisors, which is vital in this regard. The review will enhance the counter-cyclical aspects of the framework, and the introduction of macroprudential instruments will contribute to increasing financial stability in Europe. The review will empower insurers to play a more significant role in financing European sustainable growth.

A regulator noted that what Solvency II has tried to achieve is also true in a different climate, because it is a market valuation based framework that takes on board what is happening in markets.

2.3 Climate related risk and biodiversity challenges

An official stated that the review will improve the insurance sector's consideration of climate risk through the Own Risk and Solvency Assessment (ORSA), stress tests, and the attention on biodiversity. The French position on environment, social and governance (ESG) is to aim high while being wary of consistency with existing cross-sectoral regulations.

A regulator noted that how sustainability is introduced can be meaningful in many ways. Elaborating on transition plans takes on board what information is already available to supervisors and what information has already been produced.

2.4 There is no need for further regulatory capital and for better enabled companies to invest in the economy

An official stated that the pandemic demonstrated that current capital requirements are at a sufficient level to ensure the sector's resilience. The compromise texts of the Council and of the European Parliament do not create additional requirements to give reasonable leeway to the insurance industry to increase its capacity to finance the European economy.

A regulator added that capital easing will take place so risk assessment and risk management will be important. Individual companies will need to be examined very carefully, and the publication of individual stress test results is welcomed. The easing is meant to benefit the green transition; EIOPA should monitor that the freed up capital is going to green investments, not to excessive dividends.

2.5 Attention needs to be paid on improving proportionality and levelling the global playing field

An official stated that a welcome feature of both compromise texts is the increased proportionality for small and non-complex companies. The competitiveness of the insurance industry is also at stake in the review. The Council's approach insists on an international, level playing field to make it clear that European prudential regulations are not being discussed from an 'ivory tower'. There should be mindfulness of the global context of a strong insurance industry to the benefit of European consumers.

The Chair noted that in December 2020 EIOPA issued its advice for the review of Solvency II, and the objectives of the revision were clearly stated.

A regulator added that the proposals recognising that low-risk undertakings can do less reporting are welcomed.

3. The insurance sector has navigated the low interest rate environment well, but new challenges dictate remaining prudent

A regulator stated that there is currently a robust insurance environment, and the industry has managed the low interest rate environment very well, but improvements had been needed in the system for long-term guarantees such as extrapolation, volatility adjustment and interest rate risk. There is a concern about the current environment, which is very challenging due to war and problems with growth. The resilience of the sector has to be maintained and everyone needs to have substantial capital in the system. The European Commission wants to reduce bureaucracy, but the current discussion is on transition plans for companies.

4. The UK insurance solvency framework shares similar adaptation objectives though focusing in UK insurance market specificities

An official stated that Solvency UK and Solvency II share the same underlying features and market adjusted valuation group consolidated frameworks. The review has been undertaken and led by the government, with the Prudential Regulation Authority (PRA) within the Bank of England playing an important role. Policyholder protection was one of the key objectives, along with sustainability, financing sustainable and productive investment, and competitiveness.

4.1 An accurate valuation of the balance sheets of life insurers is one of the objectives

An official explained that in November 2022 the UK government issued the high-level areas of the review, the vast majority of which were completely in line with the PRA's views. All elements to do with the valuation of the balance sheet of life insurers will be used to protect policyholders against any risks, including stress tests with individually published results. The PRA can also set fundamental spread add ons on the valuation.

4.2 UK insurance market specificities require attention

An official stated that in June 2023 the PRA published a consultation paper with the first package of reforms, and in the autumn the second paper will be published. Everything will have been implemented and be in the rules by the end of 2024. UK Solvency has a difference in focus; the UK focused on the matching adjustment portfolio, while EU colleagues focused on the volatility adjustments. The design of the risk margin reforms is the same in Solvency II and Solvency UK, but the calibration is different.

5. Solvency II enables a pan European organisation model, but engagement with all supervisors is needed

An industry representative stated that their company's current business in Europe is from an acquisition that took place in 2010. The bigger impacts for the company around Solvency II were around four pieces: the legal structure used in Europe, the regulatory engagement approach moved to, the risk management at a business level in terms of the products, and the strategy of the company's European subsidiary and its businesses around Europe. On integration, the company's decision based on the Solvency II framework was to reorganise in a hub-and-spoke model, having one subsidiary in one member state and then to convert all other subsidiaries around Europe into branches.

The company had needed to create something new and needed to maintain its legal structure. The business went around Europe talking to prudential supervisors and convincing them that it was fine to move prudential supervision away from them. Due to the legal structure, the regulatory approach and the risk management approach, the business is examined in a pan-European way. The business limits the volatility.

6. The definition of the ICS global Solvency minimum standard is at its final stage

6.1 The ICS will be launched at the end of 2024

An official stated that their organisation is at the final stage of delivering the ICS, which is a very well tested and well monitored standard. An essential step will be achieving a robust assessment of the comparability of the ICS and the US implementation of the ICS. A consultation paper was issued in June on the ICS as a candidate Prescribed Capital Requirement (PCR). A PCR is a Solvency standard, which is a minimum standard that international colleagues have to observe or be above. In March 2023 robust criteria were also agreed for a comparability assessment between the ICS and the US implementation of the ICS.

An official emphasized the importance of the comparability exercise to succeed in establishing an international level playing field. While recognizing the commendable work of the IAIS in designing the standard ICS, it was necessary to move to the next steps of the process only when conditions were fully met.

A regulator stated that the consultation document is a key moment for everyone involved, and the findings in the fourth monitoring exercise will be crucial for the final document. The world needs an international minimum standard, and a final ICS would currently not result in a need for a Solvency II review.

6.2 Focusing on the comparability of the outcomes is essential

An industry representative stated that the IAIS is doing the comparability study, and the focus has moved from equivalence to comparability. The focus is the outcomes, and focus is needed on the stress tests to see whether the same outcomes occur, and whether the same points of regulatory intervention appear for both regimes.

6.3 ICS should use internal models as a framework for internationally active insurance groups and should not lead them to implement two different standards

A regulator stated that their organisation has essentially introduced and implemented an ICS. It is very important that the ICS takes the internal models on board; all internationally active insurance groups have internal models, which will also be an element of the ICS.

An industry representative stated that it is not clear what prudential regulation will mean at a global level, as a minimum harmonised framework is not yet in practice for different regions. Solvency II is a fairly complete and advanced framework, and there should not be two prudential regulation standards and indicators.

The Chair expressed hope that the ICS will be finalised soon and as expected, because it will be an added value for the supervision and for the protection of policyholders globally. The insurance sector deserves to have a global capital standard, and the hope is that the ICS will be a catalyst for convergence of a prudential framework around the globe.

Sessions

III

DIGITALISATION AND TECHNOLOGY

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Technology transformation and policy implications

1. Technology impacts and related opportunities

1.1 Magnitude and speed of the digital transformation underway in the financial sector

An industry representative stated that digitalisation is profoundly reshaping the way financial services are conceived, delivered and consumed. The adoption of technology such as cloud services is contributing to modernise the financial services sector and providing significant opportunities in terms of efficiency and safety enhancement. A Central Bank official added that digitalisation may lead to many positive changes in the financial sector, such as enhancing transparency, the depth and liquidity of markets and increasing innovation with new forms of competition entering the market. Digitalisation might also contribute to improving risk mitigation and financial stability because banks may be able to make more informed decisions using digital tools.

A second industry representative observed that the changes and enhancements from digitalisation will come progressively in different parts of the financial sector and the broader economy. An immediate and fundamental digital transformation in all areas of finance should not be expected and whether these changes will eventually be transformative will be seen in the longer term. Significant changes are already happening through mobile applications, web portals and chatbots. There is currently emphasis on improving customer experience, but broader transformations as a result of new technologies are still to be seen in terms of new product offerings, shifts in revenue mixes, efficiencies and cost curves, and improvements of financing options, strategies and liquidity. The impact of the digital transformation indeed has to be evaluated from a customer and company perspective and also on a broader market level in terms of infrastructure, competition and market liquidity. The wider impacts on economic growth and the financing of the economy also need considering.

A third industry representative pointed out that the short-term impacts of technology tend to be overestimated and longer term impacts underestimated. That has already been proven for many technological disruptions such as the internet and smartphones. That however will give some time to adapt the regulatory approach to these new developments.

A regulator highlighted the rapid pace of technological change in financial services. In October 2022, the FCA and the Bank of England surveyed a number of UK financial firms, all of whom reported increased usage of artificial intelligence (AI) and machine learning (ML). 72% of firms reported using or developing ML applications. Surveyed firms also expected the overall median number of applications of AI and ML to increase 3.5 times over the next three years. 50% of respondents reported regulatory constraints related to ML development, showing that although designed to be technologically neutral, the regulatory rulebook may not be fully adapting to the on-going technology evolutions within financial services.

1.2 Evolution of the IT infrastructure and data management capacity

An industry representative noted that there needs to be a transformational shift in the IT systems of financial institutions to reap the full benefits from digitalisation. Some legacy tech stacks are not compatible with future technologies, and the ability to use data effectively with legacy systems is very challenging. Complex processes that do not align with new technologies pose an additional risk. Data is becoming a key competitive advantage of financial companies, so understanding a company's data estate and building blocks is essential for future evolutions, such as implementing distributed ledger technology (DLT).

A second industry representative emphasised that replatforming the sector's IT infrastructure, which is dated in many cases, is essential for supporting an effective digital transformation. The legacy infrastructure needs to be transformed, leveraging new technologies such as cloud services, artificial intelligence (AI) and application programming interfaces (APIs) in a way that does not disrupt the current business or increase systemic risks. The objective is notably to better exploit the data available to better serve customers and enhance the efficiency and safety of the financial ecosystem and also direct capital to the areas of financial services where there is most value.

A second area where technology can play a key role, the industry representative suggested, is ESG and supporting the sustainable transition, which requires the collection and storage of huge amounts of data in a trusted way. The scope of the data needed was not anticipated in the design of IT systems built more than five years ago, so most market players are confronted with this problem. This is a challenging area however, because there is the risk of being accused of greenwashing if the data used is incorrect or incomplete.

A third industry representative noted that cloud services sit at the heart of the ongoing digital transformation, as the computing power available in the cloud is needed to fully leverage the potential of AI and generative AI in particular. An important benefit of the cloud is lowering the barriers to access to technology, both for the bigger and the smaller financial entities. That may facilitate the access of new entrants in the market, which is important for stimulating innovation and competition, as well as the emergence of new use cases based on AI. Cloud services can also help to strengthen operational resilience, which is essential in the current geopolitical context where cybersecurity risks are rising.

1.3 The opportunities from digital assets and tokenisation

An industry representative highlighted that tokenisation and the move towards digital assets are a significant area of change supported by new technologies. Many initiatives taking place in this space demonstrate that digital assets work technically. The most promising applications are primarily for asset classes that are currently less efficient than core securities such as listed equities and government bonds.

An official stated that tokenised assets were a theme in the 2023 BIS annual economic report. To allow a significant evolution towards digital assets and leverage the opportunities of tokenisation, the right infrastructures need to be in place. The idea is to go towards a 'unified ledger', where tokenised assets and central bank money can meet for handling transactions that are currently very expensive or not possible to execute.

The objective of asset tokenisation is not just having a digital representation of assets. It also offers the possibility of reviewing the rules and logics that govern asset transfers. Digital assets allow for example the simultaneous performance of actions, such as buying and selling, in one go and conditionally to certain events. There are many opportunities from the use of these new technologies for addressing inefficiencies in certain areas. One of these is supply chain finance and supporting suppliers involved in long distance trades. In an ideal world there would be payment upfront before processing a new order, but that is usually not the case in a cross-border environment. It is therefore hard for small and medium sized enterprises (SMEs) to compete with large companies in this area. With tokenisation there is the possibility to perform different actions in a contingent and simultaneous way and to integrate external data such as GPS data, leading to a more effective handling of such transactions and an optimised use of collateral. Tokenisation is also a way to build in trust where it is needed, provided a reliable settlement asset can be put into play. There is a preference for settlements in central bank money as it is safer and more effective. The BIS is experimenting with those issues, with several ongoing wholesale central bank digital currency (CBDC) projects, and the development of a dedicated environment comprising all necessary information to trade contingent transfers of digital assets on a unified ledger.

The official added that tokenisation and CBDC may also support the evolution underway in the financial services sector towards 24/7 services and instant delivery, and also increased requests for cross-border services. Customer expectations are indeed changing significantly and financial services delivered within two days will no longer be acceptable for future generations. It remains to be seen whether tokenisation will be the main solution, but such an evolution must be anticipated. Many changes are happening in the payments area in particular. There are around 65 fast payment systems in the world which are growing quickly, but they all cater for needs in only one currency. There are already attempts to connect those systems across borders to enable people to send money peer-to-peer (P2P) or platform-to-business (P2B) almost instantly. However, simply scaling up those platforms and maintaining many connections across borders could result in a tangled system. BIS's Project Nexus is an attempt to solve that, with a gateway connecting multilaterally fast payment systems of different jurisdictions. BIS is working with an initial group of five central banks to build the gateway, and many more countries are advising on the project. However, a fast payment system in euros is still to be set up. Project mBridge is another pilot for a common system for making cross border payments feasible and issued by central banks. The current geopolitical developments are a challenge for building cross-border systems but the technologies will be used anyway, so it is better to try to develop such systems in a common, safe and transparent way.

2. Challenges and risks associated with digitalisation

An industry representative stated that a first challenge for banks is the cost of digitalisation and the validity of the related business case. There is a trade-off for many banks between investing in digitalisation in order to create more value in the future or using the corresponding capital to buy back shares, enhance immediate profitability or give it back to shareholders in the form of dividends.

A second challenge is the speed of change that can be imposed by some technologies and the fear of missing out, the industry speaker added. Everyone agrees that generative AI is potentially very disruptive and has an impressive pace of adoption. ChatGPT reached 100 million users within two months and became a top level agenda item for many banks in less than six months, being discussed at most boards and excos. Generative AI is promising for the industry, with the potential to improve the productivity of relationship managers by up to 40% and IT development by up to 60%. There will be a major competitive advantage for players who implement it in the right way, leading many bank CEOs to put top-down pressure on their teams to decide on an AI strategy. The risks associated with AI also need considering however, because the technology is immature. The models are still foundation models that could come up with unwarranted answers and expose banks to copyright issues for customer-facing use cases, as well as data leakage and defamation risks. A balance is therefore needed between quickly rolling out technology such as generative AI that has a significant transformational potential, and putting in place sufficient safeguards to mitigate risks, as well as the learning and talent needed to master that technology.

A regulator noted that the risks posed by new technologies in terms of fraud and misinformation could lead to an undermining of trust if they are not appropriately tackled. For example, scams have evolved using AI such as deepfake videos promoting investment scams. The increased reliance on third party service providers creates benefits but also new risks such as operational resilience risks and cyber threats. The increased connectedness across markets created by digitalisation and the cross-border dimension of critical third-parties, including cloud service providers (CSPs), also presents risks, including in terms of financial stability.

3. Adapting the regulatory and supervisory approaches to increasing digitalisation

The Chair asked panellists what policy responses would be helpful to strike the right balance in dealing with the risks and challenges from new technologies, while also benefitting from all the possibilities the technology brings. As mentioned for generative AI, while it is important not to hinder new developments that may potentially enhance the competitiveness of the financial sector, consideration is needed around the maturity of the technology and how it will evolve, also taking into account the insufficient level of data quality.

3.1 The need for an adaptative regulatory framework

An industry representative stated that for traditional financial activities and products it has been possible to find a balance in most cases in the regulatory framework between responding to customer needs and preserving the integrity of the financial system. However, when it comes to technologies such as AI which are still in the making, it is not possible to impose hard rules from the start. Policy needs to first be principle-based, as the technology evolves and the industry progresses in its mastering of the technology. Imposing hard rules too quickly may lead to unnecessary restrictions or sanctions that may deter financial institutions from using AI. It is also important to ensure that policy work is globally coordinated in this fast-evolving area, because it is vital not to create any regulatory arbitrage or give a competitive edge to one geography over another. The Chair noted that the frameworks in place adopt a technology-neutral approach, which should help in this regard.

A second industry representative observed that the starting point should be a regulatory framework that supports the adoption of technology, but initiatives in Europe are not all conducive to that. Innovation is a journey, not a destination, and therefore regulation and supervisory practices have to evolve accordingly. That dynamic environment introduces challenges, as policymaking takes time, particularly in Europe. A further challenge at the European level is that a significant number of horizontal digital policies including the AI Act now coexist with more specific sectoral policies such as the Digital Operational Resilience Act (DORA). As the next mandate of the Commission arrives, it would be beneficial to take stock of the overall impact of the different initiatives put in place, both horizontally and sectorally, before engaging further changes.

A further challenge in terms of regulation, a third industry representative observed, is that the extent of the transformation happening with digitalisation and its unprecedented speed mean that the end stage is uncertain, as well as the path to get there. The path of evolution will moreover differ significantly across market players, depending on the type of business they are in and their legacy systems, so an evolving regulatory framework is needed. The regulatory framework should not aim to address the end game of digitalisation, but different milestones should be determined in terms of digitalisation and the regulatory framework progressively adapted to those milestones. This will allow requirements to be changed over time, if needed, to adapt them to evolutions in the technology or in the way it is implemented and used in the market or to new incoming technologies. Taking the example of digital assets, not all players will be able to adopt them at the same speed. There will therefore be a need to run a digital infrastructure and a traditional infrastructure in parallel, probably for the next 15 to 20 years. The regulatory framework will need to take into consideration this gap because bridges will be needed between these different infrastructures. The discrepancy between some market participants who might be ready on the digital front and counterparties still transitioning towards new systems will bring some additional complexity for a period of time. The Chair added that another challenge is that the processes supported by a new technology and the existing processes transitioning to a new technology may need different types of supervision.

A regulator agreed that the regulatory approach needs to evolve in order to support ongoing technological change as well as likely future change. The regulatory approach has already adapted in the UK to take those evolutions into account. The FCA is clearly focused on outcomes-based regulation, and that should stand the industry in better stead for ensuring that regulation is technology-neutral. If the desired outcomes and the harms that regulators are seeking to prevent are clear, then it should help support future change and innovation.

3.2 Taking evolutions of the value chain and market structure into account

An industry representative stated that regulation will need to adapt to evolutions of the financial value chain and market structure triggered by new technologies. There are many potential benefits from the breaking up of traditional value chains and the involvement of new players, such as efficiency, ease of use and cross-border development, but this raises challenges in terms of regulation and supervision that currently focuses on financial institutions. Further challenges come from the potential dematerialisation of infrastructure and increasing outsourcing to ICT providers which raise questions about the focus of regulation and supervision going forward. When taking the example of a structured finance bond issuance, it is unlikely that the same players will participate in the initiation and delivery of a bond in the future and that the processes will remain the same as today.

A Central Bank official suggested that a key feature of digitalisation is the fragmentation of the value chain and an increasing number of tasks due to be performed by unsupervised third-party providers and algorithms. The emergence of new categories of players in the financial sector is a challenge for supervisors used to dealing with more traditional financial players. But the challenge from the developing role of algorithms with AI driven decisions and self-executing smart contracts may be more significant, as it may lead to an evolution towards a new kind of 'driverless, autonomous' finance, with risks shifting from humans to algorithms. In principle the overall responsibility remains with the managers of the bank, but that may be difficult to enforce if algorithms function autonomously in the context of end-to-end processes. It is currently unclear whether that leads to a risk reduction or a risk increase, but the challenge for banking supervision is significant, because the priority may be technological supervision in the future rather than financial supervision.

An industry representative noted that while AI systems and algorithms may be making many decisions in the future, behind them there are humans who have coded and trained them, that need to be effectively controlled.

An official agreed that in the current world it is not enough to only understand what is happening in economic and financial terms; an understanding of the technology side and how it changes operational processes and customer preferences is also vital. The Innovation Hub of the BIS is collaborating with central banks to explore how the public good can be built in this regard, notably to meet their objectives on monitoring financial stability.

A regulator noted that there is a programme of work ongoing internationally on digital operational resilience and the risks from critical third-parties. In the UK, part of the recently passed Financial Services and Markets Act gives the UK Treasury the ability to designate critical third parties, which will then come under the remit of the Bank of England and the FCA. They will be responsible for regulating the services provided by critical third parties to the financial sector from an operational resilience and financial stability standpoint.

The Central Bank official observed that there is a similar approach in the EU with the DORA regulation, aiming to tackle the risks from critical third-parties such as CSPs. The concept of third party provider may be too narrow however for such players, because CSPs are becoming an integral part of the future digital infrastructure due to support digital assets in particular. DORA is not yet a sufficient answer to the fundamental importance of that infrastructure for the digital transformation of the financial sector.

3.3 A more collaborative and customer-oriented approach to regulation and supervision

In response to a question about the potential impacts of the use of new technologies on supervision, a Central Bank official suggested that adapting the policy approach and supervision to innovations in the market is a common journey for the authorities and the industry. New forms of regulation need issuing to address the opportunities and risks from digitalisation and supervision needs to evolve, but it is also up to the industry to adapt to these changes and interact with the authorities to ensure that policy measures and supervisory approaches are appropriate. Different authorities also have different approaches to these evolutions, with supervisors focusing more on the risks and central banks considering market impacts in a more holistic way in terms of efficiency and stability.

An industry representative agreed that supervisors and regulators need to work closely with the private sector to understand the implications of new technologies – i.e. which parts of the financial sector are impacted, what the associated risks are - and to design the supervisory framework together to ensure that the integrity of the financial services system and consumers continue to be protected. From a supervisory perspective it is vital in particular to understand the implications and impacts of new technologies such as generative AI and their on-going evolutions in order to ensure that companies are not blindsided in their use of this emerging technology.

A regulator stressed that effective outcomes focused regulation is needed to address technology-related developments. It requires good collaboration and partnership between policy-makers and industry. The FCA is looking to build much greater engagement with industry and potential users. It is important to consider the impacts both for industry participants and consumers, because the trust element is essential in this context. In addition to conducting consultations and gathering feedback on policy proposals, regulators need to move towards an evidence-led approach and collect input on the potential impact of policy options early in the process. This can be done by convening industry and consumer groups and making greater use of existing statutory panels.

The regulator added that testing is also a key factor in this context. The FCA has a well-established digital sandbox, which has supported 867 firms since its inception in 2014 and is now permanent. This has enabled successful testing of many new products and product evolutions. Another objective for regulators is creating sufficient space in the regulatory agenda to deal both with future innovations and existing activities. Finally, there is a further area of reflection about how supervisors and regulatory authorities can use technology to perform their own supervisory activity and address market risk in a more effective way.

4. Wrap up

The Chair summarised that while significant impacts from digitalisation are anticipated, changes are not yet happening all at once and across all financial activities. It is a progressive journey of change. The outcome is still uncertain, as to whether it will lead to autonomous products functioning on unified ledgers for example, or whether value chains will end up being further disintegrated with third parties being part of the supervised community.

The industry is adapting to benefit from the competitive advantages of technology, which raises questions around how policymakers and supervisors should evolve their approach to strike the right balance between supporting innovation and mitigating the related risks. The panel generally supported the need for principle-based and outcomes-based approaches to policy in this area due to the speed of innovation, and emphasised the importance of international cooperation due to the cross border dimension of digital activities. Supervision has also to adapt to 24/7 business and is increasingly a consumer-focused activity. Testing and interacting with the market and consumer representatives is important in this respect. Supervisors will also need to supervise the development of a new digital world of finance, while overseeing traditional activities in a transitioning process.

Competitiveness and stability impacts of technology

The Chair outlined the main themes of discussion of the panel: the impact of artificial intelligence (AI) and the on-going digital transformation on the competitiveness of the EU financial sector, the impacts of digitalisation in terms of resilience and financial stability and whether the EU regulatory and supervisory framework is helping to foster greater competitiveness and increased resilience in the financial sector with the increasing use of technology.

1. The impact of new technologies on competitiveness

1.1 Competitiveness impacts of AI

An official stated that digitalisation and the integration of new technologies such as AI represent a transformative opportunity to reshape the economic landscape. For example, AI will extend the connections between human and technological resources, enhance customer experiences and speed up assessment processes. AI will help automate processes and operations in the financial sector. It will improve data processing, which will enable firms to understand data more deeply and to more efficiently use the knowledge derived from the data. It could also help combat financial crime such as fraud more effectively.

An industry speaker emphasised that technology offers the possibility to rethink how traditional businesses work and how markets could be transformed. AI will be critical to all sectors because it drives competitiveness by helping businesses reduce costs and improve products and customer service. In the financial sector, AI is already being used in several different ways. It is used to improve financial firms' understanding of customers, which helps firms to offer their customers products and services that are more suited to their needs. AI is also used for customer retention, as it can help to identify customer dissatisfaction. AI can also support the management of customer interaction and speed up communication with customers. In this regard, chatbots can be extremely useful.

There have also been evolutions since the pandemic. There is a new generation of customers who prefer to interact with banks and financial services firms through online services. This is facilitated by apps that are easier to use, more user friendly and continuously upgraded to improve customer service. AI can also improve risk management, which is extremely important for banks' performance as the complexity of their operations increases. For example, AI can be used to identify trends such as the deterioration of a customer's credit status. This allows banks to take the best course of action to manage potential credit default risk. Finally, AI might also have a positive effect on financial inclusion. More efficient AI driven risk assessment and management might make it possible to extend credit to customers who might otherwise have failed a traditional credit analysis.

The industry speaker observed that there is also mutual benefit in the finance sector using AI. AI contributes to the competitiveness of the financial sector and the financial sector, which holds a great deal of data, can help to enhance AI. However, there are some important roadblocks to consider. Even if banks and financial services firms have every intention to adopt and use AI, they can be prevented from doing so due to internal company structures, legacy technology and data fragmentation within their organisation or in the financial ecosystem.

A second industry representative concurred that AI can help to enhance the competitiveness of financial firms in different areas. AI is not a new technology and has been developed over the last two decades. Some AI use cases have become routine, such as AI-based contact centres that help to improve consumer experience for end-users and reduce customer waiting times. AI also helps to enhance the efficiency of regulatory reporting, fraud detection and anti money laundering (AML). With AI and machine learning technologies, financial firms can detect two to four times more genuinely suspicious activities than false positives, which are very common in the fraud detection space. There is also a huge potential for generative AI to help financial firms improve their risk management, regulatory reporting and ability to make sense of the huge amount of data they accumulate.

A Central Bank official agreed that digitalisation will bring very significant changes over the next 5 or 10 years. Some of these technologies are already in use, but it is impossible to predict what will happen in the future. In general, people tend to overestimate the short term impacts and underestimate the longer term ones.

1.2 The role of cloud computing

An industry speaker emphasised that cloud technology has become an enabler of access to AI and machine learning for organisations of all sizes, not only financial services institutions but governments, SMEs and start ups,. With cloud computing, these organisations are able to use the same large language and foundational models as those used by the cloud service providers (CSPs) for their own services and have access to adequate computing power. The added value of the cloud is enabling all customers to access state-of-the-art technology and models in order to innovate with their own data. Customers bring their own data into these models and can adjust the models to suit their own use cases. Cloud services therefore have to be as accessible as possible to fully leverage the potential of AI.

Another industry speaker agreed that cloud services are a major enabler of AI. Currently, the best AI services are delivered via the cloud. Hopefully, further additional CSPs, perhaps including some larger European ones, will eventually emerge to support the development of the sector.

1.3 The need for enhanced digital literacy

A public representative observed that competitiveness will only truly be enhanced by using human resources and technological innovation in combination in an efficient way. This means there needs to be a good understanding of AI and digital technologies, which requires the labour force to be well educated.

Digital literacy should not be underestimated. If there is insufficient understanding of how these technologies will be used and the added value they bring, people will be resistant to them and worry about losing their jobs. There also needs to be a good understanding of these technologies within regulatory bodies to ensure that any regulations can be properly implemented. Currently, there are significant differences in the level of knowledge between different regulatory bodies and member states, which may lead to an inconsistent implementation of digital and data legislations.

An industry speaker agreed with the importance of developing an understanding of AI and its potential benefits among market stakeholders. Without this understanding, the market will not be able to take advantage of AI. In this regard, a great deal of education is still needed.

2. The implications of new technologies for resilience

An industry representative observed that the adoption of cloud computing helps to improve resilience and cybersecurity by giving customers access to the defence mechanisms used at scale by CSPs to secure their own activities.

A Central Bank official emphasised the importance of also taking into account the risks to resilience posed by the growing use of new technologies in the financial sector. There are three key risks from a financial stability perspective: operational resilience, governance and contagion risk. Consumer-related risks such as consumer protection and discrimination risks are also important to tackle.

In relation to operational resilience, cybersecurity is the main risk. Each time a new technology is introduced in the financial system, it opens a new channel for cyber-risk. In addition, adversaries such as criminals and hostile governments are also increasingly using these new technologies. Outsourcing is also a critical aspect of operational resilience risk. This is quite a complex issue which could have serious implications in terms of tail risks and crisis situations, in addition to everyday business continuity issues. The financial sector is increasingly dependent on outsourcing to tech companies and cybersecurity firms, including both large CSPs and smaller providers. The issues related to governance risk are mainly connected to AI. These include explainability, accountability, data governance and model governance risks, as well as black box algorithm and algorithm validation issues. There are particular risks when AI systems are used for liquidity measurement and risk management. As for contagion risk, its importance is illustrated by the SVB and Credit Suisse crises during March 2023. If the same AI models are used across the market, it could lead to herd behaviour and market manipulation. This risk should be taken seriously because markets are very fragile.

A public representative noted that two key aspects of resilience came up in the debates in the EU Parliament around digital and data legislation. The first is the safety and resilience of digital infrastructure which requires sufficient investments to be made. The second is the potential lack of accountability for example in some decentralised platforms based on blockchain.

3. Regulatory and supervisory implications of the ongoing digital transformation

3.1 The objectives and challenges of digital regulations

An official noted that the Spanish EU Presidency is currently managing several important and sensitive dossiers that aim to pave the way for a new digital economy based on human centric technology and an adequate protection of rights. These include the AI Act and the Cyber Resilience Act, on which work is ongoing. A close collaboration will be needed between the public authorities and all the relevant stakeholders to finalise these frameworks and ensure their sustainability.

While short term initiatives on competitiveness are important for the development of a digital economy, longer term policies focusing on resilience will ensure that the development of AI is sustainable over time. To accomplish this, Spain is pursuing the Digital Spain 2026 agenda, which has three areas of focus: (i) infrastructure and technology, which covers AI and quantum computing; (ii) building awareness among companies of the opportunities of digitalisation; and (iii) ensuring people are trained and have sufficient digital skills. Training and digital skills will ensure that people understand the key risks from digitalisation, such as biased information and explainability and the importance of data. People also need to understand the cybersecurity risks from the poisoning of data and how data-related issues might affect their lives.

A public representative stated that the EU has led the way on establishing a regulatory framework for technological developments such as AI, but the challenge for policy-makers is about how to balance safety and innovation and how to preserve competitiveness as further technological developments take place.

A first challenge is to ensure that small and medium sized enterprises (SMEs) can remain competitive in the global market. In the Data Act, which is the first legislation to put an economic value on data and properly define it, there is an important emphasis on SMEs. The Data Act seeks to ensure they can benefit from access to bulk data which they cannot generate themselves. This is the only way for them to be competitive in global markets. Secondly, the competitiveness of the start up sector needs to be further promoted and boosted. The European Parliament is developing initial legislation on European start ups with the idea of guaranteeing small entities within the EU access to private capital to help them grow. This includes properly defining what a start up is, which should include notions around innovation and technological development. Finally, progress must be made on digital and financial literacy in the coming years in order to leverage the potential of technology in society.

An industry representative noted that the Data Act has tremendous value for cloud services because it facilitates the interoperability and portability of data, which will enable industries to adopt a multi cloud or open cloud approach and facilitate choice between providers. The AI Act is also an essential piece of legislation, as it defines how Europe should deploy AI for decades to come. As Google's CEO has suggested, AI is too important not to regulate and too important not to regulate well. A responsible development of AI is needed, which means not only mitigating the risks from its use but also ensuring that AI can improve people's lives and address social and scientific challenges.

Another industry speaker added that AI also requires appropriate data regulation. This is a challenge because the European data space is fragmented. Some sectors are subject to open data requirements, for example, while others are not. Concerning the AI Act, the European public authorities, which are endeavouring to be trendsetters in this field, should be careful not to over-regulate. That would only limit the capacity of European companies to take advantage of the technology.

3.2 The possible need for sectoral AI regulation

Answering a question from the Chair about whether a more targeted and sectoral legislation of AI would be needed, an industry representative stated that the risk based and outcomes based approach of the AI Act needs to be preserved. AI models are purpose-agnostic, which means that the same models can be used for multiple activities. The same technology that can be used for abusive activities can also be used to tackle abuse. Regulating all the different activities using AI and foundational models would be an extremely broad scope. This does not seem like a relevant approach to take. This is important to bear in mind as trialogues are progressing.

For the time being, there should be a focus on high-risk applications, the industry representative suggested. If sector specific AI requirements are needed at some point, this could be achieved without developing a new AI regulation. Existing financial services regulation may be adjusted to make it applicable to AI. The use of sandboxes could also be a helpful approach. For example, the Monetary Authority of Singapore (MAS) has created a principles-based framework and assessed the ability of tech providers and banks to implement AI in line with it.

3.3 Supervisory implications

A Central Bank official emphasised that new technologies create new supervisory challenges. Supervisors need to understand any new technology and they need to be able to check whether supervised entities understand how it should be used and the risks it may create. This can be a challenge for supervisors because some of the risks posed by these technologies are still not fully understood, especially when several different technologies are being used in combination. In addition, the risk profiles may differ when technologies are used for different services.

Significant changes in the division of competencies between supervisory authorities will be needed in the coming years to tackle these risks. Financial supervisory authorities (FSAs) should become increasingly involved in digital issues. There should also be a new culture of cooperation with other supervisory authorities, including financial intelligence units (FIUs), data protection authorities and cyber protection authorities. Secondly, the deployment of technologies such as AI will require agile and adaptive partnerships between financial entities and supervisory authorities. It is extremely important for supervisors to have open and feedback based communication with financial entities. Eventually, all FSAs will also use AI systems. If both banks and FSAs use AI systems, it will create the possibility of real time supervision.

The Central Bank official added that further clarity will also be needed on the rules regarding data sharing both between banks and with supervisory authorities for addressing issues such as AML and sanctions. This kind of data-sharing is highly beneficial, but there are currently some restrictions.

An official emphasised that sandboxes can also be useful when developing AI systems. For example, Spain is developing an AI sandbox. The goal of this initiative is to set up a environment in which stakeholders can discuss and collaborate on the use of AI and the effects of the AI Act. In order to track how companies and institutions apply these measures, Spain has created an AI supervisory agency, which should also foster the Spanish authorities' understanding of how to apply any future regulatory measures.

Cryptoasset and stablecoin regulation

1. Value added of crypto, market trends and opportunities

1.1 Cryptoasset and stablecoin trends

An industry representative observed that, so far, crypto has developed as an early-stage technology with fast adoption and boom-and-bust cycles. With unabated interest in the market, there is little doubt about the trajectory of growing adoption. This will however depend on whether regulations focus on the right areas, while leaving room for innovation. In established crypto companies, despite the significant March 2022 downturn, there has been no reduction in developer activity or open-source code engineering work. Institutional investors are increasingly interested in entering the cryptoasset space. Coinbase was recently onboarded to BlackRock's Aladdin platform to provide Aladdin institutional clients with access to crypto trading and custody. Applications of crypto are also developing in other areas such as cross-border payments. Visa recently announced the integration of a stablecoin-based settlement mechanism for their payment system. Observations have also been made by the Bank for International Settlements (BIS) that a tokenised store of value could be a solution for dealing with the complexities and limitations of the current cross-border payment system.

A regulator noted that the first wave of crypto development was mainly in the retail market. In France, 8% to 10% of households have invested in crypto. The key priority for supervisors at present is to ensure that these customers are protected by implementing the Markets in Cryptoassets Regulation (MiCAR) as soon as possible.

An industry representative stated that banks have been exploring use cases in crypto for many years. Stablecoin issuance that will be covered by the upcoming MiCAR regulation is one of these areas. Stablecoins are not viewed by banks as a goal in itself e.g. to provide an additional retail payment solution, but rather as an enabler to allow corporate clients to develop their business-to-business use cases on a blockchain infrastructure. In this sense, stablecoin is an infrastructure-focused project. Blockchain has long been used for recording transactions, but adding a technology for payments in the blockchain environment would open up new applications. A stable currency issued by a regulated and reputable institution could for example be used as a means of payment in trade finance, allowing automated payments to be triggered conditionally to the arrival of freight in a port and recording this on a blockchain. The Chair agreed that it could be transformative if banks develop a viable business case for the use of stablecoins in trade finance and other business-to-business transactions.

A regulator stated that technological innovation normally leads to use cases in the form of products or services, which are then brought to market by firms. Eventually, those firms may capitalise the products into assets and sell them as financial assets with future expectations of returns. The crypto process, however, has gone from the technology directly to the assets by-passing products and firms. With discussions around the use of distributed ledger technology (DLT) within banks and other financial institutions, questions around the products that may be brought to the market are now being addressed. Trade finance is an example of a product that can be supported by DLT and stablecoins.

It is necessary to first define the products that can be developed with DLT and cryptoassets, the firms that can bring these products to the market, and also the risk management capabilities and governance needed around them, the regulator emphasised. There is now a good understanding of the different use cases of DLT both for financial and non-financial purposes, the potential of the technology and the related risks. MiCAR clearly defines some financial products based on crypto technology, including asset-referenced tokens, e-money and stablecoins, which will be able to be safely developed in the market under the MICAR requirements. There are other applications of DLT within financial institutions that have nothing to do with selling financial products and that could be taken advantage of, such as trade finance, facilitating intermediation, and transaction recording. As these use cases develop, specific regulation within the prudential framework of banks, albeit of a different nature, will probably be needed.

1.2 Opportunities from the underlying crypto technology and tokenisation

An industry representative stated that the value of crypto is simple but profound. Currently, it is easy to send information via the internet. However, without crypto technology, it is not possible to transmit ownership or value. Crypto is therefore a significant technology with financial and broader societal applications. In the US, there is a concern around privacy in relation to large tech intermediaries. Tokenised identity can be a solution to that. NFT-based crypto solutions can also be a solution in terms of enforcing rules around supply chain controls and making sure that ESG or human rights rules are protected. There are also applications with AI. The ability to tell the difference between a legitimate AI outcome and a deepfake can be achieved with a tokenised paper trail of digital information that goes into the algorithm. These are non-financial applications of crypto that regulations should not inhibit.

A second industry representative agreed that tokenisation is a key use case of crypto technology and has many different applications. Tokenisation can facilitate the trading of traditional assets, such as securities. There are also markets for digital assets, such as game characters, and digital assets can also be useful in areas such as intellectual property, music rights and sports club memberships. What is missing, however, is a well-regulated and trusted payment solution to support these use cases. Unregulated and unbacked stablecoins cannot play that role, and global stablecoins are politically unpalatable following the Libra experience, as they may compromise monetary sovereignty. Banks could issue payment tokens, either in the form of 'tokenised deposits' falling under the banking prudential regulatory framework or stablecoins covered by MiCAR. This could allow the provision of trusted and euro-denominated means of payment available on a blockchain infrastructure. The recent guidance published at the international level by the BIS indicates a preference for tokenised deposits over stablecoins. However, both can co-exist if they are well regulated.

A regulator agreed that the tokenisation of traditional financial assets is a promising route because significant productivity gains are difficult to achieve in the current post-trading space which is structured around legacy infrastructures. There is significant interest in evolutions around DLT and digital assets among market participants in France, which is why the French regulator has supported the EU DLT pilot regime initiative. At present, however, some key enablers are missing, most notably a settlement means of payment available directly on the blockchain to support transactions between market participants. The challenge in this respect for the public authorities is to provide as much certainty as possible to market participants, because the technology is somewhat ahead of the legal basis. This requires engaging proactively with market participants to help them implement projects and develop their ideas in the safest way possible.

2. Risks from crypto and policy challenges

The Chair stated that the regulation of crypto activities faces several challenges. Some are specific to crypto, such as the difficulty of identifying responsible persons[1]. This issue is more significant for DeFi activities but can also be encountered in more centralised cryptoasset activities and even TradFi (traditional finance). It is addressed in both IOSCO's recently published DeFi recommendations and the CPMI-IOSCO stablecoin recommendations. Other challenges are more common and relate to innovation in the sector. One issue is appropriately balancing investor protection and financial stability objectives with facilitating innovation. A potential weakness in the policy approach is also the slow pace of policymaking given the speed of innovation. The full implementation of MiCAR is scheduled for 2024, with a review currently scheduled for 2027. Although MiCAR is a decisive step forward, there is a risk that it may be outflanked by further innovation.

A Central Bank official stated that the 2022 turmoil showed that the crypto sector has fundamental problems relating to basic risk management, internal controls, weak governance and a lack of segregation of client accounts. Following these events, there was a strong regulatory and supervisory response, with recommendations around implementing controls, appropriate regulatory tools and proper supervisory cooperation at the international level. It is hoped that these recommendations will be implemented by jurisdictions globally. Although MiCAR is a positive development, it will not solve all these problems. Once MiCAR is in place, there might even be a false perception that the crypto sector now functions in a sound way, but the crypto sector still needs to evolve towards a more mature base of quality and safety. This should be worked on in parallel with the implementation of MiCAR.

The traditional financial sector's interest in moving into the area of crypto may also be a double-edged sword. On the one hand, its involvement will contribute to improving the safety and quality of activities in the sector. However, it may also increase interconnectedness risks. So far, the impacts of the failure of certain cryptoassets and cryptoasset service providers (CASPs) have been limited in terms of financial stability. This might no longer be the case with greater interconnectedness. Addressing these matters will require additional work on the regulatory framework. While the difficulty of identifying responsibilities in the crypto space is often put forward, it should be recognised that there is a reasonable level of centralisation in crypto activities, which should make it possible to enforce regulatory requirements. Authorities need to prepare to act forcefully when requirements are not followed.

Another policy objective that has been widely discussed at the Financial Stability Board (FSB), the Central Bank official added, is to ensure that all major jurisdictions adopt recommendations so that crypto activities and stablecoins are properly regulated around the globe. However, there may be some opportunistic behaviour by smaller jurisdictions seeking to attract business. Policymakers need to ensure that all jurisdictions implement the recommendations and that small jurisdictions do not try to service the rest of the world from a lightly regulated area, in order to achieve a sufficient level playing field. A further issue is that the legal situation regarding these activities varies across jurisdictions. In some jurisdictions, they are already captured by existing legislation, whereas in other jurisdictions new legislation needs to be implemented to ensure proper regulation of stablecoins and cryptoassets.

An industry representative acknowledged that there have been governance issues in the crypto sector, but many bad actors have been washed out by the market downturn and the advent of regulation should also help to address this issue. The area where regulation is most

1. One particularly striking case is that of Tornado Cash, in which the company argued that it was just a collector or an aggregator in code. The government's argument, and the ruling of the federal district court, was that Tornado Cash was an association and could therefore be sanctioned.

urgently needed is intermediaries such as cryptoasset and virtual asset service providers (CASPs and VASPs) that hold client assets and therefore need to be subjected to proper rules and supervision. Policymakers in some jurisdictions, including the EU, are taking action in this area but others, such as the United States, still need to move faster.

3. Implementation timeframe of MiCAR and issues to further consider at Level 2

A regulator noted that MiCAR came into effect as of June 2023, with a period of application until the end of 2024 in two phases: rules concerning asset-referenced tokens will start to apply at the end of June 2024, while the remaining rules concerning CASPs and other cryptoassets will start to apply at the end of December 2024. The development of the Level 2 regulations has started, with some Level 2 documents already put forward for consultation on issues relating to how to bring cryptoassets to market including authorisation, complaint handling and qualifying holdings. There will be further consultations on issues relating to the reliability of these products such as governance, composition of reserve assets and liquidity requirements. Many of the issues are similar to those covered for other financial products. Another point being worked on is the coordination of the authorities within the European Union so that the process of authorisations runs smoothly. The EBA is responsible for issuers of asset-referenced tokens, but other ESAs are responsible for CASPs. The ESAs are working closely together and it is hoped that this provides a framework in which firms can operate efficiently and safely in providing services to customers.

Until MiCAR Level 2 requirements apply, it is important that firms developing cryptoassets and applying for authorisations consider how these developments will fit with the MiCAR framework, the regulator emphasised. The European Banking Authority (EBA) issued a statement on this point in July.

An industry representative stated that MiCAR is a major step forward and provides a good template for other jurisdictions to emulate. It provides regulatory clarity and a passported rulebook that allows operation across the EU market without needing to build a multiplicity of legal entities. The industry must adapt to the standards that regulators expect. However, as Level 2 requirements are developed, the goal of policymakers should not be to simply import the business model of the traditional markets into crypto rules. The specificities of crypto need to be considered. The traditional finance model, unlike crypto, is quite fragmented with many intermediaries and infrastructures involved in the life cycle of transactions, causing lags between trades and final settlements. These are not strengths of the current system, but legacies of how the architecture was developed. There is an opportunity to take advantage of atomistic settlement and tokenisation, which are more efficient and safer than current processes and eliminate lags, but this may require adjusting the current regulatory approach and focusing more on achieving similar outcomes than reproducing identical rules.

An industry representative noted that the timelines for the implementation of MiCAR and particularly those for stablecoins are very ambitious, since they will enter into force midway through next year. Supervisors, banks and institutions normally take at least six months to prepare for a new authorisation or regime once the regulatory standards are available.

A Central Bank official added that, as market developments in this sector are difficult to predict, a further challenge for supervisors is to prepare for these requirements in terms of resources and capabilities.

4. MiCAR implementation challenges

4.1 Issues raised by the transition to the new MiCAR requirements

A regulator stated that MiCAR is a key priority for the French regulator. CASPs cannot remain unregulated, either due to a lack of applicable regulation or to non-compliance. In France, the PACTE law, passed in 2019, introduced a national registration requirement for CASPs with a licensing regime that remains optional. The first full licensing was granted a few weeks ago. A degree of uncertainty while new regulatory requirements are implemented is normal, but this issue is magnified in the case of MiCAR by the provision for a transitional period of up to 18 months, starting from December 2024 for CASPs already registered at the national level, during which they will be able to continue to operate under the domestic regime.

The regulator stressed that there is a risk of regulatory arbitrage and of forum shopping during this transition period. Industry players have an incentive to register domestically to postpone the implementation of the MiCAR requirements and some entities are trying to obtain registrations in multiple EU member states, as a proxy to a passport. This is a major loophole in the regulation. It is hoped that the implementation of the MICAR regulatory technical standards (RTS) will allow these loopholes to be closed. However until then a coordinated approach is needed at EU level to accelerate the inclusion of crypto market participants in a common regulated framework, for example with the introduction of stricter requirements in current domestic registration requirements aligned with MiCAR requirements.

4.2 Level playing field and consistency issues at the EU and international levels

A regulator emphasised that beyond the risks of regulatory arbitrage and forum shopping during the transition period, there is also a risk of continued non-compliance, particularly in the context of reverse solicitation. Some crypto market participants operate platforms that market - under reverse solicitation - crypto derivatives considered as financial instruments under EU law. This issue is amplified by the fact that there may be a different interpretation of what reverse solicitation is across EU member states. This reinforces the need for a coordinated approach to the implementation of MiCAR across the EU. A further issue is that many market participants are global and operate in models implying intragroup transactions that may rely on market participants located abroad. This potentially exposes the EU market to weak points in the global system and may affect the capacity of regulators to enact their mission. For example, a CASP might be fully licensed in the EU and fall under all MiCAR requirements, but if it imports prices from a global platform located in a third country, European regulators have no authority to ensure that there is appropriate price formation. To address these issues, it is essential that there is a coordinated approach at the global level to the implementation of the principles being developed by IOSCO and FSB in the area of crypto.

An industry representative noted that, in terms of implementation of MiCAR, there is also a need to ensure a level playing field across the EU. Supervision will occur at the national level, which means that there is the risk of inconsistent application of rules across different member states and potential for gaming the rules, which is a key concern for large CASPs in particular.

A second industry representative felt that the preferred solution would have been centralised EU supervision in this area in the same way as the Single Supervisory Mechanism (SSM) for banks. For political reasons, that was not feasible. Unfortunately, the RTS sometimes leave room for national interpretations and a lack of harmonisation.

A Central Bank official agreed that there are concerns relating to the level playing field, forum shopping and regulatory competition because providers will be able to enter at the national level and then move to the European level under MiCAR. As these are new issues, it will be necessary to monitor the implementation of requirements, but what the EBA, ESMA and the involved national competent authorities (NCAs) have delivered so far in terms of Level 2 is moving in the right direction.

4.3 Additional challenges related to distribution and prudential rules

An industry representative stated that there is also room for improvement at the distribution level in the EU. Retail investors must have the support they need to make choices and engage properly in the financial markets. Distribution models in Europe mainly rely on non-independent advisors recommending inducement paying products. MiFID rules have not shifted that pattern so far. Disclosures are not sufficient for consumers to fully understand the products they are investing in and just mandating additional disclosures will not solve the issue. There need to be more radical proposals for the longer term, which might entail significant changes to distribution structures.

An industry representative noted that the prudential treatment of cryptoassets on banks' balance sheets is currently being negotiated in Brussels. The signals are that political agreement is close. The differentiated treatment of different cryptoassets which is envisaged, with a 'look through' treatment of tokenised assets and stablecoins is positive, but the proposed prudential treatment of cryptoassets that are very liquid (group 2A in the BIS terminology) will make it difficult for banks to keep them on the balance sheet. It remains to be seen what the Commission will propose as a final treatment in this area.

DeFi opportunities and challenges

Introduction

The Chair observed that decentralised finance (DeFi) has been marketed as an innovative way to transact without intermediaries, although in practice DeFi platforms are still often decentralised in name only. DeFi offers potential opportunities in terms of efficiency and transparency and also poses new risks related for example to control over protocols, stablecoins and governance. Developments in the DeFi market are being assessed by several international organisations including the OECD. Growth has been seen in the sector over the last few years, both at national and international levels,. Many platforms operate without geographic location, requiring a global policy approach to these developments.

1. State of play of the market and main trends

1.1 Characteristics and size of the DeFi market

A Central Bank official stated that, while the Financial Stability Board (FSB)'s definition of DeFi relates to services in crypto markets replicating traditional financial system functions in a decentralised manner, the decentralisation of existing DeFi platforms is partial and regulators sometimes argue it is illusory. Significant points of centralisation exist in several areas including governance and voting rights, financial ownership, development teams and the oracles providing data feeds.

An industry representative explained that DeFi is based on smart contracts primarily located on the Ethereum blockchain that automate business logic so that individuals can transact directly with one another according to pre-determined rules. DeFi activities include decentralised exchanges (DEXs) using decentralised order books, algorithmically collateralised lending and automated market makers (AMMs). They aim to replicate in a decentralised way activities performed by traditional financial institutions such as banks. This means that DeFi is quite different from the more centralised activities of crypto exchanges and cryptoasset services providers (CASPs), which focus more on digital asset transactions, staking and digital asset custody solutions. DeFi is a complex area that remains nascent. Implemented at scale in 2017 it is not growing by volume, but sophistication, performance and safety are increasing. Despite the recent downturn in the crypto market and the failure of several CASPs and stablecoins, DeFi DEXs and AMMs kept running and users did not lose money.

A second industry representative highlighted that DeFi is a niche market with current assets stabilised at about $45 billion. The volumes traded on DeFi DEXs represent 16% of the volumes on centralised cryptoasset platforms (CeFi), with the total market cap of DeFi standing at $12 trillion against the $250 trillion market cap for traditional financial assets. The main blockchain used to develop DeFi protocols is Ethereum, with a 60% market share and more than 570 DeFi apps, followed by BNB Chain and Tron. Most applications of DeFi are pretty standard financial activities and this is expected to continue. In terms of share of the DeFi market, DEXs represent 22% of the total value of assets on DeFi, liquid staking comprises 15% of market share. Lending protocols that enable the lending of money in the same way as banks also represent a significant share of the market.

1.2 Main opportunities associated with DeFi

An industry representative believed that there is huge potential for innovation with DeFi: reducing the need for intermediaries, introducing new efficiencies for exchanging assets, reducing costs and providing better returns. One example is AMMs, which operate as trading venues without a traditional order book, using mathematical formulas to continuously price transactions based on orders and available liquidity.

A Central Bank official agreed that DeFi is an important source of innovation that promises efficiency, inclusion and a vision for a different type of financial system.

A regulator concurred that DeFi is innovative and has tremendous promise in financial markets and other areas, but the potential economic benefits gained from integrating intermediaries in the markets and centralising activities also need considering. These may include price discovery, price accuracy and price transparency, as well as reduced costs. It would be helpful to understand whether the suggested advantages of DeFi compared to CeFi have materialised and whether there is adequate price accuracy and price transparency in the context of DeFi platforms.

1.3 Main drivers of the DeFi market

An industry representative outlined three main drivers of the DeFi market. First is regulation. Regulators claim that DeFi is decentralised in name only, which means that they can have jurisdiction over it. In reality, all crypto projects have both centralised and decentralised elements and, as regulation continues to seek central entities to regulate, projects may be decentralised further. Second is artificial intelligence (AI), which will drive DeFi as computers can interact directly with each other. And the third is institutional adoption, which should support the future development of DeFi.

A second industry representative agreed that institutional adoption is essential to drive the growth of DeFi. It will help to entrench it within the wider financial system and support its development with positive feedback loops. Increasing flows from institutional players will help create a wholesale use case for DeFi and as institutions help build services and products for themselves and their customers, they will support the mainstreaming of DeFi. Institutional involvement will bring more emphasis on compliance, safety and stability building confidence in the market and leading to more efficient and safer products, services and processes, which will in turn benefit all users and the overall market. An example of institutional involvement in DeFi experiments is the Monetary Authority of Singapore (MAS)'s Project Guardian which took a number of institutional players to assist with testing DeFi use cases. This includes using a public blockchain and tokenised assets for performing cross-border payments, bridging the gap between traditional and digital financial activity. In addition to institutional adoption, an increasing use of DeFi technology by non-financial firms is expected. Amazon has for example a new Web 3 infrastructure and Google has teamed up with crypto partners in this area.

The complementarities between DeFi, traditional finance (TradFi) and CeFi will also support the mainstream adoption of DeFi, the industry speaker believed. DeFi is an additional way of doing finance using digital assets and automated and decentralised processes that may better answer certain customer needs and provide additional efficiencies. Some users will also use DeFi for the control it allows them and others will prefer to work with an intermediary, utilising the opportunities from DeFi without having to become an expert in it. Ultimately DeFi, CeFi and TradFi should complete each other, providing alternative and complementary mechanisms for performing financial activities.

2. Risks and challenges from DeFi

2.1 Main risks posed by DeFi

An official emphasised that DeFi raises specific issues in terms of safety and security including cyber-risk. The exposure to cyber-risk might arise on cross-chain bridges in particular. Chainalysis statistics for example, highlight the number of hacks and cyber-security issues in the context of cross-chain bridges, that might not be present where custody does not rest with the platform. The simple fact of transferring on and off platform presents risks and prompts decentralised platforms to centralise elements of infrastructure to enable better governance controls around transactions. However if those off-chain elements of infrastructure or operational technology are being integrated it is uncertain whether this remains pure DeFi. Another challenge is the potential for market manipulation in terms of pricing, given the arbitrage opportunities that arise across liquidity pools. That may affect the integrity and long term success of DeFi if unaddressed.

A second official stressed that the rapid expansion of the DeFi ecosystem means that new opportunities and also challenges and risks are constantly emerging. The risks are mostly related to DeFi's dependence on properly-functioning technology. They concern smart contracts, bridges, oracles and the governance frameworks in place. Oracles in particular are a potential source of operational risks and errors. Manipulations or attacks on oracles may also have negative consequences for several protocols. The reliance of DeFi lending activities on collateral that may be re-used as the lender and borrower are hidden behind the cryptographic digital signature is a further source of risk. This may increase leverage and procyclicality and could trigger sharp adjustments in price. A regulator also highlighted the significant risks associated with the governance of smart contracts.

A Central Bank official emphasised the connectivity risks between DeFi and core financial markets, which are currently limited but may evolve. Big swings in the total value locked into DeFi could lead to swings in the demand for stablecoins, which play a key role in DeFi ecosystems helping market participants avoid the inefficiency of converting between fiat and crypto. Stablecoins hold significant assets in the core credit markets and could produce risks similar to money market funds if they became disorderly in a liquidation sense.

An industry representative noted that traditional finance exposure to crypto remains limited. A 2022 survey found for example that only one-third of traditional hedge funds are investing in digital assets and crypto represents less than 1% of their assets under management. Moreover, the level of security of DeFi protocols appears to be higher than CeFi on average. The five top CeFi losses from hacks, scams and bankruptcies in 2022 amounted to $178 billion, versus $3 billion for DeFi, highlighting an improvement in security in the DeFi space.

2.2 Regulatory and supervisory challenges

An official highlighted the main challenges that regulators are facing with DeFi: it does not rely on traditional centralised intermediaries, is technologically native, and operates 24/7 with users all around the world. From a policy perspective, the lack of a legal person and the automaticity of smart contracts make the application, interpretation and enforcement of the law difficult. There are also many entities participating in the market and protocols are constantly being added. Any potential new regulation concerning DeFi should be proportionate however.

A second official emphasised the challenge for regulators of understanding whether current regulatory and supervisory tools are fit for purpose to use in the context of DeFi. Recent enforcement actions in the US have shown that a significant number of existing regulations could map onto the DeFi market infrastructure, for example those concerning fraud and market manipulation. Other elements are not fit for purpose and need further consideration. This includes identifying who is responsible for operational processes in a decentralised infrastructure and who can provide paperwork to begin the enforcement process. In addition, operational risks that arise as a result of the design of DeFi platforms are not easily overcome. This has been observed in the context of AMMs for example. Regulators will moreover have to think carefully about how and when to regulate, as the deployment of platforms continues.

3. Possible policy approach to DeFi

3.1 Objectives of the regulatory and supervisory approach

An official stated that regulators are open-minded towards DeFi. Their objective is to maintain integrity and stability in the market with these new developments.

A regulator agreed that regulators must remain open-minded to developments in the DeFi and CeFi crypto markets. Concerning DeFi, the question is not whether it is fully decentralised, but whether decentralisation will bring value and impact security in the system. There is a tendency to focus on specific use cases of DeFi, but these are quite limited at present. Supervisors therefore need to consider more broadly the potential risks associated with the different components of DeFi systems, including the service layer, where there are often intermediaries and interfaces accessed by the client, the smart contract layer and the infrastructure layer, which is the blockchain where the smart contracts operate. In addition, while regulation should remain technologically neutral it should not be 'technologically blind'. It is important to take into account the specific technical characteristics of DeFi and not simply apply traditional regulation, particularly when technology is replacing parts of current organisations.

A Central Bank official noted that DeFi poses risks that are novel and it is important for regulators to anticipate them while DeFi is small, to get ahead of the curve. Any regulatory proposals concerning DeFi should be proportionate to the size of the market and to the risks posed and aim to achieve the same regulatory outcomes as with equivalent activities in traditional markets. DeFi is not yet a threat to global financial stability. However, it is important to remain vigilant.

An industry representative took the view that regulating such a tiny activity as DeFi in its current stage of development would require disproportionate regulatory effort and run the risk of stifling innovation if the rules are too restrictive. Currently, many options are being considered for regulating DeFi, with no real consensus among stakeholders. An alternative approach is to adopt a more progressive approach starting with the setting up of an observatory for DeFi at a European level involving public and private sector representatives. The aim of this observatory would be to gather knowledge, monitor the development of DeFi protocols and identify the risks they pose and also to evaluate the most appropriate way to regulate such activities based on a shared understanding of the opportunities and risks. Consideration should also be given to whether regulation and supervision can be embedded in DeFi. This could be done for example through the use of soulbond tokens, an NFT that has the KYC of the user embedded to support the monitoring of AML compliance in particular.

A second industry representative stated that it should be possible to agree on how to regulate certain elements of DeFi without harming the sector and suggested three areas to consider. First, intermediaries could be regulated in the same way that CASPs are regulated in the Markets in Crypto-Assets Regulation (MiCAR) regulation. Secondly, it seems difficult to apply regulation to the publication of software used on DeFi platforms. Thirdly, where fraud and intentional misconduct is identified it should be pursued aggressively by regulators and law enforcement. Individual prosecutions can achieve significant results even in a space where volume and activity are limited.

A third industry representative was in favour of a risk-based approach to the regulation of DeFi, which would necessitate an adequate understanding of the risks and efforts on the part of public and private sectors to educate users adequately on the risks of DeFi.

3.2 Possible focus of regulatory measures concerning DeFi in the EU

A regulator highlighted that the Autorité de Contrôle Prudential et de Résolution (ACPR) recently published some proposals to address the regulation of DeFi activities, considering the three layers of DeFi systems. Concerning the infrastructure layer, it is proposed to implement security standards to ensure sufficient stability and safety of the infrastructure for customers transferring money via the blockchain. One of the objectives is to avoid the concentration of transaction validation capacities and reduce hacking risks on the blockchain. For the second layer related to smart contracts, which aim to replicate parts of the traditional financial activity, the idea would be to regulate them as a technological object, when relevant, rather than a financial service provider, with a certification of smart contracts rather than an authorisation process. Regulators and supervisors indeed want to be able to interact with the responsible entity and in some cases the smart contracts are the responsible mechanisms of service on DeFi platforms. The third proposal relates to the service layer and the customer access points, because it is likely to be difficult for ordinary individuals to access DeFi without intermediaries. Although DeFi claims to work without intermediaries, this will probably change if DeFi becomes more mainstream and traditional consumer protection rules could then have a role.

The regulator shared some preliminary output of a consultation led on these proposals. The proposal to implement a certification of smart contracts was well received, indicating that this could be an avenue for future regulation, and many suggestions were made regarding the governance of smart contratcs. Many questions were also raised about layer 2 systems[1] and the location of assets on the blockchain showing that the ecosystem is not yet mature. A final issue, mentioned but not developed in the ACPR paper, is the scope of the conduct rules and how to address decentralised

1. Layer 2 protocols or network L2 protocols are a list of communication protocols used by Layer 2 devices (such as network interface cards (NIC), switches, multiport bridges, etc.) to transfer data in a wide area network, or between one node to another in a local area network.

autonomous organisations (DAOs). DAOs are structures with no central governing bodies in which token holders participate in the management and decision-making of the structure. Another working group in the French market has shown there may be a legal way to find a responsible entity within DAOs and further work is underway on this legal basis.

An official agreed that smart contracts should be regulated with a different approach from the corresponding traditional activities, relating more to audit testing or design requirements. Regulation around the governance framework and requirements for oracles that interact with smart contracts would also be beneficial, as they are a major source of risk in the DeFi ecosystem. AML is a further area to consider from a regulatory standpoint because DeFi services might not be subject to AML obligations under the existing Financial Action Task Force (FATF) standard, so potential gaps in the existing framework may need to be filled.

A second official observed that, in the same way as traditional exchanges or clearing houses, DeFi platforms will be expected to report to the public on how they are managing operational and cyber risks and self-police in the management of those risks. In the same way as all well-functioning businesses, DeFi service providers should have adequate corporate governance, internal controls, risk management and oversight in place to ensure independent decision-making and compliance with regulation and avoid market manipulation risks.

3.3 Policy response in other jurisdictions and international coordination issues

A Central Bank official noted the UK focus on the regulation of stablecoins, which play a key role in the DeFi ecosystem. Stablecoins are both a means of payment and a store of value, so require the same levels of protection as in the traditional market for both of those functions. The Bank of England is soon to publish a discussion paper on a regulatory regime for non-bank systemic stablecoins that are used for payments, while the Financial Conduct Authority (FCA) will focus on the non-systemic side. An official agreed with the importance of regulating stablecoins, hoping that there will soon be a similar US initiative with a Government response in this area.

An industry representative highlighted the need for international coordination to implement standards in the DeFi area, with the involvement of international institutions such as the FSB and the OECD.

A regulator felt that it will be possible to reach common critical foundational principles across jurisdictions on minimum standards to ensure the integrity of crypto markets, for example in the AML/KYC area. A number of other areas where common principles can be agreed are identified in the proposals made by the FSB and IOSCO in particular.

The Chair agreed that international regulatory cooperation is needed for DeFi as this is a global development in nature and platforms often also operate without geographical location. The OECD is facilitating cooperation and dialogue in this area in order to promote global consistency, as well as provide technical assistance.

AI: Unleashing its potential in finance

1. Uptake of Artificial Intelligence in the financial sector

The Chair noted that the view of Omar Selim, founder of an AI firm called Arabesque, is that AI may become the most important driver of the digitalisation of finance. Finance has been ahead of other industries in the adoption of AI. This is driven by the wide availability of structured data sets that facilitate the training of algorithms and the fact that the prevailing tasks in the financial industry are information intensive and often repetitive.

1.1 AI use in the financial sector is increasing

An industry representative highlighted the importance of considering the uptake of AI with both a long and short term view. The speed of the uptake of generative AI in particular is impressive, with ChatGPT reaching 100 million users in three months, while mobile phones took 16 years and Facebook four and a half years to reach that level. A recent study indicated that 98% of executives in financial services believe that AI including generative AI will be part of their three to five-year strategy, which is the timeframe that tech providers such as Microsoft are considering in discussions with their own customers.

A regulator noted that insurers collect data then assess, price and underwrite the risks. Insurers have therefore been data analysts for decades. An EIOPA survey in 2018 revealed that 35% of the European insurance industry is using AI and another 25% is engaged with it in a proof-of-concept mode. EIOPA is conducting a new survey now and the expectation is this number will go up significantly. Numbers of AI use by insurance may be underestimated, since some models used by insurers that are not labelled as AI systems could also be included in that categorisation. Developments in AI are however not yet moving at a disruptive speed in the insurance industry.

A second regulator noted that there has been a significant progress in the uptake of AI in the French financial sector. Surveys have indicated that, while four or five years ago most banks and insurance companies were engaged in projects with AI, last year all respondents had real AI use cases implemented in their organisations.

1.2 Use cases of AI in the financial sector and related opportunities

An industry representative noted that the opportunities from AI use in the financial sector are at present very much related to efficiency improvements at employee level and in the context of customer satisfaction, but a movement towards operational efficiency in the middle and back-office processes is expected.

A regulator observed that in the insurance sector AI is still primarily being used in the back office area to make processes more efficient, improve data quality and support the transition from legacy to new systems. However, AI use is moving slowly to the consumer interaction and front-office side. For example, new tools supported by AI are being developed to facilitate the submission of simple claims by customers, speed up and improve the answers received and optimise the pricing of insurance. The handling of claims is the area where AI applications seem to have most potential. At present, consumers have to first call the insurer, then send pictures and have someone come to their house to assess the risk. In the future a consumer might send a picture to an AI-based system that will assess the risk and organise a payout. Prevention based on AI and data analysis is another area for potential development. Consumers could be warned of adverse weather events and advised on steps to take to protect their property.

A second industry representative noted that their organisation, as an exchange, is trying to improve price discovery and price formation in securities and derivative markets by developing tools supported by AI. The introduction of a new AI-powered order type was recently approved by the US SEC. A matching engine ensures that there is sufficient liquidity to enable traders to trade as much as needed, considering 140 different parameters every millisecond to decide the best moment for the order to go into the market. More and more applications of this type are going to be seen in the financial sector, as it learns how to use large language models to drive efficiencies. Learning will also be shared across industries.

The critical factor for success in AI and machine learning is talent, including an organisation's data scientists, and its access to models, the industry representative considered. Breakthroughs around large language models are driving progress on the talent side. An organisation can also be more or less data rich depending on its access to data and how well it organises its data. In addition, access to sufficient computing power is needed, which has been facilitated over the last decade by the uptake of cloud computing.

A regulator stated that there has been an increasing use of AI for customer relationship chatbots, fraud and anti-money laundering (AML) detection and claims settlement in insurance in the French financial market in recent years. Generative AI such as ChatGPT, which is a second generation of AI, should support new use cases. The central banks and supervisory authorities are also evaluating the potential of AI for their own activities. AI use in the supervisory space is expected to increase in the coming years. The ACPR for example has developed a tool for AML risk detection based on transaction clustering that is used for identifying suspicious transactions in the banking and insurance sectors. This tool is sometimes more efficient than traditional processes and tools used by financial institutions. A predictive tool is also available to assist supervisors in their day-to-day supervision. In addition, a whole set of more generic tools used by supervisors, such as speech-to-text or translation tools, include AI and machine learning components.

2. Challenges and risks associated with the use of AI in finance

An industry representative commented that the key issues raised by AI are explainability and privacy. Explainability is lacking in the case of ChatGPT for example, because only the result is provided, not the information on which the output was based or how it was provided. This is a problem. The technique of embedding can address this. ChatGPT's knowledge base is from September 2021, which means that subsequent information and developments are not taken into account in its responses. However, if a more recent document is copied and pasted into the prompt, it will be taken into account in the context of the response. It is therefore possible to build an additional and more specific knowledge database by introducing documents into the AI system through the embedding process. This can also be used for improving explainability, since the most relevant documents in the database can be selected for each prompt and the response can be asked to be provided taking into account those documents.

Concerning privacy, there are two paradoxes, the industry representative observed. The first is that models are often trained with personal data, but the AI Act only mentions privacy twice. The second is that, even though there is no AI regulation yet approved in any jurisdiction, companies have already been fined for the use of AI systems in connection with the General Data Protection Regulation (GDPR) rules and therefore for privacy reasons. A further issue is that the European Parliament stated in July 2020 that the process of training a model is a new processing activity. This means that consent will need to be gathered for the data used to train AI models, but it will be very difficult for companies to obtain this new consent. The solution to this is moving towards an adequate anonymisation of the data, meaning that it is not personal and not subject to GDPR or a pseudonymisation, which is halfway.

A second industry representative commented that while there is a sense of urgency around the need to embrace AI, it is important for financial institutions to balance the value propositions and opportunities that they perceive with the complexity of the implementation of AI systems. Discussing this is a priority for all boards of financial services organisations. Important considerations concerning the complexity of implementing AI include the complexity of organisations' data estates, the level of process maturity and the current and expected regulatory landscape. Another consideration is how much of the information that is provided by customers for using AI applications can be shared. AI is currently often used in an advisory or contact centre role by banks and customers provide information for receiving a reply to a question in real time. Restrictions around sharing this data externally are clear, but how this data may be shared internally should also be considered to ensure that customers' data is safeguarded within the organisation.

Data and the design of models raise further challenges, the industry representative emphasised. Using the wrong data will produce the wrong AI model. Having a well-managed data estate is very important and has been a challenge in the financial industry for some time. It is crucial that the models used are well designed with an appropriate structure to avoid disinformation or approximation. The model should also be used for what it is intended and approved to be used for. There is a need to not only be compliant with requirements but also build customer trust and have an ethical approach. Financial firms should start to explore and test the technology and progressively learn how to use it best. A dialogue is also needed with regulators and within banks, with the recommendation for banks to establish an AI ethical board to guide the organisation on these issues.

3. Main objectives of the AI Act and expected impacts

The Chair observed that the main purpose of the AI Act is to balance the advantages of AI with the need to ensure that AI systems used in the EU are safe and respect fundamental rights, but it will not address financial risks from the use of AI in finance. It must be ensured that these different objectives can be achieved with the matrix structure of regulation that is emerging, combining horizontal measures such as the AI Act with sectoral financial regulation and supervision.

A regulator explained that the horizontal nature of the AI Act means that all AI systems used in all sectors in the EU will fall under this Act. This makes sense because AI is a technology, so the same rules should apply in all industries. The AI Act follows a risk-based approach, creating three categories of AI use. The 'forbidden' category concerns uses such as facial recognition on the street for prosecution. AI use in the 'high-risk' category will need to comply with specific requirements, notably in terms of human oversight, documentation and risk assessment, and will be supervised by a newly created AI Board. At present, two use cases are considered as 'high-risk' in the financial sector – AI-based risk assessments and pricing in life and health insurance and credit scoring and creditworthiness assessment systems – in order to avoid the exclusion of certain categories of customers by AI-based profiling. The remaining AI systems, such as chatbots, will also have to comply with some rules, particularly in terms of transparency. Specific transparency requirements for generative AI have also been included in the AI Act, with a mandatory disclosure for content generated by AI, measures for preventing the generation of illegal content and the required publication of summaries of copyrighted data used for training.

The AI Act is well suited for insurance generally, the regulator felt. It addresses the main issues posed by AI in the sector including transparency, explainability, non-discrimination, fairness, risk management, human in the loop, recordkeeping and data quality. In addition, insurance and banking activities are already highly regulated and many aspects that are relevant for AI, such as data processing and sharing, data quality and fairness, are already supervised. The risk-based approach that has been adopted is also relevant, because not all uses of AI pose a high risk and in some cases AI systems are just a model enhancing data analysis. The European Supervisory Authorities (ESAs) may also propose additional guidelines for AI systems that are not considered high risk, if needed.

4. Issues to further consider in the regulatory and supervisory approach to AI

4.1 Articulation between the AI Act and financial regulation and supervision

A regulator stated that the AI Act sets out appropriate principles that will support progress of AI use. A cross-sectoral approach to AI regulation is relevant, provided it is well articulated with sectoral regulation and supervision at two levels in particular. First, the existing financial supervisors will need to integrate AI use and the rules of the AI Act in their scope which includes consumer protection and financial stability. Secondly, while the AI Act focuses on risks for citizens, particularly via the 'high-risk' categorisation of certain AI systems, there are critical aspects of AI use in models used for AML or consumer relationships for example that also need to be supervised. It is therefore necessary for the principles of the AI Act to progressively diffuse into the different areas of application of AI.

A second regulator stated that cooperation and coordination will be necessary at the supervisory level. The AI Act provides for an AI Board, responsible for supervising AI use particularly for systems considered as high risk, to be appointed in every member state. However, there are already domestic supervisors in most member states who are dealing with these issues. Therefore, close cooperation will be needed between the AI Board and the existing supervisors.

4.2 Human-machine interaction

A regulator suggested that AI will change the relationship between the human and the machine. Mastering AI will require supervisors to strengthen their understanding of the complex interactions between machines and humans, whether the latter are in the position of customer, internal controller or external auditor. It is not sufficient to state that a human must be put in the loop, because if the human is in the wrong place of the loop they may not be useful. That issue remains to be addressed.

The ACPR recently tested, as part of a research project, customers' perceptions of explanations of investments in life insurance products given by an intelligent chatbot to identify whether people, first, were more convinced by the machine and, second, better understood the investment proposals. In addition, two versions of the robo-advisor were tested: one giving advice tailored to customers' profiles, the other providing wrong advice. The study concluded that the explanation of the machine does not significantly improve the customers' understanding of the products sold. Also, the explanations provided by the machine in the form of a human conversation wrongly increased users' confidence in incorrect proposals. This example illustrates the challenge ahead with AI: since it profoundly transforms processes, the use of AI will require regulators and supervisors to take into account the changes that algorithms will induce in human behaviour. The new generation of AI is raising the stakes in this regard, because machines can now speak like humans. People may trust them although they may be wrong.

An industry representative noted that an experiment in the healthcare system had concluded that a person understood ChatGPT better than a doctor in an explanation about a prescription, because ChatGPT explained as many times as required and took more time to reply, demonstrating that different aspects of human-machine interaction need considering.

4.3 Balance between risk mitigation and innovation

An industry representative stated that tech adoption requires clear rules of engagement. There should however be a balance in digital regulations such as the AI Act between providing guardrails and ensuring that innovation can develop, because it is important that Europe and companies in Europe can benefit from these innovations that are happening around the globe and stay competitive.

Data sharing is another important issue that needs addressing for the development of AI. Applications in the area of AML are an example of this. The fragmentation in the financial system at the international level is exploited by criminals to move funds between different entities. Performing AML analytics on only one entity in a network will never identify these problems. AI need to be used in the context of an adequate sharing of data across financial entities to be effective for fighting AML. For example, in the US, Nasdaq provides services to 2,400 banks and credit unions that have put in place a consortium data lake with anonymised data. AI is used on top of that shared data to identify not only what happens in one particular bank or credit union but across the consortium.

4.4 Implementation issues

An industry representative stated that the AI Act raises two issues in terms of implementation. First, it is a legal document that does not contain enough technical detail or requirements for a software engineer developing a new AI system. Secondly, its impact is not yet proven. To address the first issue, the Spanish Government, which has established AI as a priority, launched an initiative, with the support of an ethics observatory and Deloitte, to draft detailed and technical implementation guidelines for the AI Act. These will provide software engineers with requirements for developing new AI systems, especially for the high-risk category. These guidelines have been drafted in Spain and further guidelines are expected at the EU level. To address the second issue in terms of impacts, Spain is establishing a regulatory sandbox where selected companies from different sectors will be able to test different AI use cases against the implementation guidelines in a safe environment and check whether they are compliant. This will also allow public institutions to better understand how close the industry is to complying with the AI Act and the implementation guidelines.

Wrap up

The Chair summarised that, although AI is still at an early stage of development, it is growing fast and may become a game changer in finance. AI has the potential to change the way many financial activities are managed and run. AI is not only about efficiency and improving customer interaction but also about decision making and risk management. AI also poses new risks that are different from traditional financial risks, including risks related to the technology itself, cyber risks, discrimination risks, risks related to the human-machine interaction and so-called hallucination with generative AI. The responsibility for addressing these risks is distributed across many different stakeholders involved in financial activities and in technology and algorithm development.

The AI Act is an important step for the EU, but does not solve everything. Supervisors cannot just rely on the AI Act to tackle all the risks from AI use in the financial sector and will need to conduct specific assessments. Lisa Caplan, director at Charles Stanley, a financial advice company in the UK, said that money is emotional and personal. In the same way, AI is a powerful tool but it remains in the hands of humans, both finance and tech specialists, who can hopefully 'tame the dragon' together with the support of the supervisors.

Cyber and digital operational resilience

1. DORA implementation: progress and next steps

1.1 Overall progress

The Chair stated that the post Level 1 negotiations on the Digital Operational Resilience Act (DORA) implementation began 12 months ago. On 19 June 2023, the first of the two main consultations on the implementation of DORA was launched by the European Supervisory Authorities (ESAs). This consultation covered four topics: the risk management framework that DORA seeks to establish; the classification of major incidents for reporting purposes; the register of outsourcing arrangements; and the policy requirements for outsourcing to third parties.

Four key principles are guiding the implementation of DORA: momentum, pragmatism, quality and proportionality. Momentum is important due to the tight timelines that have been agreed and the material risks involved. It is vital to be pragmatic because this is a highly complex area with only a short period of time in which to achieve implementation. This means reaching a compromise on the Level 2 requirements with a level of detail that is not excessive. There is also a commitment to a high quality standard in the ongoing work and proportionality has been integral to the proposals.

1.2 Ongoing consultations

Asked to comment on the key aspects of the DORA implementation and the related ESAs' consultation documents, a regulator explained that the consultation process plays a key role in the formulation of the final framework and also allows regulators to engage with the industry and test and share ideas. It is still work in progress. The consultation on the first batch of documents concluded on 11 September. Four sets of provisional documents were published on information and communication technology (ICT) risk management and incident reporting. The aim is to finalise these documents, taking into account the feedback from the industry and other stakeholders, and make proposals on the approach to the implementation of the requirements by the end of 2023. There are many complex and multifaceted issues to address however, for which further specification will be needed.

It will be important not to place an excessive operational burden on ICT providers and financial entities and for this, proportionality is extremely important. There is still conceptual work to do on the classification of incidents and the categorisation of services. It will also be important to define the scope of the requirements, in particular whether they will apply to registers of information, the level of application at group and solo level, the required level of consistency, how engagement with firms will be conducted and the level of flexibility granted to providers and financial entities. These elements must be calibrated and fine tuned before the end of the consultation. At the same time, the ESAs are also working on the incident reporting framework and developing a proposal for advanced testing.

The regulator added that the ESAs are preparing a second batch of policy documents. A response will soon be published to the Call for Advice (CfA) issued by the Commission on the criticality assessment and the oversight fee model. The methodology will be contained in a second instalment, which will be published within six months of the Commission's adoption of the delegated act, which is likely to be at the end of 2024.

2. The main challenges raised by the implementation of DORA

The Chair stated that the implementation of DORA is unusually complex and will require a huge amount of preparation and interaction between regulators and the financial industry. It is cross sectoral; it affects all firms, large, medium and small; its reach is global, European and national. The outsourcing registers are a good example of the complexity involved. A financial group might have numerous points of entry, and a third party provider (TPP) might have numerous relationships in terms of sub outsourcing arrangements.

2.1 Challenges for market participants

A Central Bank official suggested that there are three main challenges for market participants. First, while some financial institutions were already included in the European Banking Authority (EBA) outsourcing guidelines, which provide a sound baseline for implementing DORA, the firms outside the scope of those guidelines are now facing a true shift in expectations, which will require significant efforts. Secondly, all market participants will need to update their existing contractual arrangements with CTPPs to include a number of mandatory provisions. Finally, market participants working with the CTPPs included in the scope of the oversight framework will likely face higher expectations from supervisors.

An industry representative explained that many financial institutions are in the gap analysis phase. They have assessed the potential impacts of DORA and they are starting to make plans and budgets for implementation.

Firms are facing both common and specific challenges. The first common challenge is around capacity and resources. There is significant demand on teams managing resilience and cybersecurity and a shortage of talent in this space. For global firms, there are also problems of global consistency, with other jurisdictions, such as Australia and the US, also seeking to implement their own frameworks in this area. The second common challenge relates to the business case and strategic aspects of DORA. As teams seek to implement DORA, they are seeing DORA both as a compliance exercise and a way to create competitive advantage. In advance of implementation, some firms are trying to better understand the intent behind the requirements in order to drive more effectively the cultural change required to embed DORA in their organisation and make the changes sustainable.

Some firms face more specific challenges. First, the focus within DORA on data classification has significant consequences for issues such as access management, data backup and encryption. These are notoriously difficult topics, notably for legacy systems and only few firms really grasp them well. Secondly, DORA will be a significant step change for some firms, particularly the smaller ones and those that do not have sufficient technical capabilities or experience in this field. Organisational changes or changes to operating models might also be needed. Some of the more challenging aspects of DORA are the ability to restore data from backups to new systems in order to address ransomware threats; the need for a control function to oversee and manage ICT risk; and the focus on threat led penetration testing. The final challenge is around the scale and complexity of the TPP ecosystem. The topic of fourth party providers is hugely challenging, for example, due to the issues around exit strategies and the substitution of third parties. The global nature of some businesses is a further challenge with third parties potentially located in different jurisdictions.

The industry representative summarized that operational resilience is about ensuring and maintaining trust and also about driving competitive advantage in the marketplace. This will require proportionality in the measures that are implemented and driving cultural change to ensure the changes are sustainable. The framework must be flexible because the threats, the technology and the operating environment are all constantly changing. It is therefore essential to have a mindset of integrated resilience involving all the stakeholders, including local and global supervisors and the industry.

The Chair agreed that there is a tension between taking a compliance approach and taking a spirit and principles approach. Achieving compliance is important, but implementing the spirit of DORA will be the key driver of positive outcomes.

2.2 Challenges for supervisors

A Central Bank official outlined the three main challenges for supervisors. The first challenge is the difficulty of coordinating the actions of the different authorities concerned by DORA at European and national level. Secondly, there is a scarcity of resources in the area of ICT risk. Regulators and supervisors will need to pool their resources in order to have sufficient expertise. Finally, DORA will impact supervisory activity. The oversight of CTPPs, for example, will require a specific approach due to the technical specificities of these providers and generate additional activity. Until now, supervisors have addressed these providers indirectly via the financial institutions using them, but they will now be supervising them directly.

A second Central Bank official highlighted three additional challenges for regulators and supervisors related to DORA. The first challenge is the timeframe. With only 15 months before the implementation deadline, national regulators must mobilise the existing knowledge in the relevant departments of their organisations to be able to quickly follow up on the recommendations of the DORA Joint Committee (JC). The second regulatory challenge relates to fragmentation. DORA is an unprecedented opportunity to implement consistent operational resilience rules across the financial sector. At national level, however, not all financial entities are regulated as financial institutions, such as leasing companies. To avoid fragmentation, DORA must cover all the entities performing financial activities. Thirdly, there is a need to update the existing methodologies and toolkits used to supervise ICT risk and monitor the impact of technology on business models. ICT risk will continue to be supervised according to the current rules until DORA is fully implemented. The improved understanding of ICT risk introduced by DORA will also need to be integrated into the overall supervisory view on banks' safety and soundness.

The Chair agreed that the practical realities of the implementation of DORA must be properly analysed. The EBA guidelines address some aspects of operational resilience, thus covering part of the scope of DORA, but the requirements will be extended to many different players and the rules will probably be less granular than what exists today.

A regulator noted that the purpose of DORA is not to repeal the EBA guidelines but to complement them. The EBA guidelines might be reconsidered at a future point in time.

The Central Bank official emphasised the importance of striking the right balance in the DORA requirements in terms of granularity. The framework should be technology neutral and not excessively detailed in order to adapt to future evolutions linked to technology. Supervision and regulation are mutually reinforcing and supervision can take over from regulation in areas where there have been new developments in the market or where regulation is not sufficiently precise. Supervision may also be faster and more effective than regulation for tackling certain issues.

2.3 The challenges posed by widespread or cross-border cyber attacks

A member of the audience commented that the nature of cyber and digital resilience will require supervisors to have a new mindset in addition to a new rulebook. With DORA, the Network and Information Security Directive (NIS2) and the upcoming Critical Entities Resilience Directive (CER), financial supervisors will be responsible for coordinating crisis management in the event of a widespread cyber-attack or failure, which could prove to be challenging. On top of classical compliance-type supervision, supervisors will need to coordinate input and actions beyond the traditional sphere of ministries of finance, central banks and financial supervisors, across different government agencies.

A Central Bank official explained that cyber-attacks are already managed in a collective way due to the interdependencies involved. In each member state, different organisations bring the relevant stakeholders around a table with the supervisors. Usually, the central bank plays the leading role in this coordination, facilitating information exchange, ensuring the compatibility of individual actions and potentially steering the crisis management or recovery process. Supervisors already look beyond the impacts on individual financial institutions and take account of the collective consequences of any actions relating to business continuity or the remediation of a cyber-attack, therefore their role will not fundamentally change with DORA.

A second Central Bank official highlighted the cross border dimension of cyber risk. DORA is an attempt to ensure coordination within Europe, but the next question is how to improve the handling of these issues at the global level. The first step is to agree on a common taxonomy of incidents. The second is to simplify and unify the framework for incident reporting. There should be a single framework for incident reporting and greater convergence on the information that is shared in order to move fast in case an incident occurs. A balance must be struck between the sensitivity of sharing information and the need to have sufficient information to understand the bigger picture. Drawing a line between critical and non-critical incidents will also be important in determining a proportionate response to these events.

3. The CTPP oversight regime: objectives and challenges

3.1 Objectives and implementation timeframe

A regulator emphasised that implementing the CTPP oversight regime will be a significant challenge due to the tight timeframe and the extent of structural change needed. The Level 1 text contains a number of indications about the oversight process, but further specification is required in many areas. The new oversight regime is due to be implemented in 2025, even if the details are not entirely finalised by that date, which means that the CTPPs and their lead overseers will need to be designated in early 2025. Fees will need to be collected during that period to ensure that supervisors have sufficient resources to constitute their supervisory teams. The ESAs and the other competent authorities will need to start engaging with CTPPs and financial entities in 2024. TPPs can also opt in to the new oversight regime, which could make the process more efficient for all parties.

The Joint Examination Teams (JETs) will be the critical element in CTPP oversight. JETs will be the main tool of the lead authority overseeing each CTPP. The Level 1 text describes their potential structure. While one of the ESAs will be responsible for leading the oversight of a particular CTPP, in practice, the work will be conducted by a joint team, including the relevant competent authorities from the financial sector and other areas. Operationalising the process will require a full oversight cycle, going from the initial identification of the CTPPs and related authorities to the oversight itself and then to the remediation and the follow up on that remediation.

While this oversight approach is new and complex, supervisors are not starting from zero. Banking supervisors have expertise in operational resilience and experience of checking the adequacy of services provided by TPPs. The Single Supervisory Mechanism (SSM) teams also conduct on site inspections at banks to check the adequacy of their arrangements with TPPs. Indeed, the EBA outsourcing guidelines were groundbreaking in this regard. They showed banks and supervisors how to think about these issues. Additionally, the ESAs are already engaging with authorities from other jurisdictions. Over recent months, considerable effort has been made to learn what other authorities are doing and to think about how to achieve consistency and interoperability between authorities.

A Central Bank official agreed that the oversight regime for CTPPs will be an important evolution of the regulatory and supervisory framework, requiring an appropriate preparation with the different stakeholders concerned. CTPPs are not limited to cloud service providers (CSPs) and can be found in a variety of activities. The criteria used to define the list of CTPPs will be very important. These criteria will be both quantitative and qualitative, and defining these will require expert judgment.

3.2 Questions and challenges posed by the CTPP oversight regime

A Central Bank official observed that setting up the oversight of CTPPs will be a significant endeavour. First, determining which entities are CTPPs will be challenging. Italy conducted a first mapping of CTPPs two years ago. This process indicated that there were a significant amount of both IT and non IT CTPPs. In addition, the degree of interconnection in the financial market makes it difficult to draw the line between critical and non-critical entities. Criticality is not necessarily a question of size.

Secondly, there must be greater clarity on the precise roles of the lead overseer and the national competent authorities (NCAs). Implementing appropriate governance will be crucial for the success of the oversight framework. The JETs in charge of the oversight of CTPPs will operate alongside the existing Joint Supervisory Teams (JSTs) and Joint Oversight Teams (JOTs). This approach works in the SSM context, because its governance rules stipulate that the European Central Bank (ECB) takes the lead in the event of conflict. This will be more difficult to manage for the JETs because they are a form of cooperation between supervisory entities operating in different areas and sectors.

Thirdly, with the development of platformisation, the traditional concept of third parties might need to be re evaluated, the Central Bank official observed. A CTPP might be the 'main player' in an ecosystem, and not a simple TPP, particularly if it serves smaller banks. In some cases, banks could be considered as the byproduct or front end of a larger platform offering data and analytics. These evolutions may require changes in terms of supervisory approach.

An industry speaker highlighted several key questions regarding the future CTPP oversight framework. First, this is a relatively new approach for supervisors. It is important for supervisors and the entities potentially concerned such as CSPs that are not supervised at present, to get to know each other. As the CTPP oversight framework is designed and implemented, it will be important to continue this dialogue. Secondly, overseeing these new types of entities will have new implications for supervisors. Supervisory practices will need to adapt to a new operating environment where innovation is continuous and largely driven by technology. For CTPPs that do not operate like financial entities it is necessary to define precisely how supervision will work in practice and how it may impact their activities and business models. For example, CSPs and their customers, which include financial institutions and governments, have concerns around the process that will be used for sharing highly sensitive information with the supervisory authorities. A further aspect to consider is that the financial industry is still at an early stage on its journey to adopt cloud computing. The regulatory and oversight framework should strike the right balance between supporting the adoption of this new technology, which has significant potential in terms of efficiency and resilience, and managing the related risks. This requires a regular dialogue between supervisors and the industry and also upskilling efforts within the supervisory authorities. The potential benefit of using technology to support regulatory and supervisory activities should also be evaluated.

A regulator commented that both supervisors and financial entities are in the business of handling confidential and sensitive data. The need for adequate data-sharing arrangements is a priority shared by all of the stakeholders concerned.

A second Central Bank official stated that supervisors are conscious that the process of oversight will need to be adapted to new entities and to evolutions happening in the market. The successful oversight of CTPPs will require close monitoring, potentially involving on site inspections similar to those carried out for financial intermediaries. The details have not yet been decided, but it is important for CTPPs to be prepared for this type of dialogue. The functioning and tailoring of the JETs will be an organisational challenge for the authorities. Regulators and supervisors should ensure that the priorities of the JETs are set correctly, building on their common experience, and that these teams have the right competencies and flexibility to perform their task. The functioning of these teams will probably evolve over time, which also needs considering. This cannot be embedded in a regulation but must be managed according to practice.

Open Finance: innovation potential and policy proposals

Introduction

The Chair outlined that open finance is about promoting innovation in the financial sector through data sharing. Digitalisation is transforming finance and many other activities both for businesses and individual consumers. The European Commission has made groundbreaking policy proposals on the use and sharing of data, such as the Data Governance Act, the Digital Services Act and Digital Markets Act, all of which apply to all sectors of the economy. However, financial data is a major part of the data space and requires a specific approach to data sharing, which is the objective of the Financial Data Access (FiDA) proposal. The ultimate goal of FiDA is to enhance consumer trust in data sharing and enable effective access to data for third party data users, in order to foster innovation and the improvement of financial services and products. It should be a win win for all parties involved.

1. Open finance: objectives and opportunities

1.1 Objectives and expected impacts of open finance

A regulator explained the rationale behind open finance. There is a broad spectrum of financial decisions that people are expected to make as informed and rational agents. This might include relatively complex decisions related to loans, investments and pensions. In addition, these decisions need to be made in a holistic way, taking into account the different accounts and investments held by savers, their current and future financial situation and so on. Individuals are not equipped with the proper tools to make these decisions. An informed person might try to download data from different financial provider websites or pension systems, but they will quickly run into limitations in making simulations, such as the lack of access to market prices or difficulty in aggregating their overall financial position. Open finance is a way to help consumers and other economic agents consolidate their financial positions and perform accurate simulations in a more holistic way or compare different financial options and products. Some users will be able to do this autonomously; while others may use services offered by new types of providers in this space.

An industry speaker observed that the use of data from multiple sources will unleash the imagination of the private sector, enabling it to develop new financial services and support customers in new ways. At the moment, data is trapped in different silos. If it flows more freely, with the consent of individual and business customers, service providers will be able to develop more personalised services. With open finance, service providers will also benefit from increased efficiency and accuracy in their data collection and management processes, which will allow them to deliver services at lower cost and risk. Open finance will also benefit consumers by giving them greater visibility and control over their finances. They will be able to better balance in their financial decisions the 'fast' money they need today and the 'slow' money they will need in the future, which should lead to better financial planning. Open finance should also provide additional lending possibilities for under served businesses such as SMEs. Less wealthy customers should also be able to use the improved view of their financial position to build up a financial cushion more easily.

A second industry representative concurred that open finance could have a very broad effect. Much financial data is currently locked in legacy systems and software, which makes it impossible to extract and utilise. Open finance will facilitate access to this data and pave the way for systems with improved data architecture based on open APIs, which may support further interoperability between systems. Financial services firms and tech companies should both be able to take advantage of the opportunities of data driven innovation in a win win way in order to provide better services for consumers.

Open finance should also help open up the EU financial market to new entrants such as fintechs, the industry speaker emphasised. This will foster innovation in the market and offer mutual learning and cross pollination opportunities in terms of data management and API standardisation. The smaller players will face some challenges from a competition perspective, however. While fintechs and start ups can be agile in the way they develop services and unlock opportunities from access to data, they may find it difficult to build customer trust and confidence. Consumers are often more inclined to trust in the services provided by larger players. The framework must ensure that the market remains open for new entrants and the requirements must build consumer trust. Conversely, the more established financial players may feel that obligations that mandate a sharing of data they have accumulated over decades sometimes is unfair. Solving these issues will involve the implementation of an appropriate incentive structure as well as efforts to educate stakeholders about the implications and benefits of open finance. It will also be important to take into account the network effects that open finance might have, which could advantage larger players, and also potential interconnectedness risks associated with open finance models.

1.2 Open finance use cases

An industry speaker suggested that creditworthiness and affordability insight is a key use case for open finance. If lenders can access more sources of data, they will be able to develop a more nuanced and granular view of a client's financial situation. This will allow lenders to optimise the cost of lending because they will no longer be lending blindly. It will also benefit consumers and businesses, who will be able to borrow at a more appropriate cost. Lenders will also be able to offer more tailored and dynamic lending solutions, offering for example more flexibility in the positioning of credit repayments. Open finance also offers new use cases in relation to sustainability. Current IT systems make it practically impossible for suppliers to share sustainability data with businesses for the purposes of sustainability reporting. As FiDA is introduced and the industry moves towards open data, this information will flow more simply and enable businesses to understand the sustainability of their supply chain on a factual basis. This will enable them to make better decisions. This cross sector data flow will potentially work to the benefit of all the organisations that contribute to it.

A second industry speaker described how open finance could contribute to a financially sound and sustainable society by creating a flow of data in the financial sector and between sectors. Sustainability will be a key area of application. One example of this is data sharing between the energy sector and the financial sector. In Sweden, there are innovative solutions which track energy usage in order to help consumers reduce their energy consumption.

Pensions are another interesting use case, the industry speaker suggested. There is a public private platform in Sweden where users can check their total pension savings and their expected pay out. This is a good example of how open finance can help individuals to take control of the 'slow' money they will need later in life.

A third industry representative observed that open finance also offers new opportunities to leverage the benefits of artificial intelligence (AI) by increasing the amount and scope of data available for training new AI models. This will allow financial services providers to better understand customer needs and offer more tailored services and products.

2. The proposed Financial Data Access Regulation (FiDA)

2.1 Objectives of FiDA

An official considered that the FiDA proposal is an adequate basis for the discussions between the co legislators and with the industry. The experience of open banking from the Payment Services Directive 2 (PSD2) shows that it is preferable to define a regulatory framework for open finance upfront before market players develop unregulated services based on web scraping and similar techniques too widely. To ensure the success of FiDA, there are two key issues to consider. First, the framework must support innovation and allow the private sector to create new services for customers based on the fluid and safe use of data. Secondly, FiDA is an opportunity to prepare the ground for a common EU financial data space through the establishment of data sharing requirements and common governance principles involving the public and private sectors. This objective is also in line with the EU open strategic autonomy agenda.

A second official noted that FiDA is part of the Capital Markets Union (CMU) action plan. One of the objectives of FiDA is to increase investor confidence and engage more retail clients in the capital markets. FiDA was launched alongside the review of the PSD2. Some key lessons learned from the experience of implementing PSD2 appear to have been taken into account.

A regulator stated that while the FIDA proposal can be seen as a continuation of PSD2, it differs from it on some fundamental aspects, because it would not impose uniform obligations on all products in scope from the outset. Instead, rules would be defined for each of the main categories of customer data covered by FiDA in the context of a specific Financial Data Sharing Scheme (FDSS) in charge of governing access to customer data and comprising representative data holders and data users. This market based approach offers significant opportunities for data driven innovation in the EU financial sector and avoids the need for extensive legal requirements. In that regard, the novelty of FiDA is that the success of the framework will depend on the industry players part of an FDSS agreeing, within a period of 18 months, on issues such as the liability regime, the compensation principles for data holders and the functionalities to be met by the access interfaces (APIs) used for data sharing. The safeguards provided by FiDA to ensure the proper use of personal data are moreover necessary to avoid the market for open finance services turning into the 'wild west'.

An industry speaker considered that the regulatory requirements for open finance should strike an appropriate balance between risk mitigation and fostering innovation. It is vital to ensure cyber resilience and protect customers, but the framework must also drive innovation and increase value for all stakeholders by creating real customer demand and incentivising data holders and open finance providers to put in place effective solutions. Excessive or inappropriate regulatory requirements will limit the incentive for firms to develop the market.

A second industry representative suggested that FiDA is also an opportunity for the EU to take a leadership position in open finance and to develop innovative solutions that are attractive for a wide range of customers within and outside the EU, including third world countries and under served markets.

2.2 Incentives for data holders and users

An industry speaker expressed support for the Commission's proposal to introduce compensation for data holders. Fair compensation models are essential for a well-functioning and innovative financial market. This is a lesson from PSD2, which did not provide for any remuneration of data holders and therefore did not lead to the high level of innovation expected. In addition the data to be shared under FiDA requirements should be related to real business cases and a customer demand.

A second industry speaker emphasised the importance of proper incentives for the success of open finance. If the incentives are correct, behaviour will evolve and data will flow. It is also essential to think about the ecosystem as a whole. Open finance will not work if it only works for one type of player; it must work for everybody. There must be an economic ecosystem model within which different viable open finance business models can thrive. Both data holders and consumers must see the benefits.

An official welcomed the fact that the Commission proposal is not overly prescriptive on the question of incentives. The compensation of data holders will be defined by FDSSs. The question is whether the industry will be able to self organise. In this regard, it could be beneficial to explore the possibility to implement a compensation scheme with a similar structure to the one used in the payments industry. The difficulty with FiDA is that the scope of the proposal is very large ranging from insurance policies to savings products. It applies to very different markets that use different types of data. It is difficult to know whether the same approach to incentives will work in every sector. It might be more productive to use a nimbler 'learn and adjust' approach instead of setting detailed rules from the start.

2.3 Safeguards for customers

The Chair noted that the FiDA proposal seeks to balance the opportunities and risks from open finance. Customers must trust the framework because ultimately, they will be taking the decision to share their data. This means they should understand the implications of sharing their data and be protected by the appropriate safeguards, including the horizontal frameworks around data and the General Data Protection Regulation (GDPR).

An official agreed that the main safeguard for individual customers is GDPR. It is sometimes perceived as a heavy burden by the industry, but its requirements are increasingly complementary with financial sector legislation and aim to balance efficiency with customer protection. For example, there is a provision in PSD2 which enables banks to process data to meet the anti fraud objectives while respecting GDPR obligations. Besides GDPR, the main component of customer protection proposed by the Commission in FiDA is the establishment of permission dashboards to allow customers to retain control over who their data is shared with. The initial consensus is that this is a good idea, but it is difficult to understand how the dashboards will work in practice without a prescriptive regulation.

A regulator stated that the question of customer trust and how customers feel about sharing their data is very important for the success of open finance. There are five key issues to bear in mind. First, customers will be inclined to share personal data if the value proposition is attractive. However, it will be a challenging task to align the interests of many data holders and data users in such a short period of time, when considering the experience of PSD2. Finding an agreement within a FDSS may be difficult indeed for data holders and data users without legislative intervention. Secondly, permission dashboards will allow customers to check with whom their data is being shared and to revoke access at any point in time, which should provide the necessary safeguards to instil confidence in the public. However, these dashboards have to be well designed and work in real time. In addition, who will administer them needs to be clarified. They could be managed as a common utility or be left to the private sector. Thirdly, it is important to determine how customer data can be accessed safely. The concepts used in the context of PSD2 such as strong customer authentication (SCA) are a possibility to further explore. Fourthly, it will be important to assess the safety and suitability of open finance service providers, given that the range of firms could expand. It would be sensible to explore whether these new entities will need to be subject to authorisation requirements or supervision. Finally, it is vital to ensure that the implementation of open finance services does not increase financial exclusion. Many consumers are already ill equipped to manage their financial decisions. If FiDA introduces new barriers to accessing basic financial services or if customer profiling means that firms only want to serve certain categories of clients, there may be a significant risk of financial exclusion. Some customers may be unable or unwilling to operate in this new environment, but they should retain access to basic financial services.

An industry speaker agreed on the importance of preventing financial exclusion. Every individual and business, no matter how small or niche, should benefit from a holistic view of their financial situation. The financial sector is moving away from mass produced products and one-size-fits-all solutions towards more personalised services, which should contribute to increasing the engagement of customers in financial services.

A second industry speaker emphasised the importance of maintaining data integrity and safety for creating consumer trust. Handling customer data is as important as handling their financial assets and must be done in a careful and sustainable way. Opening data to third party access increases privacy risks and creates new vulnerabilities. Operational resilience and technical robustness requirements are being reinforced. Data holders also work persistently on security. At the same time, customers do not always fully understand what data sharing entails and where privacy risks might arise.

A third industry representative emphasised that customer education is also important for achieving effective data sharing and permission management. With the progress of AI, GDPR and the multiplication of consent requests, people are becoming more vigilant about sharing personal data and want to understand what their data is going to be used for. Consumers must be educated about these technologies and the possibilities that open finance will make available for them in order to embrace these new market developments more readily. This is not being done sufficiently at European level. In countries such as Singapore, for example, processes akin to country wide upskilling happen on a regular basis. Mitigating risks that may impact customers such as cyber-risks, fraud and data leakage is also essential for reinforcing trust in a context where open finance will further open up access to customer data.

3. FiDA implementation challenges

An official noted that the main challenge for co legislators is achieving a balanced legal framework that leverages the potential of open finance for the benefit of citizens and the whole financial system. This is not an easy task. There is a need for coherence between FiDA and the rules that exist in the payments area, where there are many different pieces of legislation including PSD2.

An industry speaker suggested that there should be a gradual approach to the implementation of FiDA. It should be implemented on a category by category basis with a different timeline for each data category. Savings data could be addressed first before moving to investments, mortgages and other categories of data. There are several reasons for this. First, this will facilitate the implementation of adequate risk mitigation measures notably concerning cyber risk. Secondly, a gradual approach would provide market participants with more time to identify business cases likely to create long term value for all stakeholders in the market and allow a more consistent implementation of the measures across EU member states.

A second industry representative stated that the lessons learned from PSD2 in terms of the need for high API quality and data standardisation need to be taken into account in the implementation of FiDA for the success of open finance. A high quality API is one that is accessible by all users and designed in such a way that any developer can extract data from it and create services around it. Ideally, the market should progressively evolve towards an open API driven architecture to support interoperability and reduce operational risk. However, systems that do not use this approach are still being installed by financial services firms. It will be a long journey to make this change throughout the market. In addition, while progress has been made on data standardisation over the last few years at the EU level and in other jurisdictions, significant work is still required in the area of data.

Open finance also faces a major challenge in terms of upskilling and change management, the industry speaker observed. This concerns the people in charge of technology and data management in the financial sector, such as CTOs and CDOs. These people need to be convinced of the benefits of open finance. Upskilling is also a relevant issue for regulators, who need to understand the implications of the systems supporting open finance and be convinced of the need for high quality APIs.

Sessions

IV

PAYMENTS AND THE DIGITAL EURO

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Digital euro business case

The Chair stated that the digital euro is a huge endeavour with political sensitivities and the question of the business case. The Financial Stability Board (FSB) advised in 2018 that Central Bank digital currencies (CBDCs) are dangerous and should not be touched, because they immediately institutionalise bank runs. Now opinions have changed. The project is advanced and has a proposal. The problems of convertibility can be solved. The question is value added for the retail client.

1. Possible added value from a digital euro

1.1 Targeted digital euro added value is not clearly perceived

An industry representative explained that, when the digital euro first emerged, there was fear of a private digital currency taking over the world. It is not anymore, the case. The only potential business case is in the wholesale market as, if clients want to pay tokenized asset by using blockchain, the available private currencies are not clean.

A civil society representative supported the project. Success will depend on added value for the EU in terms of security, confidence, acceptance, and accessibility, without cost. The need for a digital euro should be considered as a European public good. There will be a systemic cost borne by society.

An industry representative stated that the ECB has built a case based on a monetary anchor, European autonomy, or independence in the payments space so as not to be dominated by American players, and financial inclusion. However, he questioned whether those were the real issues to be solved as there are not real problems for citizens and there are other alternatives as well. He also highlighted that opportunities are much clearer in the wholesale space, where he recommended to start with.

Another industry representative explained that stakeholders are not at the centre of the project, and enthusiasm is missing. The main drivers are the threat of private stablecoin to Central Banks and possible international competition between digital currencies. The process has been mostly administrative and political, whereas commercial and economic answers are needed to benefit customers. The new use cases are not clear, so customers' reaction and whether the general public will adopt it cannot be predicted. Any failure would be negative for the euro and for the ECB. The ECB is trying to build a narrative and has regular meetings of technical groups, but after months there are the same questions.

1.2 Focus on providing first a safe digital currency for citizens' transactions in the digital context, which fosters innovation

A Central Bank official stated that there has been political support for the digital euro. The key reason is citizens do not have access to Central Bank money in a digital form. For a digitalised economy, a digital euro will be the natural evolution of currency. Paying in Central Bank money must remain an option and there needs to be a digital alternative to cash. There has been a strong level of support in engagement with consumers and merchant associations. Consumers look forward to a pan-European digital equivalent of cash and the ECB and the European Commission have echoed the call to make a digital euro free and widely available, with the availability of offline use.

1.3 Leverage privacy in the digital sphere

An industry representative stated that the main advantage of a digital euro to the client experience is privacy similar to cash, particularly regarding the offline option, mitigating money-laundering and fraud risks. This is the main challenge of the Digital Euro in order to be used by individuals as a mean of payment.

The Chair noted that, once it is online, the digital euro is e-money has anti-money laundering (AML) regulations that need to be fulfilled. There is privacy rather than anonymity.

1.4 Accelerate the creation of a European payment system

An industry representative stated that an advantage is the opportunity to have a European payments system. A Central Bank coin may trigger the private sector to speed up agreements with different platforms. It will otherwise be implemented by an American payment player or tech company.

A Central Bank official agreed that merchants look forward to a widely adopted, cost-efficient solution in the fragmented European payments market, where a pan-European solution is missing. For intermediaries, a digital euro does not seek to crowd out private payment solutions. It could allow banks and intermediaries to innovate, to achieve a pan-European reach and expand on use cases, as the ECB and Eurosystem ambition is not targeted for a specific market share. A digital euro would always be available. It would fill any vacuum left by lower cash usage and address any risk that means for citizens.

The holding limit is a safeguard for intermediaries and the figure of €3,000 can be discussed when issuing the digital euro. There are no plans to remunerate the digital euro and give an incentive for consumers to hold vast amounts. It is expected to be closer to the amounts of cash that people hold. The digital euro will go to places that cash does not. The underlying reason for the monetary anchor is as a digital alternative to cash.

A government official stated that it would have been good for retail consumers to have a bank-based solution like the European Payments Initiative (EPI). It is harder to explain why a digital euro is needed. There is no pan-European private sector solution, so one is needed for consumers that functions without relying on third-country providers.

1.5 Leverage banks' AML know-how

An industry representative mentioned that there is an opportunity for the banking industry to value AML and fraud controls and frameworks.

1.6 The digital euro should have leveraged the blockchain technology in the tokenisation context

An industry representative explained that tokenisation of assets becomes complicated, without a digital money to pay against delivery. A clean/safe Central Bank currency involved on such a blockchain-based transaction could be useful. At the beginning, it should probably be a wholesale system. However, if blockchain is generalising and is a promising technology, it could also be used for retail transactions. It is disappointing that what is on the table is different and not digital, because it is not blockchain-based. It is just an ECB current account open to all European citizens.

2. Rather than setting a strict monetary anchor, it is the confidence of citizens that comes from being able to carry out transactions in Central Bank money in all circumstances that is at the core of the digital euro project

A Central Bank official explained that there is a separate monetary anchor for the digital euro because there is less usage of cash. There will be a market where there will be no Central Bank money in circulation. The digital euro is not part of the transmission mechanism for monetary policy implementation. This is why there needs to be a Central Bank currency in digital form. There is not a difference between the monetary anchor on the digital euro part and the e-money part of a card.

The Chair stated that the monetary anchor concept needs to be explored further. It is an option for people to pay with Central Bank money. A Central Bank official agreed that it is important for the payee to be in the Central Bank realm because it is still considered commercial bank money. For counterparty risk in a retail transaction, there is a lot of faith in banks. There is value in commercial bank money with well-regulated financial institutions, but there is also a role for cash. There are geopolitical tensions that may be seen in the future, so authorities like Central Banks tend to prepare in advance.

3. Possible drawbacks and difficulties to address

3.1 Make clear the specifics of the digital euro added value versus other existing payment means, in particular cash and cards

The Chair explained that Austrian banks have created a consortium that provides Mastercard and Visa cards, so clients can pay and withdraw anywhere in the world with digital money. The difference the digital euro makes is different in other countries, where banks issue cards that only enable withdrawals and payments from that bank's terminals. The question is whether such cards should be enabled to use existing infrastructure with public money and special rules.

An industry representative advised the need to clearly explain all citizens what a digital euro is. The narrative is very important. It is not easy to explain what the difference is between cash, the digital euro and bank deposits. Public and private sector must work together on this. It will be key for the success of the project.

A civil society representative stated that the status of legal tenders is important. The European Commission proposed some possible exemptions. It is crucial to have a clear legal framework and to harmonise standards among member states. A communication campaign is important to explain that the digital euro is not a cryptocurrency or a threat to citizens' privacy, and is not cash, but a complement to it.

3.2 Underestimated infrastructures and interoperability costs

An industry representative advised that one underestimated cost is that of building an infrastructure for millions of customers. In the beginning, the investment is borne by the ECB with fewer dividends for governments, so it is borne by taxpayers. The additional infrastructure for enabling interacting with other payment systems would also be very expensive.

3.3 Addressing distribution challenges requires involving existing financial intermediaries

An industry representative warned that the difficulties of distributing the digital euro are being underestimated. An industry representative stated that European banks are the best distributors to assure the ECB is not taking new risks, as they are the same providers that distribute cash. This is also good for merchants as a new means of collection from their customers. It is going to be at a reasonable cost because there will be a cap, and merchants will have the opportunity to include this means of payment in their portfolio.

An industry representative noted that the second question is how to design a CBDC that fits with intermediaries and how long it is going to take. The representative highlighted also the challenges of the project regarding its implementation and operationalisation. Again, this should be something where the public and private sector have to work together. The intermediaries and the Central Bank should discuss how to operationally design something that fits with IT and other aspects, so as to leverage as much as possible on the successful payments grounds that we already have in Europe and that citizens know well as not to leave anyone behind.

3.4 Determining the appropriate and balanced holding limit, notably to preserve financial stability and banks' ability to lend

An industry representative acknowledged that, when stability is needed, the digital euro creates instability. This problem could be solved with a threshold of zero. Payments could be made with the digital euro, but without a balance in digital accounts. The business case and how this affects banks' financial stability need to be considered.

A civil society representative stated that the project must not negatively impact on the lending potential of credit institutions or put the Eurosystem and the private financial system into conflict. It could create cooperation between the two drivers for the economy, providing an incentive for euro banks to have their own payment systems.

An industry representative explained that the digital euro is a means of payment, not a store of value. This is relevant in assessing the value added to citizens, intermediates, or merchants. The holding limit is a key question. Policymakers are being asked to align with the monthly card expenses of citizens, starting small as there will always be opportunities to adjust depending on the usage by citizens, performance, and overnight bank deposits.

One recommendation is that this should depend on the ECB rather than the European Parliament. The limit €3,000 is too high for the financial stability of commercial banks. A deeper analysis is recommended on whether to start with €1,000. There could be a second tranche for a lower offline limit, where privacy is important.

3.5 Mirroring citizens' current accounts in the Central Bank book and interlinking the digital euro with the various payment systems make it complex to operationalise it

An industry representative noted that another difficult aspect is that, for a digital euro to be a great opportunity, customers will require to understand that the euros in their current bank account and the digital euros to be available in a Central Bank form are different, and the need, which leads to duplicating accounts. This will be difficult to explain to our customers. The private sector, the ECB and politicians should discuss how this is going to work and how dislocation is going to happen.

The next discussion is how to operationalise the digital euro if the design becomes too complex for intermediaries to implement it, there is a risk it will not be fit for purpose. It could become very complex, and institutions might adapt slowly. The line between creating a currency, which is the remit of the Central Bank, and designing with a new payment system is complicated. Work is needed focusing on interoperability within Europe payments private solutions as well before approaching the US or the UK.

4. Understanding what makes attractive the business case for each stakeholder is a key success factor which requires sensitive political decisions

The Chair stated that banks and public sector officials have been fantasising what consumers want.

An industry representative agreed that it is difficult to find the added value, but it is time to move beyond the existential debate for a digital euro and to focus on advising the ECB and policymakers to ensure it succeeds. Success will depend on the design and the ability to create a system of incentives for citizens, entrepreneurs, financial intermediaries, and business. Time is needed to make an effective proposal. Another important issue is payment service provider costs, which need to be compared with the benefits for actors based on the shift of retail payments towards digital channels. The ECB is called on to evaluate and monitor the extent to which payment service providers can recoup investments.

A government official agreed it is key for the project to cooperate with the financial sector. Business models that work for banks and companies have to be explored with co-legislators in member states.

The Chair stated that this is a political environment. Retail clients will judge what is done. The upcoming election is also a vehicle for innovation. There is tension between the Central Bank and the financial sector, which is for legislators and policymakers to resolve.

One issue with the business case and the legal tender obligation is the cost to merchants of accepting the digital euro. If the fee is lower than the interchange fee for private solutions, private payment solutions are crowded out. If it is more expensive, the project is not very successful.

A Central Bank official noted that the legislation mentions comparable fees that intermediaries may charge, so there should not be crowding out or privilege. The value has to be low, because AML cannot be controlled in the same way in the offline mode as digital euro payments.

The Chair suggested that if the digital euro is successful, online traders may no longer accept credit cards. Then there will not be the same security for online customers who currently can countermand e-payments if their goods arrive damaged or not at all.

5. Europe is at the forefront regarding Central Bank digital currencies accentuating the challenge

The Chair stated that Europe is the first jurisdiction seriously trying to engage a CBDC.

A Central Bank official believed that others are watching closely. The UK is studying it but has made no commitment to issue a digital currency. It may be stronger on that side and promoting stablecoins, but it has strong contact with the market and something similar to the market advisory group.

Digital euro role and challenges in the EU payment landscape

1. Digital euro should enable easy and safe use of central bank money by citizens

The Chair detailed that the payments landscape in Europe is constantly changing. There is the growing importance of e-commerce and online platforms, an increasing shift to digital, new business models and innovative use cases. Central banks around the world are working to complement cash with central bank digital currencies (CBDC). The Eurosystem has been investigating the digital euro since October 2021, with the ambition of ensuring that central bank money remains easily accessible and usable.

An official noted that in an increasingly digitalised economy, the use of cash is falling. If public money has a distinctive role to play in the functioning of the monetary system, digitalising cash makes sense.

An industry representative suggested that the digital euro is a solution to a problem that is either unclear or does not yet exist. There should be consideration of the goals of financial stability and customer trust. The digital euro should be considered in the context of the triad of green, digital and social. Primacy should be given to customer security. The digital euro should have cash-like features. It must be anonymous. There must be unrestricted access offline. There must be high levels of security. Banks play an important role in terms of customer thinking. With all of that in focus, the digital euro can be discussed in terms of looking forward and innovating using the current solutions and systems to meet customers' needs, rather than as a problem in need of a solution.

An official agreed that the digital euro should not be seen not as a response to a current problem but with a forward-looking perspective. There will likely be a strong future for CBDCs and being in the lead is better than being at the back in that regard.

2. Essential features of the digital euro

2.1 Enabling people to pay with central bank money

A policy-maker emphasised that the environment is becoming increasingly digital. The idea of the digital euro is to remain at the forefront of technological relevance by providing a universally accepted digital means of payment that can be used by consumers throughout the euro area. The digital euro will not take away other means of payment. It should be a clear alternative for people who want to pay with central bank money in the digital age.

The European Commission´s proposal provides a legal basis. Trust in the digital euro is vital therefore clear, enforceable legal rules are needed. There is a long list of issues to be addressed, such as how to distribute the digital euro and how to give it legal tender access rights. There is also a significant international dimension and issues around data protection and privacy. A democratic process of negotiation with the co-legislators is needed.

There is a common responsibility, both public and private, to explain the project and bust any myths. How online digital euro payments will work and what happens when using it offline have to be well communicated.

An official noted, regarding anonymity and anonymity risk management, replicating the qualities of cash means thinking about how smaller-scale transactions could have lower anti-money laundering (AML) and countering the financing of terrorism (CFT) requirements, and similar issues.

An industry representative added that cash is anonymous and has a significant level of privacy. That has to be the case with the digital euro. That presents a challenge from a money laundering perspective. There are several legislative proposals. For AML, there is the Markets in Crypto-assets Regulation (MiCA) and the Payment Services Regulation (PSR), so there will be tools to cope with the challenge of AML.

2.2 Gaining successful adoption by all the stakeholders

An official emphasised that for the digital euro to be successful it has to be widely used. That requires the legal tender proposal, but that is not sufficient. There have to be certain economic incentives for economic actors, consumers and merchants to use the digital euro. Then there is a need for effective communication and a narrative to explain to domestic policymakers and the general public.

From the consumer side, it is important for the digital euro to be widely adopted in all areas of economic life. There have to be as few exceptions as possible to ensure a network effect. The aim is to replicate the usability of physical cash. There should also be convenient adoptability and accessibility. The onboarding process has to be as smooth and straightforward as possible. There has to be consideration of the digital euro being accessible without having a commercial bank account. There is also the issue of pricing. The basic services for the consumer should be free. If offline functionality is properly explained to the public it could make a significant change compared to the existing solutions in the payment solutions market.

Some of the issues mentioned are equally important for businesses. There is also price competitiveness and the price that merchants and businesses will have to pay for adopting and using the digital euro. A cost-competitive model compared to the alternatives in the market that does not push them out will also foster the adoption of the digital euro. More effective international payments would also be useful for some merchants. It is very important to have an effective narrative. It has to be explained to the population that the aim is not to get rid of cash. The value-add that will create compared to the existing solutions and apps also has to be explained.

An industry representative emphasised that the financial sector has to be on board, which means factoring in the business cases. One question is whether the digital euro can be used where eurozone banks have a presence outside of the eurozone. If so, that should be with the agreement of the different central banks.

3. The EU single market needs its own efficient means of payment

An official noted that public money being the anchor of the monetary system, the internal market and strategic autonomy are dimensions far removed from the day-to-day worries of most citizens. There is a need to build and convey a narrative that explains the value-add and the use cases of the digital euro.

An industry representative remarked that the EU payments ecosystem works relatively well and is quite competitive. The exchange fees are quite low compared to other geographies. One of the main challenges in the short term is cross-border payments. The EU has just launched its open strategic autonomy project and the question is whether the digital euro will play a role on that.

There are private initiatives, like cryptocurrencies, that bring some benefits but also raise some threats. The International Monetary Fund (IMF)'s Global Financial Stability Report indicates that an extended use of such assets may be a risk to the proper transmission of monetary policy and financial stability. The legislative process must guarantee a level playing field and there has to be consideration of interoperability.

4. Developing competition in wallets

An industry representative remarked that online commerce has changed significantly. Shopping online started as a clunky and was not necessarily safe and secure. With the growth of ecommerce we then entered a war of payment buttons. Everybody was paying to put something on websites. We then it was transitioned to using apps for our shopping. Now it is more and more about payment wallets. Intermediaries that did not exist in the past have inserted themselves into transactions.

Having a wallet is very important, but in the context of the Digital Euro, having multiple wallets is howwe can enable competition. Only by allowing citizens to hold multiple Digital Euro wallets, can we prevent unintended consequences. With a one-wallet limit, there is a clear risk that each citizen would by default open their wallet where they have their main bank account and this default would significantly stifle competition between banks and non-banks, ultimately limiting innovation and choice.

5. The digitalisation trend in the retail space

5.1 Public-private partnership

An official urged the private sector to see the digital euro as an opportunity. It is a project that will take time, but it is progressing. The way it will be put into practice will be based on public-private partnership. Central banks should not start opening accounts for people. The European Central Bank (ECB) will be providing backend services and infrastructure, but the frontend and user-facing services will be provided by private market players.

That should include both bank and non-bank players, because a level playing field is needed. In practice, that will open doors and create room for new business models, innovation and add-on solutions for the infrastructure provided by the ECB and the Eurosystem.

5.2 Addressing financial stability and monetary policy transmission issues

An official indicated that the hope is to get to a wholesale digital euro, which could materially increase the international role of the euro going forward, but first step might be retail. Given the way the digital euro is currently designed, it is meant to be a payment solution. It is not meant to be an investment instrument or a store of value. Holding limits are foreseen to avoid creating negative financial stability. The intention is not to challenge the monetary policy transmission model.

5.3 Preserving the current role of banks and the central bank

The Chair highlighted that there are more than 130 CBDC projects around the globe. Many other central banks or currency zones will likely introduce their own CBDCs. There has to be such a project and preparation for the eurozone.

An industry representative emphasised the need to get the discussion and the ECB's powers right. When attempts are made to change an entire system, and the ECB is given too much power and takes the main task away from banks, the system is being changed in a way that could lead to a significant risk.

The digital euro being too successful would mean that there is a crowding out of bank intermediation, which is a risk for the banking industry. If it is not successful enough there would be a waste of money and resources, and not enough acceptance by citizens, which would be a threat for the ECB.

A policy-maker remarked, regarding the question of whether the digital euro is destroying the existing ecosystem, that synergies between private payment solutions and the digital euro are ultimately sought.

There should be healthy competition.

To that point, what is created for the distribution process of the digital euro will also be supportive of private payment solutions. If standards are created, they should build, as far as possible, on what is already there. That would also minimise the cost. Any new standards that are developed should not only be used for the digital euro but also for private payment solutions. For financial stability, holding limits are needed and there should be no remuneration of digital euro holdings.

An industry representative remarked that it is absolutely key to guarantee financial stability. There must be readiness for the digital euro being too successful. The limit and caps are key. There should be prudence. It will always be possible to increase the caps, but it will be very difficult to decrease them.

6. Creating a context to trigger swift and effective adoption

An industry representative suggested that the biggest challenge for the digital euro is adoption. One of the challenges for adoption is the need to reach scale relatively quickly. Otherwise, there would be a loss of momentum in the process and investment. In general, if the market works there is no need to put a cap on prices. In the beginning a price cap could even be detrimental to the adoption of the Digital Euro, because changing consumers' habits is not easy. Therefore, something very attractive has to be put in front of them and this can only happen if Digital Euro wallet issuers have sufficient financial resources to develop innovative products.

While it might be very attractive from a merchant perspective to have price cap, we also need to consider the investment they will need to make to set up the acceptance of the Digital Euro. As pricing options are thought about, similarities with the four-party card schemes structures is perhaps not correct to begin with. An official agreed that to ensure adoption there have to be win-win spaces for all stakeholders. The project needs allies, and it is not clear it has any beyond the public sector. Unlike other pieces of legislation this will be voluntary. There has to be a value-add that all parties can see, which includes the business case and rationale for adopting and deploying the digital euro.

7. Pursuing a pragmatic digital euro solution and timetable

An official stated that with European elections coming up in mid-2024, there are only a few months left until part of the work has to be put on hold. After the publication of the European Commission proposal, it is time to have a deep debate on the co-legislators' side. Discussions have started at the Council working party level. The first meeting was in late July and the second will be in the following week. Meetings will continue monthly. There is no rush.

This has to be framed as a democratic process. All voices must be heard and taken into account. The appropriateness of launching a digital euro should continue to be reflected on. If it is agreed that it is needed and the regulation is approved, the Eurosystem will be in a position to decide on the actual issuance and rollout of this new form of the single currency.

Several speakers agreed that it will be possible to pay for something with a digital euro in 2027. Some speakers emphasised that the focus should not be on any specific date.

The Chair summarised that a broad discussion of this project is needed together with a very good communication strategy, which is already being prepared by the relevant stakeholders. A transparent process in the upcoming years is also necessary.

Global payment infrastructures and cross-border payments

1. The CPMI/FSB multidimensional programme to improve cross border payments has entered the implementation phase

The Chair explained that in 2020 the G20 leaders had endorsed the programme that the Committee on Payments and Market Infrastructures (CPMI) produced in close cooperation with the Financial Stability Board (FSB) to improve cross-border payments. The programme has been pivoting from analytical and policy development phase to implementation phase is going to take place and several industry working groups have been set up. The programme is very complex and multidimensional, and will take place over many years. The G20 cross-border roadmap covers various segments such as remittances, retail payments, wholesale payments and digital assets.

2. Cost, speed, access and transparency are common targets for wholesale, retail and remittances cross border payment activities, but the challenges are different

An industry representative stated that it is extremely important to separate the wholesale business and the retail and remittances businesses. The overarching themes of the cross border roadmap are cost, speed, access and transparency, but the question is whether these challenges are equally important in the three market segments. There is wide consensus around cost and speed being an issue in the remittances business. There are high-speed highways between some high-income countries but there are other routes where it is more difficult.

2.1 Transparency, traceability, speed and effective interoperability are the main retail cross border payments challenges

An industry representative stated that their company recently conducted a survey to consumers and small businesses showing that security and transparency matter most for low-value cross-border payments. Customers expect payment providers to share information on the amount to be delivered in local currency, fees to be charged, what FX is being applied, and when funds will to be credited. Another area is speed. The G20 goal seeks 75% of payments to be provided within one hour; 89% of payments over Swift arrive to the recipient bank within an hour. When it comes to customers' preferences, 25% expect instant cross border payments and 40% expect them to be delivered within minutes. There is also an increased fragmentation in the retail space

2.2 Significant cost effectiveness gains are at stake in remittances, which requires improving domestic infrastructure

An industry representative stated that their company supports the work the G20 is doing in helping to solve some of the challenges involved in cross-border payments. Remittances is the area that is facing one of the most important challenges; the cost savings associated with digital remittances are significant, and there has been a significant increase in digital remittances. In 2016 about 25% of remittances were digital, and it is now 57%. The average remittance cost of sending $200 is about 6.4%, but when one of the legs is digital it is 4.7%. The Global SmaRT Average shows that it can go down to 3.3%. Security will also be very important, and more domestic efforts are needed to improve the digital infrastructure.

2.3 The key to achieving targets in the wholesale space is access to currencies

An industry representative noted that in the wholesale space the challenges are different to retail and remittances, as the wholesale space has well functiunning high-speed highways. Access to currencies is a key point that needs to be addressed. Their company currently settles 18 currencies, which represents more than 90% of FX traffic. Around 80% of all traffic can be settled, but solutions need to be found for the remaining 20%, which largely relate to emerging market currencies. The challenge is predominantly of a legal, regulatory and geopolitical nature. New technologies alone cannot overcome existing challenges in the FX space.

The Chair added that there needs to be a coherent strategy to join everything together to achieve the goal.

2.4 Safety of financial institutions, financial stability, human rights and financial inclusion also deserve focus

An official stated that the key remaining policy issues under the G20 roadmap are legal, regulatory and supervisory frameworks, the potential misalignment or perceptions of misalignment between them, and a fragmentation in payment data frameworks and identifiers. Public authorities and the private sector talk about what is possible in cross border payment system arrangements, but do not always focus on the criticality of a set of economic policy areas, payment system access, payment system interoperability and cross-border payments. These are issues such as how to ensure and protect the safety and soundness of financial institutions, financial stability, privacy, human rights, and financial inclusion.

3. Key agenda efforts

3.1 Fully leveraging an already swift and transparent cross border payment network requires extending operating hours, pre validating beneficiary account details, making payment related information available, and identifying cost mutualisation opportunities

An industry representative stated that there is a misconception that cross-border payment chains over correspondent banking are long and complex, but 74% of payments see one intermediary at the most. GPI payments[1] are quite fast and 48% of payments are delivered within five minutes. Good progress has been made on transparency, with their company GPI enabling end-to-end traceability of the payment. The next step is to provide that information to corporates, because they also need to handle their treasury and their accounting in the proper way.

An industry representative added that their company is working on finding the right spots for cost mutualisation. Work is ongoing around validating the beneficiary account details and the account holder matching before the payment is triggered.

The Chair noted that one of the biggest challenges is the anti-money laundering and countering the financing of terrorism (AML/CFT) control.

3.2 Improved interoperability and data exchanges will contribute to further reducing fund availability delays, as well as enabling opportunities for payment automation and efficiency gains

An industry representative stated that a recent pilot their company undertook was connecting the GPI cross-border part of the payment with the instant payment systems. It had been possible to get the transactions end to end in less than two minutes. The migration to ISO 20022 reflects the bold move of an entire industry towards more harmonisation. Institutions will take advantage of the fact that they can exchange far more data fields to enrich the payment method to enable data automation, which means it is machine readable.

3.3 In the context of ever developing data use and new players, updated and clear regulatory frameworks are needed that target risks and allow competition and innovation

An official noted that payments is a regulatory field where many different policy priorities intersect. There is encouragement for greater fluidity of data across borders to foster transactions. Achieving the goals will require the flow of more data. Clarity and consistency in data frameworks is important to avoid more drastic measures and blunter tools around data-restrictive policies and data localisation.

4. Conditions for achieving an ambitious and complex global project

4.1 Engaging with the industry and accurately monitoring progress are critical success factors

The Chair agreed on the importance of engaging with the industry.

A Central Bank official stated that it is important to measure progress as accurately as possible. A group of experts has developed a set of KPIs that have been put in relation to the targets. A report is under preparation with a first global assessment of the progress being made in different segments compared to the different targets.

4.2 Maintaining the current momentum and extending the efforts beyond the G20 toward regions under the IMF and World Bank umbrellas are essential

A Central Bank official stated that the first key success factor is to keep the current level of momentum. The work needs to be put under the umbrella of the roadmap to achieve results for a large number of jurisdictions. Another key success factor is to prolong and develop the explanatory work with new technologies and new infrastructures, and to work on the interoperability issue between old infrastructures that are trying to be improved and new ones that are emerging.

An official agreed with the point around political momentum. It is important that the public buys into the changes and that there is a clear view of both the benefits and the steps that public authorities need to take in order to achieve them, in conversation with the people that public authorities work to serve. Enthusiasm and experimentation in other forms of digital assets is sometimes motivated by weaknesses in, or challenges related to, capacity in local payment systems. There is desperate need for engagement in relation to the particular frictions that the private sector is seeing.

4.3 The success of cross border payments in addressing the diversity of user needs relies on the continued commitment to public-private partnerships

An industry representative stated that the cross-border roadmap is in its third year, and the current phase of prioritisation and action is the most challenging part. After Herstatt Bank collapsed there had been a concrete assignment of responsibility from the public sector to the private sector to provide risk-reducing services. When their company had gone live in 2002 it had seven currencies, and today it has 18. The growth has been as

1. Global Payments Innovation (GPI) is an initiative from SWIFT to improve the experience of making a payment via the SWIFT network for both customers and banks.

a result of the public-private partnership. The company is also working on the challenge of emerging-market currencies.

An industry representative noted that the most important factor to the success of cross border payments is the continued commitment to public-private partnerships, because each sector has its own strength. The public sector excels in setting standards, harmonising those standards, continuing to protect consumers, continuing to foster competition within the environment, and maintaining the integrity and stability of the financial sector.

5. Technology is an ongoing challenge to reap all the benefits, and to allow safe, inclusive innovation and fair competition while avoiding creating new sources of fragmentation

A Central Bank official stated that the impact of new technologies and new types of payment service providers has been positive, but there is a distinction when speaking about new technologies. Some technologies are already widely exploited and some are emerging. Regarding emerging technologies, it is important to continue to extensively explore the potential improvements they might bring to cross-border payments. There are also concepts of global platforms being developed; the BIS has its view on a collective ledger, and the IMF has also developed a concept called the XC platform. That could be a way to facilitate interoperability in having those platforms at the centre with existing systems in different ways. That type of investigation is worth undertaking and deepening further, as it might bring benefits and ensure the sustainability of progress.

An industry representative highlighted the continued need for investment in technology, particularly when it comes to security and safety. The investment in technology and the different technologies that are going to emerge are going to lead to more new entrants coming into the markets. Interoperability and interconnectivity between different regions, sectors and players is going to be very important.

An official added that the world is going through a period of remarkable payment system innovation, much of which is taking place in the private sector. There is a degree of experimentation going on in the public sector that is valuable, but the task is to build an ecosystem and provide an environment where that innovation can continue in a safe and inclusive way that supports the stability and functioning of the overall payment and financial system.

A Central Bank official recalled the phrase of a central banker 40 years ago who had said, ‘Prediction is very difficult, especially for the future’. The vision of a global payment system is being transformed. It is still diverse, with a combination of mature and new infrastructures, but less complex and more integrated on a regional basis and more aligned with the G20 targets.

The Chair characterised the journey with the G20 roadmap as one towards a better global payment ecosystem that should benefit everyone, and wished a “Buen Camino” to all the stakeholders involved in this journey.

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V

EU AND GLOBAL SUSTAINABILITY AGENDA

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Supporting the green transition

Finance is one part of the solution to the transition to net zero and the protection of the environment, but it cannot be a substitute for government action. The priorities for accelerating the climate transition have been clearly identified during this session, but there are still a number of difficulties.

1. The priorities for accelerating the climate transition have been identified

1.1 Technology will be a gamechanger, but investments need to make economic sense

An industry speaker commented that banks are not the final investors in technology projects. Banks lend to investors, and investors only borrow money from banks if they see a financial return on their investment. Investors are not going to change their financial behaviours unless the green cost premium is reduced and an enabling policy framework is created.

Some investments make economic sense because the technology is already viable. The way to increase the number of these projects is to create a better system of permissions and to make it easier to do business. Other technologies are proven technically but not economically. For these projects, public resource is required to incentivise private investment. These projects include technologies with a green cost premium such as carbon capture, green steel and green cement, sustainable aviation fuel or hydrogen. There are also projects that are not yet proven technologically, such as nuclear fusion, electric planes or truly smart grids. These projects will require both public and private sector money and the help of other stakeholders, such as universities, companies and other civil organisations.

1.2 Transition finance must recognise geography while supporting common goals

An industry representative highlighted the global dimension to the green transition. If Organisation for Economic Cooperation and Development (OECD) emissions were zero, the world would miss its climate targets due to emissions growth in Asia and Africa. It is cheaper to borrow the money to build a solar plant in France than in South Africa, yet the emissions displaced by one in France are a fraction of what would be displaced in South Africa due to the higher carbon intensity of the electricity grid in the latter. Development risks, combined with the cost of capital and the low returns in some markets mean there is no pipeline of projects. Without a pipeline of projects, these projects simply are not built.

In other words, transition finance needs to be context specific. It should take account of the policy and socioeconomic realities of the transitions in different jurisdictions and industries. In practice, the activities and sectors considered to be 'supporting the transition' will vary geographically and over time. In emerging markets, the Just Energy Transition Partnership (JETP) frameworks can help bring together donor governments and create blended finance offers by enabling donors, host governments and commercial banks to determine where concessional finance can tackle blockages in the demand pipeline. An internationally aligned approach can only be facilitated if local requirements are consistent with global initiatives, such as the work of the International Sustainability Standards Board (ISSB). The regulators should focus on maintaining this consistency and ensuring that local frameworks have sufficient flexibility to accommodate evolving practice in developing credible transition plans.

1.3 Overcoming technological and regulatory uncertainty

An IFI representative explained that the key issue is money. There is a need for money at liquid and price effective conditions to finance projects deemed too risky for the private sector. Public money must leverage private resources. This will enable projects to be financed while bringing more money into the sector. Some projects are considered risky due to technological uncertainty: No one know for instance what fuel will be used in plane whether it will be hydrogen, sustainable fuel or other technology. But there is also a problem with regulatory uncertainty. There is no visibility on the future of regulation. Investors want assurances that they will get a return on their investment.

There is also the question of global competition. A global problem requires a global solution. Europe is taking the lead on this issue, but there is a critical need for a wider adoption of mechanisms like the Emissions Trading System (ETS) or Carbon Border Adjustment Mechanism (CBAM). Other countries are already putting in place measures to make their products compliant with these initiatives.

1.4 Green growth requires both profound political commitment and proper regulation

An official agreed with the urgent need to address climate change. Last week, the G20 recognised the need to accelerate investment in renewables. Any future growth will need to be green to be sustainable. There is a business case to be made about the economic value add of green growth, which is connected to strategic autonomy. There will be an additional value add to reducing Europe's dependency on certain producers and on critical raw materials. Green growth will therefore provide a double dividend: there will be a greener and more productive economic structure and industry will be more competitive. This is even more important in view of increased international competition.

There are three ways to address the challenges. First, leaders and ministers must continue to demonstrate political commitment to the process. Driving growth in a green environment will require public investment at national and EU level, private investment and regulatory reform. Secondly, businesses must be prepared for the regulatory shock. It will be essential to ensure SMEs can remain competitive while making these adaptations. Finally, there must be an international dimension to the transition. After the Eurofi conference, ministers from Europe, Latin America and the Caribbean will be meeting in Santiago to discuss the green transition and the joint green investment agenda.

1.5 Aligning EU capital markets policy to support the green transition

An industry speaker underlined that banks and other market participants have a core role to play in supporting the green transition. 70% of Europe's financing needs are provided by the banks; 30% are provided by the capital markets. This is the inverse of the US. From the perspective of investors, this 30% needs to increase significantly. The availability of green projects can be increased by creating packages of investments. Europe continues to evolve the European Long-Term Investment Fund (ELTIF) framework to channel private savings towards long term infrastructure investments. With some tweaks and perhaps greater competition from other wrappers or packages, there should be an increase in green investment. It would also support the green transition if member states' pension systems were reformed to allow a greater proportion of savings to be invested in the capital markets.

2. There are several difficulties preventing the implementation of these objectives

2.1 Economic and regulatory bottlenecks

An official outlined the economic and regulatory bottlenecks which have emerged from the political process of addressing climate change. Transition paths are determined by climate change experts, but there is no discussion of whether these paths are realistic. Electromobility is an example of a significant bottleneck. In some areas, the grid cannot support the installation of enough electric vehicle charging stations to serve the local population. This is not a problem of political will; it is a bottleneck that was not considered in the calculation of the transition path. For some countries, it is easy to produce 100% renewable energy. It is much more difficult to tell people who own gas boilers that they must replace them. The political difficulty of this process has become clear over the past year, but there will be significant consequences if these economic bottlenecks are disregarded.

2.2 Ending fossil fuel subsidies and supporting alternative energy mechanisms

An industry representative cautioned against using developed nation's indebtedness as a reason not to invest in reducing emissions. The counterfactual is not what exists today but what will happen tomorrow. It will not be possible to burden emerging markets, impose CBAM on their exports, not provide debt relief and then expect them to make emissions reductions unless we do so ourselves. There must be some give in the system. One option to create fiscal space would be the removal of fossil fuel subsidies. At the moment, governments support the exploitation of fossil fuels to a greater extent than they support mechanisms for alternative energy. There must be a global carbon price. Business models and consumer habits are often based on brown subsidies. Politically, the abolition of brown subsidies is not a free lunch.

The Chair suggested that carbon intensive agriculture subsidies could also be removed, including the Common Agricultural Policy (CAP).

An industry representative noted that, excluding flights, diet is the biggest contributor to a person's carbon footprint. Farmers in the EU are being subsidised to produce carbon-intensive products. If these subsidies were removed, there would be a transformation. If the green transformation is prevented, the European economy will be overtaken. For example, 50% of the vehicles produced in China are now electric vehicles. Chinese manufacturers will dominate the world market unless Europe's electric vehicle transition is accelerated.

An IFI representative agreed on the need to re evaluate the subsidies for fossil fuels and agriculture. Usually, the argument is made that people do not want this and that it would create a huge social problem. The argument that people do not want it is not correct. Surveys suggest that between 66% to 90% of people support more stringent measures and additional costs because they believe they will see long term benefits such as higher income, more jobs and a better quality of life. The question of social cost should be left to social policy. The money generated by removing subsidies should be spent on the people who are worse off. These decisions should be made based on the price system, which is how costs are revealed and internalised. It is also important to bear in mind that some overindebted countries are not contributing to climate change but are suffering the consequences of it. These countries should be enabled to transition without suffering excessive penalties through mechanisms such as debt for climate swaps or the reallocation of SDRs.

2.3 CBAM is a major breakthrough for global climate diplomacy, but it has its limits

A policy maker emphasised that 2050 is now a legal commitment. The market based mechanisms like ETS or CBAM work by providing incentives for industry. Instead of regulating the carbon content of products, which might happen in the next decade, the decision was made to create a market based mechanism that incentivises industries and investors to create greener products by providing a price signal. CBAM seeks to incentivise companies in third countries to align with companies in Europe on decarbonisation. It is already having a triggering effect. Turkey is developing its own ETS, and Serbia, Japan, South Korea, China, Indonesia and New Zealand are all expanding or thinking about expanding their approach to carbon pricing.

The CBAM regulation with financial obligations will enter into force in 2026. There will be until then a transitional period during which there will be a period of intense cooperation on decarbonisation measures across the OECD, the Inclusive Forum on Carbon Mitigation Approaches (IFCMA), the Climate Club, the International Monetary Fund (IMF) and the World Trade Organization (WTO). There is a broad focus on the merits of carbon pricing as a complementary tool. The system for carbon pricing in Canada or China might not be identical to the one in the EU, but the world is moving towards more carbon pricing, and a higher carbon price is better for the environment.

An industry speaker noted that BBVA has advised its clients and the authorities in Turkey that Turkey should create its own ETS or else Turkish businesses will end up paying taxes in Europe.

A policy maker added that both the Nigerian President and the CEO of Tata Steel have recently identified the opportunity to green through carbon pricing.

A policy-maker agreed that CBAM is a very good idea. The entire system can only work with a border adjustment mechanism. However, there is a significant problem around product inputs from third countries. There is no problem if a product is 100% produced in Turkey, but the rules of origin are such that, if 49% of the product comes from outside Turkey and there is no adjustment mechanism between Turkey and the country of origin, this CO_2 will not form part of the CBAM calculation.

2.4 Decisive action is needed in the EU banking sector due to over reliance on bank financing

An industry speaker explained how citizens both in the EU and abroad can support the transition by using their own pension savings to invest in effective investment vehicles as part of a truly unified EU capital market. In particular, securitisation will free up bank balance sheets and allow banks to participate in more green financing. It is important to understand whether the current rules and regulations on securitisation, insolvency law and taxation are supportive of international investment in these projects. The world's largest global asset owners consider tax to be the key barrier to entry in the European capital markets. In some European markets tax relief or reclamation can be done very quickly, but in other markets the process takes years. There are many other similar issues for investors, such as depository passporting, all of which sit under the Capital Markets Union (CMU) banner.

An IFI representative underlined several key measures to overcome uncertainty: clear, transparent and implementable regulation; risk sharing mechanisms which allow small amounts of public money to leverage large amounts of private money; investment in mitigation and R&D; and a deeper CMU to create a level playing field.

This final point connects to a much wider discussion about Solvency II and why the venture capital and scale up market in Europe is much weaker than it is in the US. In Europe, life insurance plans and pension plans are not allowed to invest in the venture capital market, as they are in the US. This is neither right nor wrong. It is not possible to have the market of the US with European social security protection and a European level of risk protection. These two paradigms cannot exist together; it is not possible to have the benefits of both.

2.5 Overindebtedness is a challenge, but there is no need to dilute EU fiscal rules

The Chair observed that all of Europe is overindebted. The solution to this might come from the markets, but there are also high levels of savings. Highly indebted economies will need to figure out how they can address huge challenges such as climate change, digitalisation and aging populations.

2.5.1 The need for international efforts

An official explained that countries in the global south often talk about being climate creditors as well as financial debtors. These countries want to balance the equation. This must be taken into account in terms of both the ownership of projects and avoiding the trade off between growth and decarbonisation. There must be bilateral and regional effort on this priority. There must also be a substantial effort on the global financial safety net. There is a role for the World Bank and the IMF to finance projects in regions that are heavily indebted. These countries still need investment to decarbonise.

2.5.2 The green transition can be achieved without diluting fiscal rules

An official stated that the Commission estimates that reaching the 2030 goal will require €600 billion per year. Meeting this need would require a reallocation of 1.8% of the EU budget. This should be considered before any other new instrument for financing. The responsibility of public budgets is to make the green transition socially affordable. Social spending in member states amounts to around 30% of GDP. Better targeting of this spending will create room to manoeuvre. The financing possibilities are similar in all EU member states, which means there is no need for extra funds and no reason to depart from EU fiscal rules. Green debt is a type of debt; it has to be borrowed from the markets and financed by people. If there is a credible greening strategy, there is no need for any kind of additional green debt.

The Chair noted that the EU budget is relatively small and not adopted along transparent, parliamentary procedures. An official suggested that half of the CAP could be reallocated for climate purposes.

An industry speaker observed that debt is one of the greatest inventions of humankind. Banks love debt, as long as it is paid back with interest. For that to happen, there must be cash flows that guarantee a borrower can pay back their debt. When it comes to the investments that need to be made, green investments must be helped and brown investments must be penalised. There will be a need for a large amount of debt to facilitate the vast investments that are needed. If the debt is not paid back, the cycle will stop.

A policy maker emphasised that there are many economic studies and impact assessments behind the EU's climate policy. The question of capacity is interesting, but currently the force of economics is not very strong when it comes to predicting behavioural changes or catastrophe risk, both of which will be crucial in the next few decades.

It is also important to consider the issue of tax. In the past, individual taxes were designed as a form of sustainable revenue. The Commission now agrees with the IMF that, while some behavioural taxes in the tax mix should be stable, some taxes will be short lived. Behavioural taxes will be developed and changed as behaviour changes. Behavioural change must be taken into account by investors and policymakers. Eating habits will change; urban development will change; industry will change.

2.5.3 When NGEU expires, further action will be required to ensure the EU reaches carbon neutrality

An IFI representative emphasised that Europe must face this challenge together. NGEU has brought approximately €750 billion of funding for the green and digital transitions, along with €300 billion from REPowerEU. Once these expire, further action will be required to set the EU economy firmly on its path to climate neutrality by 2050. There will need to be a budgetary mechanism that creates a level playing field. The costs of a global problem cannot be imposed equally on countries in different situations. There must be a just transition.

The question of debt sustainability does not take into account whether debt is green, yellow or blue. Without debt sustainability, the transition will not make sense. The transition path must bring resources to the sectors that need them. NGEU provides the means to fund these projects. Countries can use the NGEU money and the European Investment Bank (EIB) and other financial institutions can leverage it. NGEU only runs until mid 2026, but the transition will happen over the next three decades. For the next three decades, the EU will need to develop something else which attracts private money in the same way as NGEU.

An official emphasized that, from a European perspective, Next Generation EU (NGEU) is providing a huge boost to public investment. Over the next few years, it will be vital to develop a pipeline of game changing projects that will outlast NGEU and continue to leverage private capital from within and outside the EU while making the industry more competitive.

Clarity and reliability of the sustainability framework

Introduction

The panel discussed the impact of the sustainable finance framework and the possibility to improve its clarity and reliability. The Commission, Council and the Parliament have worked hard in the last few years to develop at rapid speed a whole new framework to respond to the climate emergency.

Two recent additions are the first set of European Sustainability Reporting Standards and the proposal on environmental, social and governance (ESG) ratings.

1. Correcting greenwashing practices

ESMA highlighted that the new framework is gradually coming into place with new legislations, regulations and clarifications for the market. While implementation is progressing, a pressing concern for supervisors, investors and broader stakeholders is to ensure trust in the system and reduce the risk of greenwashing. Greenwashing concerns and occurrences have been observed during the first phase of the implementation. The immediate concern for supervisors and the financial industry is preserving trust in the system and the risk of greenwashing. That risk is material, real and no longer contested.

The three European supervisory authorities published their interim report on occurrences and sources of greenwashing in the financial markets in June 2023. They developed a common definition of greenwashing and have identified the types of practices that are most exposed to greenwashing risks.

The final report is due in May 2024. It will include reflections on whether the regulatory framework is enough to combat greenwashing or if additional policy developments are needed. The overall objective would be to enhance the reliability and legal certainty of the framework in order to build trust in sustainable investment and support the transition to a more sustainable economy.

The second angle in combatting greenwashing is to ensure proper supervision and enforcement by the national authorities. ESMA's role is to foster more convergence through consistent messaging.

2. Implementation difficulties for SFDR disclosures

CSSF remarked that significant efforts have been deployed by the industry and supervisors to ensure compliance with SFDR requirements. There is a lack of common understanding at a European level regarding some requirements, as well as diverging supervisory practices among national competent authorities (NCAs).

These divergences, mainly due to the lack of legal clarity within the framework leading to different interpretations amongst stakeholders, have resulted in low levels of comparability in disclosures.

That does not help in terms of comparability.

A regulator stated that as long as key concepts such as 'sustainable investment' are not further defined at (European) level one, there will continue to be comparability issues. SFDR is a disclosure regulation but has been conceived as a labelling regulation. It would be a good idea to extend the SFDR combine it with minimum requirements for labelling at the European level.

Supervisors have to be present. The framework is not perfect, but it can be perfectly supervised. To spot cases of greenwashing, the Austrian FMA started a quantitative greenwashing market screening this year and compared the description of sustainability-related aspects in different fund documents (image of sustainability) with the actual pursuit of the investment strategy (investing in sustainability).

To combat greenwashing, also eco-financial literacy has to be enhanced. The Austrian Institute for Advanced Studies did a survey based on a learning tool to provide relevant information about sustainable investing. The results show that on average only half of the questions on sustainable finance necessary for investments can be answered correctly by a representative sample (concerning age and gender) of the Austrian population.

3. Availability and quality of ESG data

An industry representative noted that the key issues that the regulatory framework seeks to address are around the quality and availability of core ESG data, which is critically important to the industry and for accelerating to a low-carbon economy. There has been significant progress under the Corporate Sustainability Reporting Directive (CSRD) and other regulatory measures, but there is still work to do. The implementation of the CSRD being seen as the end point could be concerning.

Greenwashing is the number one blocker for increased investment in sustainable products and assets. Among the investors who are not engaging with sustainable investment strategies, 40% say that the risk of greenwashing is holding them back.

Tackling greenwashing comes down to enhancing the quality of ESG disclosures. With the wider scope of the

CSRD, we expect is a large increase in the availability of ESG data. Corporates are facing challenges around the production of the data and the interpretation of some of the requirements. That is an area where improvements will be needed from everyone.

To reach the net zero goals and carbon neutrality by 2050, it is estimated that $100 trillion will be needed by 2050. The provision of accurate, reliable and robust data is key to accelerating this investment allocation. The ESG ratings regulatory framework will inspire the transparency needed in the industry. There is strong need for such tools and analytical frameworks to analyse ESG performance and profiles in the markets. It is very important for the input data to be transparently sourced. It is also important to have a focus on the independence of thought and research.

Financial market participants have been using proxies to cope with the lack of data. Some issues have emerged when using proxies, such as the lack of transparency on the methodology and metrics used. An industry representative highlighted that terminology confusion is a major problem in sustainable finance. It is broader than some of the terms highlighted and could also include doing no significant harm, sustainable investment, transition and greenwashing.

Markets and regulators need time to understand the terms and requirements of the framework, and to agree on their implications. It is also in part because people are looking to impose a meaning with terms that might be inappropriate or stretch language so far that it becomes misleading, which leads to greenwashing. ESMA, the European Supervisory Authorities (ESAs) and the NCAs have done excellent work with the interim report by identifying the nodes along the sustainable investment value chain. It is important to think about being part of that investment value chain.

Much of the greenwashing challenges come down to confusion around terminology and the ability to distort a version of a sustainability profile. In its report, ESMA identified the moral hazard. Beyond language, there is a problem around the high demand for sustainable investments in the market and the very low number of sustainable investments available. ESMA has found that, in the funds and equities space, and corporate bond holdings, only 1.4% is aligned with the taxonomy. An industry representative's firm ran its own exercise a year ago. Of 4,000 companies in Europe, only 0.02% were aligned. Only one company was completely aligned. Over 99% were not aligned. This is a fertile space for confusing and misleading terminology.

The terms listed in the question are distinct things along the sustainable investment value chain. Good guardrails are needed for all of them to be clear on what is being talked about.

The confusion about what an ESG rating is doing has to be resolved. Some have a double materiality lens. Some are purely impact focused. Some are financially material. There is a need to know what is being measured. The methodologies need to be transparent. The governance needs to be there. There should not be any confusion in two years' time on ESG ratings. Clear labels are needed in the space. ESG ratings and ESG scores are the same thing, so they should have the same name. There is a need for harmonisation, transparency and clarity in the ESG ratings market. There should be a regulation for them. The International Organization of Securities Commissions (IOSCO) has done good work there. An ESG rating is not the same as an ESG factor in a credit rating. There is the Credit Rating Agency Regulation. Credit ratings look at credit risk and although ESG factors can be relevant in credit ratings they not always are.

Applying the term ESG to information should be done with discretion. The question is whether this problem should be solved in the disclosure area via the CSRD, the International Sustainability Standards Board (ISSB), or assurance at source so that everyone gets comparable, reliable data. When an ESG data product has a rating or threshold, and is providing a judgement, going beyond the estimates, or representing itself as something beyond pure data, there is a need to know where the threshold should be drawn on regulation.

4. Priorities to improve sustainable transparency

A regulator emphasised that labels are the most important aspect to prioritise. A number of pieces has already been put in place, although not necessarily in the right order, so the situation is much better. When the Commission and the co-legislators reopen the framework, a forward-looking perspective is needed, taking into account what will be in place in three years. There will be the CSRD and the European Sustainability Reporting Standards (ESRS), and the hope is that there will also be the ESG rating proposal. There is strong support from ESMA on this. A key point that needs to be considered collectively is how to support investors with meaningful EU-level labels, rather than just going for disclosures.

A regulator remarked that the recent initiatives are important milestones towards transitioning to a sustainable economy. However, the foundations of the existing regime should be strengthened before moving forward. Defining sustainable investment is a core pillar of the framework. Without this, the threat of greenwashing will increase and the objective of investor protection will not be achieved. There is divergence between funds that are disclosing under Article 8 of SFDR today, which raises issues of the comparability of the products and of having a level playing field for different member states.

The objective of a sustainable finance framework is to transition to a sustainable economy, and there should be a coordinated EU response. The EU should remedy initiatives that create market fragmentation. For example, there is the introduction of national top-up SFDR regimes and differences in the application of SFDR for different financial products. This should be addressed in level 1 text and should concern all products that are in scope of SFDR.

A regulator agreed about the importance of the CSRD for completing the framework. There will be data, but the challenge there will be not only to get quantitative, but also qualitative data, where there is a common challenge in getting the resources and trying to clarify the likely inconsistencies. Regarding resources, it will be difficult to find sufficiently skilled personnel. Furthermore, inconsistencies and interpretation issues in the reporting standards as well as with regard to the application of CSRD will have to be clarified in a close dialogue between the regulators and the industry. An industry representative stated that there is a need to focus on the foundations. It is important to not be so prescriptive that the market is stifled. When it comes to CSRD, the focus must be on embedding and supporting corporates to produce better-quality data, recognising that there is a vast discrepancy in terms of levels of maturity and resourcing. Focusing on fixing the data quality and availability problems at source are the key activities where support from regulators and policymakers is sought.

An industry representative noted that categories of products should be created. A labelling regime in parallel to SFDR would help avoid the use a disclosure regime for labels. There is also a need to recognise that there is a spectrum of investment when it comes to the ESG space, from ESG integration all the way through to sustainable impact thematic strategies. Any future labels should take this into account. Many existing labels in the market are exclusionary-focused. Stewardship has a major role to play in achieving real-world outcomes, and labels also have to take that into account.

An industry representative emphasised that the sustainable disclosure revolution that is about to happen is extremely important. It is good that ESMA has identified this as an EU strategic supervisory priority to be coordinated as much as possible, and that fragmented implementation of the directive in different markets should be avoided, together with the application of the ESRS. It is regrettable that the materiality assessment will leave some gaps, but the implementation of that disclosure piece is extremely important and needs to happen.

The Chair noted that the SFDR will be reopened and there will be a public consultation soon that will run for three months. The issue is being considered with openness and from a global perspective. The intention is to launch a comprehensive project under the new mandate, subject to the political approval of the new Commission and college.

Converging globally on sustainability standards

Introduction

The Chair welcomed everyone to the session on sustainability reporting standards. This year has seen the first two inaugural standards of the International Sustainability Standards Board (ISSB), the adoption by the European Commission of the European Sustainability Reporting Standards (ESRS) adopted by the European Commission on 31 July based on EFRAG's technical advice, and the endorsement of the G20/OECD Principles of Corporate Governance at the G20 leaders' summit. In September the Taskforce on Nature-related Financial Disclosures (TNFD) will issue its framework.

1. The Reception of the ISSB standards and of the EU standards (ESRS)

A standard setter stated that the ISSB package of standards comprised of S1, a general requirement to report risk and opportunities relating to material sustainability matters, and S2, direct disclosures on risks and opportunities regarding climate. The ISSB has been set up as a response to global demand, so the response from the global investor community has been supportive. After the release of S1 and S2, the Financial Stability Board (FSB) determined that its work on the Taskforce on Climate-related Financial Disclosures (TCFD) and monitoring of disclosures would pass to the ISSB. In July the International Organization of Securities Commissions (IOSCO) provided an endorsement of S1 and S2, which will form a global baseline of reporting for IOSCO membership.

The Chair noted that the speed with which IOSCO has endorsed the standards is a strong message.

A standard setter stated that the Corporate Sustainability Reporting Directive (CSRD) has been adopted on 31 July 2023 by the European Commission and that the process has been very consistent. The content's depth has been adjusted to incorporate the feedback received during the consultation. The mandate dictates that significant impacts, risks, and opportunities must be reported using a dual-materiality approach. A comprehensive system involving a legal framework with robust standards, appropriate governance, implementation of materiality, auditors, and stakeholders is expected to ensure a high level of quality.

The European Commission noted that additional phase-ins and an extension of the materiality assessment was aimed at reducing possible costs. A cost-benefit analysis made by CEPS for EFRAG estimates the cost for companies subject to sustainability reporting for the first time would be around 0.013% of their turnover. In the long term, it is clear that the benefits will outweigh the costs.

An official stated that Switzerland is a very strong supporter of the ISSB and its global baseline standard because it is based on the TCFD recommendations. There is room for non-EU members to be compliant, so Switzerland decided to integrate TCFD early on. A TCFD-based regulation stipulating mandatory disclosure will come into effect in January 2024. Companies are free to choose the details of how to report, as long as it is compliant with the TCFD recommendations and the minimum requirements set out in the regulation, and are free to integrate ISSB elements into their reporting. There will be a review after three years and the next stage will address how to deal with the ISSB standard.

As a small jurisdiction, Switzerland is mindful of comparability when planning to achieve climate-related goals. In addressing small- and medium-sized enterprises (SMEs), Switzerland is working on the assumption of an equivalence with the EU. There is engagement in the Net-Zero Data Public Utility Facility that supports comparability of data and also in the Sustainability Standards Advisory Forum.

1.1 The US regulation agenda

The Chair sought an update on the US regulatory agenda and potential alignment with the ISSB and European standards. An industry representative stated that Bank of America supports the convergence and efforts to achieve transparent, comparable, and consistent disclosure requirements. The more reliable and comparable the data is the more investors will be informed to make the right decisions and banks to deploy capital where it is needed.

It is not clear what the Securities and Exchange Commission (SEC)'s final rules will be when they are issued in October, but Bank of America believes jurisdictions should work together to find a somewhat uniform approach at international level when it comes to disclosure. The US is contemplating just climate disclosures for the time being and achieving convergence in this area would be a good outcome. In the US the legal culture is very different in nature to that of Europe with a higher incidence of litigation. The SEC should take into account that data quality will be poor for some time, so targets should not be set in stone.

1.2 The Taskforce for Nature-related Financial Disclosures (TNFD)

An industry representative stated that the TNFD is trying to emulate the TCFD and will also be built around four pillars of governance strategy, risk management, metrics, and targets. The TNFD will be neutral in terms of its materiality approach and a company can explain whether they will report under single materiality or double materiality. The TNFD will be explicit that organisations should start reporting where they can and commit to expanding over time. The Chair understood that the TNFD will offer a baseline, which is already consistent with other approaches.

2. The implementation challenges of the sustainable reporting standards

An industry representative stated that the ISSB standards are seen as the global baseline for sustainability reporting. Although the ISSB and ESRS are broadly compatible further work will be needed to iron out the differences between ISSB and European guidance. Bank of America is subject to CSRD, starting in 2025 for the main EU-based entities and 2029 for the US. The European Commission has simplified the standard, which is an improvement, but hurdles to implementation remain, in particular the lack of reliable data, materiality assessment, and comparability of reporting between big and small entities, which cannot be achieved immediately.

The poor data quality means we can expect inconsistent disclosure practices which can result in different results for similar entities. This could impact comparability and the reputation of the standards. If conclusions are inconsistent this will be a real problem for the market and the investors. The European Commission and EFRAG should set up an interpretation forum to give clear guidance on the flexibility of implementation.

The Chair asked whether the standard setters could address some of the concerns. An industry representative stated that ideally there will be a single set of uniform standards and clear guidelines so that elements that are unclear can be interpreted.

2.1 The response of the standard-setters to the call to support the implementation of the standards

A standard setter stated that COP27 will work on the capacity building with partners. The IFRS Foundation will play a strong leadership role in terms of capacity building and implementation guidance. A knowledge hub will be launched. The document A Journey to Adoption of S1 and S2 gives a sense of the transitional provisions provided by the IFRS foundation and this will be enhanced by an adoption guide.

A jurisdictional working group will be formed to share experiences. Advanced work with the European Union, EFRAG and the European Commission will bring together the S2 and EU requirements on climate. The Foundation and the European Union have recently commented on the strong level of interoperability leading to a minimisation of any sort of double reporting. Asked whether the IFRS Foundation had the capacity to respond to requests for technical assistance, a standard setter explained that this would take place via the knowledge hub and that the work to provide responses will be split between the European Commission and EFRAG.

The Chair asked whether further guidance can be issued to help with the implementation and quality of data, given the concerns that the quality of the first reports will be low and that this could undermine the credibility of the system. A standard setter understood the challenges but would not call them concerns. The 2002-2005 transition to IFRS was deemed almost impossible in the EU, but it was achieved with discipline and success. There is a need to facilitate the capacity of users to analyse and the key element is a simplified mandatory regime.

The balance that has been struck is reasonable, with the phase-in being key points. EFRAG and the European Commission aim to contribute to the global progress of sustainability reporting and avoid multiple reporting. EFRAG is strongly in favour of a single report and due to the efforts on both sides, 99.1% interoperability has been achieved. ESRS incorporates ISSB disclosure points on climate. EFRAG's joint statement with the Global Reporting Initiative (GRI) acknowledges a high level of interoperability, which means that companies reporting on their ESRS in the EU will also be deemed to report with reference to GRI. All of these should be translated into the digital format and an access point will be opened for questions.

The ESRS is also consistent with the Sustainable Finance Disclosure Regulation (SFDR) or the Pillar 3 indicators. Going forward, there will be a SMEs standard, on a voluntary basis to ensure SMEs are not excluded when asked to provide regional data to large companies.

The Chair noted the challenge on the auditing side where it is expected that auditors audit to the reporting standard but also check the materiality assessment of the companies.

In terms of key challenges for assurance reviews, the European Commission noted that audit and assurance is a very important element of the framework, because it is important that the information that is disclosed is reliable. Auditors and other assurance providers can be called to exercise this power and issue an opinion, but one challenge will be that it is not yet known whether the markets or providers are available and to what extent auditors have the knowledge to produce opinions in a new area. The system allows member states to introduce different auditors for financial statements and assurance providers for sustainability reporting, so the interaction between those two assurers will have to be taken into account.

The support from EFRAG will concentrate on guidance concerning the materiality assessment. The audit and assurance side will need some published guidance and the Commission intends to help with a portal where questions can be collected and answered. Such guidance will be essential to support companies with this new exercise.

2.2 The implementation challenges of the TFND framework

The Chair asked for a view on the disclosure of nature-related financial risks and the implementation challenges to the TNFD. An official supported nature-related aspects. Switzerland is supporting the TNFD work from a financial perspective and has established a national consultation group where companies can familiarise themselves with the framework. The TNFD should be a firm basis for the development of a standard.

An industry representative agreed that biodiversity should be the priority for the next project for the ISSB. Most people are saying that implementation should be the focus of the ISSB, which will actually be done by the national or European standard setters and supervisors. This will be the SEC in the US, the EFRAG and Commission in the European Union, and the Sustainability Standards Board of Japan (SSBJ) and the Financial Standards Agency (JFSA) in Japan.

The ISSB should let the regional and national regulators carry out the work. There can be coordination later, if needed, but currently the focus should be on the new project because it is only the ISSB that can provide the global baseline. The ESRS and the ISSB S1 and S2 are not entirely aligned, so the ISSB should focus on filling in those gaps and work on implementation later.

Conclusion

The Chair thanked the panel for their excellent contributions. It was recommended that the community learns from the experience of the implementation of the first IFRS standards in the 1970s and not let it take 30 years to reach convergence on these standards, although it is a huge change. The third parties on the OECD side are interested in gaining the data and want companies to produce this as soon as possible, although the goal of consistent, comparable data will require huge, costly, and timely transformations. It will happen very quickly this time.

Transition of financial activities towards net zero

1. Transition investments are increasing as country-specific policies to deliver net zero commitments are starting to materialise

An industry representative stated that the transition is a techno economic transition and is accelerating. €1.1 trillion of transition investment took place in 2022. The two key vectors of decarbonisation, renewable power, and electric vehicles, both hit records. There were about 340 gigawatts of new wind and photovoltaics (PV), which is a 21% increase from 2021. Another increase to 500 gigawatts will take place in 2023. The world is getting high double-digit percentage yearly increases in the annual deployment of wind and PV. Every year is also a record on the electric vehicle (EV) side, with over 10 million new EVs on the road in worldwide sales, which is a 62% increase on 2021. The number is on track to hit about 16 million in 2023, which is another 50% to 60% increase. In the first half of 2023 16% of all new vehicle sales were electric.

Around 90% of the world has a net zero commitment either legislated or under discussion. The policy to deliver those commitments is starting to materialise, including the Inflation Reduction Act (IRA) in the US and industrial policies all around the world. The world is currently on track for around 3 degrees of warming. For 1.5 degrees, around 500 gigawatts each of wind and PV are needed to get on track in the current decade. 35 million EVs are needed each year, with the removal of around 100 gigawatts of coal each year up until 2030. The emissions trend by country is not a one size-fits-all story.

He added that banks are now setting targets for many high-risk sectors. At their institution (HSBC) policies have been put in place such as a coal phaseout policy in 2021 and an energy policy at the end of 2022. The transition requires a switch in thinking is the finance sector from risk management and compliance to building commercial strategies.

An industry representative stated that in recent years various jurisdictions presented a mix of initiatives to encourage the transition to net zero. The EU is moving from the 'stick approach' to the 'carrot approach' with its Net Zero Industry Act, following the IRA in the US and the GX Strategy in Japan. Both approaches are necessary to achieve the net zero environment

An official noted that the second element is to have the best mobilisation of public and private investment. The Spanish Recovery and Resilience Plan (RRP) has almost 40% of the envelope devoted to the green transition.

2. Ongoing swift policy efforts regarding green bond markets, sustainability labels and disclosure standards, as well as sustainability risk assessments, contribute stimulating the transition to net zero

An official stated that the objectives of fighting against climate change are valid, as record high temperatures occurred over the summer. The legal framework that the European Commission designed in 2020 has almost been completed, with the Sustainable Finance Action Plan (SFAP). The three main pillars of the whole plan are taxonomy, transparency, and tools. During the Spanish Presidency of the Council of the European Union we are working intensively in the regulation on environment, social and governance (ESG) ratings.

If there are no objections in October the new delegated acts on the four environmental objectives around the mitigation and adaptation of climate change will be introduced, so the screening criteria for the Taxonomy will be completed. The European standards of sustainability reporting of companies will hopefully be in place around November. The legal framework is very complex. The Spanish Treasury`s Sustainable finance public policy is being organised around three main elements. The first is to adapt to the European legal framework and to participate in collaboration; the second is climate risk assessment; and the third is to boost the green bond market.

3. Many jurisdictions focus on developing decision useful information for investors which avoids global duplication

An industry representative observed that the progress made on the sustainability disclosure with the publication by the International Sustainability Standards Board (ISSB) and in the EU with the Corporate Sustainability Reporting Directive (CSRD) and the European Financial Reporting Advisory Group (EFRAG) work are important milestones that contribute to realisation of the transition. Each jurisdiction needs to recognise and respect the approach in the other regions that have declared their commitment to net zero. There is no "one-size-fits-all" for transition. Recognising that there are differences among jurisdictions should be at the basis of each policy action. The administrative burden of new requirements on companies should not be excessive.

An official stated that the official sector is trying to ensure that there is genuinely decision useful information available to investors in the private sector. The official sector is able to put structures in place that allow global firms to produce that information in a way that minimises duplicative requirements. The Task Force on Climate-Related Financial Disclosures (TCFD) had been created, and the ISSB has been set up and delivered its standards, which had been endorsed by the G7, G20 and the International Organisation of Securities Commissions (IOSCO).

The UK will set up a framework for its adoption of the ISSB standards by the middle of 2024. The ISSB allows for divergences in the ways that jurisdictions will do this. In the UK the divergences will be minimised by ensuring that UK firms have the building blocks for a disclosure that is compatible with an international approach to disclosure information. The aim is for a UK firm's disclosure to be compatible with ISSB standards. The Chair noted that it is also important to think about the real economy.

4. Key success factors for a swift transition

4.1 Further accelerating the transition of SMEs is a challenge, which represents critical economic, competitive and sustainability stakes for the EU

An industry representative stated that 99% of all businesses in Europe are SMEs. SMEs are responsible for 63% of the CO_2 emissions of the EU. Some companies are more advanced due to their business model or practices, but others are lagging. Managing climate issues will give them a competitive advantage.

4.2 A green sectoral plan should be envisaged to clarify the roles of the public financial and corporate sectors, foster cooperation for private financing, and reduce regulatory uncertainty

An industry representative stated that according to Banque de France 65% of large companies managed and implemented energy decarbonisation measures. A significant amount of uncertainty remains regarding a manageable regulatory framework, especially for SMEs. Clarity is needed on a clear cut role split between public authorities, industry, and banks. The public authority has to define sectoral transitory paths for each industry.

On public spending and the budgetary normalisation, it will be impossible for public spending to finance investment in member states. The solution remains in the private sector. It is important to have information that allows companies to help finance and advise its clients on their transition path. The regulatory framework should be rationalised and simplified for all companies, not only SMEs.

4.3 An effective transition requires further clarification of what needs to be done and what is deemed sustainable

An official commented that it is vital to understand what public authorities expect and what legislators require of companies. Companies, particularly on the financial sector side, need more data to clearly understand what is going on and to identify the companies that are transitioning effectively and the corporates that provide that data. Clear guidance from public authorities about expectations are needed, as well as clear orientations and definitions around what needs to be done and what is deemed sustainable.

4.4 Monitor both the availability of finance and the uncertainty hindering transition projects in order to focus public sector intervention

An official stated that there is sufficient financing capacity to finance the transition needs but there are not enough projects to finance. The real economy is not transitioning fast enough. Investments by corporates and individuals for the transition are costly in the short term, but their expected returns in the medium to long term are often too uncertain. Public utilities have already done a great deal. The EU has set up a comprehensive disclosure framework, which will provide a large volume of data to all market participants. There have also been attempted definitions of what is sustainable in the EU taxonomy.

Regarding the lack of profitability of projects that limit the decisions made by corporates and individuals, public utilities have provided a great deal of support to try to increase the profitability of the projects in specific cases. In the context of the green industry law, the French Minister has announced tax cuts to foster investments in production capacities in batteries and solar panels.

Much is being done but those actions are potentially not leading to sufficiently quick progress. Setting up disclosure frameworks takes a significant amount of time. The CSRD starts in 2024 and the first reporting will be in 2025. So, it will take several years to specify the disclosure requirements in each sector. The EU taxonomy is also not yet completed. The work should be done at the international level as much as possible. Some areas are asking for more public support but there are constraints in public finance. It is vital to ensure that public sector interventions are targeted and well justified.

4.5 Monitor and support the competitiveness of the EU

An industry representative stated that larger companies need to protect themselves as there is a significant issue of competitiveness. In the EU the industry needs to be helped to compete during the energy transition with its main external competitors. That is the purpose of the Carbon Border Adjustment Mechanism (CBAM). The size is apparently too small to ensure that a level playing field will be guaranteed. Without a CBAM at the European level it will be very difficult to manage transition in the EU without creating de industrialisation. There will be zero impact at the level of the planet itself, because there will be no industry in Europe and more industry elsewhere.

5. EU SMEs need multi form support

5.1 Addressing SMEs lack of finance, availability, and expertise

An industry representative commented that the first key challenge for SMEs is the lack of resources, as they do not have the required budget, time, employees or expertise. SMEs also cannot keep up with the new regulations as they do not know how to apply them. The situation is going to be even harder with the CSRD. Some companies have not started because they do not know how or where to start. One idea could be to implement an online toolbox where SMEs will find everything they need.

It is important to adapt the policies to SMEs, involve SMEs in the regulation process, and set up communication tools to explain regulation to SMEs. A helpline could be created with subject matter experts that answer questions that SMEs have.

5.2 Focus and simplify SME reporting obligations

An industry representative noted that the priority for SMEs should be action, not reporting adaptability to CSRD reporting. SME actions need KPIs, which need to be understandable by SME managers.

6. Proportionate and practical transition plans are needed to clarify companies' approach to the transition to net zero, including the consistency with public policies

6.1 Transition plan disclosure standards for corporates and explicit sectoral transition pathways are necessary

An official sympathised with some of the comments about the challenge of keeping up with regulation. In the UK the view has increasingly been that the core of the challenge is trying to get firms to explain what their plan and approach is to the net zero transition in a proportional and practical way that is useful for investors and in line with public policy. It will also help support a dialogue and feedback loop between the private and public sector.

The public sector in different jurisdictions is in various stages of development about what sectoral transition pathways look like. The key is getting to a point where there is practical information available that supports cross border capital flows. A genuine debate is needed between the public sector, the industry, academia, and non-governmental organisations (NGOs). In 2022 the UK set up a Transition Plan Taskforce (TPT), that included the representatives from these areas. The Taskforce is going to publish its final guidance and recommendations in the next few weeks. The aim is to build on the platform of the ISSB, and to give firms practical guidance to support the transition plans that are genuinely useful in a global marketplace.

6.2 National, regional, and global public policies must clarify the technologies and timeframe for decarbonising high emitting sectors and the consequences on investments and emissions of other sectors and their pace of transition

An industry representative stated that the key challenge is to ensure that sufficient capital is deployed towards "transition finance". In order to achieve net zero, the financing should go where the emissions are. It is the responsibility of finance to reduce the transition risk, but policy makers and public need to understand that reducing transition risk may temporarily lead to an increase of the "financed emissions" on banks' balance sheet, because they are supporting hard to abate sectors to decarbonize. There is a need to first decarbonising higher emitting sectors such as energy and power.

In Japan and other Asian countries decarbonisation of the energy generation sector is a key priority, because it accounts for roughly 50% of the total CO_2 emissions. Policymakers, society, and the private sector need to agree on the methodology and potential new technologies that allow the achievement of net zero. Ahead of COP28 will take place in the next few weeks and the industry representative's MUFG will present its Transition Whitepaper 2.0 that focuses on the decarbonisation pathways for the hard to abate sectors and discuss how best to deploy public and private capital to support the transition to a carbon neutral state in Japan for the energy and power sectors.

6.3 Adequate energy public policies will reduce cost uncertainty, spark investment, and enable private finance support

An industry representative observed that finance is ready to go, particularly in the global north, but there are too few a lack of bankable projects. The important thing for the policymaking community is to shift its attention away from the fossil fuel supply side to focus on the end-use demand side. EVs need to be brought into the market in order to decrease emissions from the oil sector. That is done by setting policies, building supply chains, dealing with battery metals, and dealing with charging infrastructure. The current amount of EV penetrations is already reducing oil consumption by around 1.5 million barrels per day. In cold-climate countries heat pumps need to go into buildings to decrease emissions from burning natural gas emissions. That is done by building the supply chain, skilling up the workforce and creating the incentives. The finance will be there to support it, but it has to have the right price signals and the right environment.

6.4 Ongoing coordination is necessary to work out and adapt national transition plans and subsequent legal frameworks

An official stated that achieving the long-term objective requires planning and a clear coordination of efforts between the public sector, the private sector, banks, and companies. In France, the Minister has recently created a committee for the financing of the environmental transitions, which gathers top level representatives of the industry, the banking sector, and public authorities to find solutions.

An industry representative highlighted that the transition is continuous work for the public and private sector. Some fine tuning of the technical aspects of the legal framework need to take place. Sustainable finance is a big topic for the private sector and for the financial industry, and a key priority for the public sector.

The Chair thanked all panellists and noted that there is a consensus on the objective. The transition is accelerating, but much still needs to be done to reach the target. Consistency in terms of regulatory frameworks at national, European, and global level would be helpful, but also terms of communication. The frameworks also need to be proportionate.

Climate change insurance needs

1. Protection gaps and climate change risk

The Chair highlighted that protection gaps and climate change risk remain an ongoing topic at both national and international levels given the impact of recent floods and storms in Europe. It is becoming expensive for insurers to step in to help those suffering damages, but some say that more needs to happen. The panel will focus on how to address this.

2. An outline of the insurance gap out of a still unclear climate related risk landscape

2.1 Transition risk remains the main focus of the insurance sector

An official stated that the community of supervisors unanimously believes that the biggest risk is the transition risk. Insurance groups participating in data collection for the International Association of Insurance Supervisors (IAIS) global monitoring exercise have highlighted that transition risk is difficult to measure and assess. The majority see the situation deteriorating heavily in the next 10 years, making climate risk a top priority for supervisors globally.

2.2 Wide discrepancies exist regarding the insurance gap in the EU

The Chair noted that in Europe insurance coverage levels against natural catastrophes stand at 25%.

An official stated that the extreme weather events in Germany over the past 20 years had each cost on average €1 billion of damage, although the coverage ratio of 52% was good in the European context.

2.3 Insurance gap's actual impact depends on the physical and economic resilience of people, communities, businesses and countries, and their adaption capabilities. Insurance is key to improve the speed of recovery from natural disasters

An industry representative highlighted that climate risk is a consequence of a number of factors including the weather itself, the state of the climate and exposure, and the consequence to the resilience of people and communities. Developing countries are being subjected to changes in weather patterns, so their vulnerability to weather events is very high, alongside little protective infrastructure, tight budgets and zero insurance protection. Globally 45-50% of losses are insured, but in some parts of the world this is 0%. Losses from a natural disaster can amount to a significant proportion of GDP for small island nation, sometimes over 100%. There is no finance for redevelopment and investing in resilience structures. Every percentage increase in insurance improves the speed of recovery from natural disasters and any protection gap can prevent countries achieving development goals in future years.

2.4 (Re)insurance needs in still transitioning emerging countries are clashing with demanding greening objectives in developed economies

A market expert highlighted the Just Energy Transition Partnership (JETP) between Europe and rice growers in Vietnam as an example of what can be done with all emerging countries. A pool of rural cooperatives are seeking a system of natural catastrophe cover to enable them to export their rice, but this is unaffordable due to the existing system of cap bonds. Local insurance companies seeking cover in Europe are told that capacities have been spent on the remaining European coal electricity infrastructure, which results in macroeconomic risk with demographic and social consequences. The JETP signed between Europe and Vietnam will help transition from coal to renewable electricity and devote part of the funding to reducing the cost of reinsurance. The United Nations Industrial Development Organization (UNIDO) should be involved in such projects.

3. Triggering swift adaption ahead of accelerating natural disasters is a complex challenge

A regulator stated that almost every state in the US has dealt with some form of catastrophic weather event, which impacts financial stability, the economy and the security individuals. Often it leads to access of coverage either people cannot get insurance coverage or afford coverage. Consumers are often confused about what coverage is available and there are gaps in coverage where insurers and reinsurers cannot participate. Some consumers only realize the inadequacy of their coverage after the event once it has happened.

Some catastrophic weather losses can be prevented or at least mitigated. In California, Colorado, and Oregon the wildfires are climate-related and man-related due to a lack of control of vegetation that has created highly combustible situations. In the southeast works to improve building codes will help make buildings more resilient to extreme weather events. There are some states that have developed a high-risk pool where money is collected to help homeowners prepare and become more resilient, making the market fairer and more adaptable.

The Chair commented that an ecosystem is needed to work together to address the issue, so that consumers and communities can find ways to prevent and mitigate risks, and this can be incentivised by insurers.

3.1 Forward-looking risk analysis in this ever-accelerating weather transformation helps adapt insurance undertakings solvency, which in turn contributes to stimulate citizens, communities, and corporates' adaptation

An industry representative highlighted several industry initiatives to integrate climate change into risk assessment models so that insurers can anticipate the reformation of the claims in the future and set aside provisions. The Autorité de Contrôle Prudentiel et de Résolution (ACPR) pilot test, an initiative of 15 insurers, concluded that the risk was a moderate exposure for the industry overall and that claims costs could be multiplied five or six times in certain departments in France.

The digital insurance and long-term risk (DIAL) chair has developed valuation models to estimate the number of potential additional deaths in the case of a heatwave. If the temperature is above 30 degrees for 21 days, with a peak of above 45 degrees, between 7,000 and 20,000 additional deaths are projected. The pilot test was unfavourable to those industries that have the highest greenhouse emissions, because reducing carbon footprint can improve sustainability in the future.

Forecasting and forward-looking models are critical to anticipate what phenomena will happen in the future, enable the verification of the effectiveness of responsible investment policies and take preventative actions.

3.2 Data gaps and capacity building are key challenges for the supervisors globally, to further leverage climate-related scenario analysis for assessing risk

An official stated that scenario analysis is rapidly evolving and an important tool to obtain an assessment of the possible impact of climate risk on insurers' balance sheets. IAIS has been supporting members to conduct climate-related scenario analysis and also to share their experience through workshops. A paper will be published later this year discussing what can be done to support insurers to conduct a climate-based scenario analysis and the more people that contribute the better; assessments can be refined to obtain more relevant results and support good policy decisions.

4. The clarification of climate relate risk would help reinforce reinsurance and cat bonds markets, which are critical for the insurance system in the uncertain context of fast-developing natural events

A market expert highlighted that the protection gap is widening more quickly than the rate of growth of economies, according to The Centre for Risk Studies at the University of Cambridge. There is a need to reintroduce insurance, especially reinsurance because reinsurance helps to accelerate the recovery of economies to better prepare for new challenges and, in coordination with public authorities, educate the population on risk awareness.

An industry representative concurred that reinsurance is a critical component of the system and that the supply of reinsurance has expanded over the last 15 years. The reinsurance cost was at its lowest ever in 2017 and since has been increasing in price with supply restricting due to the current comparatively inflationary environment. The increase in the frequency of weather events as well as inflation is impacting the cost of recovery.

It is better to invest in data and models, not just on climate, but on the risks themselves. This data is not always reaching the insurers, and so there are many parts of the world in which there may be no information about the types of risks that are being insured. The assets and climate modelling data has to improve to achieve the understanding required to obtain cost-effective reinsurance. Reinsurance pools are being set up in some places in the world to enable cheaper access to reinsurance. For example, the Caribbean Catastrophe Risk Insurance Facility (CCRIF) pools risks to obtain more favourable coverage in the international reinsurance market than could be accessed as individual states.

5. What roles for public authorities, the insurance industry and citizens

The Chair commented that there is clearly a role for public authorities, but also for people. All elements should be part of the solution.

5.1 In a context where natural events make certain risks increasingly uninsurable the first area for cooperation between the public sector, the insurance industry and local communities is to help consumers understand the risk that they are facing

A regulator highlighted that protection gaps continue to widen rather than narrow, occurring where the insurer looks at risk as unsustainable and cannot participate. It is either unaffordable for the customer or they are unaware they need the product. Consumers will buy if they understand the risk that they are facing, and the industry can do a better job informing customers about their need for coverage. Consumers may have an inappropriate understanding that somehow government will come to their rescue when there is a catastrophic event, which it may do to some degree, but never to the extent needed. The NAIC is doing its own catastrophe modelling and data collection to determine where the gaps are in each individual state.

5.2 Avoiding investors and risk carriers leaving the market is essential to better spreading risk. Triggering swift, adequate and pragmatic citizen adaption is key in this respect

A regulator highlighted that industry can be assisted to handle the unsustainable risk by spreading the risk further with pools of multiple carriers. The more that risk is spread the more it will keep carriers from leaving the market. States are laboratories of innovation because the same thing will not work in every state. In many places there are homes and buildings that would not meet US building codes and therefore not withstand earthquakes, hurricanes, and other catastrophic events.

US Regulators and states focus on making communities more resilient. For example, in South Carolina there is a program to provide grants to fortify their homes. The Strengthen Alabama Homes program helps homeowners retrofit their properties to ensure that building codes are passed and strengthened. The Safe Florida Home programme provides free home inspections, so that people can find out what they can do to fortify their homes. Louisiana and Minnesota have passed mitigation programs. Idaho will attempt to pass a mitigation program using premium taxes from insurance companies, which will allocate a proportion towards making homes more resilient to forest fires.

5.3 Having public and private sector partnerships, enabling or adapting risk, mutualisation or reassurance schemes is essential

An industry representative explained that the French public and private sector partnership for natural catastrophes created in 1982 allowed for a small amount of money to be set aside from each home policy to go into a general public fund allocated to cover natural disasters. The mutualisation of the fund means that it can be taken advantage of to cover the risk and disaster. It is an excellent system but will need to be adapted in certain elements given the acceleration of climate change and catastrophic events.

France Assureurs has issued an initiative to work on the many challenges that need addressing, including new risks like big fires, clay soil shrinkage and swelling, and which are threatening the fund's ability to pay. The threat of marine submersion and erosion could destroy up to 1,500 houses in France by the end of the century. Mutualisation is a great approach and there is a need for public and private sectors to work together with customers and supervisors to address the issue and raise prevention awareness.

5.4 Financial support is by far not the sole effort necessary to address insurance gaps; individual risk mitigation and general regulation adaptation are essential

The Chair noted that when EIOPA had looked at the flooding in Ahrtal only 35% of the individuals that had been impacted had insurance, which had led to a discussion about how to insure the houses that had been built back in the same place.

In terms of what else needs to be done at a policy level, an official highlighted the differing roles for the public and private sector. The private sector needs to signal that prevention is key, because loss prevention is effective and a premium should be given if preventative measures are being taken. On the public side it is important to have stricter building codes and, for example, invest in higher buildings on the German coastline.

The Chair agreed that not everything can or will be covered by public money and to do so might be an inefficient system, but there is still a role for public authorities, insurers, consumers, and the worldwide community. EIOPA has published a paper with the European Central Bank that starts with what the individual can do to mitigate, how the insurance sector can help to incentivise and build insurance and reinsurance capacity, and to ensure that there is capital. Risk pooling in a multilateral context can bring public-private partnerships to a national level. The takeaway is that an ecosystem will be needed to deal with this problem, rather than pushing risk to public authorities, which cannot solve this problem alone.

Sessions VI

CMU NEXT STEPS AND CHALLENGES

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Capital markets growth: impact from CMU

Introduction

The Chair observed that there are seven months left in the current political cycle. The renewal of the institutions in Europe will then lead to some delays in the adoption and implementation of new legislations.

A letter from the Finance Ministers of France and Germany (published in the Financial Times on 13 September 2023) advises that work must intensify on the Capital Markets Union (CMU) to close the EU capital markets gap. The letter draws comparisons with what is happening in the US and mentions listing, retail investment, securitisation, sustainable finance and building clearing infrastructure capacity in Europe as areas needing to advance. The letter states that 'Europe has made substantial progress but we have only laid the groundwork. We need a new dynamic if we are to build a genuine CMU worthy of the name for our citizens and businesses'. This statement shows that there is still political momentum behind the CMU, although the initiative was not mentioned in the latest State of the Union speech.

1. State of play of the CMU initiative and progress made in the growth of EU capital markets

1.1 Significant progress has been made on the CMU legislative agenda

A policy-maker stated that the Commission has delivered all the 16 legislative proposals of the CMU 2020 action plan. Eight of these proposals are still being negotiated by the co-legislators. The elaboration of these proposals, taking into account significant input received from the public and private sectors, has been a demanding but successful endeavour. There is no room for complacency however, as these proposals still need to be implemented through concrete actions, which will take time. The Commission has provided an enabling framework, but further engagement is required from the member states and the industry to transform these texts into meaningful actions. It is therefore crucial that member states play their part in implementation and complement measures taken at EU level with reforms in local markets. The letter from the French and German Finance Ministers is encouraging in this regard.

The policy-maker highlighted a number of deliverables under the three headings of the 2020 CMU action plan. With the Listing Act now under negotiations it will be easier and cheaper for companies, in particular SMEs, to raise capital in the EU stock markets, thus contributing to the first goal to support the diversification of company financing, which remains a matter of concern in the EU. The network of SME envoys at EU level is also expected to play a role in this regard. The Retail Investment Strategy (RIS) is expected to increase citizens' capital market participation in line with the second heading of the 2020 action plan. The third heading is about further integrating national capital markets. The agreement on the MiFIR review proposal is a success in this regard and notably the decision to implement a consolidated tape (CT) of trading data on secondary markets.

An official was also optimistic on the CMU and emphasised the commitment of the EU institutions to moving forward with its implementation. Capital markets are crucial to convey finance into the real economy, which is particularly important given the realisation that public funding will not be sufficient to finance the digital and sustainable transitions. In a statement made in the margins of the April 2023 ECOFIN meeting in Stockholm, the EU Council, Parliament and Commission committed to advance as fast as possible with the completion and implementation of the CMU 2020 action plan and, where possible, finalise negotiations on the main outstanding files before the end of the current legislature. Less than four months later, political agreements have been reached on four significant CMU proposals that will contribute to increasing the efficiency and transparency of EU capital markets: the European Single Access Point (ESAP), the Central Securities Depositories Regulation (CSDR), the review of MiFIR, and the review of the AIFMD and UCITS directives.

A regulator stated that the large number of CMU initiatives currently in progress are a very significant step towards making EU capital markets more attractive. There is no CMU silver bullet, so the progress will be incremental. In addition, political will, as demonstrated by the recent statement of the German and French Finance Ministers will help to drive the initiative forward. The agreements that have recently been achieved on the ESAP, and the ELTIF, AIFMD, UCITS and MiFIR review proposals are important milestones for the development of EU capital markets. The political agreement on the MiFIR review and the CT is a significant step forward in particular. These measures could be a gamechanger, bringing transparency to the markets via a CT, consolidating all the vital information from European capital markets and improving the integration and efficiency of the European markets. ESMA is committed to supporting these initiatives, not least by ensuring that the selection of different CT providers is completed in a very short timeframe.

1.2 EU capital markets remain under developed

A regulator commented that, unfortunately, European capital markets remain underdeveloped, as shown by market data. Despite significant progress on the legislative proposals of the CMU, much remains to be done to further develop EU capital markets. Market growth is limited, although this is partly driven by the current adverse macroeconomic environment. In 2022, there were just 44 new listings in the EU, worth €10.2 billion, with one IPO accounting for 90% of that amount. In 2021, only 11% of global IPOs took place in the EU, while 38% were in the US, 18% in China and 4% in the UK. In 2022, the amount raised in primary equity markets was reduced by 60% compared to 2021. There have also been a number of de-listings from public markets, although this trend is not specific to the EU. Work should focus on making the raising of capital on public markets more attractive and more of a focus point for companies.

A second regulator agreed that, although much has already been done in the context of the CMU building, the length of the process and the slow growth of capital markets in Europe remain a source of frustration. Efficient European capital markets are critical to contribute to the huge financing needs of the green and digital transformations, but also to strengthen the strategic autonomy of the EU. Brexit has been a gamechanger in this regard. The European Union now has to develop its own markets and financial players to provide sufficient funding of the European economy. Recent geostrategic evolutions have emphasised further the importance of strengthening the EU's strategic autonomy in all areas of the economy, including finance.

Although the US are not necessarily a relevant reference point due to a different institutional setting and approach to finance, a comparison with the US markets shows that EU capital markets have significant room for development and that there is still a long way to go to achieve the objectives of the CMU. For example, securitisation has not picked up in the EU since the financial crisis, whereas it has increased in the US. Efforts must be made to 'close the gap', as suggested in the French and German Finance Ministers' joint letter of September 2023 (building on the Council conclusions of March). Listing is not sufficiently popular in Europe either, even though Paris has become the largest financial centre by market capitalisation in the EU, with approximately €3,000 billion in market cap, before London. It is hoped that the Listing Act will be a game changer, increase the incentive for listing on public markets and encourage listed firms to raise more capital on markets than they do at present.

There have also been several positive developments in the EU capital market in the last few years that are a source of optimism, the regulator added. Private equity has developed. The cross-border provision of financial services has increased. ESMA figures show that, in 2022, 7.6 million clients in the EU were using cross-border financial services. The diversification of financing has also improved to a certain extent. Debt financing from capital markets now accounts for almost 20% of non-financial corporates' credit financing, up from 10% in 2008. Another positive factor, at least in France, is retail investor participation which is slowly increasing and returning to levels seen before the financial crisis. Surveys indicate that younger investors are coming to the capital markets more. This is not a major trend, but demonstrates that investor culture is increasing, although there is still much to do in terms of retail participation. The CT and the amended ELTIF rules should indirectly contribute to this objective, including for investments in smaller caps, but financial literacy still needs to be further developed.

An industry representative stated that the success of CMU will ultimately be measured by market outcomes. If the number of IPOs and listings and the trading activity in Europe do not improve, not enough progress is being made. Although some CMU regulations will not be implemented before 2027 or 2028, and although there is progress in some areas, the figures previously referred to around numbers of IPOs and listings suggest that the CMU is far from being achieved and that European markets are becoming less competitive compared to the rest of the world. That is concerning, but the objectives of the CMU can still be achieved with sufficient commitment and if the right policy choices are made.

A second industry representative agreed with previous speakers that, while much has been achieved with the CMU in terms of policy framework in recent years, the market impacts are not yet convincing. Europe is clearly being outpaced by the Asia-Pacific region and the United States in terms of traded volumes in the secondary markets. This is less the case for primary markets. Since 2008, European GDP has grown by about 14%, whereas US GDP has grown by about 70%. In the same period of time, European trading volumes in equity options and index options, have been stable, while US volumes have grown by about 800%. This suggests that the EU capital market is insufficiently competitive and does not sufficiently favour efficient risk transfers.

A third industry representative observed that retail capital markets are particularly underdeveloped in the EU. Just under 44% of EU households' total financial assets are still in bank deposits. In the context of a 5% to 6% inflation rate, that is an issue that needs to be addressed.

2. Short term priorities for the CMU

2.1 Next steps under the current legislature

An official stated that the Spanish EU Presidency is strongly committed to advancing the adoption of the remaining proposals of the 2020 CMU action plan. Technical work is being finalised on the MiFIR and AIFMD reviews in particular, with the aim of formally adopting these initiatives by the beginning of 2024.

Three other important measures are still on the table, the official added. The EMIR review will be of utmost importance in strengthening clearing in the EU and mitigating financial stability risks posed by offshore clearing. Work is ongoing to reach general agreement in the Council on this proposal. Negotiations with the Parliament are scheduled to start at the end of November if a general agreement is reached in the Council. A consensus still needs to be found on several points on which there are diverging views, including the active account measure and the supervisory arrangements proposed. The Listing Act and the RIS are currently being assessed by the co-legislators. Both aim to increase the size and depth of capital markets. The Listing Act will simplify listing requirements to encourage enterprises to list and remain listed and remove obstacles to listing, for example with the proposal to implement multiple-vote share structures to address the reluctance of some company owners to lose full control when listing on public markets. An agreement was reached at the Council level on the Listing Act proposal in Spring 2023 and it is hoped that trialogues will start in October. The RIS was launched late during the Spanish Presidency. The aim is to reach a general agreement at the Council level before the end of the current legislature, but this will be challenging because of the complexity and length of the proposal.

A regulator hoped that the co-legislators will make rapid progress on the Listing Act and RIS proposals. These will reduce administrative burdens for SMEs and encourage more retail investment.

2.2 Issues to be addressed concerning the RIS proposal and product complexity

An industry representative welcomed the RIS proposal recently put forward by the European Commission but advised that the priorities pursued should be adjusted. There is an excessive focus on product costs in the proposal, based on claims that investment product fees are too expensive in Europe. In reality, the price of UCITS equity funds decreased by an average of 6% during the last five years, which is quite significant in an inflationary context. The price of a UCITS fund in Europe, on average, is equivalent to the price of an actively managed mutual fund in the US. The focus should instead be on other essential objectives, such as improving financial education or product disclosures. A Eurobarometer study revealed that less than 20% of people have a high level of financial education in the EU. Product information, such as the key information document (KID) mandated by the packaged retail investment and insurance products (PRIIPs) regulation, is still too complex and insufficiently meaningful. There is also the challenge of encouraging risk-averse European retail clients to invest in capital market instruments in a context where the rise in interest rates means that they can now get 3 to 4% return on guaranteed capital products.

A regulator emphasised that, with the current low level of financial literacy in Europe, it is essential to protect investors from products that are insufficiently transparent or too difficult to understand, such as some structured products, in order to build customer trust. The RIS aims to ensure that retail investors can benefit from advice and that advice is provided in the interest of investors, but more should be done to protect investors from complex products in case of direct investment without advice.

A second industry representative noted that some measures aiming to enhance transparency for investors do not target the right products. Many member states have rightly used their product intervention powers to direct retail investors away from structured products, which lack transparency and may be relatively costly and risky. However, some simpler exchange-traded and listed products have inappropriately been grouped together with structured products in these measures. For example, futures and options are grouped in the same category as contracts for difference (CfDs), even though they are transparent on exchange products.

3. Priorities for the next steps of the CMU

3.1 Overall priorities for the future steps of the CMU

A policy-maker stated that a number of capital market directives will need to be reviewed as part of the future steps of the CMU, although there should be no need for a major overhaul. In addition, there should be a focus on initiatives that foster further growth of European capital markets in order to support the green and digital transitions. The European Green Deal, for example, a key initiative of the European Commission, will need to be strongly connected to the CMU in order to achieve the necessary transition aims by 2030. Improving pension schemes and taxation could also be gamechangers for the CMU, but will be challenging issues to address at the European level. Supervisory convergence and home-host aspects will also need further consideration to ensure that EU legislation is implemented in a consistent and effective way across the Union.

A regulator noted that measures around pension schemes and taxation have helped some local capital markets to develop successfully in the EU, for example in Sweden. However a few successful local markets are not sufficient to achieve the CMU. An objective ahead is to leverage these individual domestic success stories for the development of a broader European capital market, with the support of the Commission and member states.

An official emphasised the importance of supporting the financing of SMEs and start ups, which are the backbone of the European economy, in further work on the CMU. The funding mix of SMEs at different stages of their growth must be further diversified. Much remains to be done on this at the EU level and by member states domestically. Spain has been very active in this regard recently, with the Business Creation and Growth Act and evolutions of the securities law. A growth market has also been created by the Spanish stock exchange, as well as a new scale-up market.

An industry speaker stated that financial market infrastructures (FMIs) have an important role to play in achieving an efficient and robust functioning of capital markets and accelerating their growth. Strong FMIs can promote liquidity, increase transparency, and reduce risks within the EU capital markets as well as support investor confidence. FMIs can also help to address the needs of various issuers and investors. To support their competitiveness, FMIs need to invest in terms of digitalisation, products and services. More needs to be done for developing SME segments in particular. Stock exchanges are also investing heavily in blockchain technology to develop new types of trading venues. Legislators and regulators also need to embrace necessary changes and facilitate regulatory harmonization, streamlined procedures, and an alignment of national rules. Important examples of measures needed include efficient tax rules that do not favour 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.

3.2 Moving towards a single rule book and a further integration of EU capital markets

An industry representative observed that there is a fundamental choice yet to be made between moving towards a fully harmonised and integrated European capital market or maintaining a conglomerate of different domestic markets that are somewhat connected. The present situation, with 20% of common rules and 80% of differing requirements across EU countries needs to evolve to 80% of common rules at EU level. For example, authorisation, supervisory reporting and information provision processes should be further streamlined, with a unified provision of information to local and European supervisors in a one-stop-shop approach.

A second industry representative agreed that progress towards a single rulebook is a key objective. There is currently often a single rulebook in name only, not in implementation.

A third industry representative concurred that capital market rules need to be further harmonized. From a buy-side and asset management perspective, there are still 27 different markets. The UCITS framework and its passporting regime are a great success but the European fund market remains very fragmented, with marketing documentation requirements that differ across the 27 member states for example. This is different to the situation in the US, where there are no differences in these rules across states. In addition, full consistency between Level 1 and Level 2 rules must be ensured when implementing the reviewed ELTIF framework so that retail investors can access these new products.

3.3 Enhancing convergence and the capacity to adapt to market evolutions

A regulator stated that European capital markets are still too fragmented to be successful. Efforts are being made at ESMA level to move towards further convergence of securities rules between the 27 member states. An active support of the national supervisors is also necessary to achieve significant progress in this regard.

A second regulator underlined that the EU legislative framework needs to be implemented in a homogenous way across all Member States. More consistency will alleviate the inefficiencies and costs of fragmented markets and avoid regulatory arbitrage and supervisory shopping, which are detrimental to investors' confidence. If there is not enough confidence in the markets, it will be difficult to develop retail investor participation in particular, which is one of the keys to developing the European markets. It is a crucial moment to make progress in this direction, as many Level 1 CMU texts are in the process of being adopted and will need to be implemented in the short to medium term.

Answering a question from the Chair about the possibility of granting ESMA new powers, the regulator noted that a more unified supervision would help to achieve a more consistent implementation of EU legislation, although it has unfortunately faced a lack of political appetite so far. Where there is room for ESMA to have more impactful powers, this should be encouraged however, as well as the efforts undertaken by ESMA to foster supervisory convergence. In the RIS there is also a welcome proposal to improve the equilibrium of powers between home and host supervisors in the cross-border retail investment space. In France, many complaints received by the regulator from retail clients stem from the cross-border provision of products and services. Therefore, host supervisors must be able to intervene to protect investors where necessary; cooperation mechanisms between home and host supervisor must be enhanced in this context. Some additional quick fix initiatives also need to be considered to help supervisors adjust regulation to new market developments, such as the possibility of using so called no-action letters at European and national levels.

An industry representative agreed with the suggestion of implementing no action letters. Supervisory tools should be adapted to be made more workable for supervisors.

A second industry representative concurred that enabling supervisors to make technical changes to regulations to adapt them to market circumstances, whether by changing technical standards or issuing no action letters, would improve the competitiveness of EU capital markets. Stronger centralised supervision is also necessary, certainly for the wholesale securities markets. ESMA is the logical place to locate that centralised supervision.

3.4 Focusing on measures that support the competitiveness and growth of European capital markets

An industry representative stated that the policy objectives that have been pursued by the Commission across the various CMU action plans, such as enhancing the transparency and competitiveness of capital markets, are the right ones. The problem is that the regulations and tools put in place do not always support these objectives. Regulations are often more prescriptive or restrictive than necessary detailing how and where products or instruments should be traded or cleared, which may hinder innovation and growth in the financial market. This may result in a one-size-fits-all approach being applied to a variety of market participants that share few commonalities, limiting the development of the most innovative firms. For example, the prudential rules for investment firms, the Investment Firms Regulation/Directive (IFR/IFD), apply banking rules to investment firms. This does not encourage investment firms to innovate and grow in Europe, potentially depriving Europe of strong players with international reach. Policy choices going forward should focus more on making Europe a growth area for financial firms, with more proportionate rules and a stronger focus on activity-appropriate and evidence-based requirements. This will support the objectives set out by the German and French Finance Ministers in their letter and help turn Europe into a global trading hub.

A second industry representative suggested that a competitiveness check should be systematically performed when new regulations are proposed to evaluate their impact on the competitiveness of EU capital markets and players. A strong CMU will not be possible without strong European market players and at present the number of EU players that are in a leading position at the global level is too limited.

Retail Investment Strategy proposals

1. Overall objectives of the Retail Investment Strategy

1.1 The Retail Investment Strategy, a key component of the CMU

The Chair observed that the Retail Investment Strategy (RIS) is one of the flagship initiatives of the Capital Markets Union (CMU). The measures proposed in the RIS proposal published on 24 May 2023 cover many different areas, including product distribution, advice, product disclosure and information, investor access, education and supervisory cooperation.

An investor representative stated that the RIS is a unique opportunity to create a CMU that works for retail investors, which is one of the key objectives of the CMU. In the public debates on the RIS, there has been broad agreement on the need to increase retail participation in the capital markets and an acceptance that this will only happen if there are better outcomes for consumers. Transparency and trust will be crucial factors in driving increased retail participation.

A regulator emphasised that the RIS adopts a cross-sectoral approach that will apply similar rules to all packaged investment products, including investment funds and insurance-based investment products (IBIPs). This should contribute to building investor trust.

An industry speaker emphasised that the need to develop retail investment is made more acute by ageing populations across Europe and the requirement for new investment in the energy transition. More than €500 billion will be needed to modernise Europe's outdated energy grids, which will have to come in part from retail investment.

A challenge however, an industry speaker noted, is that many European savers are risk averse. They worry more about maintaining their capital rather than obtaining significant net return. This explains why guaranteed savings products remain popular although they provide a real negative return when considering inflation.

1.2 Enhancing financial literacy

An industry speaker emphasised that improving financial literacy is one of the main challenges faced by European society and should be a key objective of the RIS. Investors must be taught to invest into capital markets in order to improve their long term financial prospects. School curricula must be reviewed to include this. This is becoming even more important in light of the ageing populations across Europe and is also a challenge in many other countries, notably in Asia. This will also create more demand for investment solutions and contribute to increase retail investor participation over time.

A regulator agreed on the importance of improving financial literacy and noted that financial education is already part of the Belgian school curriculum. People need to be aware of the need to invest for the long term and the benefits they can get from financial advice. Retail investors will only fully benefit from the RIS proposals if they have a sufficient level of financial education. For example, to benefit from additional disclosures, retail investors need to be able to understand the information that is being provided. Financial education is also needed to ensure that investors understand the risks and opportunities offered by the green and digital transitions and can detect possible scams or misguided recommendations made by financial influencers. Another regulator agreed that it is crucial to make progress on financial literacy, and also underlined that the role of influencers needs to be addressed. France has recently published a new regulation on the latter subject, notably creating a certificate for 'responsible' finfluencers.

A third regulator noted that conducting initiatives on financial literacy is essential. This will require extensive work at European and NCA level. However, not all NCAs currently have a mandate in this space.

1.3 Strengthening cross-border supervision

A regulator welcomed the measures proposed to improve the equilibrium between home and host supervision. There is indeed increasing cross-border provision of financial services in the EU under the freedom to provide services principles, which is due to continue with digitalisation, but investor complaints about transactions and services provided on a cross border basis are also growing. Therefore, without questioning the European passport, the relations between home and host supervisors must be enhanced. Since the passport is still not supported by a single supervisory model, the enforcement powers regarding conduct and product governance rules should also lie with host supervisors, to ensure a homogenous implementation of regulations across the EU.

2. The RIS proposals on value-for-money

2.1 Objectives of the value-for-money measures

The Chair explained that the value-for-money (VFM) measures will require manufacturers and distributors to compare their products against relevant product benchmarks developed by ESMA or EIOPA to ensure that they provide retail investors with sufficient VFM. The assessment of VFM should not only include cost, but also performance and a wider range of characteristics that create value for retail customers.

The objectives of the VFM proposals were welcomed by several panellists.

A regulator stated that improving VFM should help build the trust of retail investors, which is essential for increasing retail engagement in the capital markets. Investors must believe that they will get VFM when they embark on their investment journey. ESMA's annual reports on cost and performance show that high product costs have a significant effect on investor returns. The Common Supervisory Actions (CSA) undertaken with the national competent authorities (NCAs) have identified cases of overcharging, which negatively impact the outcomes for retail investors.

Another regulator underlined that more investors' engagement is needed. The concept of VFM is key in this perspective. Supervisors have an essential role to play (through their controls, they may witness unacceptable cost structures that do not allow any return for investors).

Under the VFM proposals, manufacturers and distributors will be expected to assess the cost and performance of products against regularly updated benchmarks, the first regulator noted. Benchmarks can be helpful for allowing supervisors to identify outliers that are not providing sufficient VFM. However, the VFM proposals could be made more effective by disclosing these benchmarks and comparisons to investors as well as to supervisors. These benchmarks could indeed enable investors to compare products, make better decisions and potentially obtain a better deal in a competitive market.

A third regulator considered that the VFM proposals should be beneficial to retail investors. These measures further develop and enhance existing requirements in MiFID and the EU AIFMD and UCITS fund frameworks and also take into account recent initiatives at European and national level around product costs, such as the ESMA CSA. The benchmarks proposed will introduce more objectivity in the assessment of product costs. This is not price regulation, but a way of identifying outliers and enabling the NCAs to tackle them with the firms concerned. As the RIS introduces explicit rules and more objectivity, this can make supervision easier and more efficient, and it should contribute as well in enhancing convergence. The significant focus on documentation in the proposals will also facilitate supervision and increase the responsibility of product manufacturers and distributors in this area.

An investor representative was supportive of the VFM framework as a way to improve outcomes and create better safeguards for retail investors, even though its goal is mostly to enforce the existing rules. The perspective of higher long term returns should encourage more retail investment and therefore the VFM framework is a positive step forward.

Some panellists were however in favour of considering alternative approaches to improve VFM.

An industry speaker regretted that the discussions about VFM have focused mainly on costs and product benchmarks. These considerations might be relevant for people who have already made investments, but they will not attract new investors. The objective should be to enforce the existing rules more effectively with a focus on tackling outliers, rather than imposing new rules.

A second industry representative suggested that the VFM objectives could be more effectively achieved in the context of the governance of fund management companies, by ensuring that the independent directors of fund management companies have a clear mandate to consider product costs.

A third industry speaker felt that benchmarks do not need to be coordinated by regulators; the process can be handled by the market as for household appliances.

2.2 The definition of product benchmarks

Several panellists emphasised the importance of adopting a holistic approach to VFM benchmarks rather than focusing solely on cost.

An industry representative stated that the current proposal regarding product benchmarks is too cost-centric. This is not how clients think about their investments. VFM is not only about cost; it is also about performance. Clients want to understand how their investments are performing, the risks they are facing and whether they could obtain a better performance with another product. In addition, consumers' interests go much further than net return: they are interested in advice and in obtaining information about new market developments such as ESG. Comparing the fees across different products is secondary for most clients. Any product comparisons should take into account all of the different factors of performance. It would also be more useful to provide investors with an indicative median return net of fees, rather than comparing product costs.

A second industry speaker emphasised the importance of taking a holistic view to VFM, which is driven by different factors. The main driver is performance, which includes cost and also other factors. The first of those is risk. Customer's tolerance of risk will depend on the situation of the customer, their investment horizon, the composition of their household, their tax environment and their life project. The liquidity of assets is another important consideration. There is an increasing appetite for real economy assets such as private equity assets, for example, which are less liquid than securities. Some other customers want to prioritise objectives such as ESG, sustainability or EU sovereignty in their investments.

It is also important to take into account some of the qualitative dimensions of VFM, such as the quality of service or of the trading platform, the industry speaker added. Some customers will need support not only during the transaction but also over time, notably during periods of crisis. The execution platform needs to be efficient and user friendly, with the ability to provide human interaction where necessary. The reputation of the management company and the track record of the firm intermediating the transaction are another part of how a customer will view an investment solution. The advice a customer may receive will be another key component, as well as its scope i.e. whether it is limited to a transaction or extends to broader wealth management. This holistic approach to VFM is at the heart of the industry's business model and is the basis of the competitive game in the retail investment business.

A third industry representative considered that transparency and product comparability are important for investors, but it will be difficult to build the type of product benchmark framework envisaged in the RIS. These proposals might also have the unintended consequence of fixing a price cap on investment products. This would be detrimental for the development of high performing products that may support the EU's strategic objectives of increasing long term and sustainable investment. Such an approach could be particularly damaging to European Long Term Investment Funds (ELTIFs), which are inherently expensive to manage due to the cost of accessing the private markets. Equally, sustainable investments involve higher governance and monitoring costs, which will need to be factored in.

The Chair underlined that VFM is about more than simply the price of the product. The challenge is in striking the right balance between the different factors to take into account. The concept must not be overly static either.

An investor representative highlighted that the RIS proposal explicitly mentions performance as well as cost as the two crucial factors for assessing the VFM of investment products. The impact of costs must not be overlooked. Studies on cost and performance in UCITS funds have found a correlation between higher fees and lower returns and shown that high fees were almost singlehandedly to blame for disappointing real returns for investors. Better Finance's research also shows that the costs of retail investment are often too high and identified cases of overcharging.

A regulator agreed that a holistic approach to VFM is needed including costs and different factors of performance such as risk-return and liquidity. The concept of VFM already exists in the current regulatory and supervisory framework, but the RIS proposals will allow to enhance it further. The solution cannot be one-size-fits-all either as the perception of VFM may vary across investors depending on their personal situation, the moment in their life cycle etc.. The use of benchmarks should enable to facilitate the comparison of packaged products on criteria that are important for a majority of retail investors. In the past, supervisors have had to use their enforcement powers to deal with unacceptable products with advertised levels of returns that were impossible to achieve with their cost structure.

Another regulator also noted that VFM is not only about cost, but about the overall value for investors. This should be taken into account in the benchmarks established by ESMA and EIOPA. The idea of performance scenarios should also be reconsidered as work continues on improving the Key Information Document (KID) for packaged retail investment insurance products (PRIIPs).

2.3 Implementation challenges concerning the VFM measures

A regulator stressed that implementation will be key for the effectiveness of VFM requirements. This requires a careful drafting of the level 2 and level 3 measures, which will be challenging. Another regulator explained that ESMA will be playing an important part in the implementation of the VFM proposal. There is still a large amount of detailed work to do to define the product benchmarks and determine how they can be used in the supervisory process. Detailed requirements will be needed to build the benchmarks, including clear definitions to ensure there is broad agreement on the aims of these measures. Data will also be needed to build the benchmarks, which might lead to additional reporting obligations.

Another regulator highlighted the main challenges raised by the implementation of the VFM measures. First, there is the need to build an appropriate methodology to establish the benchmarks. One part of the work in the design phase will be to produce a cost structure that is meaningful for supervisors and clients, using a sufficiently holistic approach. There will be a challenge in identifying the relevant peer groups, especially if the benchmarks apply across Europe, because retail investment markets are very fragmented and differ quite significantly from one country to another, making it difficult to make comparisons across products. In the Netherlands, for example, pension funds are very important, while in France, life insurance products and regulated savings accounts are more prominent. Tax treatments vary also, as do financial investment cultures. There will be a second challenge around the assessment of product performance. Under the current PRIIPs framework, forward-looking performance scenarios are compulsory and the use of historical performance is prohibited. However historical data can also be useful for certain investors to understand how a product has performed in the past. Finally, there is a challenge about the data on which these benchmarks will be based, because creating an additional unnecessary layer of reporting should be avoided. The data from PRIIPs KIDs could be a basis for establishing the benchmarks potentially.

An investor representative acknowledged the concerns about the difficulty of implementing the VFM measures. EU policy-makers should compare the measures proposed in the RIS with some lighter measures such as the value assessments introduced by the UK Financial Conduct Authority (FCA). Similar measures could be very beneficial in the EU.

An industry speaker agreed that the implementation of the VFM measures is a complex challenge. The information given to consumers should also be concise, understandable and useful to avoid a detrimental information overload. The framework should also be innovation friendly and stable. This will be a costly process, which will require significant investment from financial firms.

Another industry speaker felt that it will be challenging to implement a system of benchmarks. Market participants already have difficulties today in mapping funds to fulfil NCAs' reporting requirements. Agencies such as Morningstar also face challenges for certain products, let alone (hedged) share classes and currencies. How this type of benchmarking can remain feasible while still having the required impact remains to be clarified.

3. Measures on inducements

3.1 The issues raised by a ban on inducements

An industry speaker stated that a ban on inducements would not be helpful. The experience in the UK and the Netherlands has shown that banning inducements causes some retail investors to leave the market because they either cannot afford or do not want to pay for advice. A ban is also difficult to implement with the current low levels of financial literacy across the EU. Most investors need advice, and this advice has to be paid for by retail investment activity. In addition, distribution has a cost. It is misleading to assume that execution only products are free. Execution platforms cost money to maintain and listing fees need to be paid. It is also not possible to invest at low cost in impact funds aligned with the SDG sustainable development goals. For these reasons, a balanced approach should be taken to each asset class and consumer segment.

A second industry speaker was similarly against a ban on inducements. There are three groups of investors. First, there are people who want to invest on their own and who usually are educated enough to do so. Secondly, there are wealthy people who are able to pay for personalised advice. Thirdly, there are average retail customers who cannot afford to pay for advice or are not ready to do so, but need to have access to advice in order to take appropriate investment decisions. The best way to provide advice for this third category of customers, which represents the majority of retail investors, is to mutualise the cost of advice among market participants. Inducements are the most effective way to do this.

A third industry representative agreed that retail investor participation will not increase unless retail investors are able to speak to human advisors during the investment process. The only way to pay for this advice in the current system is through the use of inducements. If inducements are banned, the cost of advice will be too high because it will no longer be mutualised and advice will be limited to the most wealthy clients.

A regulator acknowledged that a complete ban on inducements would have unintended detrimental consequences, but stated that progress must be made on this subject. One area of improvement is to make inducements transparent and facilitate their comparability across products, which would help clients to understand the potential influence they may have on advice.

An investor representative considered that the RIS introduces a welcome ban on inducements for unadvised transactions and extends the measures on inducement to IBIPs. However, member states should not have the possibility to opt out of this ban by making advice mandatory. This would further reduce the already quite limited scope of the inducement ban.

A regulator observed that advice is not free and has to be paid for one way or another. People do not want to pay for it upfront, but they often do not realise that they are paying for it already in an indirect way. This issue needs to be dealt with in the approach to inducements.

3.2 Best interest of the client criteria

An investor representative emphasised that advice must be provided independently and in the best interests of the client. There is a large amount of evidence showing that advice from conflicted parties does not provide good outcomes for consumers. A Better Finance study on the French market and a recent study published by the Regensburg University on the effect of commission bans on household wealth both show this.

A regulator agreed that advice should be in the best interest of investors, meaning that it must be fair, unbiased and adapted to their needs, profile and objectives. Progress therefore needs to be made in this respect. Access to advice must in any case be ensured.

An industry representative highlighted that the 'best interest of the client' criteria that are due to replace the current 'quality enhancement test' for allowing the payment of inducements are confusing, although the principle is intellectually appealing. The concept is based on the best interests of a standard investor, but there is no such thing as a standard investor. Every investor's situation is unique, which is why MiFID requires personal 'suitability' or appropriateness. In addition, the proposed criteria are unclear, particularly the requirement to 'offer at least one financial product without additional features which are not necessary to the achievement of the client's investment objectives and that give rise to additional costs'. Advisors are supposed to recommend the lowest-cost product without unnecessary additional features, but there is no clarity on how this should be done.

3.3 The prospects of digital advice

An industry speaker observed that digitalisation is often presented as a way to further reduce the cost of advice, but financial institutions are already digitalising their processes, including profiling, underwriting and contract management, therefore the incremental gain will be limited in the future. This is a long journey that requires a considerable amount of investment, but it is happening. It is also important to remember that retail investors want to speak with human advisors when it comes to making important investment decisions for the long term. A recent survey conducted in France indicated that 75% of customers want to speak to a human being during the investment process. People are happy to accept a hybrid system, but they want to be able to contact a human advisor if needed for advice or for finalising an investment, which comes with a cost.

A regulator added that digital advice may be a solution in the future, but for the time being most investors, especially those who invest large amounts, tend to be older than the average population. We must remain cautious that a higher reliance on digital advice does not result in a new form of advice gap.

Retail Investment Strategy in the digital age

1. Current state of play of digitalisation in the retail investment space

An industry representative observed that digital investment channels are one of the fastest growing trends in the European investment market, changing the business offering of traditional distributors and supporting the growth of new distribution channels. This trend is expected to accelerate with assets invested through digital channels expected to double to €50 billion by 2026. The use of digital technologies is also helping to streamline the traditional advisory process, allowing advisors to analyse risks at product and portfolio level and select products in a more efficient and cost-effective manner. This is making institutional level portfolio analysis affordable by retail investors. The demand for digital analytical tools is also set to grow with the increase in demand for sustainable investments.

Digitalisation has brought a wave of new entrants to the market that are attracting new investors to the capital markets, the industry speaker added. Lockdowns were a catalyst for bringing new investors into execution-only digital platforms and that trend is set to stay. Exchange-traded funds (ETFs) are also a growing product segment despite the challenging investment environment. There are new digital brokers in Italy and, in France, the digital platform Boursorama ranks in the top 50 visited websites in the country, with over 25 million visitors a year. In Germany online ETF savings plans have grown seven times since 2018. An ETF savings plan enables retail investors to invest a small monthly recurring amount into a range of ETFs of their choice, helping to build long-term wealth and benefit from a smoothing out of market movements. These plans have attracted first-time investors and demographic groups that are under-represented in the traditional retail investment market such as the younger population. Past statistics show that the investment approach of investors in these plans is relatively long-term with holding periods of over eight years, showing that such plans could be a cornerstone for further developing retail investment.

An official agreed that digitalisation is progressing in the investment market. A recent survey in Ireland showed that 62% of retail customers already use online channels. Over 50% are making new investments online, and one in four through a trading app.

A second industry representative explained that digital platforms have been in operation in the life and non-life insurance sectors for several years in Europe, but most of the business is still managed physically. Digitalisation is progressing but the pace of change is relatively slow. The significant investments that digitalisation requires to remain competitive in the future are a challenge for the insurance industry. In addition, insurers must continue to support their existing physical network. The balance between those two approaches and getting the transition right towards more digital distribution is quite tricky. Comparisons with other sectors also show that the first players in the market providing effective digital solutions will likely take the largest share of the business and profit most from those evolutions, which requires significant investment.

A third industry representative noted that digitalisation can provide significant cost saving opportunities, particularly with a fully digital customer journey. However, it is important to consider the facts. Only 2% of sales in the life segment in Germany are purely digital and the reality is that the traditional intermediated model is still the most effective for bringing investors into the market. The majority of distribution is expected to be performed in the future by agents or advisors equipped with digital tools, rather than by direct digital distribution, because personal advice is difficult to perform purely online. Investment decisions are also important decisions and even the younger generation does not use fully digital channels in this case. In the end, distributors will adapt to customer needs.

The Chair commented that the situation is due to evolve. In the future the new generation will likely want to interact in a more digital way, so this reality has to be anticipated.

A regulator considered that the simpler products that are traded or invested in more frequently will generally be those that come down the digital channel, whereas once-in-a-lifetime and more complex products will continue to need a component of human advice. There is now a chunk of activity in the investment and trading space that is ripe for digitalisation, but not all member states are equal in terms of digitalisation of their services industry. Germany for example is still quite under digitalised in parts of its service industry. An industry representative commented that digitalisation is a long journey in Germany because the old legacy systems require renovation alongside the investments needed to further digitalise processes.

2. Benefits and challenges from digitalisation for retail investors

2.1 Main benefits for retail investors

An official observed that thanks to digitalisation capital markets are now much more accessible to retail investors. With the growth of neo brokers and robo advisors and the greater dissemination of financial information via digital channels, many barriers that discouraged small savers from entering the investor space have been removed. There is now a clear appetite among the retail saver population to take advantage of these new opportunities.

An industry representative highlighted that digitalisation can provide retail customers with added value in terms of transparency and ease of interaction. Digital customer portals can for example facilitate access to pre-contractual information and the interaction with customers.

A regulator noted that the digital delivery of investment services brings many opportunities in terms of cost, efficiency and self serviceability, allowing individuals to access the market more easily without having to go through an advisor. There are also benefits in terms of competition. New players, such as neo-brokers, offer different or more competitive services, which ultimately may drive the interest of clients.

Another regulator added that EIOPA research shows that there are clear benefits from digitalisation in terms of product comparison. In a recent survey, 65% of respondents preferred to search, compare and make up their mind online. However, at the purchasing stage 70% preferred in-person advice. People indeed prefer to have some contact with human advisors when making long-term decisions, such as investing in an insurance based investment product (IBIP), because they need tailored advice. The industry should focus on the added value of digitalisation, which is mainly to provide a more effective way to inform customers and help them prepare their investment decisions.

2.2 Main challenges and risks for retail investors

An official observed that the easier access to capital markets facilitated by digitalisation comes with challenges. There is a risk that less informed or financially literate investors might be misled or led astray and there is also potential for financial exclusion in a digital world. There are still many retail investors who prefer traditional channels offering the possibility to interact with human advisors and have paper documents. A number of those may also be among the customers who have larger portfolios and higher investment appetites. It will not be a binary choice between digital channels and human advice. Different access channels need to be maintained, including digitally assisted human channels.

A regulator observed that digital channels have their own risks. It is potentially easier to lead people into more speculative behaviour with digital tools than with analogue tools. Without the social control of human interaction there are greater risks of addiction and being enticed to do things one would not otherwise have done. The fact that betting industries have moved to an online model is illustrative of this. So-called 'dark patterns' can also be introduced in digital investment platforms that attempt to lead people into certain behaviours by the way the trading interface is presented. For example action buttons to encourage trading may be highlighted, whereas the visibility of 'cancel' buttons that may lead people to think twice may be reduced. Action was taken to stop such practices in Germany.

Other issues relate to what happens with the data that individuals provide about their investment preferences, and whether clients using digital service providers always know with whom they are transacting and whether or not these providers are adequately supervised, the regulator added. Since digital services can be provided cross-border at a relatively low incremental cost, some digital platforms may be tempted to seek a less regulated space from which to provide their services, without the client being fully aware of this and of the potential lower level of protection.

Another regulator highlighted several emerging risks from the use of digital tools. A first risk comes from the streamlining of processes on digital platforms, which might not allow a sufficient identification of the customer's expectations and needs, if the questions used to assess the customer's personal situation are over-simplified. This issue also exists in traditional channels, but is more widespread in a digital environment. Second, there is a challenge of ensuring that customers are provided with appropriate information while not getting lost in an overflow of information. Digital channels allow a broader distribution of information, but its quality and relevance need to be ensured, as there is no human filter. Thirdly, the algorithms used in digital channels such as robo-advisors, may produce a bias in the outcome if they are not adequately designed and monitored. The more complex the algorithm becomes, the more difficult it is to spot a possible failure before a large number of people are impacted. It must be possible to understand why a particular algorithm delivers a certain outcome and the integrity of the data used also needs to be guaranteed. Fourthly, it is important to have user friendly and accessible interfaces with clear instructions, as well as a sufficient interoperability across platforms and systems. Finally, care must be taken to avoid digital exclusion and discrimination with digital tools.

3. Expected impacts of the Retail Investment Strategy (RIS) proposals

3.1 Alignment of the RIS rules with the digital environment

A regulator stated that taking into account the challenges raised by digitalisation in the retail investment space is not the RIS's main purpose, but some aspects of digitalisation are touched on in the RIS. There are proposals about adapting marketing communications and pre-contractual information to digital interfaces. In addition, the issue of cross-border supervision is addressed in a context where digital tools facilitate the cross-border provision of financial services and products.

Another regulator observed that although the RIS does not specifically aim to support digitalisation, it should help retail investors to take advantage from the added value of digitalisation in terms of easier access to the market and enhanced competition. Since digitalisation is still an emerging trend, an iterative policy approach will be needed and the RIS is a useful step in this perspective. More generally, there should be trust that, whatever the channel used for accessing financial services, the potential risks to investors are addressed, because that contributes to creating value and reducing costs in the market. The crucial questions are whether proper governance and 'fit and proper' tests are in place at the level of supervised entities, whether the financial education of investors is sufficient and whether risks can be addressed with current supervisory mechanisms. In regard to supervision, with an expected development of cross-border activity supported by digitalisation, closer cooperation is needed among supervisory authorities and investors must be able to verify that an entity is authorised to operate in a given market.

An industry representative highlighted the technology neutrality of the RIS, as the priority is to ensure good outcomes for consumers, whatever the channel used.

Another industry representative suggested that the dots also need to be joined between the RIS and the Financial Data Access (FIDA) proposal aiming to develop open finance. How retail investors can benefit from open finance and control the sharing of their personal data remains to be clarified.

A regulator emphasised the importance of putting the consumer at the centre of the thinking when assessing the impacts of digitalisation, which the RIS can contribute to achieve. With regard to the risk of discrimination and exclusion associated with an increasingly digital and data-driven provision of financial services, it is important to define a perimeter as to what data can be shared and how this data will be shared in the interest of retail customers. The more data that is shared and processed the greater the risk of data breaches and of potential discrimination against the most vulnerable customers. The concentration of data within certain market players that open finance may lead to also reinforces this risk of exclusion.

An official emphasised that for developing a single market for retail investment, trust is needed in the products, the originators and the distributors, and the activities they perform all along the value chain. Supervisors also need to have confidence in their counterparts in other member states. There is a need for confidence that there are adequate legal protections and frameworks to protect customer rights if anything goes wrong. The RIS and the overall Capital Markets Union (CMU) package of which the RIS is a part of address these different aspects.

3.2 Value-for-money and inducement measures

An industry representative observed that the main points under discussion in the RIS from an industry perspective concern the value for money and the inducement ban proposals. There is a strong focus on cost in the value for money approach, but it is important to consider that cost is just one element of value for customers. A more balanced approach is needed taking into account the performance of investment products, and also the quality of service which can be measured in terms of e.g. customer complaints and lapse rations. With insurance products, the most relevant issues for customers are how claims are handled and paid, the service they obtain and the ease of underwriting a contract, rather than product costs.

The industry representative added that at present the intermediated model is the most likely to attract new retail investors, because of the service and advice provided. That needs to be taken into account in the approach to inducements. Quality advice has a cost, which is covered by inducements. A ban could therefore have a significant impact on the capacity to encourage more retail investment and achieve the CMU.

A second industry representative welcomed the RIS package which contains relevant measures to foster consumer investment, increase savings and close the pension gap, and was optimistic that the issues with the Commission proposal, in particular regarding the best interest test and value for money benchmarking, can be overcome.

A third industry representative noted that there is more work to do to revisit the ban on inducements for execution only transactions taking into account the impact this may have on end retail investors, in particular when they access investment services through digital platforms.

A regulator stated that the core objective of the RIS is to improve fairness and suitability in the investment and sales process and ensure that retail consumers are provided with appropriate products. Some existing products are unable to provide retail investors with a suitable pay-off because of the way they are set up in terms of cost structure and inducements. The RIS package is a call for the industry to tackle these problems. Otherwise a full inducement ban will have to be imposed. Supervisors also need to help the industry find ways to improve their product offering and be able to deliver more consistently the right products at the right price.

Another regulator emphasised the importance of product costs and verifying whether they are really justified, in addition to having a qualitative analysis of the different features of any product. This is one of the objectives of the value for money concept. There is benefit in proceeding with this work because each and every cost should be justified taking into account the product benefits including qualitative aspects.

3.3 Measures to enhance financial literacy

An official emphasised the importance of addressing the risks for the less financially literate consumers from a facilitated access to capital markets in a more digital environment. The RIS measures can help, by further empowering supervisors to intervene where they see inadequate practices or infringements and increasing accountability for promotional and marketing activities. The RIS moreover aims to improve financial education. This is a significant line of defence because more financially literate investors can better assess the risks posed by investment opportunities and act in a more autonomous way. Safeguards and appropriate support should however continue to be provided. Financial education is also important for policymakers, regulators and Parliament to enable them to make the right policy decisions.

An industry representative noted that financial education will also help investors to seek more relevant sources of information. If this cannot be found from financial service providers or platforms, investors will look to alternative channels such as 'finfluencers'. More however needs to be done in the RIS to define the type of guidance and education models that are needed to support this objective. A second industry representative suggested that a concrete proposal for regulators would be to develop a standardised one page pre contractual information document for all retail investment products.

A third industry representative noted that the enhancement of financial and digital literacy are heavily linked. The consequences of digitalisation need to be thought through to define the right transition path for investors and the pace of change needed.

Investment products: trends and policy needs

1. Current trends in the EU investment fund sector

The Chair asked the panellists for their views on current market trends in the EU investment fund sector, which market segments are the most dynamic at present and the main opportunities and challenges particularly from a retail perspective.

1.1 Overall market trends and flows

An industry representative noted that the implications for European savers of the current macro-economic environment first need to be taken into account. There are some positive trends. A great deal of the savings from the Covid period have now been used but the labour market is still extremely strong, so negotiation for wage increase is possible. Fiscal spending is relatively high globally also, led by the US. On the more negative side, further increases in energy, food prices and wages cannot be ruled out, despite action taken by the European Central Bank (ECB) to address inflation. The ongoing monetary tightening might also lead to the risk of economic recession. Increasing long-term participation in capital markets in order to achieve better returns remains a major objective for retail investors in the EU. Deposits indeed continue to be the dominant asset class for retail clients despite a negative return in real terms. There is still more than €16,000 billion in deposits in the EU, approximately half owned by retail investors and half by businesses.

Trends are positive in the EU asset management sector in 2023 in terms of net inflows, the industry representative added. Fixed income is attracting renewed interest from investors, with the increase of interest rates, creating a further element of diversification for their portfolios. Sustainability remains a strong investment objective in line with the objectives of the EU Green Deal, representing 60% of industry flows.

An investor representative regretted that the majority of EU citizens' excess liquidity remains in deposits and savings accounts. This will not provide the type of funding needed for growing businesses and investing in the green transition. There are some positive signals in the retail space, although retail investor participation must be increased further. Over the last seven years, the total size of their investment increased by 70% in UCITS and 80% in alternative investment funds (AIFs). UCITS remain the primary vehicle for retail investors in the fund market, accounting for 75% of the retail fund assets.

1.2 Increasing adoption of ETFs

An industry representative stated that a new trend since the 2020 Covid crisis in the EU is a significant increase in the adoption of exchange traded funds (ETFs). These funds are appealing to both retail and institutional investors in terms of diversification, transparency and liquidity, but also because they facilitate investments in a variety of asset classes including fixed income and investment on ESG criteria. A further feature is that with ETFs retail investors have access to the same investment vehicles as large institutional investors, which is a major driver of democratisation in the investment space. On the institutional side, ETFs were already used in 2020 as fully-funded proxy-futures for strategic and tactical asset allocation purposes. Now ETF wrappers are also increasingly popular with retail investors in Europe. There has been an increasing usage of ETF building blocks since 2020 as part of managed or advice products. Fixed income ETFs have grown in popularity with retail and the advisory channel, as well as ESG building blocks with the clarification provided by article 8 and 9 fund rules.

Until now, the absence of a consolidated tape in the EU has limited the adoption of ETFs and their liquidity, as the same instrument has to be listed in many different venues to attract investors, the industry speaker noted, but this is being addressed in the current MiFIR review proposal. A similar shift in retail investor appetite towards ETFs was observed in the US a few years ago, accelerated by the implementation of a consolidated tape and the fiscal alignment of ETFs and mutual funds. The development of ETFs is also supported by the growth of digital wealth platforms, which propose savings plans involving a regular investment in a portfolio of ETFs. This trend started in Germany and is expanding to southern Europe. These platforms target self-directed investors, the number of which may increase as a consequence.

Another industry representative highlighted that ETFs currently dominate inflows, representing 70% of net inflows into fund products, with a significant increase in active ETFs. Many areas of the economy, including the agenda of promoting decarbonisation in the EU, will however continue to require active asset management.

A regulator noted that some potential impacts on the wider economy from the rise of passive investment need to be monitored. Corporates will increasingly need to be part of an index to have access to liquidity. This may advantage the larger corporates, contrary to some of the objectives of the Capital Markets Union (CMU) aiming to diversify the funding of SMEs. In addition, the growth of ETFs can raise questions about the efficiency of the underlying market in terms of numbers of shareholders.

1.3 Fragmentation of the EU fund market

The Chair asked whether the current fragmentation of the EU fund market and the relatively small size of EU domiciled funds is an issue for retail investors, and whether there is an over or undersupply of investment products in certain areas of the EU retail market.

A regulator noted that, despite observations that the active investment fund market is overcrowded in Europe, consolidation is ongoing in certain markets. In Belgium, there has been a decrease in the number of open-ended funds of 36% between 2017 and 2021 and an increase in the average net asset value of funds of 37% over the same period. The value-for-money proposals of the Retail Investment Strategy (RIS) that may put pressure on product costs, might accelerate this consolidation and help European funds move towards a more critical size, at national level at least.

Some challenges associated with a further consolidation of the fund market also need considering, the regulator underlined. Market consolidation and the optimisation of product supply at the EU level also face several obstacles related notably to tax differences and the current distribution architecture, with most retail capital being intermediated by banks which reinforces domestic bias. 86% of funds offered in the Belgian market are foreign, but 60% of savings are concentrated in the 14% of Belgian domiciled funds, so there is clear bias in favour of Belgian funds, in part due to the way they are distributed. In addition, while the further consolidation of funds may appear necessary from a cost efficiency perspective, it may have other consequences in the market, notably in terms of stability if risks are not appropriately managed.

An investor representative was favourable to more consolidation in the EU fund market. The UCITS and AIFMD directives have succeeded in creating a market for open-ended funds that reached 56,000 funds in 2018 in the EU, which is four times as many funds as in the US. But the total value of assets under management in EU funds is only 42% of that in the US. This demonstrates the fragmentation of the EU fund sector and is inconsistent with the objective of creating a single market for funds and generating economies of scale at the EU level. Funds have fixed costs, so those that are distributed among a smaller number of clients are more expensive and less competitive, hindering their ability to adequately fulfil the needs of investors. Fragmentation also creates a gap with other more competitive markets, in the first place the US.

The underlying issues in the European fund market are however more the sub-optimisation of the single market and the insufficient competitive pressure, rather than an excessive supply of products. Fragmentation is an issue for almost all areas of the European financial services market and is in part a legacy of the past. The national and home bias remains very strong in Europe, hence the inflow of funds from other member states remains suboptimal. In the Netherlands, for example, some of Europe's best performing funds are not available for retail clients because fund managers decide not to market certain funds in smaller markets due to the specificity or complexity of requirements and the related costs. Inducements also play a role as they preserve the current distribution structure and favour biased advice, undermining investor confidence and interest. This combination of legacy fragmentation and lack of investor trust creates many missed opportunities for the European fund sector. More direct retail investment is also needed in EU capital markets, in addition to pension funds and institutional investors, to provide liquidity to the markets and ensure appropriate price formation.

There are further drivers of fragmentation at the supervisory level that the Retail Investment Strategy proposal is attempting to address, the investor representative added. Home-host arrangements are not appropriately coordinated at the EU level. Consequently investor protection rules remain fragmented. Rules are also interpreted differently across member states for example concerning marketing requirements leading to fragmentation and regulatory arbitrage risk.

2. Enhancements expected from the reviews of the EU fund frameworks

The Chair asked whether the existing investment fund categories in the EU and the corresponding frameworks, address the main needs of retail investors and what enhancements are expected to result from the AIFMD, UCITS and ELTIF reviews.

2.1 AIFMD and UCITS reviews

A regulator stated that the existing fund regulatory frameworks allow for a broad range of products: actively and passively managed, long-term and short-term, traditional and alternative. They also meet the needs of the main investor categories: high net worth individuals to whom tailor-made products can be proposed within these frameworks, autonomous investors who may invest in UCITS and increasingly ETFs and mass retail customers for whom UCITS are also adequate. The ongoing reviews should also lead to a greater alignment of rules for substitutable products, which will benefit investors.

An investor representative highlighted that the AIFMD and UCITS directives have delivered successful brands that are recognised as the gold standards at the global level. They allow an effective pooling of investments and access to professional portfolio management. A further alignment and harmonisation of the requirements is however needed, which is one of the objectives of the ongoing reviews.

A regulator considered that UCITS has been successful in addressing investors' needs, offering a transparent and well-regulated product that provides access to a wide range of asset classes and strategies. Investors indeed want access to a wide choice of instruments and to information enabling them to make the right decisions. Like regulators, they also want products to be predictable, which UCITS funds are. The amendments made in the context of the UCITS and AIFMD reviews should ensure continued investor interest in the related products.

2.2 ELTIF review

A regulator expected that the reviewed ELTIF regulation (ELTIF 2), which is now in development, will bring significant improvements over ELTIF 1 and should be more successful. The main enhancement of ELTIF 2 is to facilitate retail investment in these funds by removing some restrictions, such as investment limits, and adapting subscription thresholds. ELTIFs will also be able to invest in more assets classes, making the product more attractive. Thresholds on the investment and redemption sides must be carefully fixed however, to ensure investor protection without damaging the product.

An industry representative noted that there is currently a strong global trend of retail investment in non-listed assets, as will be highlighted in an upcoming World Economic Forum study. ELTIF 2 should help Europe to take advantage of this trend, with many fund manufacturers interested in launching ELTIFs with the new rules. ELTIF 1 did not work with only 100 ELTIF funds licensed in total across the EU 27 compared to a total of more than 30,000 UCITS funds. It is hoped that the review of ELTIF will allow the market to develop, particularly with the objective to facilitate retail investment in these funds, which are complementary to UCITS funds.

Care must be taken however not to impose too many constraints at Level 2, as this may jeopardise the success of ELTIF 2 funds. Two main issues need adjusting in the drafting of Level 2 requirements. First, ESMA proposed a minimum holding period for ELTIF fund units of three years in its advice, which is a long period of time. Recommending a minimum holding period is quite relevant, but imposing it by regulation seems difficult. Secondly, ESMA's consultation proposed a minimum redemption pace of 3 months, which is the pace at which ELTIF fund units may be redeemed. Fixing such a parameter in absolute terms is inappropriate. It should be adapted to the different investment strategies of ELTIFs which cover a wide range of underlying assets including real estate, infrastructure, private equity and private debt, and also to the investors targeted, who are quite diverse. These different aspects could more easily be taken into account by supervisors, when asset managers submit authorisations for ELTIF funds, rather than being fixed in absolute terms by Level 2 requirements.

The industry speaker added that domestic best practices in the area of long-term assets sold to retail investors should be capitalised on. In France, open-ended retail funds invested in infrastructures have been very successful, demonstrating how the real economy can be financed by domestic savers. The same approach should be pursued at the EU level, directing retail savings towards the EU economy, in line with CMU objectives.

Another industry representative observed that ELTIF 2 will provide a solid basis for the democratisation of alternative investment funds if the liquidity risk is managed carefully.

3. Expected impact of the Retail Investment Strategy and related issues

The Chair asked whether the Retail Investment Strategy (RIS) is expected to have a beneficial effect on the supply of retail investment products in the EU and whether further improvements to existing product frameworks and ranges are needed to foster retail investment in the EU.

3.1 Expected impacts of the Retail Investment Strategy

A regulator considered that the RIS should encourage more retail participation in capital markets and also contribute to enhancing the consistency of investor protection across the EU. Investor protection rules are currently provided in the main investment product regulations, including AIFMD, UCITS and ELTIF, but they tend to differ between different financial instruments and may be interpreted differently by member states. This inconsistency leads to cumulative or differing requirements, which may be confusing for retail investors.

Another regulator highlighted the importance of enhancing the financial education of the mass retail clients who can afford to put money aside but do not have the knowledge or time to inform themselves. They largely depend on financial intermediaries such as banks and insurance companies for their savings and investments. Their level of knowledge would need to be enhanced particularly around long-term saving strategies and being able to take a critical stance with regard to the marketing information they are provided with, especially via digital channels. These objectives are currently being addressed in the context of the RIS.

An investor representative stated that in order to develop retail investment in Europe, regulation must strengthen investor confidence, with adequate investor protection rules, and provide a framework that fosters fair and efficient capital markets. Progress can be made with the provision of adequate product information and financial education, but it is essential that on top of this EU policies, such as the CMU and the RIS, should incorporate a concept of client centricity, whereby the client's interests are placed at the top priority for all public and private institutions. Supervisors at the EU and domestic levels must also foster further convergence and should be further empowered to act against outliers. The measures proposed in the RIS to improve cross-border supervision and home-host cooperation are a step forward in this regard. The introduction of pan-European collective redress is also crucial to preserve shareholder rights. It should be possible to go to court not only in one jurisdiction, but also in a pan-European context. The impacts of technological innovation should also be considered from a retail investor perspective.

Another industry representative emphasised that the ultimate objective of the RIS measures should not be forgotten. It should be to build a 'retail financing union' within the broader CMU, aiming to ensure that more retail savings are channelled towards the financing of the real EU economy, such as infrastructure investments or the green transition. The proposals of the RIS to enhance the consistency of retail investor protection rules or improve the value that investors get out of their investments should be considered in this perspective.

3.2 Value-for-money measures proposed in the RIS

An investor representative considered that the development of cost and performance product benchmarks by ESMA and EIOPA proposed in the context of the value-for-money (VFM) measures of the RIS should contribute to developing retail investor trust.

A regulator observed that while the objective of increasing VFM is relevant, some measures proposed in the RIS that over-emphasise costs need reconsidering. Other important elements also need to be taken into account as part of VFM, such as the expected performance of funds and the quality of the service. Lessons from similar approaches in other jurisdictions, such as the UK, can also be useful to take into account.

There are also many questions around how product benchmarks on costs and performance can be appropriately implemented, the regulator emphasised. Some funds contain different compartments pursuing different investment strategies within one vehicle. It is unclear how a benchmark will work in this case and whether it will be possible to group different strategies in one benchmark. There is also the risk of a race to the bottom with a benchmark approach. Funds with costs higher than the average will need to take action, whereas those with lower than average costs will not need to. The latter funds may however increase their costs gradually, for example when launching new products, which will need to be closely monitored. In addition, there may be discrepancies in the application of benchmarks between home and host member states. This could increase market share concentration in some countries. Rather than a narrow focus on product cost benchmarks, the VFM approach should ensure that all retail investors receive an adequate explanation of how financial instruments are offering value for the money invested and that this information is presented in a comparable way.

An industry representative agreed that while the principle of VFM and maximising value for investors are essential objectives for asset managers, such a framework should not excessively focus on cost, because retail investors consider a range of different values in their product choice, such as performance, service quality or sustainability. How the proposed cost and performance benchmarks will work in practice will also need to be understood. Peer groups will be created for comparing funds, but different tax regimes and local characteristics make it difficult to compare products at the EU level. Whether these benchmarks should be performed at the domestic or pan European level is an open question. In addition, the larger asset managers also have a share of their business outside the EU based on UCITS, which may be influenced by these measures.

The industry speaker added that the UCITS regime already offers a remarkable level of protection and transparency with regular reporting to supervisors on cost and performance information and transparency for clients in the key investor document (KID). While information can always be further improved, it seems more urgent to address as a priority in the RIS the current low level of financial literacy of many EU citizens.

A regulator stated that the RIS is not about price regulation or encouraging people to invest in cheaper products but instead about requiring producers and distributors to explain their added value and supervisors to check these explanations. The first step towards this is for regulators to develop and publish their own benchmarks. The approach must be sufficiently simple to implement in order to be usable and enforceable at the EU level, but not over simplistic, which is quite challenging.

Costs and yields must be compared in particular, the regulator noted, but with the current proliferation of funds which often seem very similar to one another, it is unsurprising that pricing is increasingly used as a differentiator, resulting in a persistent downward pressure on costs. The assessment of the costs that the RIS includes in the product governance rules is likely to enhance that. For traditional, actively-managed funds it can also be difficult to prove their added value compared to ETFs and straightforward saving products, particularly in a context where rising interest rates will improve the return provided. The VFM measures will hopefully make it easier to identify this added value. Finally, supervisory convergence around these requirements is vital so market stakeholders can trust that different supervisors have the same interpretations.

3.3 Inducement rules

A regulator suggested that further clarity is needed around the best interest of the client test proposed in the RIS for allowing the payment or receipt of inducements, how it may be implemented and its potential impacts for investors and on the market.

An industry representative noted that the proposal to ban inducements for execution-only transactions could potentially limit the usage of ETFs for direct investors using digital platforms to access the products. This must be considered in the ongoing development of the RIS proposal.

Consolidated Tape proposals

1. Overall progress on the consolidated tape initiative

1.1 Political agreement on the consolidated tape proposal

The Chair explained that the journey to political agreement on the consolidated tape (CT) project has taken 10 years. Implementing a CT was originally proposed as part of MiFID 2, but it never materialised. Recently, there has been a new push on CT in the context of the MiFIR review. In June 2023, a political agreement was finally reached on the introduction of CTs for four asset classes: bonds, equities, derivatives and exchange traded funds (ETFs). The implementation will be staged, starting with bonds. The technical trilogue has started and is currently working on the details of the proposal.

A policymaker stated that the CT project met with a great deal of opposition at the outset. Arguments were raised about a lack of private sector providers interested in running the CT and its insufficient use for retail investors. Finally, an agreement was found on a project potentially worthwhile for all market stakeholders. Different consortia have now come forward to participate in the tenders and there is interest from retail investor representatives.

An official explained that the CT proposal was an important priority of the French EU Presidency and was continued by the Czech and Swedish EU Presidencies. There were diverging views on the Commission's proposal during the negotiations, but a satisfactory agreement has been reached. The CT will increase transparency and promote integration within the European capital markets landscape in line with the objectives for the development of European capital markets set out in a recent op-ed by the German and French Finance Ministers[1]. It will also send a signal to investors around the world that Europe is making concrete progress on the Capital Markets Union (CMU) agenda.

An industry speaker agreed that the CT will be critical to CMU. It will enhance the visibility of issuers and companies in the market and enable investors to better assess market conditions. Another industry representative concurred that the compromise on CT is a positive sign for CMU. Building on the reforms that have helped to shape a more resilient and efficient trading and post-trading landscape in the EU, the transparency provided by the CT should encourage investors, including retail investors, to participate more in the capital markets. Greater market visibility in periods of crisis thanks to the CT should also help investors to better manage their positions. Transparency will also increase the accountability of market participants to investors and regulators because the level and quality of execution will be more easily measurable.

1.2 Implementation approach and selection process of CT providers (CTPs)

A policymaker remarked that a number of technical details concerning the CTs still need to be finalised. The Commission is coordinating the finalisation of the legislative text and the sequencing of the implementation with ESMA.

A regulator welcomed the staggered approach to implementation and the priority given to the bond CT. The sequencing of the different CTs will leave more time for preparing the implementation in a context where the market's response to this new tool is still uncertain. A number of key details still need to be finalised, such as the type of information that will need to be produced and shared and the format of the data. Once there is a stable text with clarity on the technical details, ESMA will be able to step up its work in a concrete way, starting with the management of the selection process for the CTPs. This is the first time ESMA will be in charge of such a process, which is a challenge. In addition the timelines are very tight, so the process needs to begin as soon as possible.

An official suggested that governance will be crucial. All stakeholders within the industry must be involved in the strategic decision making concerning the implementation of the CT, irrespective of which firm wins the tender, in order to create a sense of cohesion around the project. A regulator advised that all potential applicants will be kept informed throughout the selection process. There will be workshops to explain how the process will be run and to clarify the information that will need to be included in applications. All players must have the same level of information to preserve a level playing field among applicants. An industry speaker emphasised the short implementation timeline. Guidance from the Commission and ESMA on the data standards will need to be communicated swiftly to give the industry enough time to prepare for implementation. Another regulator pointed out that ESMA will be mandated to assess whether the CTPs are meeting their objectives in 2026, which means the implementation process should start as soon as possible.

1. Bruno Le Maire and Christian Lindner: We must close the EU capital markets gap – Financial Times 13 September 2023

1.3 Main factors of success of the CT Level 2 requirements: flexibility, simplicity

A regulator stated that the detailed requirements for data reporting must make the reporting simple for end users. The requirements must also be flexible enough to be adjusted to future market developments, which means that they should be specified in Level 2 regulation, rather than at Level 1. ESMA should have the capacity to assess whether market conditions have changed and to propose amendments to the rules if needed. A second regulator added that it will be critical to have flexibility in areas such as data standards and data reporting, because technology and standards evolve very fast. There are some questions about how to achieve this, but the most adequate solution seems to design these details at Level 2 with input from the market data expert group. Amending Level 1 requirements would require another legislative process, which is not an effective use of co-legislators' time.

An industry representative observed that flexibility is a key factor of competitiveness in a fast evolving market. An official agreed that the requirements will need to adapt to evolutions in the market for EU capital markets to remain competitive in the post-Brexit context. This will necessitate an appropriate allocation of the rules between Levels 1 and 2. Some issues need to be discussed within the Council and with MEPs, but others should be delegated to ESMA. While flexibility is important, the delicate balance agreed at the political level must be preserved. The Level 1 text and Level 2 requirements must stick to the political agreement, particularly in regard to pre trade data for the equity CT. A regulator acknowledged the importance of respecting the political agreement. However, the process is moving now to an implementation phase that requires a proper calibration of requirements and without the right level of flexibility the CT will not be a success.

1.4 Market structure issues

An industry speaker emphasised the importance of continuing to improve the structure of the European securities market beyond the implementation of the CT, in order to strengthen these markets and make them more attractive. Many companies are choosing to list outside of the EU for valuation reasons. Valuations in the EU are impacted by market fragmentation and the overall lack of depth in the EU equity market. Market structure is also important in the bond market. 75% of bond trading in the EU is over the counter (OTC). This structure is less relevant in a higher interest rate environment, where bonds have become more attractive for end investors, especially retail investors.

2. Equity CT: expected benefits and outstanding challenges

2.1 Relevance of the agreed proposal and expected benefits

The panellists were satisfied with the position reached on the equity CT proposal and commended the European institutions for achieving a political compromise after intensive negotiations. A policymaker noted that the political agreement on the equity CT goes further than the Commission's initial proposal on the pre-trade data. An agreement was found on a hybrid solution with a real time publication of anonymised pre-trade European best bid and offer (EBBO) data and a non-anonymised publication of post-trade volume and price data. This should improve transparency and liquidity in the market, but it remains to be seen whether this approach will produce the expected results. This will have to be monitored over time. The existing equity CTs, notably in the US, use a different approach for pre-trade data which is non anonymised.

A regulator stated that the conditions are right for the emergence of a real time equity CT. The CT should improve the situation in the EU equity markets by reducing fragmentation, improving transparency and creating a comprehensive view of equity trading. This is particularly relevant in the EU, where there are many different trading venues. Another regulator considered that the compromise on the equity CT strikes an adequate balance between transparency and feasibility.

An industry speaker stressed that the publication of post trade data will significantly strengthen best execution. Once a trade is completed, investors will be able to see the outcome and what other venues would have offered. This will help them to prepare future trades since it will be possible to see alternative quotes that could have been obtained. In addition, an anonymised CT for pre trade data will avoid several issues raised by a non anonymised pre trade CT including: latency issues, potential market front running risks to the detriment of the less informed investors and giving the advantage to computers over humans, who cannot exploit real time information as quickly.

An industry representative observed that market-makers and large intermediaries will continue to buy market data directly from exchanges. With the fast pace of trading in the equity market, they will not wait for the results of the CT. However, the 'golden source of truth' provided by the CT will be beneficial for other market participants. The data on the CT needs to be real time and comprehensive enough to provide the whole market with maximum information. This CT might also be useful in the event of an outage. Instead of putting pressure on exchanges to resolve outages within two hours, the CT might enable trading to resume sooner and give exchanges time to get back up and running. Another industry speaker emphasised the importance of reliable reference prices in this context provided by the exchanges.

The Chair was encouraged by the positive reaction to the equity CT proposal. Providing a single source of truth and reference price for equity trades has been a longstanding objective in the EU and should contribute to unifying the different existing pools of liquidity. The quicker resumption of trading following an outage could be another benefit.

2.2 Outstanding challenges: revenue distribution and data quality

Several panellists emphasised the importance of ensuring the commercial viability of the equity CT. To achieve this, the revenue distribution scheme needs to be properly defined.

A policymaker noted that the details of the revenue sharing model are still being discussed in the technical trilogue. The current position is balanced: it rewards small exchanges, which is fair, and it also rewards listing, which is very important for the overall objectives of CMU. All the elements are now on the table for market stakeholders to collectively conclude this debate. A regulator observed that stakeholders' opinions must be taken into account in the design of the scheme. The CT must be feasible in terms of cost and commercial interest. An official added that the detailed requirements of the scheme need to be clarified to prepare the implementation of the CT. These criteria are very important because this scheme is a way to reward primary listing. An industry speaker stressed that it is important not to threaten the viability of smaller exchanges, as this would be counterproductive to the wider efforts on CMU.

Data quality is another key consideration to ensure an effective CT. An industry speaker noted that ESMA has already carried out empirical work in this area, but more work needs to be done on systematic internaliser (SI) data. On the post trade side, 90% of SI data is shared within 30 seconds of execution, which is good, but the remaining 10% will also be needed, particularly if the pre trade transparency regime is extended in the future. A regulator noted that the incentives must be set correctly in order to ensure that all trading venues contribute to the CT and that the adequate level of pre and post trade transparency is achieved. It is also important to get the opt in mechanism right in order to reach as close to 100% coverage as possible.

3. Bond CT: expected impacts and outstanding challenges

The Chair explained that the bond CT has a different structure to the equity CT. There is a request for quote (RFQ) order system for bonds instead of a central limit order book for equities, which has led to an emphasis on post-trade rather than pre trade data in the bond CT.

3.1 Expected impacts

The panellists welcomed the bond CT proposal and agreed that it should bring transparency to a market that is currently opaque and fragmented. A regulator stated that the bond tape is strongly supported because of its obvious value to everyone. Bonds are an OTC market that is very fragmented and has huge data quality issues. Another regulator was favourable to the priority given to bonds in the CT project, because the market is less transparent than equity and the bond CT is likely to have the most impact. An industry representative noted that 85% of fixed income trading is not published immediately; it is usually published four weeks later. In these circumstances, it is difficult for investors to assess market conditions. The bond CT will allow investors to verify the depth of the market in particular.

An industry speaker highlighted the elements of the proposal that will maximise the chances of a bond CTP emerging and that tackle issues that have been an impediment to a bond CT previously in the MiFID II context. First, the decision not to include pre trade data will minimise complexity. Given the practicalities of bond trading, the value of pre trade data for bonds is debatable. The RFQ trading system inherently allows investors to evaluate liquidity in the pre-execution phase, therefore the decision to target the pre-trade transparency regime around central limit order book and periodic auction systems is relevant. For the bond CT the focus should be on simplifying the post-trade transparency regime. Secondly, legislators have recognised the importance of improving the deferral regime for bonds and taken the first steps to simplifying and harmonising maximum deferral periods. Previously, MiFID II's complex and unwieldly deferral regime resulted in trades being withheld from publication until after any usable time, diminishing the usefulness of consolidated trading and volume data. The CTP will also not be generating value added services, which avoids the possibility of a monopoly emerging.

3.2 Outstanding challenges for preparing the implementation of the bond CT

The panellists highlighted issues requiring further clarification for the success of the bond CT in two main areas: the calibration of price deferrals and revenue distribution.

A policymaker stated that the calibration of deferrals is essential to the success of the bond CT, but will be challenging. The Commission has tried to push for a US type model with a short price deferral and longer volume deferrals. The compromise agreed in the EU is to have long deferrals for both price and volume, which is a new model that has not been used by other jurisdictions. When this is implemented, the authorities will have to assess whether it is producing the expected results. The real debate will be around the calibration. A small difference in calibration will make an enormous difference to the day by day success of the bond CT.

An industry representative agreed that the question of deferrals will be crucial to the success of the bond CT. In the US, firms have 15 minutes to report a trade. The price, which is the main factor for investors, is published almost immediately, but the volume can be published, if it is a block, six months later. The US Trade Reporting and Compliance Engine (TRACE) system has been used for 20 years and its development has been iterative. It will be important for European regulators to have the flexibility to recalibrate the CT, if necessary. Academic studies have indicated that the US market grew exponentially following the implementation of TRACE. It is expected that the bond CT will be very beneficial for the EU fixed income market as well, which is essential to support economic growth. Another industry speaker observed that the EU bond CT will not have the same impact as TRACE unless there is a solution to the issue of 85% of bonds being published four weeks after transaction.

A regulator added that the exact calibration of deferrals will be critical for the CTP selection process. The selection procedure can be initiated without this but cannot be concluded until this detail is known. As with the equity tape, applicants will need clarity on inputs, outputs and formats in order to be able to finalize their proposal in terms of price and planning. An industry speaker agreed that the parties tendering will need this clarity because it will form part of the calculation of their revenue potential. The tender process can be launched without this but in an ideal world, there would be clarity on deferrals before it begins. The Chair commented that the value of the tender for providers will depend on the level of deferrals, as less deferrals will mean more value.

A regulator noted that beyond deferrals, the quality of the data provided will also be very important for the usefulness of the CT. ESMA and the national competent authorities (NCAs) are working to improve data quality and it has improved substantially during the last few years. The level of compliance with the data quality test is now almost 100%, but there is still room for improvement.

An industry speaker emphasised that revenue distribution is the main outstanding issue for the bond CT. It has been addressed for the equity CT, but there is a push for it to be excluded from the discussions around the bond CT, which does not seem appropriate. This is not a question of fairness, as it is for the equity CT, but more of incentives. Different data contributors such as trading venues and approved publication arrangements (APAs) will be mandated to provide data to the CT. That will probably work out, but having some form of incentive would make the delivery of a bond CT go much more smoothly.

Securities trading: market structure and transparency evolutions

The Chair highlighted the main changes in the political agreement reached in June 2023 around the Markets in Financial Instruments Regulation (MiFIR) review. Some measures will need to be further specified in the technical work of the trilogues or at Level 2. A first block of changes concerns transparency and waivers. This includes the elimination of the cap to the negotiated trade waiver and the replacement of the double volume cap by a single 7% cap for the Reference Price Waiver (RPW). The intent is to fully harmonise waivers and deferrals in normal times to eliminate the national specificities, with the notable and surprising exception of sovereign debt.

A Classes of Financial Instruments Approach (COFIA) has been introduced for classifying debt instruments as liquid or illiquid for the purpose of transparency requirements. Some changes have been introduced on the derivative trading obligation (DTO) and clearing obligation, which have been much debated in the context of MiFID. The application of the DTO linked to the transaction being subject to the clearing obligation is an important change. There is also a possibility to suspend the DTO in certain circumstances. An exemption from that obligation for certain firms that mainly trade with non-EU firms was very contentious.

Significant changes have also been seen on the open access regime, especially for exchange-traded derivatives (ETDs), which has been removed in effect. The systematic internaliser (SI) regime has also been amended. There have been changes in terms of mid point matching for orders below large in scale, and in the application of the non-equity pre-trade transparency for SIs or execution methods different from auction systems or a central book. The share trading obligation has also been reduced to ‘EU shares’. A ban on payment for order flow (PFOF) has moreover been implemented, with a transition period until June 2026 for countries that currently allow it.

1. Outcome of the MiFIR review proposal

A regulator was satisfied with the outcome of the MiFIR review and the balance that has been achieved in the requirements, with rules that have been added and other that have been taken out or amended. The ban of PFOF that will be progressively phased out until June 2026 is an important measure of the MiFIR review. It was already possible with MiFID II but member states had interpreted rules differently, which created an unlevel playing field. With PFOF it is unclear whether best execution is obtained at a trading venue, since payments for attracting transactions are involved, which is why the best option is to eliminate PFOF. Other key measures include the objective to reduce complexity in the transparency requirements with the removal of the double volume gap and the objective to increase the proportion of transactions on lit markets such as exchanges. It is still uncertain however, whether the measures proposed to increase lit volumes will be effective, notably those targeting SIs.

An industry representative agreed that the effectiveness of the amendments to the transparency regime, such as the simplification of the single volume cap, for supporting lit markets and fostering an efficient price formation will need to be checked and monitored over time. It is also hoped that the measures concerning SIs will have sufficient impact. Those venues have a growing relevance in the market but do not always function as intended. Initially they were meant to handle large orders, but in practice relatively small orders represent a large part of their activity. This creates regulatory arbitrage. In addition the orders traded via SIs are not subject to transparency requirements and do not contribute to the price formation process. The new restrictions that will be imposed on SIs in terms of order size and mid-point matching opportunities should be designed to contribute to improving the level playing field with other venues and to enhancing transparency.

Another industry speaker detailed the expected impacts of the reviewed MiFIR transparency regime for different asset classes. For shares, there is a natural tension between the interest of each market participant, which is to reduce the impact of its orders and their contribution to price formation and the interest of the community, which is to make sure that the price formation process considers as much of the interests that are present in the market as possible. The replacement of the double-volume cap by a single cap and the changes in the rules for SIs should normally bring more flows back to lit multilateral venues and have a positive impact on the price formation process. An issue which is difficult to address however is that the end-of-day transactions represent up to 40% of the volumes on certain days, which hinders the price formation process throughout the day.

For bonds, there is value in the harmonisation of the deferral rules because it is a truly pan-European wholesale market. The level of the deferrals in terms of post-trade transparency is however problematic, notably in relation to other jurisdictions, from a competitiveness standpoint.

For derivatives, the simplification of transparency rules and the move from ISINs to UPIs for the identification of instruments are appropriate. The decision to increase transparency on single name credit default swaps (CDS) for global systemically important banks (G-SIBs) is questionable however, as it had been taken with limited analysis and an incorrect assumption that insufficient transparency in the EU CDS market fuelled the fall of shares of European banks on 24 March in the context of the Silicon Valley Bank (SVB) and Credit Suisse crises. The problem was in fact due to excessive and inappropriate transparency in the US CDS market. Indeed, the US has transparency on CDS, including on European underlyings, but it focuses on the price and does not specify the seniority of the debt instrument being covered by the CDS, which makes the data difficult to interpret. If this problem subsists in the US, there is not much point in increasing transparency in the EU.

A regulator welcomed the measures proposed in the MiFIR review in terms of harmonisation, simplification and enhancing transparency, including the single volume cap threshold at 7%, a more consistent deferral regime, and amended rules for SI orders. The MiFIR review could have gone further on certain aspects, the regulator felt. An opportunity has been missed to create a full level playing field across the venues that are not multilateral trading facilities (MTFs) but share multilateral features. Different multilateral systems have emerged in the market over the years, but have not been treated on the same grounds. This could have been addressed in the MiFIR review to avoid differences in legal interpretations. Secondly, ESMA could also have been given more powers to define requirements in certain areas based on further assessments e.g. of the liquidity of instruments or of the size of transactions. ESMA has a significant amount of data that could be used to perform those assessments. Finally, transactions in sovereign bonds could have been approached differently. This is normally a liquid asset class, but certain differentiations could be made in the deferral requirements to cater for national-specific contingencies.

2. Issues to consider in the establishment and implementation of the MiFIR review framework

An official stated that the MiFIR review measures generally align with the broader ambition of increased transparency and simplification in the capital markets. Price discovery and the role played by stock markets is essential, not only in the context of trading, but also for the broader economy and as a public good. This is reflected in the OECD corporate governance principles, which were recently updated and endorsed by the G20. A clarification that has been made on the occasion of the update of these principles is that all investors are expected to contribute to price discovery, regardless of investment strategy.

However, price discovery is sometimes challenging in the EU context, because there are 27 countries and a large degree of fragmentation in the market. There are more than 500 trading venues in the EEA, of which almost 200 SIs. That makes improving comparability essential. The consolidated tape (CT) is the most important measure that has been agreed in this regard.

In order to ensure a successful implementation of the MiFIR review proposal, three aspects should be considered. First, any significant change to market structure or functioning will run up against competing interests. A thorough and objective assessment of the likely impacts is therefore needed. This was seen with the implementation of TRACE in the US 20 years ago which led to a great deal of discussion about the effect that transparency would have on bond market liquidity. The rules were phased in over several years, and the consensus in the end was that the impact on liquidity had been neutral at worst.

Secondly, when waivers are being considered, which can be legitimate, they should have a clear rationale against which they can be evaluated. For example, waivers limiting pre-trade transparency aim to reduce the market impact of large orders. In that context, the rationale for lit trading waivers for small trades seems limited. Research shows that small trades are in fact being executed in the dark, which goes against the objective of enhancing transparency and price formation. This has been observed in OECD research on the US market, where there is no difference in the average trade size between dark and lit orders. Data on the French market also shows that the median size traded on SIs in French blue-chip stocks is smaller than the average Euronext trade. SI trading is between 15% to 20% of all trading in France, of which less than a quarter is subject to pre trade transparency.

Thirdly, rules have to be adapted to the market in which they apply. Before MiFID II was implemented in the Swedish corporate bond market a national rule required volume and price disclosure by 09.00 am at the latest on the day after the trade. On the face of it, MiFID II was much more stringent and mandated near real time disclosure, but because of the waivers for non-liquid bonds, the actual effect was a reduction in transparency. An impact assessment of this measure conducted by the Swedish FSA in 2019 showed that only one Swedish ISIN bond was considered liquid; if the entire market is an exception, the regulation is not fit for the market where it applies.

3. Competitiveness issues associated with the MiFIR review

The Chair noted that in a recent op-ed published in the Financial Times by the German and French Ministers of Finance calling for closing the EU capital markets gap[1] it was suggested that competitiveness should no longer be a secondary objective. There is also a significant discussion in the UK about whether the mandate of regulators and / or supervisors should include competitiveness.

1. Bruno Le Maire and Christian Lindner : We must close the EU capital markets gap – Financial Times 13 September 2023 'we must make our market framework more agile and no longer treat competitiveness as a mere afterthought'

3.1 Impact of the MiFIR review in terms of international competitiveness and access to funding

An official considered that the MiFIR review proposals are moving in the right direction when it comes to competitiveness, but that significant work remains. When evaluating the impact of regulatory changes on EU capital market functioning, it is useful to consider two separate perspectives: international competitiveness and access to finance. This is effectively equivalent to dividing the discussion into the impact on large and small companies.

On the first point of international competitiveness, the objective is to attract foreign companies to list in the EU and to retain successful EU companies within the EU. From the perspective of a CFO of a large company, the aspects that determine where you decide to list are essentially: the prospective liquidity of your stock, the accuracy of the price, your cost of capital, and having access to capital when needed. The MiFIR review proposals are relevant to these topics, and should therefore help improve competitiveness to an extent. However, the primary issue with EU capital markets is not trading, which is downstream from capital market development more broadly. Instead, the most important issue is one of scale: the EU needs more institutional investor capital, notably pension funds, in the equity markets. The proposal will not address this issue, meaning we should expect improvements mostly at the margin.

In terms of access to finance for smaller companies, trading rules are likely to have less impact. This is because trading is concentrated in large companies[2]. In addition, OECD research shows that in every major market around the world the average institutional investor stake is significantly higher in larger companies than in smaller companies. For smaller companies, retail investors are instead an important investor group, meaning that improving the access to finance for SMEs requires attracting retail investment to the market[3]. Pre-trade transparency is less useful as a tool in this respect. Instead, measures related to financial education, fiscal incentives and a functioning framework for qualified retail investors, as well as measures to encourage ease of use of trading platforms are needed. Another aspect to focus on are the prelisting conditions, and whether there is a vibrant venture capital (VC) market and a well-functioning funding ladder from private funding to public listing to support companies in their different stages of development. Those aspects are also partly covered in the Listing Act proposal.

An industry representative emphasised the importance of ensuring the competitiveness of European market participants compared to their competitors outside the EU. A competitiveness check should be systematically performed when new regulations are proposed to evaluate their impact on the competitiveness of EU capital markets and players. Absent such test, we find ourselves correcting ill-calibrated rules several years after they have been implemented and have damaged the competitiveness of EU market participants. This is typically the case with the application of the DTO to situations where EU entities trade with non-EU clients, that was implemented with MiFIR and will only be corrected when the provision in the MiFIR review for the targeted suspension of the DTO is applied.

Another industry representative pointed out that the objective of increasing competition and competitiveness in the market may lead to further fragmentation which may go against the objective of increasing transparency in the market and improving price formation, unless more volume can be driven to lit markets. Those effects also need to be taken into account.

3.2 Flexibility and capacity to react to market evolutions

The Chair noted that a key element of competitiveness is flexibility and the capacity for regulators and supervisors to adapt rules to the fast pace of change that is seen in markets. The UK has empowered the Financial Conduct Authority (FCA) to take significant decisions on how much dark trading there should be, but the EU tends to tackle this via the legislation. This requires having sufficient flexibility and agility in the EU rule-making system to adapt rules to the market changes, but this still needs improving in the EU. In recent years there has been the need to suspend the DTO on some occasions, but the process takes months. By the time the suspension is effective, the market may have changed course. Markets are complex and evolve quickly, meaning that everything cannot be pre programmed in a Level 1 instrument that is reviewed every 10 years; solutions need to be found to adapt the requirements while preserving legal certainty.

A regulator stated that the adjustments being made in the MiFIR review as a result of Brexit and market evolutions should contribute to building a European capital market that can compete more effectively with other large trading blocks, including the UK, the US and Asia. That should result in a larger, more integrated, liquid, and transparent European capital market. To remain competitive in the future, it would however be beneficial to make most of those regulatory changes at Level 2 and give a broader mandate to ESMA to change specific rules, in order to speed up the policy cycle.

Another regulator agreed that more measures should be defined at Level 2 than Level 1 to allow flexibility. The market is still in a post-Brexit context and the wholesale market review (WMR) is being examined in the UK. The outcome of the WMR for the trading obligations for shares and derivatives is different to the MiFIR review, as the UK has decided to abolish some requirements that the EU introduced, which may have significant competitive impacts on the EU. Sufficient flexibility to adapt the rules to changing market and competitive conditions is essential in a context where UK regulators have more freedom to adjust rules, possibly necessitating a push towards Level 2. The EU

2. On Euronext Paris the largest 20 companies represent more than 60% of total turnover. In Amsterdam it is over 80%. It is the same in the US, Japan and everywhere else. The largest 10% of market cap is between 70% and 90% of trading.

3. For example on First North, the Nordic growth market, more than 50% of all trading is retail driven.

institutional setup may also need reconsidering to speed up rulemaking and amendments.

An industry representative considered that speeding up the EU legislative process will be difficult. With this in mind, care must be taken in particular to not encapsulate measures with fixed levels in the Level 1 text that will take many years to change, particularly in a context where the UK is making sure that the process to amend its regulation is as quick as possible, which will require rules to be adapted for the EU to remain competitive. Unfortunately, some measures of the MiFIR review concerning transparency for bonds for example have some fixed levels set in Level 1. That should be left to the Level 2.

Another industry speaker agreed that the capacity of reaction is vital, as regulation is usually significantly behind the markets. Regulation must move faster and help to reduce fragmentation in a context of divergence with other jurisdictions.

Enhancing central clearing in the EU

1. EMIR 3 active account proposal

1.1 Objectives of the EMIR 3 active account proposal

The Chair explained that the EMIR 3 proposal includes a requirement that EU market participants subject to a clearing obligation should be mandated to clear through 'active accounts' at EU CCPs a portion (to be defined) of the products that have been identified by ESMA as of substantial systemic importance. This is a continuation of the work that was initiated with EMIR 2 and the categorisation of central counterparty clearing houses (CCPs) in different tiers, following which ESMA identified clearing activities that can be considered of substantial systemic importance for the EU and invited mitigations for addressing the related risks.

Most of the panellists agreed on the need to strengthen clearing capacities in the EU and the relevance of active account (AA) requirements for achieving this.

An official explained that the proposal to implement AA requirements must be seen in the context of the discussions following Brexit on how to reduce the financial stability risks resulting from the EU's dependency on offshore clearing. The response from the representatives of the EU authorities and a large part of the industry was that a larger proportion of the clearing of euro-denominated clearing activities should take place in the EU. The question however was how this could be achieved. Different options with varying degrees of constraint were assessed for reducing the current over-reliance on offshore clearing. The solution retained to implement AA requirements seems appropriate.

An industry representative agreed that, for activities that are systemically important for the euro, the EU should be the primary regulator and have the necessary supervisory and regulatory powers. Moreover Europe is an attractive place to locate central clearing activity, because the regulatory framework is sound and strong, and thought leadership has been demonstrated in many policy areas such as recovery and resolution, margin appropriateness and margin anti-pro-cyclicality (APC). While colleges work well in normal market conditions, in a crisis situation when every hour counts it is necessary for there to be only one hand at the steering wheel. That means that the current situation, where a significant proportion of euro-denominated instruments is cleared outside the EU, needs to evolve. Market-led solutions such as incentives to attract business to the EU can help to make progress, but are not sufficient to fully alleviate financial stability risks.

A second industry representative agreed that measures are needed to gradually increase clearing flows and volumes in the EU in order to increase clearing capacity and make the EU clearing offer more competitive. This will support Europe's strategic autonomy objectives as well as contribute to financial stability.

A Central Bank official emphasised that the over-reliance on third country CCPs to clear critical derivatives is a source of systemic risk to the EU financial system. The concern is not about the risk management practices of offshore CCPs or decisions taken by the home supervisors of these CCPs in a business as usual scenario. The concern relates to tail risk scenarios, and in particular the possibility that a third-country CCP might take discretionary actions that could have adverse effects on the EU financial system in a crisis situation, because crisis management priorities of the third-country may not be aligned with those of the EU. A situation where the EU authorities are obliged to take ex post corrective actions due to the unintended consequences of discretionary decisions taken by another jurisdiction must be avoided.

The market has made some voluntary efforts to relocate clearing business to EU CCPs, the Central Bank official acknowledged, but not to the extent that is needed for a balanced clearing landscape, especially for interest rate swaps (IRS). Regulatory measures are therefore needed to reduce the stock of clearing exposures to third-countries. The intention is to move gradually and in a measured way, but for progress to be made, some 'nudging' of the market participants is needed.

One of the panellists was against imposing AA measures, because of the risk of impeding access to clearing for EU firms, competitiveness issues and the possible increase of risks in the financial system that these measures may lead to. The AA measure proposed would target mainly IRS. That market is global in nature and multi-currency. EU participants only represent 14% of the IRS market and for euro denominated IRS, EU firms only represent around 25% of the notional cleared volumes. The diversity of transactions and participants at the global CCPs that currently clear euro-denominated IRS such as LCH's Swapclear, enhances the efficiency of risk management and the resilience of the liquidity pool by reducing concentration risk. In addition, EU participants need access to these global liquidity pools to remain competitive. The largest clearing members must continue to have the ability to connect to multiple CCPs to hedge their positions and the smaller players must also have the ability to access the global clearing market. An AA requirement would impede this access if EU participants had to guarantee a minimum market share at certain EU-based clearing providers. This would increase their costs, affect their competitiveness and their ability to manage risks efficiently. AA requirements would also create artificial market fragmentation that might increase risk at market level if netting sets are broken up. That may eventually lead to a dysfunctional clearing market, with an imbalance of supply and demand, and unnecessary directionality with most participants in the EU subject to the same economic cycle.

1.2 Options to operationalise the active account proposal

An official was in favour of a combination of qualitative and quantitative criteria for implementing the AA requirement. A clear quantitative threshold is needed, otherwise the measure will not provide sufficient incentive to bring back euro denominated clearing volumes to continental Europe.

An industry representative considered that the AA measures need to take into account the global characteristics of the clearing market and should also preserve the competitiveness of the European financial institutions that are members of EU CCPs, which is a matter of strategic autonomy for the EU. Currently, 95% of euro swaps are cleared through LCH, and 75% of euro swaps do not involve any European counterparties, which means that most of the liquidity of the euro-denominated swap markets is outside Europe. Clients not subject to EMIR cannot be forced to clear inside Europe, since EMIR is not extraterritorial. In addition, the split of clearing between several CCPs that a relocation of the clearing of euro denominated swaps to the EU would entail, would lead to additional costs and liquidity needs for clients that have multi-product or multi-currency positions, with a deterioration of their netting benefits. For a 10-year euro swap, it would be three basis points more costly to clear in the EU for those clients, due to lower liquidity. Finally, forcing a fast relocation of significant clearing flows to EU CCPs that might not match clients' pricing expectations would either expose dealers to unsound market basis risks or lead to the CCPs losing trades.

The best solution would therefore be a two-phase approach, the industry speaker suggested, starting with a qualitative phase to ensure that AAs at EU CCPs are operational in case there is a need to host new clearing flows in the EU. After this first phase, ESMA could conduct an assessment of the efficiency of the qualitative approach and determine whether quantitative thresholds need to be fixed in a second phase. A new legislative process would be needed to achieve a relevant definition of a perimeter of this quantitative AA requirement and the calibration of the thresholds. The Chair noted that an approach involving a new legislative process could take a long time to implement in the absence of an improvement of the current EU legislative processes and supervisory tools.

A second industry representative also favoured a more gradual approach to the implementation of AA requirements with a first qualitative phase. The assumption that EU clearing members can relocate transactions with EU clients to an EU CCP with minimal costs is misguided. When a trade arrives at a clearing member, the choice of the CCP has already been made by the client. Putting a quantitative constraint on EU clearing members and EU market makers would not result in a transfer of liquidity from UK CCPs to EU CCPs, but instead in the transfer of client volumes from EU clearing members to non-EU clearing members. A quantitative approach that is not properly calibrated, and that does not include a market-making exemption, would therefore be counterproductive and increase the euro swap market's dependency on non-EU market makers and clearing members.

What is needed to mitigate the risks from the dependency on off-shore CCPs is to ensure that EU CCPs are scalable enough to clear a significantly larger number of transactions if a fall-back scenario is needed in case of disruption, the industry speaker stated. That requires strengthening the competitiveness and attractiveness of the EU clearing system. A certain number of provisions aiming to achieve this are already in the EMIR 3 text, but a measure would be needed to encourage more voluntary clearing by national and supranational European entities within EU CCPs to increase their liquidity and the diversity of the flows they clear. A second aspect is about margin exemption for equity options. The current exemption expires in early January and is likely to be revived under EMIR 3, as both the EU Parliament and the Council have included it in their proposals. EU market participants will hence need a solution to cover the interim period until EMIR 3 comes into force.

A third industry representative agreed that the AA measures should not disadvantage European clearing members. There have been calls from banks for certain exemptions on the market-making side and on the global client clearing side, which need to be taken into account because European banks should not end up being in a poorer position as a result of AA requirements. A two-step approach starting with a more qualitative step and then having the possibility of an automatic transition into quantitative measures could be a compromise. However, the qualitative requirements should be drafted in such a way that a reduction of risk can be initiated and that these measures cannot be easily circumvented.

A fourth industry representative stated that from a financial stability perspective what should be checked is that the main global clearing members have different options to clear euro denominated swaps and that those options are valid so they can shift their positions if needed in the event of a crisis. However, putting in place quantitative thresholds for clearing at EU CCPs does not address that. Other measures of EMIR 3 aiming to facilitate buy-side access to central clearing seem more relevant. The access of pension funds, insurance companies, and other market players financing the real economy to central clearing would indeed guarantee a more diversified and resilient membership of EU clearing houses. There is also a need to address inconsistencies in the EU regulatory framework that currently impede access to clearing. Sponsored models have been put in place, which allow the buy-side to mitigate some of the cost and the sell-side to reduce the balance sheet costs of access to clearing. The ongoing discussion about recognising these models should be pursued. This would not only broaden access to CCPs but also help to achieve a more stable, shock-resistant EU clearing ecosystem with deeper liquidity pools.

A Central Bank official emphasised that no progress will be made if a minimum level of activity and thresholds are not imposed for AAs. Without this, AAs will serve as a contingency. There might be some token transactions posted on them, but they will basically remain inactive. In effect, a qualitative phase one has been taking place for several years. Some progress has been made, but that has tapered off recently so more action needs to be taken. This is why an AA measure with actual thresholds is needed. The potential impact on market-making must be considered, but simply carving out this business from the threshold is difficult, because it constitutes the bulk of EU clearing members' activity at present. If market-making is excluded, the additional business brought to EU CCPs will be limited, there will be no additional liquidity, so entities will not move to EU CCPs. That is a 'chicken and egg' situation. The thresholds and their phasing-in need to be set carefully however, as any possible exemptions, following a technical assessment conducted by ESMA in cooperation with other authorities and taking into account market needs and risk mitigation objectives.

2. Improving CCP supervisory processes

The Chair suggested that one area of progress for the competitiveness and safety of the European clearing market would be to improve the flexibility of the regulatory process and reduce delays for amending the rules in cases where there is a need to adapt them to market evolutions, to close gaps between regulations or to react quickly to a market crisis. This should be part of the objectives of the incoming Commission. This might require improving the current legislative and supervisory processes based on the Lamfalussy approach or providing ESMA and the national competent authorities (NCAs) with additional tools, such as the ability to use no-action letters to react to crises.

An industry representative agreed that current supervisory processes are an issue for competitiveness as it may take several months or even years in the EU to launch new products and services, whereas it takes weeks in many other jurisdictions. The measures proposed in EMIR 3 to streamline supervisory processes with shorter procedures and standardised applications are welcome. Another option is to give more power to ESMA at the supervisory level, which means that the rules can be less specific and can be more easily amended or completed centrally. A further improvement would be for ESMA to have more power in the supervision of EU CCPs.

The Chair agreed that the EMIR 3 proposals to shorten procedures for the authorisation and extension of clearing activities are positive, but the processes for amending legislations will generally remain quite complex and lengthy. A Central Bank official noted that ESMA's competencies when it comes to Tier 2 CCPs can be improved, but ESMA is not their home supervisor.

3. Margin procyclicality issues and access to central bank liquidity

3.1 Margin procyclicality issues and measures proposed for energy markets

An official stated that the energy market crisis of the previous year put significant strain on the clearing of energy derivatives. It is important to strengthen the resilience of the EU clearing system for energy derivatives, strengthen the liquidity preparedness of energy firms and improve the transparency of margin models used by CCPs and the margin requirements imposed by clearing members. In the previous year, ESMA and the CCPs were flexible, but there should be reflection on how to better address such problems. Transparency is needed, including for the collateral systems. The proposal to extend the eligible collateral to un-collateralised bank guarantees for non-financial companies when clearing energy derivatives, and to public guarantees for all types of counterparties is a good idea, but for other possible collateral there should be caution about not posing new risks.

A Central Bank official highlighted that the episodes of financial turmoil in the past year have confirmed that 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. Despite the complexity of the situation, the crisis was handled well thanks to the intervention of ESMA and other public authorities. However, the market still has to be placed on a more solid basis. The EMIR 3 proposals head in the right direction by asking participants to provide more clarity about their liquidity needs and extending eligible collateral, but more reflection is needed on the risks that could be built into the system.

Margin pro-cyclicality is another important matter, the Central Bank official stressed. EMIR 3 measures will help to make participants more aware of the liquidity needs, but further actions are needed. Work is being conducted on these issues at EU level by ESMA, which is revising the regulatory standards, and also at the global level by the BCBS, CPMI and IOSCO. Cooperation with the market is also needed to understand the models for setting the margins.

The Chair noted that proposals have been made to improve the governance of the process in the redraft of the APC measures in order to improve awareness of the importance of transparency, but these measures will not concern all parties, such as non-financials, for which the EMIR3 measures will be needed.

An industry representative observed that the generalisation of central clearing and margin calls following the 2008 financial crisis was based on the idea that the use of liquidity through margin calls would help to avoid the propagation of default events. However, the need for liquidity during the energy markets crisis in 2022 was so massive that it went close to inducing default events. Two solutions could be envisaged for tackling those issues. First, circuit breakers could help to reduce the volatility in markets which leads to higher margin calls. Markets should not end up being blocked, however, because if CCPs have no reference price then they have to increase their margin calls. The second solution would be to increase the transparency on margin models with the provision of simulators for clearing members and their clients.

3.2 Access to central bank liquidity

A Central Bank official noted that attention must be paid to the conditions under which CCPs can access central bank liquidity in times of stress. There is an on-going discussion at the Eurosystem level on this possibility. 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 by making EU CCPs more attractive.

An industry representative emphasised that CCPs making margin calls on one bank and just putting that money in another bank does not ensure financial stability. There were reservations in Europe about opening up monetary policy mechanisms to CCPs. Some, such as Eurex, acquired a full bank licence to have access to the ECB refinancing facility if necessary. Half of the total margin pledged by clients is high quality securities that are mostly eligible with the ECB. Without access to central bank liquidity, CCPs will continue to have bank licences, but that produces conflicts with EMIR. CCPs have two recovery and resolution plans; one for the banking regulator and one for the CCP regulator. Resolving that would be appreciated.

Securities post-trading infrastructures efficiency and resilience

Introduction

The Chair explained that post-trading infrastructure in the EU has undergone significant changes in recent years. New actions are underway in the regulatory space including the Central Securities Depository Regulation update (CSDR Refit) and a targeted harmonisation of insolvency rules proposed in the context of the Capital Markets Union (CMU) action plan. In the Eurosystem space, there has been action and momentum with the TARGET Services consolidation, the implementation of the Eurosystem Collateral Management System (ECMS) and the work on wholesale central bank digital currencies (CBDC).

1. State of play in terms of harmonisation and integration of the EU post-trading space

1.1 Progress made and remaining issues

A Central Bank official confirmed that there have been significant improvements in European post-trade integration over the last two decades. Many of the original Giovannini technical barriers have been tackled, such as differing business hours, infrastructure, settlement cycles, and the lack of settlement finality and remote access to infrastructures, and others have been significantly reduced, such as those relating to messaging standards and issuing practices. TARGET2 Securities (T2S) has been key in these improvements, both in terms of technical infrastructure and of the harmonisation of rules needed to support its implementation. CSDR has also fostered regulatory harmonisation and progress in terms of governance, business continuity arrangements and operational risk management. The implementation of market standards for corporate events and collateral management has also fostered further integration and harmonisation.

A fully integrated post trade landscape is nevertheless still a faraway goal, the Central Bank official observed. The relative value and volume of cross-CSD settlement is still very limited. Differences in national market practices subsist despite common market standards. More importantly, differences in national securities, corporate and tax laws prevent the full integration of the EU settlement space.

Another Central Bank official added that there are efficient post-trading infrastructures in Europe at the domestic level, but cross border transactions are not sufficiently integrated and remain a small fraction of the overall business. The CSDR Refit will also improve the supervisory framework for overseeing the market and the CSD passporting regime, which should contribute to a further integration of post-trading.

An industry representative explained that the CSDR goes beyond offering a harmonised legislative framework for CSDs. There are safety elements in it, which is important for CSDs, whose primary objective is resilience and preserving financial stability. Some measures of the CSDR Refit also aim to support the competitiveness of CSDs, allowing them to offer additional services to issuers and investors along with their core services. The CSDR Refit also reduces some of the red tape but it does not tackle the main legal and fiscal hurdles to cross-border settlement.

A Central Bank official stated that TARGET Services, including the new consolidated platform as well as ECMS, provides European financial participants with an attractive service offer for the safe and efficient movement of cash, securities and collateral. TARGET Services also acts as a catalyst for further harmonisation and standardisation in the European capital markets, which will contribute to building a deeper and broader European CMU. The consolidated platform for example now has a multi currency capability that may support cross border payments and facilitate access to central bank liquidity.

1.2 Next steps for enhancing the harmonisation and integration of EU post-trading

A Central Bank official stated that the Eurosystem will continue to play a catalyst role in terms of integration by focusing on the remaining barriers and achieving a high level of compliance with existing market standards in the fields of corporate events and collateral management. The Eurosystem, as an operator of central bank money infrastructure, contributes significantly to the evolution of TARGET Services. Five additional CDSs joined T2S at the beginning of September 2023. Initiatives such as the EU Issuance Service (EIS) being rolled out for the bonds issued by the European Commission will also be further leveraged, building on T2S.

Another Central Bank official noted that deeper fragmentation issues remain to be tackled, such as differing taxation rules, securities and insolvency laws. Eurosystem central banks will contribute to these integration efforts by making sure that the new provisions of the CSDR are enforced in a consistent way and advocating the importance of harmonisation in their domestic market.

An industry representative emphasised that concerning taxation, the Commission recently proposed the Faster and Safer Relief of Excess Withholding Taxes (FASTER) Directive, which aims to make withholding tax procedures in the EU more efficient and secure and could facilitate cross-border investment by making the reclaim process faster and smoother. This proposal, which requires unanimity to be adopted needs to be promoted towards the member states. Another industry speaker highlighted the work conducted by the European Post Trade Forum (EPTF) in the wake of the Giovannini group to lift barriers to cross-border settlement which has also been beneficial.

2. Measures proposed to improve settlement efficiency

2.1 CSDR Refit improvements

An industry representative noted that settlement efficiency is currently an important topic for the post-trading industry. The CSDR Refit should allow an improvement of the provisions of the CSDR on settlement efficiency, notably concerning penalties and mandatory buy ins (MBIs). The fact that the penalty mechanism can be reviewed on a regular basis is also very positive as that can ensure that it remains proportionate.

The industry speaker noted that the EU is the only major jurisdiction where MBIs are used. There is a different regime in the US with no late matching penalties and no MBIs. Settlement inefficiencies are penalised through additional costs in the US but are not forbidden like they are in the CSDR. The decoupling of penalties from MBIs and the restriction of the use of MBIs proposed in the CSDR Refit are an improvement. For example for securities financing transactions (SFTs) such as repos, penalties make sense, but MBIs are useless. A two step approach has also been adopted whereby outstanding fails will be considered at the end of the extension period and MBIs would only be implemented at a later stage. There is however still room for improvement concerning MBIs. The implementation of MBIs is operationally challenging for firms and for clients and unnecessarily costly for the industry. There is hope that the Level 2 measures of the CSDR Refit to be drafted will be well calibrated and focus the use of MBIs in such a way that cost and competitiveness impacts are limited.

Another industry speaker agreed that in the US there are no real penalties, it is closer to clean up costs. In other jurisdictions, such as APAC, the penalties regime is stricter however. To address settlement failure in the future, three areas need to be assessed - the accuracy of the information and of instructions, the communication, and fixing issues faster – which are all part of modernising the market infrastructure.

A Central Bank official observed that settlement efficiency has significantly improved in Europe over the last 12 months. This is in part due to rising interest rates which have increased the cost of inefficient settlement, but it shows that progress can be made on these issues. What was missing were the incentives. If the situation continues to improve MBIs might no longer be needed.

2.2 The opportunity of shortening settlement cycles and moving towards T+1

An industry representative noted that with the forthcoming implementation of a T+1 settlement cycle in the US, Canada and Mexico, ongoing work in this area in the UK, and the report due to be published by ESMA by 2024 about settlement efficiencies in the context of CSDR, there is an opportunity to start a broader discussion in the EU about improving settlement efficiency and how automation and standardisation could benefit the European market notably in the pre settlement space. This should be part of the next steps of the CMU initiative. The US Securities and Exchange Commission (SEC) proposal about settlement cycles also discusses the confirmation / affirmation process[1], which is partly in the pre settlement space. In the US, a central matching service is offered for confirmation / affirmation with the generation of a unique transaction identifier (UTI) for each security, which is a positive development in terms of standardisation.

A second industry representative observed that the outcome of the market evolutions being tested in the US and Canada is uncertain. Firms and clients might not be ready to implement T+1 by 28 May 2024, the deadline fixed by the SEC. The US project should nevertheless be followed closely by EU market stakeholders, because it will have a concrete impact on EU firms and their clients trading US securities. A first impact is on the operational processes. Firms and clients outside the US will have to adapt their operating model to the new DTCC rules related to T+1 such as cut-off times. Secondly, impacts can be anticipated on specific products which have a US component such as exchange-traded funds (ETFs) composed of foreign stocks, cross-currency FX and depository receipts, for which there are no exemptions from the US rules.

The opportunity of moving to T+1 in the EU should be assessed carefully with a detailed cost/benefit analysis and an evaluation of the expected incremental benefits compared to the settlement efficiency measures of CSDR, the industry speaker stressed. The EU and the US markets function differently and there is a huge cost involved with this evolution. The EU is a complex and fragmented market, with many CCPs, CSDs, currencies and national specificities unlike the US. There is moreover no US equivalent of the EU Settlement Finality Directive (SFD), which means that irrevocability aspects are very different in the US.

A third industry representative observed that settlement efficiency is currently a prime focus of

1. The confirmation/affirmation process refers to the transmission of messages among broker-dealers, institutional investors, and custodian banks regarding the terms of a trade executed for the institutional investor. Because the trades of institutional investors involve larger sums of money, larger amounts of securities, more parties, and more steps between order entry and final settlement, institutional trades are usually more complex than retail transactions.

ESMA and the European Commission with multiple taskforces working on this issue. One question is whether additional tools should be introduced in the processes of CSDs, such as partial settlement or shaping, to increase settlement efficiency. There are also discussions about whether the EU should align with the ongoing approach being discussed in the UK. Concerning the shortening of settlement cycles, it is important to realise that this goes beyond CSDs and requires an evolution of the whole ecosystem towards a new standard, which is why further assessment is needed.

The first industry representative noted that there are some misunderstandings about what is happening in the US, where the shortening of settlement cycles is an evolutionary process. When the US moved from T+3 to T+2, Europe was ahead, but it was clear that a move to T+1 would happen eventually in the US. That was anchored by the SEC's decision, which took into account the proposals made by the industry (SIFMA, ICI, DTCC) in this regard. The possible move to T+1 is often discussed in the EU as if it were to happen immediately, but this is not the right approach. The settlement cycle can be decoupled from the reflection about the efficiencies that can be brought into the market, for example on trade allocations, to progressively evolve towards a shorter settlement cycle. Automation and standardisation will be key in this regard. It is moreover hoped that the EU and UK can coordinate on this work.

A Central Bank official agreed that settlement efficiency is an opportunity that needs to be further assessed, and it is important to assess the potential benefits of T+1 for the European market and learn from what is happening in the US, despite the differences between the markets.

Another Central Bank official noted that the Eurosystem is ready to make further functional improvements in TARGET Services and T2S in particular to accompany market developments such as T+1 settlement and facilitate cross border CSD settlements.

3. Leveraging the potential of DLT in the post-trading space

The Chair moved the discussion to other changes happening in the post-trading landscape related to new technologies and the opportunities their deployment might offer to move forward on the journey towards an integrated, efficient and robust infrastructure.

An industry representative commented that the existing infrastructure of the equity and bond markets in the EU is quite efficient. While the benefits of an end-state based on a totally distributed DLT system can be imagined, it is necessary to realise that such a move would involve a very challenging transition from the current state. The whole ecosystem will have to evolve towards a new market organisation: CSDs, intermediaries and also the issuers. In addition, the economies of scale from this new technology will only materialise progressively and the scalability of the DLT technology is still to be significantly increased to deal with large volumes. This also means that legacy and new DLT systems will be operating in parallel for a long time.

The DLT pilot regime can help to test new solutions and act as a catalyst in the market, but it will only provide learnings on the feasibility of DLT systems on a small scale and in a very controlled environment, the industry speaker stressed. A different approach will be needed to prepare the transition path towards a new settlement system for core securities and to test interoperability and connectivity on a large scale. This requires a comprehensive reflection at market level on how settlement efficiency can be improved while maintaining resilience. Different drivers need considering such as technology and the reduction of settlement cycles. A 10 year period is the standard period for large developments such as this. In the shorter term, optimisations should focus on financial instruments that are less automated with less efficient processes. In parallel a path for the future may be devised building on the learnings of these initial improvements.

A Central Bank official emphasised that the Eurosystem monitors and analyses technological developments that may be relevant for future TARGET Services enhancements. One of the aspects is the role that central bank money settlement could play in the context of new technologies like DLT. Practical explorations will be carried out together with the market starting in May 2024, to gain insight into how different solutions could facilitate interactions between TARGET Services and DLT platforms. This demonstrates the practical willingness of the Eurosystem to keep pace with the current dynamics related to technological innovation. Market participants are asking for further process improvements that can speed up transaction processing and cut down risks and costs. From a financial stability perspective, it is also important to provide future proof, safe and efficient settlement mechanisms functioning in a continuous way and ideally settling in central bank money. This is exactly why the Eurosystem recently announced to launch explorations in the context of the 'new technologies for wholesale settlement contact group'.

A technological big bang is not expected however, but an evolution, where interoperability may play a key role, between different evolving asset chains and in connection with TARGET Services. Concerning the connection with TARGET Services, a 'trigger solution', that has been experimented by the Bundesbank, could provide a technological bridge for the settlement of DLT based wholesale transactions in traditional central bank money in TARGET Services. This quick-win would enable the Eurosystem to foster the development of innovative DLT platforms without the need to provide DLT based central bank money in the short-term.

With regard to the DLT pilot regime, the Central Bank official considered that it has a raison d'être, since existing EU regulation on securities markets is only applicable to tokenised transferable securities. However, the value threshold that has been set, as well as the limited period of application, may lower the attractiveness of this specific regulatory sandbox, particularly for established players in the market. In this respect, it is uncertain whether it can truly be a gamechanger.

A second Central Bank official stated that Central Banks have a role of nurturing innovation in a safe and controlled environment. Innovations such as DLT, smart contracts and tokenisation should be embraced, even if their potential is not yet fully demonstrated, but in a safe way. If an accident occurs at an early stage in the development of a new technology, it will be discredited and discarded, which may lead to missing out on the potential of this innovation. In this perspective, the Eurosystem is devising different solutions to provide central bank money that may allow carrying out the settlement of transactions on DLT systems in a safe way. It is urgent to start discussions about how to develop these solutions, which require significant investment and time to mature, and how to transition from the current state.

A third Central Bank official stated that the ECB is endeavouring to leverage TARGET Services and the systems and technical know how of Central Banks to support innovation. Trials and experiments involving the market will take place in the near future. A survey is currently being conducted by the ECB to gauge the preliminary interest among financial market participants and DLT operators for participating in these experiments.

Conclusion

The Chair noted a broad agreement amongst the panel that innovation should be embraced in its widest sense, but an immediate big bang cannot be expected. Progress is been made on the collective journey of market participants and Central Banks to improve post trading infrastructure. There is momentum and different opportunities are emerging related to settlement efficiency and technology, which is very positive. Transitioning towards a new optimised system is nevertheless a long term project that involves the whole market ecosystem and requires appropriate assessment and planning.

Sessions VII

FINANCIAL STABILITY AND CLIMATE RISKS

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Financial stability risks in Europe

The Chair stated that although financial stability risks are currently under control, the question is how long that will remain the case. The panel will consider the main risks and vulnerabilities, first in the banking sector and then in the non-bank sector.

1. Financial stability impacts of the current monetary and economic environment

1.1 The macro-economic environment of persistent high inflation and low growth

A regulator pointed out to the strong bank performance in Europe over the last months. Also, the recent results of the stress tests have hinted at stronger resilience against an unprecedented adverse scenario. On the other hand, high bank profitability is high not because of structural reforms in the banking sector nor for the credit institutions' capacity to enter into new markets or launch better products, but because of the automatic widening of the net interest income (NII), which is due to changes in monetary policy conditions but has been also helped by the banks' slow response on the pricing of their liabilities, first and foremost their customers' deposits. This is a historically unprecedented case of inertia and perhaps even sleepiness. Certainly, credit quality has improved and the Single Supervisory Mechanism (SSM) has done its work. However, the buffer of NII profits will be eroded, making more difficult for banks to insulate from global adverse trends.

In fact, the economy is weakening, and inflation has remained high, while real GDP is expected to remain subdued in the coming months, having broadly stagnated over the first half of this year. Besides the overarching issue of tighter financial conditions, macroprudential authorities have pencilled many reasons of concern, like fragility in commercial real estate, and problems from lower growth in China and worsening trade fragmentation.

That raises some fundamental questions. How quick profitability will be reduced, also due to the already significant decreasing lending demand? What impact will rising interest rates have on asset valuation? Will deposit stickiness be preserved, or will new technologies erode the franchise value of banks?

1.2 Risks and vulnerabilities are sensitive to the tightening of financial conditions

1.2.1 Member state public indebtedness and the sovereign bank loop

A Central Bank official emphasised that financial stability is necessary for the smooth transmission of monetary policy. Central banks should be concerned with public debt issues, because they are part of the financial loop, and government bonds are in banks' portfolios. Public debt increased because of the pandemic and the energy sector problems, but it is falling back now despite the fact of still large primary budget deficits in certain member-states. The situation is indeed under control because of the so-called snowball effect: the difference between the nominal growth rate and the effective interest rate on public debt is positive because inflation goes high as GDP growth is positive. Despite interest rates rising because of the European Central Bank (ECB) activity, the average interest rate on public debt is still 1.7% in the eurozone. That has helped governments bring down the public debt to GDP ratio.

However, as monetary tightening has caused a general increase in interest rates and weaker growth, there is no room for complacency in fiscal policy. The average interest rate on public debt is expected to go up. That will impose strains in the public debt path. Moreover, the bank sovereign loop is still important and remains a supervisory concern. Regulatory reasons dictate it because banks use government bonds in their portfolio to satisfy liquidity coverage ratio needs, and also because there were large public deficits, so there was a great deal of issuance.

1.2.2 Keeping a restrictive fiscal stance

A Central Bank official stated that it is in everyone's interest to have a prudent fiscal policy that takes care of deficits and makes sure that public debt is falling. It would be imperative for the European Commission, the Eurogroup and the European leaders to agree on the new fiscal rules, since the old ones are characterized by inflexibility and pro-cyclicality. The balance sheet of the Eurosystem has shrunk a great deal, not because of outright asset sales but due to TLTRO redemptions and the pause in APP reinvestments.

1.2.3 Where the impact of higher rates could be felt

A Central Bank official noted that it is difficult to think about banks in isolation because banks' balance sheets reflect the balance sheets of the economy. The big story over the past 18 months has been that sharp transition to higher rates combined with greater market volatility. Large parts of the financial system and the economy have been resilient to the rate rises; the impact will take time to come through.

Part of the story for the system's resilience has been the regulatory measures put in place. The UK and Europe have capitalisation for interest rate risks in the banking book and high levels of bank capital. There are high levels of liquidity buffers and regular stress testing. What happened in March in the US is the impact of the higher rate environment on the banking sector starting to flow through. There is higher NII for a while but not forever. It does impact and increase unrealised losses.

There is a long list of potential areas where the impact of higher rates and greater volatility could come through. Commercial real estate (CRE) is an obvious area. There are leverage loans as well. The slowdown in China and the geopolitical environment are also on the list.

The Chair noted that each market is very different in terms of CRE. The financing structures and tenors are different. However, the US, Sweden and Germany demonstrate an obvious shakeout. The question is whether these will be healthy shakeouts required after a boom phase, or will overshoot into the collapse of healthier vehicles, developers and players.

A Central Bank official added that there is a structural trend in the CRE sector. Some buildings are easily made more sustainable than others. There are shifts in demand patterns away from town centres. With stress, many of those structural issues are brought forward.

The Chair observed that due to the interest rate driven stress that all asset classes are subject to, plus office and retail in parts, there are structural factors, and in many jurisdictions, it is the end of a long boom phase, so there are exaggerations that were built up in recent years.

1.2.4 The benefits of the increased interest rates on banks profitability are transitionary

A Central Bank official stated that the tightening of monetary policy supports banks' profitability through net interest rates and related income, but this is not expected to continue. Although banks immediately priced the new interest rates on their lending rates, the beta on deposits is small, especially in the European south. This will not continue because depositors will try to find other outlets for their savings and the reduction of loan demand. Furthermore, access to capital markets and bond markets will be more expensive for minimum requirement for own funds and eligible liabilities (MREL) needs, so over time the net interest margin will fall and the funding costs will be higher. Hence, banks should be prepared for a more difficult banking and macroeconomic environment.

The Chair agreed that there will be a normalisation of interest margin, which was artificially low in the zero or negative interest rate environment. It might be artificially high now, and most banks probably know that if they do not reduce that margin themselves by treating their customers differently then somebody else will come and change their interest margin for them. The sustainability of that part of the profit and loss should not be projected into the long-term future.

1.2.5 Implementing Quantitative Tightening (QT)

A Central Bank official suggested that the place to start is pre-crisis, prior to quantitative easing (QE). What was learned from that period was that the level of reserves and liquidity in the banking system was too low. Central bank balance sheets expanded, and that partly addressed that issue. Central bank balance sheets will remain larger than they were pre-crisis for financial stability reasons.

The difficult question is what the end state looks like, in terms of the level of reserves needed in the system. That will depend on the future size and makeup of banks' liquidity buffers. Banks' liquidity buffers are a combination of reserves and high-quality liquid assets. If the right makeup is known then the right level of reserves can be targeted in response. Getting there involves thinking about implementing these strategies gradually, always taking into account financial stability.

The Chair added that there is a need for close coordination and information exchange between supervision and the monetary policy side of the central banks.

1.3 The relevance of the crisis earlier in the year to the full implementation of the Basel standards in all jurisdictions

A regulator noted that the international standards already contain a number of prudential controls for interest rate risk. For the marked-to-market portfolio, changes in interest rates affecting asset valuations are reflected in both the accounting and regulatory capital frameworks. More problematic is the treatment of interest rates in the banking book. The international standards prescribe that this should be dealt with under Pillar 2.

The potential controls were not effectively applied in the case of the US during or before the turmoil. Silicon Valley Bank (SVB) and other regional banks in the US are not subject to the Basel standards, and the applicable prudential regime implied that some unrealised capital losses in the marked-to-market portfolio, while recognised in accounting income, would not be deducted from regulatory capital. That is a very odd situation under which the accounting regime is more prudent than the prudential regime. In addition, there is no articulation of Pillar 2 in the US. Therefore, interest-rate risk in the banking book is not subject to specific prudential controls, such as capital add-ons.

The situation in Europe is much more robust, especially because of the application of both Pillar 1 and Pillar 2 to basically all banks. The developments in the US have shown that the increase in interest rates has unveiled clear vulnerabilities in the business models of some regional banks. Those banks were running unsustainable business models characterised by excessive risk concentration on the asset side, excessive dependence on unstable sources of funding on the liability side, and excessive maturity transformation.

1.4 More effective, forward-looking and intrusive supervision

A regulator remarked that there is no capital or liquidity that could compensate for an unsustainable business model. Intrusive supervision is needed. The framework in the EU is quite robust. Within the Supervisory Review and Evaluation Process (SREP) process there are specific chapters for interest rate risk in the banking book and for business model sustainability.

In general, the first priority of most banking authorities around the globe should be to strengthen supervision. Supervisors need to have the powers, tools and culture required to effectively challenge the business model, governance structure and risk management procedures by financial institutions.

The Chair agreed about the need for a combination of regulation, supervision and bank risk management. The lesson from the US regional banks is that if a bank does not have this correctly on its radar and under control, and if the regulator or supervisor is not on it then this risk category can take banks down very quickly.

An industry representative observed that Europe has been very pragmatic. It has had data driven, collaborative engagement with industry and those impacted by its decisions. Interest rate hikes do not necessarily cause holes in the system, but they can but reveal them. SVB and other incidents revealed what all have acknowledged were supervisory failures.

2. Assessing and addressing risks in non-bank financial intermediation (NBFI)

2.1 Ongoing work to enhance NBFI resilience

The Chair stated that the distribution of risk throughout the non-bank sector in comparison to the setup prior to the financial crisis is risk reducing, because of that dispersion, but there is a danger of blowback into other parts of the financial system. The risk has been moved into less transparent parts of the system.

A regulator explained that asset managers are trying to adapt to the abrupt end of low-for-long. On the other end, an entire generation of asset managers has never experienced interest rates this high, nor macro conditions with inflation like currently. Are they going to be able to manage risks appropriately? Bond funds are reducing the duration of their portfolios, which is per se welcome. Also average portfolio maturity for money market funds (MMF) dropped sharply in 2022, while now is fluctuating.

A few risks have to be controlled, first and foremost credit risk. The credit quality of portfolios exposed to certain categories with lower credit standards has now deteriorated to a five-year low. The capacity of markets to exercise foresight on incidents is also limited: for example, with Archegos it was not just macroprudential authorities that were surprised. Banks did not even know size and complexity of their exposures. Finally, dramatic developments like those with liability driven investments (LDI) also pointed out to the serious adverse impact of domestic political risk.

Turning to commercial real estate, real estate investment funds are often even more important than banks, in terms of support they provide to market participants via alternative lending. Counterparts are exposed to high volatility in valuation.

On the other end, some measures have been taken. Recently, EU authorities reached an agreement on the review of Alternative Investment Fund Managers Directive (AIFMD) and undertaking for collective investment in transferable securities (UCITS). This contains a strengthening of liquidity management tools. Previously the only available tool was 'institutionally charged' possibility for suspensions: now, there are 10 tools. Each alternative fund manager will have to choose at least two of them. The European Securities and Markets Authority (ESMA) has been given an important implementing mission.

The Chair noted that with the LDI there was the NBFI moment in the UK, which showed that when talking about margin call risk, hidden leverage or underestimated leverage risks there is something there.

2.2 A system-wide perspective to address risks to financial stability

A Central Bank official noted that the Financial Policy Committee put in place a resilience standard for LDI. This provided some helpful pointers for how to think about building better resilience in the non-bank sector. There is not likely to be a single macroprudential tool to address some of the risks in the NBFI sector. The role of firms within market-based finance and interconnections between them can change through time and often quite quickly. Monitoring and being able to stay on top of some of these issues is crucial in this sector because it is not necessarily a slow-moving risk.

In terms of identifying risks a broad approach is needed. Weakness in a business model or a type of product if well managed may, in and of itself, probably not be an issue. It is a risk that needs to be managed and mitigated. However, when it interacts in the context of a market or a stress, it can be an amplifier. With the LDI experience, weaknesses in business models in a relatively concentrated market combined to risk causing real economy impacts.

One approach being taken to improve the ability to spot those risks is a system-wide exploratory scenario (SWES). It is focusing on a number of core UK financial markets. Specifically, gilts, gilt repo, sterling corporate bonds and a number of associated derivative markets; this involves 50 market participants (banks and non-banks) in the UK aiming to reflect both activity and diversity in those markets. The idea is to model a stress with these participants to see where the strains and weaknesses appear, where liquidity flows to, and where it does not, and to see how to think about these risks in a system-wide way. This reflects a macroprudential and system-wide focus – and a desire to better understand market resilience rather than individual firm resilience.

2.3 The European approach to MMFs

The Chair stated that the MMF sector has served as a systemic risk accelerator at least twice recently. An industry representative highlighted the need to talk about non-bank financial intermediaries. Asset management there is extremely well-regulated, extremely transparent and extremely resilient. It has very proven risk management tools that it uses on a consistent basis. It partners with regulators who help and provide even more tools.

With respect to MMFs, Europeans should be applauded for their approach. A number of real-life stress tests have been withstood. Whether it is specific to MMFs, or even more in open-ended funds longer term, it should be ensured that sectors that have actually proven that they have been resilient through real-life stress tests are not gone after. Central bankers and regulators have an obligation to investigate and identify the dangers there are. If they see something, they have to assess the threat. However, their first instinct should not be to kill the sector. It should be to identify what the data demonstrates and then to act appropriately.

The Chair challenged the observation that MMFs have always been resilient. There have been a couple of episodes where they were only resilient because there was a market maker of last resort from the central bank community. The aim is to avoid that happen again by finding the right tools. An industry representative emphasised that it is not always possible to solve for the 0.1% exogenous event. Central banks are seen as the lender of last resort that save the industry when things are out of the ordinary.

The Chair remarked that the concern is around the moral hazard that comes with the idea that there are market makers of last resort. When considering what has happened in the non-bank markets, and the risks that have crystallised, crypto, energy and commodity markets can be looked at.

2.4 The interaction between non-financial intermediaries and the traditional financial system

A regulator noted that there have been some recommendations by the Financial Stability Board (FSB) on how to improve the regulation of the MMF market. First is trying to mitigate the role that MMFs could play in accelerating problems due to liquidity mismatches, leverage and so on. A sector-by-sector approach is helpful, but a comprehensive framework to understand how different players interact in creating and accelerating financial instability is preferable.

The most urgent area for the regulatory and supervisory community is around the interaction between the non-financial intermediaries and the traditional financial system. The problem with Archegos was not Archegos itself but its links with some traditional financial institutions, including Credit Suisse. Banks are quite exposed to NBFIs. They provide liquidity facilities, investment opportunities and prime broker services; they also facilitate access to centralised clearing and act as a counterpart in derivative transactions.

Therefore, although the growth on NBFIs has implied a transfer of business from traditional banks to NBFIs, the risks have not disappeared. Banks are still indirectly exposed to the same risks through their exposure to the NBFIs. Those linkages between the traditional banking system and the NBFIs are concentrated on a few entities. ECB data shows that in the banking union there are 11 significant institutions with 80% of those linkages on the asset and liability sides. Those interconnections can be a cause of financial instability, so the regulatory and supervisory framework may need to be adjusted to be able to deal with them.

The Chair suggested that parts of the sector are more difficult to make visible to understand the connections, but the interface back into the banking system is one that banking supervisors are tasked with seeing. The Archegos episode shows the risk management is not adequate. It can very quickly spiral into something extremely damaging.

2.5 Addressing the structural change in the financial system

A Central Bank official stated that the non-bank financial sector, including MMFs, hedge funds, private equity funds, asset management companies, insurance companies and pension funds, has in general behaved rather well despite the multiplicity of shocks in recent years. Banks outside of the remit of eurozone supervision, such as SVB or Credit Suisse, had problems. The work of the SSM should be praised. It has managed banks quite well and has eliminated the national bias from the supervision of banks.

However higher interest rates, low growth and demanding market valuations provide reasons for concern, particularly given the various exposures of banks to non-banks. The policy framework has to be completed and the sector made more resilient.

Supervisors and regulators of non-bank financial institutions should strengthen their rules, especially regarding governance, liquidity mismatches and capital adequacy. For instance, the same governance required of banks should be required of the non-banking financial sector. Excessive exposure to commercial real estate and retail real estate could be dealt with through borrowed based measures and macroprudential buffers. The April 2023 crisis management/deposit insurance proposals of the European Commission should proceed without delay as a step in the completion of the Banking Union in Europe.

All supervisors should increase their coordination, cooperation and exchange of information. Supervisors should enjoy independence and respect in the exercise of their duties, as well as have adequate resources. The SSM has been successful in the supervision of European banks and should be used as an example in other jurisdictions. Enhanced cooperation is also needed between banking supervisors, capital market committees, bond supervisors and capital market supervisors.

Climate and environmental risks in the banking sector

1. Most significant difficulties faced by banks attempting to assess climate risk

The Chair stated that both transition and physical risks must be considered in addressing the existential challenge of climate change. The difficulties relevant to facing physical and transition risks are becoming more salient each year. G20 financial institutions have close to $22 trillion of exposure to carbon intensive sectors.

Work is ongoing by international organisations, supervisory authorities, and regulatory bodies to foment a global transition. The panel would consider the actions taken by banks and financial institutions in this regard and recommend actions to take the transition forward in two rounds of discussion: the first on the environmental, social, and corporate governance (ESG) practice of banks and the second on the regulatory framework. The panel are asked to describe the most significant difficulties faced by banks in attempting to assess climate risk.

1.1 Data availability, accuracy of methodologies, addressing the long term and forward-looking nature of sustainability risks, customers and sectoral and regional transition plan availability are among the many challenges ahead

A Central Bank official commented that availability and quality of data and its interpretability from a financial point of view is a key challenge faced by banks when assessing climate-related risk. Different banks report data based on different standards, which is mitigated somewhat using data from third-party companies, and different countries have different approaches, regulations, and paths to decarbonisation.

The methodologies available to measure climate-related risks, which are forward-looking and long-term, lack sophistication. Transition planning, while a valuable tool for management of climate risk, must be based upon the plans of banks' clients. These clients have yet to develop fully mature transition plans. There is also a lack of expertise in the sector. Litigation might become a challenge in the future. In some cases, social pressure is increasing, which might accelerate the impact of climate risk on financial institutions' balance sheets.

Supervisors can support banks and financial institutions to continuously engage with their clients. Supervisors share many of the challenges of banks when assessing climate risk and are attempting to overcome them through groups of external experts and internal networks.

1.2 The heterogeneity of banks' approaches adds to the challenge

An industry representative noted that financial materialisation of the financial risk of climate change is still limited in bank's balance sheets, not allowing for ex-post empirical evidence or ex-post risk differentiation, nor the use of the usual back-testing. Methodologies between banks are highly divergent and it is difficult to obtain high quality data. Banks and financial institutions are yet to fully appreciate the potential impact of climate risk on business activities. Relying on stress testing as a single tool might not be sufficient to properly evaluate climate risk management. A holistic view must be taken of the metrics and tools available.

An IFI representative stated that financial institutions are in one of three categories: early stage, developing practice or advanced practice. In the early stage, institutions might quantitively assess the physical risks of a number of investments. When exhibiting developing practice, institutions might start to undertake qualitative assessment. Advanced practice, wherein physical and transition climate risks are identified, described and both quantitively and qualitatively assessed for inclusion in risk management and business planning, is the aim. However, few institutions are currently in this position.

2. Stress testing is a key tool for assessing climate-related risk in a forward-looking way. Progress on client-specific data, modelling, accuracy and granularity is still needed, while mainstreaming stress testing among banks and their clients

The Chair observed that stress testing is another key focus. A regulator stated that, in addition to data disclosure, a forward-looking approach must be developed to foment a deeper understanding of climate-related risk.

The Autorité de Contrôle Prudentiel et de Résolution's (ACPR)'s first pilot exercise in 2020 showed an overall moderate level of vulnerability in the French financial sector and in Europe as a whole. The exposure of French institutions to the sectors most impacted by transition risks is relatively low. The cost of risk and the probability of default have increased. In some cases, the cost of risk is tripled. Insurance claims on physical risks might multiply five or six times in certain French areas between 2020 and 2050 and some parts of the country are at risk of being uninsurable.

The European Central Bank's (ECB) stress testing has resulted in a number of lessons learned. Stress testing is instrumental in identifying and quantifying the financial risks of climate change and it is a complex exercise. Progress has been made in terms of improving scenarios and methodologies, but there is still more to do.

Testing must become operationalised. There must be investment in climate-related data collection in order to lessen reliance on proxies. Methodologies and models must be improved, and customers' transition plans integrated into banks' own. An industry representative agreed that, to ensure accuracy, there must be a bottom-up approach to transition planning. The macroeconomic assumptions made by the Network of Central Banks and Supervisors for Greening the Financial System (NGFS) must also be taken into consideration. External validation is key to ensure a robust approach.

An industry representative commented that the results of stress testing might be reflected in capital requirements in the future, but stress test methods are not ready yet and are still developing and are currently not accurate enough to be used directly for risk management in his view. Also, in relation to climate related scenario analysis, it is key to improve the scenarios to help financial institutions predict risks for long term into the future. Such improvements will be supported by deep understanding of their clients' business, industrial structure, and transition plans, which could be obtained through engagement with the clients. Financial institutions need to work with various parties including regulators and clients to improve the scenario analytical skills.

The Chair summarised that both stress testing and integration must move from the pilot stage into operationalisation.

3. A key challenge for financial institutions is to become able to take the additional medium- to long-term strategic risk specific to the support required by the clients' transition

An industry representative explained that financial institutions must be able to take strategic risks in order to provide financial support for their clients' transitions based on careful risk management and ongoing engagement. Not only banks but the clients of financial institutions are also planning to make transition, and this will be important for our society to achieve transition. Financial institutions will support the transitions of their clients by providing financing if the clients meet certain criteria, a mere exposure reduction to carbon related industry will not achieve the transition. Development of a risk control framework around carbon-related sectors aids this process. Client exposure to carbon intensive sectors should be assessed alongside the measures in place to address transition status of the clients.

Support for the transition could lead to a temporary increase in Financed Emission for financial institutions so it is important to establish transparent process to confirm the reliability and transparency of clients' transition strategies especially when financial institutions need to explain the efforts to respond to climate change to the stakeholders. As such, financial institutions need to pursue good balance between transition support financing and risk management.

The Chair agreed that transition plans are a key aspect of the debate.

4. Transition planning is emerging as the prevalent tool to manage climate-related risks with a forward-looking mindset

An IFI representative observed that transition planning presents a valuable opportunity for banks to ensure that the institution itself is green, in line with the Paris Agreement. Transition plans are emerging as the primary tool by which institutions can do this and be forward-looking when attempting to manage climate-related risks.

Transition plans allow financial organisations to take into account their specific starting point and move to the next level of climate-related risk analysis. Climate risk integration must be accompanied in the transition plan by transparency around climate-related risk disclosures, which in turn requires the development of more effective data infrastructure.

5. Transition planning is the operational tool to assess and achieve banks' sustainability risk reduction

5.1 Key transition planning success factors

A regulator observed that transition planning is the action required to push the banking sector towards decarbonisation. There are three high-level factors to make such a plan effective. First, it must be credible and align with the means of banks and their counterparties. Ambitious targets are of no use if there is no way for them to be met. Second, it must be consistent with EU climate-related objectives and sectoral transition plans. The whole environment must be taken into account.

Finally, it must be compatible with existing requirements, including Pillar 3 Implementing Technical Standards (ITS) and Corporate Sustainability Reporting Directive (CSRD) accounting standards. Information should be standardised to facilitate compatibility and the latest scientific advice must be considered.

An IFI representative stated that transition plans must also include targets on emission reductions. The end goal of net zero by 2050 must be taken into account during the planning process and applied to both financed emissions and those of the company itself. A bank's fossil fuel policies should be supported by strong internal governance, intent on pursuing climate risk measures. The NGFS May 2023 stocktake indicates that existing transition plans are too focused on either strategy or risk. The two factors must be merged and balanced for success.

5.2 The reliability of transition plans and their consistency with banks' environments are two critical factors

The Chair noted that transition plans form an important element of stress testing. An industry representative stated that stress testing is only one approach. Banks are responsible for managing their own risk, but there is an evaluation role for supervisors to play. The European Banking Authority (EBA), ECB and ACPR hold the key to achieving better risk management, as they consider business model, governance and risk and capital through three of the four European supervisory review (SREP) pillars.

Alignment of a bank's transition plan, commercial offering, governance, risk policies and stress testing is crucial to all parties concerned. Validation of decarbonisation plans by the Science Based Targets initiative (SBTi) ensures their adherence to scientific standards. It is also wise to incorporate climate risk into a bank's credit granting policy and credit positioning.

Both banks and supervisors should take a holistic view of climate risk exposure and strategy. There is a lack of expertise and resources within supervisory bodies, leading to reliance on external independent bodies. The latest European Commission consultation might help in this regard, by providing a robust framework to ensure consistency.

5.3 Guidelines and regulatory and supervisory standards are necessary

A regulator stated that the EBA would develop guidelines, in line with Basel Committee discussions, to inform the transition planning process. The first priority would be to define the content required. Supervisors would also have an interest in ensuring that transition plans are actually implemented, which might require some additional powers. It is likely that such powers would be granted by the upcoming Capital Requirements Directive VI (CRD VI).

Climate risk is arguably a new risk, not an addition to those existing within the SREP framework. It must be integrated as its own category, as it has the potential to impact on governance, business models, strategy, and other risks. Within the Pillar 2 framework, supervisors might recommend that banks adjust their business models according to climate-related risk, as well as asking for higher capital requirements.

6. Expected impacts of climate-related risk on the three pillars of banking regulation

The Chair noted that supervisory bodies appeared to have the upper hand as to the effective assessment of climate-related risk.

A Central Bank official highlighted the final EBA paper on incorporation of climate risk into Pillar 1. It is to be treated not as a separate risk, but as an element of traditional financial risk. For example, it is recommended that climate risk be taken into account when rating or validating collateral as part of credit risk standards. In such cases, the internal ratings-based approach (IRB) is favoured, as its models are flexible. It is important that climate change-related factors are taken into account in operational risk, as some might trigger operational losses.

In terms of Pillar 2, supervisors are forced to rely on the 2021 paper issues by the EBA, as well as the Single Supervisory Mechanism's (SSM) approach to including climate risk in SREP analysis. The latter includes climate-related risks as a factor that might impact traditional financial risk, not a risk in its own right. The ITS from the EBA has put Pillar 3 into practice and institutions are beginning to publish data homogeneously.

The Chair summarised that it is clear the sector is moving forward in the area of climate-related risk. It is hoped that institutions will work together to facilitate a transition to the benefit of all in a timely manner.

Climate and environmental risks in the insurance sector

1. Aspects of sustainability risk

The panel will focus on how to measure the impact of climate risk on insurance companies and how to communicate the risks, exposure, and sustainability activity.

1.1 Insurance gap

A market expert remarked that there is hardly a need to repeat the messages about how insurance business models see themselves impacted by climate risk. There have been many discussions recently about insurance companies withdrawing coverage, raising premiums, and advocating for private/public partnerships to help cover the risks.

1.2 Sustainability risk's impact

A market expert highlighted that despite the gravity of the discussion and what is happening, the scenario analyses have concluded that things are fine, which is at odds with reality. The main conclusion of these exercises is that they are currently not useful for deriving any meaningful measures to mitigate and address the risk.

These exercises still have many limitations and are increasingly at odds with what climate science says. Many models used for scenario analyses are inherently flawed from an economic perspective. For example, the scenario analyses conducted by the NGFS do not consider extreme weather events, sea level rises or major societal impacts from climate change, such as mass migrations. Although these exercises should not be abandoned, they have to be improved and be both realistic and based on the climate science facts.

2. Improving risk measuring tools and data

A regulator stated that the European Insurance and Occupational Pensions Authority (EIOPA) is trying to create a bridge between scientists, universities, the people involved in measuring climate risk and the practitioners in the industry. That is being done with the CLIMADA app. Especially for smaller, medium-sized insurers, the capacity to measure the impact of climate risk on their businesses is limited by the lack of data. User-friendliness of data is an area EIOPA has tried to improve.

Improving the quality of the data is one of the topics in EIOPA's sustainability agenda. The European Central Bank (ECB) and EIOPA are working on how to enhance the capacity of the system to cope with natural catastrophe risk linked to climate risk.

Thanks to application guidance issued by EIOPA on how to reflect climate change in ORSA, insurers are coping more with the risk and are trying to measure it.

2.1 Data availability and quality

An official stated that insurance supervisors consider climate risk to be a driver of many risks that insurers are exposed to, so it needs to be embedded in the risk management and supervisory work, both on the macro and micro prudential sides. What matters is having a forward-looking perspective, and that is where scenario analysis is needed.

The first challenge is that there are still many data gaps. Relevant data is needed to carry out the analyses and entities do not necessarily have all the necessary underlying data. Progress has been made in filling the data gap, but, for example, geolocalisation data are still sometimes missing.

The second aspect is that the climate scenario is still rapidly evolving and not all of the industry or all supervisors are specialists in climate science. A great deal of capacity building needs to take place. Sharing experiences between supervisors is very important.

The last element is that there is a great deal of complexity due to the many aspects to consider in the balance sheets of the insurers, as well as volatility in the results. It is not linear work, so sometimes a small change in some assumptions can have drastic results. That involves selecting whether to only look at baseline scenarios or how extreme the scenarios should be, in order to give an evidence base to supervisory decisions and incentives for insurers to adapt.

An industry representative added that entities have to look at their portfolios and the exposures on companies that are heavily involved in fossil fuel activities. The biggest challenge is how to assess the impact of transition-related risk and physical risk on other sectors in the portfolios. One example is how such risks could affect the banking sector, which is typically one of the sectors that life insurance companies invest a great deal in. There is a reliance on ratings and assessments, which are provided by third-party information providers and rating agencies. That is a challenge because there is a need to improve the quality of such data from external sources.

Even more challenging is incorporating, on a forward-looking basis, climate-related risk analyses in the solvency capital assessment. These efforts are aimed at determining, from what there is in the portfolio, what could happen in the long term. There are guidelines from regulators on how to do that, but a common industry framework has to be developed.

An official remarked that another aspect is disclosure at corporate level. The International Sustainability Standards Board's (ISSB's) work is welcome. It will help to create momentum and resolve many of the issues around data gaps. IAIS is engaging with the ISSB on the industry-specific aspect, to assess the level and quality of information that insurers need to disclose. One issue is how to use the disclosures to improve the approach of climate-scenario analyses and how to translate the enriched disclosure into the supervisory work and insurers' disclosures.

A regulator emphasised that it is important to return to practicality. The ISSB's work helps in that respect, as will endorsement from international regulators and ensuring that there is interoperability with the European Financial Reporting Advisory Group (EFRAG). In the UK, insurance companies, banks and others have become signatories to net zero commitments. However, we need to move from commitments to action, to ensure firms can achieve the targets they have set. UK insurance companies have started to act in relation to their investments, such as disposing of coal assets. Transition plans will be key in helping firms to assess what more they may need to do.

2.2 Top management involvement is a prerequisite

An industry representative remarked their organisation decided to involve the top management of the company on climate-related risk, and it developed and implemented some guidelines. It has a policy for responsible investments, guidelines on how it invests in 'sensitive sectors', and guidelines on how it engages with counterparties, including how to exercise voting rights. The implementation of those policies is under the direct responsibility of the top management. The challenge has to be tackled from the top.

3. Disclosing consistent forward-looking projections

3.1 Defining disclosure standards on transition planning

A regulator remarked that an entity indicating what its scope three emissions were for the previous year does not help them reach 2050 targets. Investors and supervisors want to see credible plans to get to 2050.

The UK Government, along with companies and regulators, have set up the Transition Plan Task Force to develop a framework for private sector climate transition plans. The draft framework mentions the ISSB standards 29 times, so although set up in the UK, it has a truly global focus. The TPT has used the regulator's digital sandbox to allow firms, including insurance companies, to test the TPTs draft framework to see how this works in practise.

3.2. Defining transitional finance

An industry representative indicated that when formulating the company's transition plan to net zero in August it was hard to find the right balance between the commitment and the uncertainties around the world. A definition of transitional finance is not yet shared among stakeholders. The G7 Hiroshima Summit communiqué mentions the importance of transitional finance, but to integrate transitional finance into transitional planning, consensus is needed on what kind of finance that is transitional.

In general, the energy composition of Asian countries, for example, is highly dependent on coal-fired power generation. Temporarily increasing financing for brown sectors, such as high-efficiency gas-fired power plants, is inevitable to secure stable and affordable alternatives. Activities and sectors considered as 'supporting the transition' can vary between jurisdictions and over time. There is a need for concrete green energy transition roadmaps at the national level. The transition plan has to also be just so no one is left behind. That involves social dimensions, such as labour mobility, re-skilling people and reimbursing communities. How to deal with hard-to-abate sectors and provide them the transitional finance has not been sufficiently discussed and will be a major theme for 2023 United Nations Climate Change Conference (COP28).

4. Reducing green washing

4.1 Improving disclosures and label accuracy

An official stated that part of IAIS's work plan was on climate disclosures. There is increasing demand from policyholders for sustainable products, either in life or non-life. That creates market conduct risk for greenwashing. The appetite for sustainable products should not lead to false or unfair representations from insurers or distributors. IAIS aims to publish another application paper later in the year considering the steps insurers and supervisors can take to avoid this risk. That might include recommendations on common definitions.

A regulator added that EIOPA is working under the mandate of the Commission to tackle greenwashing. The legislation in place is not complete or clear and with the increase in demand for more sustainable products this can lead to abuse and greenwashing. An insurer could say that for each product it sells it plants a new tree but then not do so. The conduct side is an area where there can be misguidance to clients about the sustainability features of a product or a disregard for the sustainability preferences of the client during the advice process.

This sustainability feature has begun to be integrated into supervisory activities at the national level. There are challenges, such as a lack of skills, but there are also opportunities. For example, supervisory technology (suptech) might help in screening the information and the disclosures. The authorities are also working to suggest improvements to the implementation of the Sustainable Finance Disclosures Regulation (SFDR). Behavioural research, for example, indicates that people still do not understand what a sustainability feature of a product is when looking at the key information document.

Currently the insurance sector does not have enormous greenwashing cases, but there have been such cases in other, non-financial fields. There can be optimism and confidence that the industry is playing its role, but the legislative framework can be improved and the supervisory skills and activities have to develop further.

A regulator suggested that the UK is similar to other places in terms of greenwashing. There have not been many guardrails or metrics like those from the ISSB, and as firms increasingly make sustainability-related claims about their products and services, there are growing concerns that some of these may be exaggerated or misleading. The UK's SDR and labelling regime will help to combat this, and the FCAs approach has consumers at its heart. Entities do not have to have green products, but if they do, then those products should do what they say they do and be able to demonstrate that. One of the labels that the UK's SDR labelling regime will introduce, will be the 'sustainable improver' label, designed for investments in firms that, while not sustainable today, are on a credible path to becoming more sustainable over time. It is acceptable to be a transitioning oil and gas company, but that has to be explained and the transition plan has to be credible.

The FCA is pushing investors. It regulates the asset managers, and many of them are the asset owners of the insurance companies. They are now pushing insurance companies to state what is meant by their commitments. In the UK, the government is consulting on whether ESG ratings should be regulated because they have a powerful role in giving valuations. That involves asking how they are doing their jobs, what methodology they have, what the transparency is like and how conflicts of interest are managed.

4.2 Consistent definitions and standards to combat greenwashing

A market expert remarked that for investors to be willing and encouraged to move to green products there have to be products available that effectively contribute to real economic activities towards being green, or which are already green. Credibility and transparency are needed so users have trust. Understanding of the complex sustainable finance terms there are also needed, so that users' wishes can be effectively translated into how these products are designed and regulated.

For the EU there is a need to create a robust and reliable concept of what a sustainable investment is, and that means SFDR. There is also a need to differentiate sustainable investment from transition finance, which would relate to creating a united concept of what transition finance is and having a consistent and robust framework for entity-level transition plans that are credible and followed up on. That means not only covering how nice the plan is currently but also the year-on-year progress.

Transparency has to align with all of that, which means product disclosure rules. Robust and consistent rules on sustainability preferences are also needed. The Insurance Distribution Directive (IDD) and Markets in Financial Instruments Directive (MiFID) rules should be aligned with SFDR and the transparency rules.

5. SFDR's contribution to shaping credible investment products targeting unsophisticated individual investors

An industry representative noted that their group serves more than 30 million clients, the majority of which are unsophisticated investors with relatively small net worths and who do not necessarily want to put in the time and effort to understand the detailed content of the financial products they buy. That is why they go to institutions that do this on their behalf.

A great deal of time and care is spent to understand the preferences of clients, including on sustainability. The organisation's clients have been asked, since 2020, about their preferences in terms of sustainability when conducting periodic risk profiling and assessments in compliance with MiFID II and IDD. More than 70% of clients expressed either an interest or a high interest in investing in sustainable financial products.

Some years previously, the organisation started to develop insurance-based investment products (IBIP) targeted specifically at retail investors that embedded some ESG characteristics. That led to the launch of the first product, which is compliant with Article 8 of SFDR and promotes sustainable investments. Many other Article 8 compliant products have since been launched. The organisation's target is to have the vast majority of products at least Article 8 compliant by the end of 2023.

The experience so far has been positive because it encouraged internal teams to focus on the kind of ESG characteristics to expect from a very low risk financial product, such as those typically distributed to retail investors, and the characteristics expected by the market, regulators and clients. Rolling out sustainability disclosure standards globally is ongoing and raises some challenges, notably regarding overseas subsidiaries and small and medium-sized enterprise (SME) counterparts.

An industry representative detailed that, with the revision of the Japanese Corporate Governance Code in June 2021, the 1,839 companies listed on the prime markets are required to disclose information related to climate change based on the Task Force on Climate-Related Financial Disclosures (TCFD), starting from this year's financial results.

The ISSB finalised two standards at the end of June and the Sustainability Standards Board of Japan (SSBJ) will develop a Japanese version. An exposure draft would be published by March 2024 and finalised by March 2025. Although using scope three as a disclosure standard is well supported, issues with the data availability and the calculation method have been highlighted and it remains difficult to accurately measure this information. In addition, the ISSB requires disclosure on a group basis, but it is very difficult for global players to collect data that includes overseas subsidiaries by the deadline.

There is a need to raise awareness of these issues with the local economies and SMEs. Glasgow Financial Alliance for Net Zero (GFANZ) is trying to construct guidance or practical facilitation activities to provide ideas that are more familiar to SMEs.

The Chair summarised that although there are challenges, there are positive messages that could improve confidence about how the sector might deal with climate risk. There is significant awareness of the need to work urgently on this issue.

AML: key success factors

1. The EU is close to completing the anti-money laundering (AML) framework

1.1 Main objectives of the framework

The Chair suggested that there was general acceptance that AML is a fundamental part of financial market regulation. Negotiations have been in trilogue since the European Parliament presented its proposals. The first main objective of the package is to provide a single set of uniform rules for the obliged entities. Directly applicable regulation aims at preventing regulatory arbitrage and makes the cross-border activities of the industry straightforward. The second objective is to have an entity that ensures that these rules are interpreted and applied identically, which is the new anti-money laundering authority (AMLA).

The risk-based approach is the fundamental principle of AML. Entities have to understand their risks in order to address them effectively. Once a risk is identified and recognised, that provides legitimate grounds and legal justification for the legislator putting a burden on the entity.

1.2 The key levers for an EU AML framework

A policymaker noted that the proposed package relies on the Commission's action plan from 2020. One of the major building blocks is the single rule book. It is important to have more harmonisation at the European level. The rules should also be risk-based.

AMLA is a key feature. It is the future supervisor of the riskiest cross-border entities. The expectation is that it will provide very high quality, harmonised supervision. There is also a need for greater consistency in the national supervisory approaches.

The task with financial intelligence is sometimes underestimated, with respect to what financial intelligence units (FIUs) are doing between the obliged entities and law enforcement. There is a need for greater coordination and more powers for FIUs.

A regulator indicated that AMLA's biggest role concerns cooperation between countries. There cannot be fragmented supervision or analyses.

1.3 AMLA faces many challenges

A regulator emphasised that moving from a directive to a regulation, and moving towards more detailed requirements, but keeping the risk-based approach, and using technology are key.

Setting up AMLA is a huge coordination exercise. The discussions need to conclude first, and the legal framework has to be introduced. There should be significant efforts to conclude the discussions, so the placement of the authority should not prevent action.

Finding the right person to lead AMLA will be a major task. The culture of AMLA should be focused on cooperation with the national supervisory authorities (NSAs). AMLA needs to not just work closely with the national competent authorities (NCAs), but also understand the context of national legal regimes, and work in close cooperation with FIUs, police, tax authorities and courts, in coordination with potential supervisors.

AMLA will also be responsible for monitoring new risks and sharing information on possible supervisory approaches to them. It will set standards through its supervision. That is an important building block but also a potential challenge. Wisely, AMLA will only supervise the institutions with the greatest risk, and it needs to remember the applicability of these standards to smaller entities and allow for proportionality.

High minimum standards must be aimed for, but that does not necessarily entail detailed provisions. One concern with the co-legislation process is that there is too much detail, and too much movement away from the risk-based approach.

An industry representative noted that the technical standards that AMLA should put in place should be harmonised. There should also be stronger and more respected FIUs.

1.4 Effective arrangements and cooperation for delivering consistency

A Central Bank official stated that the proposed package provides a lighter kind of supervision ("oversight") for the non-financial sector. The authorities are extremely varied and not harmonised. The rulebook will be harmonised for non-financial entities, but the system and distribution of competencies will be extremely fragmented.

The supranational unification of these matters will be in AMLA, and AMLA will face some complexity when it comes to the non-financial sector. The general board has different configurations, and for the non-financial sector the board will be composed of different national authorities. That might be challenging and might make the governance and functioning difficult, at least initially. AMLA will have the very important task of knowing this non-financial sector better and can provide the Commission with knowledge and information to plan possible further steps for even more advanced harmonisation.

1.5 Key success factors

A regulator noted that being too descriptive can pose dangers because supervisors or entities might check boxes more than actually look at the riskiest areas. The

AML and combating the financing of terrorism (CFT) of tomorrow are not caught by building rules on what is seen today. Regulating AML will have an impact on crime, but it cannot take the place of fighting crime.

2. A risk-sensitive regulatory and supervisory framework is not a comprehensive approach

An industry representative highlighted that a risk-based approach means focusing on the riskier patterns. However, that is not exhaustive, so some things will still go unnoticed. It is very important to manage expectations in that respect. During the trilogue there might be a temptation to increase the level of control. There must be caution to not go into too much detail and to not be too restrictive. The initial objective is to increase the current framework and make it efficient.

A regulator stated that risk-based supervision (RBS) is an essential tool for supervisors. A great deal of effort goes into creating the metrics. There will be situations where, for example, resources are not focused on supervising non-life insurance companies but instead on crypto asset providers and alternative investment funds. RBS models and the tools that will be developed can help AMLA and all supervisors to focus on the riskiest areas. Supervisors cover large populations. When tools are developed and risks are added, there needs to be continuous development to ensure the tools are fit for purpose. The model needs to be constantly re-assessed and improved.

A regulator noted that Malta worked both with the European Commission and the European Banking Authority (EBA) to build a risk assessment tool and recommended that AMLA follow a similar approach. The model being discussed needs to obtain a great deal of information and then it has to be analysed. The model needs to be calibrated so that there are mitigating factors and aggravating factors. The algorithms need to give a risk score to each and every entity. It is not only about size, so various components like product services, customers, channels and geographical distribution have to be captured.

An industry representative remarked that there was general agreement that taking a risk-based approach meant focusing on specific risks. While other risks might fall by the wayside, the goal of any institution is to ensure that the risk aperture is as small as possible. That might mean hiring more people or using more advanced technology.

Firms are headed in that direction already. For example, firms use technology to sift through their transactions data in order to find risk and financial crime typologies that they then incorporate into their transaction monitoring rules and thresholds. This information is also used to develop and implement risk-based customer-focused onboarding processes. On an ongoing basis, technology helps firms and the broader financial eco-system because it helps firms collect data in a faster, easier to manage and scalable manner. The challenge, however, is that there are multiple ways to use technology and in order for it to be effective, technology has to be used in a very specific and focused manner.

2.1 Balancing data privacy with data quality

An industry representative remarked that data will be challenging from an implementation and industry perspective. It is very important that from the start everything is clear in terms of the relationship with the General Data Protection Regulation (GDPR), for example. This applies to both data management and access. A data hub at AMLA is essential. It is also essential to share information across countries and institutions.

A regulator emphasised that cooperation, information, and intelligence sharing are necessary next steps to elevate the efforts against money laundering and terrorist financing. There seems to be growing concern as to whether the required level of data protection and privacy is achievable, and this is related to the increasing digitisation of society and the ever-growing amount of data that is available. There is no choice but to find a balance. Not doing so will make it almost impossible to fulfil the mandate for combating financial crime.

This also goes back to the management of expectations, and having public acceptance by providing sufficient information on how the associated privacy consequences fulfil a higher purpose. That entails an open discussion of pros and cons, and of the trade-off between new initiatives in the preventive efforts and privacy. Criminals are not entertaining such notions. They are just continuing to develop their methods.

A one-size-fits-all solution is not possible. The focus should be on developing a regulatory framework that sets sufficient legal safeguards, while allowing for new, effective initiatives to grow on a national level. AMLA will be busy with the tasks assigned to it, so there will be a start at the national level. That allows for greater efficiency, and for front-runners to be innovative, preferably in public/private partnerships, and thereby gain valuable learnings that could benefit everyone.

The Council proposal for the new AML regulation with a national exemption regarding the sharing of information is the right first step. It is key to remember that the legal frameworks, such as GDPR and the Human Rights Charter, provide a set of checks and balances rather than direct prohibition on information sharing.

Data-sharing initiatives should be subject to confidentiality requirements, minimal human processing and access to data. The responsibility for compliance should remain with the obliged entities. Therefore, there is a need to engage with relevant stakeholders, such as data protection authorities, so there can be assurance that new information sharing initiatives are structured with the necessary safeguards.

A regulator noted that without data, entities cannot be assessed and scored. The expectations for AMLA are high in terms of consistency and it becoming a point of reference for all NCAs. It should be leading by example.

A Central Bank official highlighted that the system is deliberately not entirely risk based. The number of obliged entities in scope is in excess of hundreds of thousands. It is not feasible for AMLA or national authorities to have a thorough look at all of them.

To some extent, although the framework is inspired by the consideration of risks, the issue is money laundering risks and not prudential risks. Money laundering risks are not necessarily dependent on dimensions or on the types of activities. There might be other elements involved such that even small enterprises or individual people could pose higher risks of money laundering.

The question is whether there are weak spots to be aware of. The experience of FIUs could demonstrate that even with trusts and company service providers, or car dealers and legal professionals, for example, there are heightened money-laundering risks without there being the capacity to reach out. That is an area of challenge where the system might have some weaknesses.

An industry representative stated that using more technology in the field is a significant opportunity. Technology is good at looking at vast amounts of data. It can also be easily adapted to new rules. However, every opportunity comes with some risk. The first risk is that technology's ability to manage data depends on the quality of data put in. Without good quality data there will not be good outcomes. The same applies to the scenario. When a transaction is checked, the patterns that do not look good have to be identified, but that requires good scenarios and the machine being instructed in a good way to do what it should. The whole system also needs to be explainable, for example to regulators and auditors. Additionally, human expertise will always be required.

An industry representative commented that AI is suitable for some aspects of AML but not for others. However, AI is an iterative technology, so if it is not ready for some things it will become better over time. A regulator stated that accuracy, efficiency, and immediate decision-making are some benefits of AI.

3. AMLA being modelled along the lines of the European Supervisory Authorities (ESAs)

A policymaker emphasised the scale of the task of determining how AMLA will work internally and with the many other supervisors and stakeholders. The architecture of AMLA in the Commission proposal is novel. There is a long list of what is expected of AMLA. One set of expectations is that it is efficient, effective and highly independent. There is also the question of how to integrate the supervisory schemes that exist in the member states.

The executive board in AMLA is supposed to take care of the authority's functioning, look into the direct supervision function of AMLA, and ensure consistent, high-quality supervision across the internal market, with any decision addressed towards national authorities. Therefore, the desire is for a smaller, independent executive body.

The suggestion is to also have a general board, to draw on the extensive experience there is with national supervisors, and to take account of the needs of national supervisors. That is modelled along the lines of the ESAs. It is recognised that this is not an easy structure, but there is a good balance between the different tasks that AMLA will perform.

3.1 AMLA needs sufficient human, financial and technical resources

An industry representative emphasised that a strong AMLA needs access to sufficient human and financial resources. Human capabilities are both about the number of people and their quality. That means people who are well-trained and know what they are talking about. Access to technology is also important. There has to be an adequate infrastructure and good partnerships in order to have adequate collaboration between all countries.

A regulator noted that AMLA has an opportunity to create an effective and efficient technological system internally from the beginning. AMLA needs to develop a system that can make good use of advances in AI. It is also important to develop the human resources, human knowledge and human expertise needed for the use of the digital innovations.

There is a need for knowledge and an understanding of all of the processes, and the functioning of the new technology and solutions. The machine learning curve is much faster, if it is set up in the right way, and that can help significantly with doing the work efficiently. Artificial intelligence is already successful in detecting and preventing suspicious activities, because it can recognise patterns and abnormalities. That is something AMLA could be pioneering.

The Chair remarked that countries have done well over the past 30 years to become technically compliant, but effectiveness with respect to AML is poor. Technology and information sharing are tools to make the system more effective. The European Union, which currently is not the best performer from a global perspective, should become the spearhead in the global fight in AML, and do so quickly. The package should be brought into force.

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Pierre Gramegna

Thank you to Eurofi for giving us the opportunity to address a topic that is of paramount importance, and that is the reform of the Stability and Growth Pact, key remaining issues and way forward. I would like to thank our Spanish hosts for organising this event together with Eurofi and I would like to thank the four panellists who are with me. Let me start by introducing Gintaré Skaisté, who is the Minister of Finance of Lithuania, Vincent Van Peteghem, the Vice Prime Minister and Minister of Finance of Belgium, Heiko Thoms is State Secretary in the Ministry of Finance in Germany, and Emmanuel Moulin, Director General of the Treasury in France.

The topic of the reform of the Stability and Growth Pact has been with us now for quite some time, and is reaching a final phase, which means compromises are going to be necessary and time is of the essence. We need a reform of the European fiscal rules that ensures that the principles of transparency, credibility, ownership and sustainability are in the limelight. In order to go more deeply into detail, we are going to have two rounds of discussion.

The first-round of question is what are the stumbling blocks, the possible solutions and key success factors in reaching a swift agreement on revising the Stability and Growth Pact? This question is obviously very wide. I would like to divide it into three sub-items which could be the following. The first sub-item is should the EU move towards a case-by-case framework approach, as was proposed by the EU Commission a couple of months ago or should the Stability and Growth Pact stay closer to the current fiscal rules with quantitative benchmarks? What are the pros and cons, how could these approaches make the Pact more effective, and eventually can the two approaches be combined? The second sub-item would be how can we make sure that the new Stability and Growth Pact can ensure equal treatment of all countries? The third sub-item would be to what extent can the revision of the Stability and Growth Pact contribute to rationalise expenditures, improve the quality of spending, create space for supply-side reforms, and last but not least, boost public and private investment. This is a very vast question and three sub-questions in three minutes is a real challenge. I count on your cooperation and ask all the panellists to focus on those points that they find are the most important. With the rule that it is ladies first, I have the pleasure to invite Gintaré to start.

Gintarė Skaistė

Thank you very much. It is a difficult topic. Previously we discussed with colleagues about the digital euro, but I said that the EU fiscal rules is, probably, even a geekier topic than the digital euro. It is an important topic, but it is difficult to explain to society what you are we doing, why it is important and what will be the outcome of the discussions with colleagues in the European Union. I would like to start from the beginning: it is a Stability and Growth Pact. The name of our fiscal rules itself suggests that we seek for stability and growth. Now we have to answer the question, is everything stable enough? Is there enough growth in Europe? Can we change the rules in a way that helps us to achieve the stability and growth better than we do today?

Looking from the perspective of recent years, I would say that the current system is not working well enough, because the debt levels have been increasing across many countries. While it was not a big concern until recently, the situation has changed with increasing interest rates as debt servicing cost has started to raise sharply. We have to answer what other expenditure in the budget will we cut because of that. These are difficult trade-offs which can become easier if have strong enough growth and debt levels that are on a downwards path.

The new rules must bring more stability and more growth. In my opinion, there is room to change the rules for the better, and the proposal from the European Commission is a step in the right direction, because it ensures more domestic ownership. Member states will be able to define their own fiscal paths and have their own political means to achieve the fiscal targets. Building individual fiscal trajectories should naturally result in more realistic and achievable fiscal objectives. Also, it is important to have space for political manoeuvre to react to changing situation, while keeping the initial fiscal targets unchanged.

The question then is how to have the certainty that countries will stick to the agreed fiscal path. We have seen previously when fiscal targets have been revised and pushed back for several years. The backloading is a serious problem and risk going forward. Thus, we must have very clear rules on how and when do we measure the progress – is it after seven years, after three years, after one year? We must have certainty how exactly the Commission will act, limiting room for discretion. We also need to have to have a very clear rules around the possibility of extending fiscal adjustment timeline to create space for certain investments and reforms. Who will measure what effect will particular reform have on economic growth? If the Commission will do the assessment, what will be the measurement of the success for the reform? We have many remaining questions and I think the answers are still not there, we need to agree on them at the political level.

Pierre Gramegna

Thank you, Gintarė. On your last point, you will have the possibility of continuing to discuss it because it is in the second block of questions.

Vincent Van Peteghem

Thank you, Pierre. My answer on your first question is 'yes', my answer on your second – 'no'. What we need to do, and that is the goal of the Stability and Growth Pact, is that we have a very clear goal, and that goal is, of course, the medium-term debt sustainability. That is important, and that is what we are working on. The only thing that we saw in the last decades was that it did not give enough growth or that the focus was not enough on investments and on reforms. If you look to the situation today, we must be honest and we have to come to realistic new rules. What do I mean by realistic rules? First, that we should look to the case-by-case situation. Every country, every member state, is different. They have different backgrounds, different contexts, different social welfare systems, different labour markets and so on. I think that we need to take into account the diversity that we have, to recognise it and look at how we are going to deal with that.

I know, of course, that today there is also a demand for still some common quantitative benchmarks. I think that is necessary as well. I understand also that question because it is necessary that there are some minimum requirements. It is necessary that there are some clear targets, again, to focus on that medium-term debt sustainability, to look at how we can be sure that in certain situations we go to a medium-term debt level that is sustainable in the long term. The main concern that I have today about the discussion that is ongoing, and I am convinced it is necessary that we come up with a new framework in the coming months – it is important to give that predictability to the markets to also be sure that we can move forward – but I have a concern about the reforms and investments that we are going to deal with and that will be linked to that package.

Some reforms cannot be done, or the impact of a reform cannot be seen, in the short timeframe of four to seven years. If we do a pension reform in our country, the real budgetary impact is not seen within four or five or six years. It is a much longer timeframe and time window, and so I am a bit afraid that countries will be afraid or be de-incentivised to actually do these reforms because they are not or cannot be linked with that planning horizon that is now also in the proposal. I understand the concern about the backloading and the frontloading. My concern is also that some countries will avoid doing important reforms that are necessary, as we all know. There is the possibility to come to a situation where we have the case-by-case approach within that new framework. The question I have, which is important, is that if we introduce the quantitative benchmarks that there is still enough room to do the investments and the reforms that are necessary.

Pierre Gramegna

Thank you, Vincent, and I give the floor to Heiko Thoms, State Secretary of Germany.

Heiko Thoms

Thank you, Pierre. Let me say it is a pleasure to be here. You ask about the biggest stumbling blocks. I can say there are still many. There are a number of issues which we will need to do a great deal of work on, but my first message would be that we are fully committed to getting these stumbling blocks out of the way and to reach an agreement before the end of the year. Not at any price, I have to say. We see the need for reform, very much so, but what we need to do is to make the system work better. That is the final goal. If we do not reach that, then I have to mention here, of course, the fallback is always to go back to the existing rules. We have to acknowledge this – nobody wants that – but if it happens, it is also a test of credibility we will all be facing in case this scenario is going to materialise, which we all do not want. We are fully committed to working this out.

You asked also about fair and equal treatment or if we want to do more on a case-by-case basis. These are not contradictions, I believe, and it is not a contradiction also in the Commission proposal. One thing I want to highlight is that we fully subscribe to the general concept that the Commission has chosen and to the methodology in general, although we would still like to understand the methodology a little better. This is what we are doing in the working groups. This is what we will be doing in the coming weeks and months. Fair and equal treatment will be absolutely essential because even perceived unequal treatment can be as bad as actual unequal treatment politically. This is why we have made our proposals, which I believe have sometimes – deliberately or not – been misunderstood, maybe because we are German, and we look serious and fierce. We are not.

Our proposal is, I believe, quite moderate. The base of this is that we accept the methodology, the general concept by the Commission, but we need certain safeguards and benchmarks. This is the reason why we have proposed, and that is the core of our thinking, an expenditure rule. Our proposal is that expenditure growth should be lower than potential growth. That is the first and then in case this does not fully work – because it may not, if there is, for instance, a structural change in revenue – we have proposed a safeguard, which means basically a holding line in debt reduction. In our proposal that we transmitted to the Commission, we put X, but let us say X is 1 for highly indebted countries per year, just a debt reduction by 1 percentage point per year, in case the expenditure rule does not achieve that goal.

These are only minimum requirements. The debt sustainability analysis the Commission has proposed is the way to go and should, of course, in some cases be more ambitious than this. Only if the methodology proposed by the Commission does not achieve the debt reduction and deficit reduction that we all see is necessary, then these benchmarks and safeguards would kick in. This is where we see the basis for reaching a way forward that would indeed ensure fair and equal treatment. Only dealing with the debt situation in a given country on a case-by-case basis will not do the trick.

Pierre Gramegna

Thank you, Heiko. That was quite clear and, for many in the room, very useful that you could explain that. Emmanuel Moulin, please.

Emmanuel Moulin

Thank you, Pierre. Very happy to be here and thank you for the invitation. We are right to try to draw the lessons of the past experience of our current rules. In fact, when we look at what happened after the great financial crisis, we had quite a bad experience in terms of growth-friendly consolidation. Consolidation was imposed on countries, which reduced investment and therefore there was lack of growth and hence we were not able to reduce debt-to-GDP. GDP was also so low that, in fact, the ratio of debt-to-GDP was increasing while we were consolidating. I think that the Commission has drawn the lessons and the spirit of the proposal of the Commission goes clearly in the right direction with a number of features.

First, ownership, because we want rules that are owned by member states and not imposed by the Commission. We need differentiation because nowadays we have levels of debt which are very different from member state to member state, from 30% of debt-to-GDP to 140% and even higher, so we cannot have the same pace of reduction of debt-to-GDP in all countries. We need to focus on the long-term also, and that is the reason why there is a focus on debt sustainability. I think that is one of the points that Vincent made. If we look at debt sustainability over the medium term, we can take into account the impact of, for example, pension reform, and we know in France that there is an impact on the long term, also you can have a political impact in the short term. We need to have an incentive for investments and reforms.

To me, these features were clearly going in the right direction. However, during the preparation of the legislative proposal, the Commission decided to include some safeguards and benchmarks. When we look at them quite deeply, they tend to defeat a little the purpose of the reform. I would like to focus maybe on one benchmark, the benchmark which was included with a bit of haste in the last discussions in the Commission, and without looking deeply into the impact. We have a provision that says that the debt-to-GDP ratio should be lower at the end of the plan period, so four years, compared to the initial position. You need to have debt which is lower after four years than in the first year.

This, in fact, creates a major change in the consolidation that you are expected to fulfill. There is a paper which will be coming out from Bruegel, which says that, for example, for France, while in the system without the safeguard, you need to consolidate either from 0.8 or 0.4, if you have the extension to seven years, this would jump to 1.1% of structural primary adjustment per year to fulfill this benchmark. We think this is the type of adjustment which is economically unsound, and which will have a procyclical bias, and so we need to revise this benchmark. We are not against benchmarks, but they should be aligned with the spirit of the reform.

Pierre Gramegna

The second round of questions is how to ensure the effective commitment of a member state to its fiscal path? Here are two sub-questions. If a country is noncompliant, what tool should the Commission use? Should it use the Excessive Deficit Procedure (EDP)? The second question is about the role of institutions – in the plural. I would like to phrase it this way, besides the key functions and competencies of the Commission and the Council of Ministers, what possible role is there for an ad hoc committee of academics, for the already existing European Fiscal Board, for the ESM, or for any other international financial institution? With this, I would like to come back to you, Gintarė. You had already touched upon the second part of the question and maybe if you could also have a view on the excessive deficit procedure, please.

Gintarė Skaistė

The answer is trust and I think that currently we have a lack of trust because of poor track record. The enforcement of fiscal rules is an issue, because the history shows that sticks envisaged in the current framework were not used consistently when member states did not comply with the rules. If no one believes that there will be consequence when you are doing something wrong, so why follow the rules? I think with this new start we can create a more credible system. If we increase the transparency of the system and of the methodology regarding the evaluation of process, if we have a very clear system how to assess if you are doing right or wrong in terms of budgetary discipline, everybody will know who is following the rules and who is not. In this regard, it will be important to ensure that the EDP, either debt or deficit based, will start automatically or at least semi-automatically. I would say that it could be an answer to have more credibility and ensure equal treatment.

The review of the fiscal framework should also bring more balance between negative and positive incentives, that should work in favour of strengthening national ownership. The ability to prepare individual structural-fiscal plans to reflect country-specific circumstances means that fiscal adjustment path will not be imposed on a country, but will be a result of joint efforts that should lead to a higher buy-in from the beginning of the process and stronger ownership later on. It will be important for member states to have enough room for political manoeuvre in shaping their reforms and investment policies, while keeping the agreed fiscal targets. I would say that the role of institutions, for example the European Fiscal Board or national Independent Fiscal Institutions (IFIs), could have a more prominent role in assessing whether your data is credible, whether you are reaching the target and moving in the right direction.

Pierre Gramegna

Thank you, Gintarė. I will give the floor now to Emmanuel, who is eager to give a few more insights.

Emmanuel Moulin

I do not want to jump the line, but to me, on the enforcement and the implementation of the rules, clearly, ownership is key. If you are drawing your own national plan and your own national trajectory, then you are much more bound to stick to it, in particular, towards your public opinion than if it is a trajectory which is imposed by the Commission. To me, member states will be more inclined to apply rules that are economically more relevant, that they understand better and that have a clear objective. I think this is key, because in the previous rules we had a medium-term objective, which was to have a balanced budget over time, which would lead to a reduction in debt normally to zero or almost zero at the end of a long, long, long period. The only objective was really a reduction of the deficit. We are balancing more the objective in terms of growth, in terms of reforms and in terms of financing investments that are needed for the green and the digital transition. I think this will make the rules easier to implement and more enforceable.

In terms of the institutional set up, I was in the team negotiating for France for the 'two pack', 'six pack' in 2011-2012 and at the time we did not trust the Council because it had failed in implementing the rule in 2005 with two big countries which said these rules do not apply to us, with the support of a small country. We did not trust the Council. We said the Commission should be in the driver's seat and now we have the Commission applying the rules, I think more smartly, but then some people say, 'Well, the Commission is not doing its job', so now we have to go back to something else, the something else being independent counsel. I do not think we need to change the institutional set up. The Commission is doing its role. We should entrust it with the surveillance; that is their role. Independent counsel can give advice. They do not have the legitimacy to impose sanctions or monitoring.

Pierre Gramegna

Thank you, Emmanuel. Heiko Thoms.

Heiko Thoms

You cannot possibly overestimate the importance of this topic of enforcement. To say at the outset, if there were no enforcement, we would eventually all be sanctioned. We will be punished by the markets, and this is why we do this. That is what we want to avoid, so we need to get enforcement right this time. It is crucial. It is maybe the biggest flaw of the current system that enforcement did not work. We still believe that the existing rules – and they are still the existing rules – would have worked if they had been applied properly, but they have not been. Emmanuel pointed at who is to blame so we know. Nobody is innocent in this respect, so we need to do it differently this time, but what we have to start with always is the willingness to implement the actual rules. Of course, if there is a lack of implementation it is the enforcement and that is probably the area that we need to do the most work on until the end of the year. We need to do this in the preventive arm. There will be things like a control account, and we will need to figure out much better what the consequences will be if there is deviation and how we will deal with this. This still needs to be spelled out because it has not been spelled out properly.

Then there is the most important aspect; we need to properly apply the corrective arm. It is important for me to mention here once again everything I said in the first round on benchmarks and safeguards. That is, of course, only for the preventive arm. If we come to the corrective arm, so that is the EDP, that is what we need to do differently this time. I have to say once again, the excessive deficit procedure is part of primary law. This is not something we can get around. This is something that we will need to apply, that we need to do, and this is where we need a lot more clarity and a lot more transparency on when the corrective arm, the excessive deficit procedure, will be applied or will be started, because this will make all the difference.

Pierre Gramegna

Thank you very much. Vincent.

Vincent Van Peteghem

We were already talking about the fact that the rules and the Pact should be more realistic, and I think that one of the elements in it is the fact that the enforcement today should be stricter, but at the same time the way we deal with it is the case-by-case approach, so that there is more flexibility. I think that ex ante there should be more flexibility. Countries should have the possibility to decide what reforms they are going to do and so on. Ex post, it will be important that we will be a little stricter on the way we are controlling everything and how everything is organised. I sometimes refer to the NextGenerationEU and how a country like Belgium, which has high debt but at the same time needs reforms, dealt with that. We proposed some reforms, and we got our money. That is a little how it worked. It should be similar within the economic governance review.

We also need to first see what kind of reforms can be done. I think that they also should be linked with some expectations at the European level, with the European Commission saying and setting some priorities. There should be a kind of labelling approach that we also had in NextGenerationEU and afterwards, of course, there should be a strict control to see what the impact is. I do not think that EDP and the financial enforcement should be the key element of it, but I think that there needs to be a stricter follow-up. There, the European Fiscal Board – or ESM, if you want – Pierre or others can play an important role in determining ex ante what kind of flexibility, what kind of labelling, what kind of investments and reforms will be done, but at the same time afterwards, following up looking how the implementation needs to be done, how it can be improved and so on.

Gintarė Skaistė

I disagree with Vincent on this topic because the example of the Recovery and Resilience Facility (RRF), in my opinion, is not the best one – because of being a rigid instrument. For example, when one government is preparing the plan, and then another government is coming in, and having to implement commitments that the previous government has made, you do not have ownership that we want to strengthen. From my perspective, the possibility to adapt the plans, while focusing on the final target, is the main issue.

Regarding the domestic ownership, Lithuania is suggesting one element of flexibility, which, in my opinion, is very important. I am not talking about the golden rule, but about smart and targeted flexibility for defence investments. For example, in Lithuania we are now increasing substantially the spending on defence, but we still have the benchmark of 3% deficit. That is our key criteria, but at the same time I cannot predict when the military equipment will be delivered, so in practice it makes it hard to follow the 3% rule strictly. For a small economy, military purchases may lead to large one-off expenditure increase causing budget deficit to go up to 3.5 or 3.7 percent, just because the military equipment came on a different fiscal year then initially planned. Thus, we argue that defence spending should be regarded as a "relevant factor" when assessing breaches of the 3% deficit limit.

From my perspective, the flexibility, when looking at the situations like that, is crucial. We need a possibility to adapt to the changing situation and to fundamental challenges, especially under the geopolitical circumstances that we currently have.

Pierre Gramegna

Thank you, Gintaré. I think the Panel showed that there is common ground. But there are still quite a few differences. The common ground I see, and that is very encouraging, is when you talk about ownership, equal treatment, transparency and the observable data and results. If we take it from there, considering the facts, what comes out at the end of the analysis is that we have a system where you can very easily say there are numbers out there. I do not dwell on what the numbers are. Not only the old ones that we know where there is a consensus that we should keep them. But also the additional data that we want that will indicate if you are complying. Then we will all help each other a lot. Then it is not only about the Commission doing a good job in judging what has been done. The numbers will speak for themselves. That is a big difference for the system that we want to have in the future compared to what we have now. That is what is interesting for the common ground.

The other thing I see for the common ground is that there is a willingness for flexibility on all sides. The different countries are a good sample, I would say, of the 27 countries and they want to use the flexibility in different ways. Let me take first what Heiko said. He explained the two safeguards that you see. You want to play on those criteria. Others would like to have flexibility in terms of which kind of investments should get maybe a different treatment or should be counted differently, which is not easy, but this is a very important topic. I like this example of defence spending, which is becoming much more important than it has been in our history for 20 or 30 years, so neglecting that factor would be a pity. At the same time, Gintaré, you are the first one to say, 'This should be quite strict. You have to go for gold', but then you are the last one to say 'Well, but by the way, for defence spending, maybe we should do it differently.'

I think that it will be important to understand all the different types of flexibilities that might be requested by member states. This might help the process reach an acceptable compromise. If we have observable data and have looked at all the possible ways of flexibility that we can agree on we might find that enforcement will be easier. Obviously, enforcement is key. Because if you cannot make sure that what has been observed and the flexibility that is built in is observed, then there is no enforcement. Obviously, then the reform of the SGP will not be a success. I thank you all. Enjoy your evening. Thank you.

Digital transformations and financial system turbulences: lessons for policy makers

Hirohide Kouguchi - Executive Director, Financial Stability and Bank Examination, Bank of Japan
Fernando Restoy - Chair, Financial Stability Institute
David Wright - President, EUROFI

David Wright

Our next session is with two outstanding people. On my left is Fernando Restoy, the chair of the Financial Stability Institute in Basel. I was looking at your CV, Fernando. I do not think it could be any more complete or better. He has a fantastic academic record in the London School of Economics (LSE) and from Harvard University, including a doctorate. He has had extensive experience in the Comisión Nacional del Mercadeo de Valores (CNMV) and was also deputy governor at Banco de España. He is somebody who is, I know, very thoughtful about the key regulatory questions of our time.

On my right is somebody also of great distinction, who we saw on the previous panel. Hirohide Kouguchi has been at the Bank of Japan since 1988, if I am right, which is a long stint by anybody's measurement, and has held a lot of very important positions. He also holds an MBA from Wharton School at the University of Pennsylvania in the United States.

We are going to talk perhaps in a little more granular detail about the digital issues and financial turbulence, and the lessons for policymakers. Fernando, when you have looked at these recent events that we saw in the US and in Switzerland, do you think that, practically, intellectually and financially speaking, these new digital issues that have arisen represent a new and clearly material risk to financial stability?

Fernando Restoy

Many thanks, David. It is always a pleasure to be at Eurofi. Of course, we have seen in the previous session that we are all quite impressed with what has happened particularly in the US, but also in Switzerland recently. We have this turmoil affecting a few banks. You could argue that, by and large, recent bank failures were not directly related to the technological disruption as such. They were mainly triggered by the materialisation of more traditional sources of risk, particularly interestrate and concentrations risk. Those sources of risk t were already addressed by the international community when it embarked on regulatory reforms after the great financial crisis.

What has happened then? What is new? The new element here is, probably, the unprecedented speed and intensity of banks' destabilising dynamics, particularly in the US. Thus, we have seen a rapid contagion from market price correction to deposit outflows. Market corrections triggered panic that spread out very quickly supported by social networks. That triggered massive and unprecedently fast deposit runs. That destabilising dynamics could partially be explained by digital banking which made massive outflows possible.,. Those developments suggest that we could be entering a a new environment in which bank runs can be more frequent and intense thereby calling into question, to some extent, the assumed stability of the deposit base of financial institutions.

The new element here in the room is precisely this: some signs that we could be observing some structural reduction in the stability of deposits of financial institutions. Of course, the good news is that authorities have reacted well with their own crisis management frameworks, and were able to preserve financial stability.

However, we should not forget about potential implications of these signs of deposit instability on the whole policy framework. Deposit stability is not only a core assumption within the current regulatory and supervisory framework, but also a necessary condition for the very sustainability of the business model of commercial banks, so we had better take this seriously.

We need to understand how the policy framework has so far contributed to this required deposit stability, and analyse whether some adjustments are required for this to continue being the case. We need to bear in mind that regulation and supervision were born in parallel to deposit insurance, with the clear and precise objective of protecting deposit stability. Afterwards, the resolution framework was developed with precisely the objective to preserve failing banks' critical functions, including access to clients' deposits. Deposit stability is a cornerstone of our policy framework and, therefore, we need to assess whether that policy framework remains sufficiently fit for purpose in a context in which banks may be facing a structural reduction in deposit stability.

David Wright

Hirohide, do you see a permanent risk now or new types of risks specifically coming through the digital framework?

Hirohide Kouguchi

I agree with Fernando on many points. Digitalisation might have brought about some vulnerabilities to the financial system. Of course, it brings about positive effects, but, at the same time, it brings new threats to the financial system. It is very challenging for financial institutions and supervisors, but I would say that there is some way to address it.

Digitalisation has dramatically enhanced efficiency in communication and data processing, thereby facilitating financial transactions in a more convenient and costless way. From the viewpoint of financial stability, a couple features of recent digitalisation are important.

First, networking massive firms and people. Information, even if it is a rumour, will spread instantaneously via social media, and tends to trigger "herd behaviour". Secondly, enormous speed and volumes of data processing and communication. Thirdly, digitalisation enables unbundling financial services and creating sophisticated ecosystems, including banks, asset management, pensions, fintechs and digital companies, non-bank payment services providers, crypto-assets and stablecoin providers. Central bank digital currencies may also be a part of it. Interactions in the ecosystem are getting more and more active, which may bring about more complex systemic implications, now that overall pictures are hard to be obtained. And fourthly, digital technology enhanced AI, algorithms or high-frequency trading. It has improved market efficiency, but, at the same time, it may increase market volatility, responding to various information at a time of stress.

As we discussed in the previous session, we observed some of these features during the banking turmoil last March, with the rapid contagion of loss of confidence in banks' financial soundness and unprecedented speed and volume of deposit withdrawal. We are enjoying convenient and costless financial services, thanks to digitalisation, so we should not stop this kind of innovation. But, at the same time, we need to pay close and due attention to how to address systemic vulnerability, that digitalisation potentially brings about.

David Wright

Thank you very much. Fernando, taking this a bit further forward in terms of the policy implications, which seem to me to be very important here, where do you see the priorities? Where do you think we should concentrate our effort?

Fernando Restoy

Going back to the scheme that I tried to put forward before, there are a number of elements in the Going back to the scheme that I tried to put forward before, there are a number of elements in the policy framework that may need to be revisited eventually in light of what we have learned from the recent turmoil. We could start by discussing some ideas that have already been floating around in different areas.

First, I mentioned deposit insurance. There are ideas out there to try to enlarge the maximum coverage of deposit insurance. Is this a good idea? In principle, deposit insurance has been revised regularly, and rightly so. Should we go all the way to guarantee 100% of deposits? Frankly, I do not think that it is a good idea and it may have important counterproductive effects due to moral hazard and also some possible frictions and distortions that it could create in the capital markets.

In the area of regulation, which is the second piece that I mentioned earlier, we have already seen and read a number of ideas and proposals starting with a possible re-parameterisation of the Basel III liquidity requirements—liquidity coverage ratio (LCR) and net stable funding ratio (NSFR)—Soem have proposed further-reaching measures such as asking banks to fully collateralise all non-covered deposits. or constraining the amount of runnable liabilities that banks could have as a function of the amount of assets that they could pledge to get central bank lending.

Those more radical reforms could eventually constrain severely the ability of banks to continue intermediating funds, or to continue being in business. Therefore, we need to be very careful about whether we consider those as possible options, because the drawbacks could be quite significant.

As a matter of urgency, we probably need the implementation of Basel III. For the first time, we have liquidity requirements in the Basel framework. We know that LCR and NSFR are not necessarily standards that have been more broadly adopted so far. In the note published by the BCBS a couple of days ago, it is clear that there is progress, but we are not yet there, so we had better attach priority to the implementation of Basel III.

Certainly, what it demonstrates as well, as has been mentioned before, is that supervision should be a priority. There is much to be gained there. When you look at the turmoil, particularly in the US, what you see is not that some vulnerabilities of the banks in relation to exposure to specific risk have created the turmoil. We have identified a series of banks that have clearly unsustainable business models characterised by excessive maturity transformation, excessive risk concentration on the assets side, and excessive reliance on unstable sources of funding. When you have an unsustainable business model, there is no capital or liquidity that could compensate for that.

If this is about business models, the tool is not regulation but supervision. Supervisors should have the powers, the tools and the culture that will allow them to enact this impressive intervention in the banks and try to correct what is wrong, such as poor risk management practices or poor governance structures. All of that will explain why, at the end of the day, they are running business models that are considered unsustainable. For me, supervision has to be the first priority.

David Wright

One point that I thought Dominique Laboureix made very powerfully on the last panel was about greater transparency and real-time reporting to central banks and improving early warning systems. Would you go along with that?

Fernando Restoy

Absolutely, but I would go even further. The current supervisory reporting system is really quite obsolete. This idea is that, whenever the supervisor needs to receive information, they have to ask the bank. They send them a template that they have to fill in. We really need much more agile interactions between supervisory and bank systems. They have to talk to each other. That is the only way in which you can get all the information that you need in a timely way in order to do exactly what you were suggesting.

David Wright

Hirohide, give us your regulatory thoughts on this issue.

Hirohide Kouguchi

Again, I agree with Fernando on many points. As we discussed in the previous session, since financial intermediation intrinsically involves maturity and liquidity transformation with asymmetric information, financial institutions are, in a sense, susceptible to digital bank runs by nature at a time of stress. It is getting more and more so. To address it, I would reiterate that macro and micro prudential policy during ordinary times should be important. And as far as non-bank financial intermediation is concerned, "same function, same risk, same regulation" should be the principle.

Since the allowance time gets shorter and shorter at a time of stress, liquidity management has become more significant. The most fundamental public backstop should be the current account balances at the central banks and the access to the central banks' standing facilities. In Japan, all the major and regional banks have access to BOJ's standing facility via a digital platform, with eligible collateral posted in advance, and BOJ is monitoring banks' liquidity management operations daily. We sometimes request banks to post more collateral, as necessary. This is a part of the lessons learned from Japan's financial crisis in the 1990s.

Another measure to tackle this issue might be the well-designed deposit insurance, as Fernando pointed out. In Japan, approximately 70% of deposits are covered by deposit insurance and, on top of that, deposits for the purpose of payments with 0% interest rates are covered 100% by deposit insurance, no matter whether the depositors are firms or households. Of course, we need to address moral hazard issue by introducing some incentive mechanisms to overcome that topic.

It may also become more important for financial institutions to monitor social media on what is being talked about them as part of market intelligence.

At a time of stress, appropriate management actions by financial institutions that are of course most important, nimble liquidity provision by central banks and a public backstop, as necessary and appropriate, should play the key roles, as I mentioned in the previous session.

David Wright

In closing, let me ask you this, Hirohide. You know everything that is going on at the Bank of Japan. Do you have real-time information systems about what is happening in the banking system in Japan? Can you or the governor look at a screen and see big movements of yen deposits instantaneously?

Hirohide Kouguchi

We are working to establish that kind of digital platform for more granular data together with Japan's Financial Services Agency (JFSA).

David Wright

You made a very important point, Fernando, about modernising this linkage between private banking system data and supervisors' data. Thank you both very much for a very interesting discussion. They are always too short, of course, with such eminent people, but I do think we have identified here a serious set of issues that need attention.

Just one point, Fernando, on the deposit guarantee. What happened in Silicon Valley Bank (SVB) was that the Fed had to bail out commercial users. It was the big deposits that ran from the big holders of positions in these banks. Deposit insurance takes you so far on the retail side, but it does not solve the problem on the major deposit holdings of corporates. Is that right?

Fernando Restoy

It is quite the opposite. Everything not covered by a deposit guarantee scheme is part of the liability base of the institution, which is very vulnerable. It could become unstable and could run very easily. That is why we are talking about business models. Should we do something about limiting somewhat the amount of non-covered deposits that banks should have? That is very important from the point of view of ensuring the stability of the business model. It is also very important in resolution. It is absolutely key. Those are elements to look at within this regulatory friction that I am suggesting. Going back to what I said before, I do not think that the solution is just to decide to use a blanket guarantee for everyone with all deposits covered. That will lead to huge moral hazard issues.

David Wright

Thank you both very much.

Conversation with Angel Rivera

Ángel Rivera - Chief Executive Officer, Banco Santander Spain
David Wright - President, EUROFI

David Wright

Ladies and gentlemen, I am delighted to have here with me Ángel Rivera, who is the CEO of Banco Santander in Spain, which is a most important position. He has a great deal of experience; he has spent more than 30 years in the financial sector. He has had a very long career at Banco Santander, which he joined in 2013. He also has something very interesting, which we will talk about; he has a lot of international experience, particularly in Latin America. In Mexico, he was involved in the transformation of the bank's business. He was head of retail and all of the other customer strategy commercial networks. He is really bringing a lot to the table if I may put it like that.

I will start by asking you about boosting the competitiveness of Europe and European banks, which I know is a theme within Banco Santander. What are your views here? How are we going to do this? What are the key priorities, do you think?

Ángel Rivera

Good morning, David, and thank you for the invitation. I am happy to be here. It is a very important topic because we are losing competitiveness if we are compared with the US and China. Nowadays, Europe is facing important headwinds with the war in Ukraine. Energy is an important topic, and so is inflation. We have to take measures in a very fast way because, if not, this lack of competitiveness will deepen, and this will not be good for the European community.

Regarding to regulation, the regulatory framework affecting companies must be revised to make it more efficient. 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. In the end, 70% of the financing of European companies comes from banks. Therefore, it is important to fix this and to finalise these banking and capital market unions in order to gain competitiveness and growth.

We also have to reindustrialise Europe. The crisis has shown that the EU dependency on foreign countries, especially China, was not a good deal for us. We have to invest in Europe and technology. The Spanish Presidency's is an opportunity to promote de development of strategic industries and to propose a common strategy, but we have to accelerate this and move away from this excessive dependency on other countries.

We also have to improve private-public collaboration. We had a good experience in Spain with ICO financing partially guaranteed by the Government and especially companies, during the Covid crisis. We probably have to do the same with Next Generation funds, not only in Spain, but also in the rest of the European Union. The banking industry can help in this regard because we have the network and the experience to do so.

In the agenda of all of the governments and the agenda of the Spanish Presidency, competitiveness is the key topic. Growth is needed.

David Wright

When you look at the US banks, it is often said, for example, that the US banks can securitise their loans. They have Freddie Mac and Fannie Mae. Are those the two main reasons why they are more competitive, or are there other reasons that you think advantage the US?

Ángel Rivera

There are structural reasons that have led to high fragmentation that we have in Europe and, for example, the absence of and European Deposit Insurance Scheme (EDIS) in the banking union. If we want to compete with the US and its banks, 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. Our recommendation is to continue working on that because it will help us to gain momentum with the other two big monsters in the world: the US and China.

We also have to gain certainty in capital requirements and the CRR3-CRD6 package is a very positive step. because of the cooperation with US banks. The last crisis has shown that the requirements of the EU Banks and the US Banks are completely different, and regulators should now take into consideration how the overall framework is affecting competitiveness and growth.

David Wright

There will be a level playing field.

Ángel Rivera

Yes. This is important. In the end, regulators have to take into consideration both growth and competitiveness.

David Wright

Let us move on to green finance and sustainable finance. I know that this is very important for Banco Santander. Are we going in the right direction? Is it happening or are we bogged down in technicity and confusion?

Ángel Rivera

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. I would also suggest that the regulators and banks have to work together in this direction because we have to educate companies and the population in general. Regulators should work closely together and with banks to spread the culture and fix the standards of these regulations. It is known true there are different requirements from the European Central Bank (ECB), the European Banking Authority (EBA) and other regulators nowadays, and this is complicated for both the banks and the customers.

Banks have to play a key role in this green transition. We have to finance this transition, and it is not easy because nowadays the binary disclosure of "green" versus "brown" needs to end. We have to move, along a good path in this transition; if not, it will be very expensive for Europe, and we will arrive at the same point of losing competitiveness. Regulation in the US is completely different. Nowadays, we are seeing a lot of movement from European companies and investment in the US market; this is a call to our regulators to pay attention and look to have the same framework.

David Wright

Are you seeing examples in Spain of companies moving business to the US?

Ángel Rivera

Yes.

David Wright

That is serious.

Ángel Rivera

In the end, companies look at shareholder returns. If they can invest and obtain better results and returns in other markets, then they will do it, and actually they are doing so. It is imperative for the EU to rethink how we are facing this transition and how regulations can affect the speed and health of this transition.

David Wright

This is just a parenthesis from me. You will have seen that Mario Draghi was given a mandate from the President of the European Commission yesterday to produce proposals for European competitiveness, so I think that all of us, including Eurofi here, will be contributing some ideas. I am sure that you will as well.

Ángel, you have a lot of experience with Latin America. I believe Banco Santander is in seven different markets, and I think it is the biggest European bank in Latin America. How do we expand this? It is a natural partner. What would you advise policymakers to do? Of course, we have here, at the invitation of the Spanish Presidency, many Latin American finance ministers. I am sure you are seeing some of them. How can we deepen this connection with Latin America from a commercial point of view?

Ángel Rivera

In Spain, we have a historical, economical and cultural relationship with Latin America, and it is a key market for the EU. We will probably have to reformulate trading alliances because we need to move away from the dependency on Asia and China, and Latin America is a good opportunity for us. The Spanish Presidency can probably help in this regard because we have a very good, tight relationship with the majority of the governments in Latin America. Especially in our case, as you mentioned, we have a strong presence and are the largest bank in the region. We have more than 6,000 branches in seven countries, and we serve a lot of European companies in Latin America. It is a great opportunity if Spain can help to reformulate these alliances in this first step, but Europe has to maintain this level of momentum in its relationship with Latin America because it is a great opportunity to expand and grow our economy.

David Wright

For example, a Mercosur trade agreement would be good; I think the president of the EU Commission mentioned that yesterday as an objective. What other things could Europe do that would develop business? Are there other ideas here, such as more cultural exchanges and things like that?

Ángel Rivera

Yes, I think the commercial agreement is one of the best ways to link both continents. I suggest that we act as a group instead of using a country-driven strategy. We probably have to revisit the commercial agreements that we have with the region and work on a new one. As I mentioned, it is important to put the eyes and the focus on this part of the world in order to gain growth and competitiveness so that, in the end, there are a lot of countries with a very good level of talent where wages are cheaper than European ones, and we can grow and gain competitiveness.

David Wright

Ángel, thank you so much for being with us, and thank you for Banco Santander's continuous support of Eurofi. It is a great pleasure to see you here, and I look forward to our next discussion very much. Thank you.

Conversation with Scott Mullins

Scott Mullins - Managing Director, Worldwide Financial Services, AWS
David Wright - President, EUROFI

David Wright

Scott, welcome, and thank you for your support of Eurofi, which is much appreciated.

Scott is the Managing Director and General Manager of Amazon Web Services Worldwide Financial Services. He is responsible for leading the development and execution of AWS's strategic initiatives in the financial industry all around the world. He comes from many years of experience in capital markets as an equity trader and as a product manager; he has worked for Nasdaq, JP Morgan, Merrill Lynch, Penson Worldwide and has done a whole lot of different jobs.

A lot of them, I think it is fair to say, Scott, have been involved in innovation and frontier-type developments in the financial industry, and I think that is what we really want to get your perspective of today. Tell us how you see the pace and the direction of technological change, given that you are right at the frontier of this; you are developing it every day. What are we seeing here? We see AI, we see distributed ledger technology (DLT) and we see many other new types of applications beginning to emerge. We heard earlier from London Stock Exchange about building new types of digital platforms. Where is it all going? How do you look at this?

Scott Mullins

David, we are delighted to be here again to support Eurofi and to be part of the exchange of ideas.

It is always interesting to hear your CV read back to you, and I appreciate the way that you couch my career as at the edge of innovation. As I view it, I look at the roles that I have had in different organisations as roles that were subject to change. Unfortunately, it seems like in my career, and I do not know if anybody else has felt like this, that the minute that I dedicated my career to a specific thing, that very specific thing changed.

For example, you mentioned that I started my career as an equity trader. I like to tell people that I picked the exact wrong time to become an equity trader in the United States. It was the late 1990s, and at that time we had two major changes in the way that capital markets worked in the US. We went from trading in fractions to trading in decimal points, which compressed margins for equity trading in the US, which is a very large change for us at that time. Very shortly after, we made another change in the capital markets, which really impacted human traders, in that we went to something called Regulation National Market System, which is the current rule that governs US markets. This meant that we had to route orders to the best price in the market, rather than 'turtleising'. That completely changed the way that we do capital markets in the US, and it changed the way that we trade and who trades. In fact, it led to the rise of electronic trading.

You rattled off a number of different things that have been on the scene for some time. I think, for some of these things, it is probably not fair to call them innovations anymore; it is more apt just to call them technology. Cloud would be one of those things. We are now in the second decade of cloud adoption in the financial services industry. DLT and Blockchain have been around for some time, and even AI, even though we are talking about generative AI now, has been around for decades.

I think what we are seeing the most is that it is not necessarily technology that is driving change in the industry. What is driving change in the industry is the expectation of consumers; the expectation that they have the ability to choose. Now, more than ever before, we, as individual consumers, including us financial consumers, we have a choice in how we transact with each other. What we do in those transactions and how we want to be served by the institutions that serve us is driving the need for iteration and experimentation within financial institutions.

Today, you may have seen that Citigroup just announced a complete transformation of the way that they are organised within the bank, which is the biggest transformation and reorganisation within the bank in the last 20 years. They are doing that because of the expectations on the organisation from their customers, so to me, what is driving change in the industry is really the expectations of our customers. What is enabling it to be possible to iterate as quickly as we are is technology. You can look at the subject of generative AI at the moment, and in Stockholm we were not talking about generative AI, and that was in April. The advances that we have seen in this particular space over a very short period of time, just four and half months, now it is all that we talk about. That is enabling all of us, including financial institutions, to rapidly change.

David Wright

When you look at this, and as a user of your services, one of the great advantages is just the incredible simplicity. Is that what the consumers want: a very simple process where you can execute your demand immediately, quickly and efficiently? One-click stuff. Is that where it is coming from?

Scott Mullins

Think about the last time that you interact with anything on this device. If anything gets difficult in an interaction in an application or a website, what is the first thing you do? You just close it and you go to the next thing, and so I think the answer to your question is obviously yes.

That also goes for organisations. AWS's role is to provide an ability to take away undifferentiated heavy lifting from institutions in the financial services industry, but also in other industries, and from individuals who begin building businesses from scratch as start-ups. We are there to provide services that you can use to build a small business and scale it to the largest business on the planet, if you would like to. Doing that without having to outlay large amounts of capital to go and build a datacentre, to buy equipment, to rack, stack, power and maintain that equipment and then depreciate that over time is an enabling quality that allows for simplification in the way that we build into play applications, but also in the ways in which we work.

One of the innovations that we are seeing in this space is the application of generative AI to the way that we develop software applications. AWS has an application that we call Code Whisperer. There are other applications like this in the market as well. This particular generative AI application will sit alongside developers and recommend code snippets and improvements to their code to actually improve the quality of code, but also the speed at which that code is delivered from a software development lifecycle perspective. We built this for Amazon itself and then have externalised it for our customers; it is available right now. Even at Amazon, we saw a 50% improvement in the delivery of software for Amazon when we deployed this for ourselves.

As we continue to move forward, simplification, especially of tasks, is going to be very important for our knowledge-base workers around the world.

David Wright

Thank you. Let us talk a little bit about Europe. The European Union has recently adopted a set of rules on so-called Digital Operational Resilience Act (DORA), which looks at resilience and so forth. Are you happy and comfortable with these rules? Are there things that you do not like and things that you do like? What is your take?

Scott Mullins

We are very pleased to see this now in level two, because level two means implementation. We were just talking about simplicity, and we are now at the point of talking about implementation and what the rules that we follow are actually going to be; the rules are the road for all of us: for financial institutions, critical third parties and not just cloud services providers, but all providers of critical services to the industry. Now that we are at the point of being able to articulate what that framework is, and we appreciate the opportunity to provide our point of view on this, that is exciting for us.

We believe that DORA has the potential to provide a framework that is going to be beneficial for all parties, because it is going to provide certainty. When you have certainty, then you can build confidence. Uncertainty is the enemy of confidence. You and I were just talking about certainty and uncertainty, and the one thing that markets and market participants hate the most is uncertainty.

To me, DORA represents the promise of simplicity, hopefully, and getting to a level of certainty of what is expected of all of us as we move forward together. That is very encouraging for us at AWS.

David Wright

From your perspective, do you see any risks here to your business? Are you fully supportive of the whole package or do you see some areas where some change would be, in your view, commercially sensible?

Scott Mullins

I think it is going to be something that is actually additive to our opportunities to serve our customers. As I mentioned, any time that we can remove complexity, whether it is us removing complexity in providing IT services or removing complexity in what it means to use those services in a way that complies with regulations, I think it is a positive thing.

Now, on the other hand, what I am concerned about is the next step. The next step is that we cannot look at DORA in a vacuum. If we do then we have failed, because Europe is not one single place. It is made up of 27 member states, and those member states have financial institutions within them that do not just work in those 27 member states. Many of you in the audience are operating in other jurisdictions. How is DORA going to mesh with the regimes that exist or that will be developed in other jurisdictions around the world? Will organisations that are subject to DORA, whether that is a critical third-party provider or a financial institution, have the ability to harmonise across the responsibilities they will have in these different regimes? If not, we are back, suddenly, to complexity. We know that complexity leads to uncertainty, and uncertainty leads to a lack of confidence, and a lack of confidence does not let us all get to a new level of comfort in progressing the digital agenda here in Europe.

David Wright

You are sounding very European here, Scott, because we had panels earlier today where we were talking about creating a common set of rules for capital markets and so forth. One of the issues is exactly that, which is, how do you implement the rules? You can have rules on paper, reams of complex legal texts, but they have to be implemented in a consistent way. One of the views, certainly in the securities area, is that more powers are probably needed to give to the European supervisory authorities to ensure that. Common implementation is really important for a business like yours, otherwise you fragment, and you end up responding to 27 different sets of rules, which is expensive as well.

Scott Mullins

Standards are important. When there is a standard, we can map to that standard. Again, it is about simplicity. When there are 27 standards or 127 standards, that adds complexity. Complexity also always adds costs, as you mentioned, and so we are very encouraged by any efforts to find harmony across regimes. We are also very encouraged by the opportunity to continue to simplify rules.

There is no need for rules written on paper to be complex. In fact, if we write rules on paper that are complex in the beginning, we have probably already failed, because rules on paper then have to be converted into actions by organisations, whether that is financial institutions or regulatory agencies which are going to have to interpret the rules and then provide oversight related to the rules. If we have written a complex rule, then we have probably not done ourselves any favours.

David Wright

One issue we were talking about earlier, and in a way it is a good time to do this as we prepare for a new political cycle in Europe next year, is the need to look at the consistency of financial and digital rules. In other words, we need to look in a cross-sectoral way at the coherence. Is that something that you think is necessary to do now?

Scott Mullins

I think yes, if you are going to talk about financial rules, then you must talk about digital rules. All finance is digital today. In fact, I was in Madrid before I came out to Santiago, and I had a conversation with a customer of mine there. This customer made a statement to me that I found to be very telling about where we are in financial services with some organisations that are moving far ahead, and that statement was simply this: 'Scott, digital is our legacy'. We have moved past digital, and we are onto the next thing, so if, when we consider financial rules, we do not consider the impact of digital, because everything is delivered to us in that way anyway today, then we have already failed.

David Wright

Let us conclude: where do you see the biggest risk to your business as you look forward in this incredibly fast-changing digital perspective? What are the risks that you worry about?

Scott Mullins

The biggest risk to our business is the same as the biggest opportunity for our business, because that is actually how it usually works. Opportunity and challenges are usually the same thing, and it depends upon how you react to them.

The biggest opportunity that any cloud service provider has, including AWS, is the opportunity to serve our customers and to provide services that not only meet their current needs, but hopefully through proper planning will meet their needs well into the future as we iterate with them. Based on the way that we provide our services, and I am not just speaking for AWS, I am speaking for other cloud providers or service-based organisations at this point, we provide those services on a consumption-based basis, which means that if we are not meeting our customers' needs, those customers can stop consuming our services at once. We have consistent and constant good pressure on us to make sure that we are delivering value to our customers every single day. In fact, not even every single day, because we build some of our services by the hour, and so at any hour, at any minute, if we are not meeting our customers' needs, they can turn them off.

David Wright

A final question. There is a lot of white noise out there about strategic concerns and US companies strong in the cloud. Does that worry you at all? Do you think that is just passing in the night? Do you worry about the politics of this?

Scott Mullins

I do not worry that US companies are very good at providing information technology. I think there is truth to that. I also think that there are other companies around the world that are also good at providing information technology. I think it is very easy for us to get a bit focused on a certain set of companies because they might be those that are the most noticeable or recognisable in providing a certain type of technology, but if you look at the financial services industry, there is a broad spectrum of companies that are at the leading edge of providing solutions and services to the industry that are technology-based. You can look at Nasdaq, for example, or some of the newer players in this space like Thought Machine, 10x Banking or Temenos, where those organisations are taking themselves from the way that they deliver the solutions that they offer to the industry.

No, is the answer to your questions, because this is a very vibrant industry that has technology at its very core and across all aspects.

David Wright

Scott, it has been a great pleasure to have you with us again. Again, we thank you for your support of Eurofi. The next one is going to be in a football stadium in Gent, apparently, so you do not need to bring football boots or a football, but we certainly want to get your perspectives of how the world will have changed by next February, in six months. Is that okay?

Scott Mullins

That is okay. It might be awkward for me, and I am glad you explained, because my football kit might be a bit different to the football kit you would expect me to bring if I came straight there.

Conversation with Daniel Maguire

Daniel Maguire - Head of Post Trade, LSEG & Group Chief Executive Officer, LCH
David Wright - President, EUROFI

David Wright

Ladies and gentlemen, I have the pleasure of having a conversation with Daniel Maguire, who is the Group Head, and post trade Chief Executive Officer of the LCH Group. Daniel, thank you for all of your support to Eurofi over many years. He has been in this position since 2020, and CEO of LCH since 2017. Those of you cognoscenti with a historical memory will know he has been very active in all of our debates on clearing.

Daniel, we are all talking about financing the EU economy and capital markets. I think you would argue that the London Stock Exchange is doing quite a lot here. Talk about that.

Daniel Maguire

Thanks, David. It is a pleasure to be here again, and thanks for the introduction. I will begin with a brief introduction to LSE, because I think there is a slight misnomer in the name. To lay the land for everybody, we employ around 25,000 people globally; 3,000 of them are based in 19 countries within the EU; and about 50% of our staff are based in Asia. We have clients in 190 countries, and offices in about 70 countries. We are a truly global business, despite the name, and we are split into three different things: data and analytics, capital markets business, and post trade, which is split into trading venues and post trade, which is my responsibility.

We are operating both directly in the EU and also from outside the EU inwards, in terms of the customer base that we have there as well. It is multi-asset class, end-to-end across all parts of the post-trade lifecycle, so we feel very much involved and ingrained. We are probably one of the biggest financial market infrastructure groups within the continent, so, despite the name, we feel very much part of the fabric here.

David Wright

In terms of your staff inside the EU, are they working on the trading side or the data side? With your merger, you have become a huge data company.

Daniel Maguire

We have. If you break the organisation down, around two-thirds of the organisation is data, with the acquisition of Refinitiv, as we have integrated that, and the remainder is our more classic markets businesses, which are vitally important. In terms of what our staff are working on, we have people from engineering, technology, product, sales and customer standpoints, so it is across the whole piece. Taking the markets businesses in Paris, which is the headquarters for LCH SA, we have about 300 staff based there, and that is very much dedicated to the clearing business as well. It is pretty pervasive across all different elements of the lifecycle.

David Wright

On the data issue, am I right in thinking that regulators should have real-time data today? We were talking yesterday about banking scandals and banking problems in the United States and Switzerland. Today, regulators and supervisors do not have real-time data. There is no reason why they should not have it.

Daniel Maguire

There is not. On quite a few occasions, there has been, if not real-time data, then very near to real-time data available. The challenge is always, if you get it, what you do with it. How quickly can you turn that data into insights? Data, in and of itself, is a raw material, but what do you do to process that and give insights? That is what companies like ours can do, working closely with the regulators.

David Wright

Finally on the data, do you find that demand for made-to-measure indices is growing in the corporate and financial sectors?

Daniel Maguire

Definitely, we are seeing more and more demand for out-of-the-box indices, but with the advent of sustainability and ESG, there is a much greater demand for more customisation. That is an area that we see as a big potential growth opportunity.

David Wright

Globally, I guess.

Daniel Maguire

Yes, very much so. There is a huge emphasis in Asia, where there is a rapid growth trajectory happening, but also all through Europe and into the States. It is a global phenomenon, rather than a localised one.

David Wright

Let us talk about one of your favourite subjects: clearing. We all accept that this is a crucial issue for capital markets union, but the question is how. We have had a number of panels this morning. What is the optimum way of doing this? There are proposals on the table that you are well aware of. There is an alternative approach, which I think you have always been supportive of, which is to deepen supervisory cooperation. Can that substitute?

Daniel Maguire

I believe that it can. We have had the debate for many years; there have been many panels at Eurofi on this for a long time. I shall not reprise them all, but I think that we have made some big steps forwards. The regulatory cooperation and supervision is very real. I can say first-hand we have ESMA overseeing us with our UK CCP. It is appropriately invasive on us, working in conjunction with the primary regulator, the Bank of England.

There is definitely a large emphasis on this, and it is important that we continue on that path, but I cannot ignore the fact that there are other noises and sentiments around this from a financial stability standpoint. I know there is a view that strengthening clearing capability in the EU will strengthen the EU. You may strengthen the clearing capability in the EU in theory, on paper, but I think, in reality, that it is going to weaken the EU in terms of participants' competitiveness and perhaps even the euro as a whole.

These are global markets. The clearing houses represent how the markets trade. They represent the supply and demand that goes on around the world, and the euro is a very pervasive currency. For euro IRS, EU firms only represent around 30% of the notional cleared volumes. In other words, 70 % of these euro transactions does not involve an EU participant, which is a good thing, but if you want to fragment and split that, the intended or unintended consequences will be a lack of access and, by extension, a lack of competitiveness for firms in the real economy in the EU.

I can understand the philosophical debate for forms of policy with quantitative thresholds and quotas, but I think it runs counter to making the EU more competitive; it makes it less so.

David Wright

If we think about your preferred option, in my words, not yours, which is to deepen supervisory cooperation and not put quotas or limits on, how would you do that? From the European perspective – I have heard Sean Berrigan say this – we have a financial stability issue if clearing is carried out in the UK. What would the elements for deeper supervisory cooperation mean? What would the substance be?

Daniel Maguire

We have a large number of the elements now, so interest rate swaps and a global market cleared globally. Participants are global; oversight is global, so we need levels of harmonisation, regulatory-wise. Our swaps business is overseen by 14 regulators globally. Pretty much all of the G20 have insight and oversight, so it is about transparency, disclosure, cooperation and testing. We have to test for the eventuality that members and customers fail, and to make sure that regulatory cooperation is real and sincere, and that there is full disclosure. At the same time, to the best of our abilities, we have to define what happens in every scenario. Sometimes we talk about the scenario of a clearing house in trouble, and if the clearing house is in trouble, how do overseas regulators get involved? I think the debate needs to go back to how a clearing house that is well run, well governed and compliant with all the regulations of the various jurisdictions gets into trouble.

The starting point is that there is a default. There is a default of a bank, which has been allowed to default and not go into recovery by a national competent authority, so the start of the actual chain is that clearing houses do not get into trouble in isolation. Clearing houses should not get into trouble full stop, but if they did, it is as a result of a bigger event that could have been prevented. We need to go back to first principles as to how we get to this situation, how we prevent it and how we cooperate, as regulators, to prevent it.

David Wright

I have two follow up questions. People will have memories of what happened in the great financial crisis. There were suddenly decisions taken by the Bank of England, I believe, to ratchet up collateral requirements on certain sovereign debt in Europe. From the European perspective, people worry about that. Is there any way one could conceive of a more legally binding set of obligations between the supervisory parties – not 'on paper' cooperation, but legally binding cooperation – which would mean that, vice versa, the supervisory institutions would not take decisions without full, mandatory cooperation and agreement in crisis situations. Could that work?

Daniel Maguire

If we go back in history to 2010, when there were changes in haircuts on repo collateral, it was not driven by any regulators. If you looked on every screen around the globe, credit spreads were pushing out on certain underlying debts, and equity ratings were pushing out on that. It was a risk management decision by the organisation to reflect what is happening in the market, as you would expect a good clearing house to do. It was not a supervisory edict, to clarify that point.

That said, it brought into focus the reliance on clearing houses, and we learnt a lot from that about how to communicate, correspond and transmit what you will do in certain scenarios, so it has made us much more prepared for those outcomes, working closely with the national banks that issue debt, as well as the regulatory fraternity. I do not think it is about codifying, necessarily, what happens in every scenario from a regulatory standpoint. Ultimately, we are the risk managers, and our job is to take action when we see changes in market circumstances. To put it bluntly, if we have interference on haircuts, driven by other factors, that is not a safe clearing house. Clearing houses have to be independent and reflect what is happening in the markets.

There are many versions of history around this one. I was in the room, so I can clarify what we did. It was about reflecting the underlying market environment and nothing else. However, it has obviously taken a different path since then.

David Wright

Before I ask you about some new initiatives the London Stock Exchange has been announcing, are you perfectly comfortable today with the crisis management arrangements for clearing houses? Are the waterfalls going to work?

Daniel Maguire

I can talk for clearing houses, but I cannot talk for the industry at large. I think so. LCH has been around since 1888, and we have been through many defaults, from Lehman to Barings, Drexel Burnham Lambert and more recently MF Global. The focus and scrutiny we have from the policymakers and the regulators is like nothing that has ever preceded it, and that is a good thing; we expect that. There is the focus, the stress testing, the quantitative analysis we are doing on how we look at the probabilities of defaults and the various scenarios. How do we get to a point where we do not have enough resources? I am pretty confident that we have covered all of the bases, so I think that the event that could take a clearing house to the brink is one that has not been considered in regulation or policy.

Across the globe, we apply whatever the highest standard is from a risk standpoint if it is in the EU. I will not get into EU, US and UK standards. If we quantitatively look at the standard, we take the highest standard and we apply that globally as a minimum across everything we do, and often we go above that as well. Business-wise and commercially, we have a very simple philosophy that the highest standard is what everybody wants. You do not want to worry about your clearing house. We have a very simple phrase: 'Nobody wants to buy the world's cheapest parachute.' It is not about being cheap and cheerful; it is about having the highest standards and protection, and that is our hallmark.

I am confident from an LCH standpoint. I cannot talk for other clearing houses.

David Wright

To close, would you be so kind as to give us some thoughts about what I am reading as new initiatives from the LSE. I picked up three, and no doubt there are more. There is one on private capital, one on distributed ledger technologies building a platform for digital assets, tokenisation and so forth, and one on listing. Can you say a few words about these directions?

Daniel Maguire

I can, yes, and there are probably more than the ones that are public as well. Given the time, rather than dwelling on the detail of each, first of all, we are definitely of the mind that we need to embrace more efficient digitalisation of the way we operate. From a listing standpoint, there is a lot said about the UK and Europe. The rest of the world is developing at pace, from India to China to Saudi Arabia. If we start having the EU/UK debate, we are missing the point. There is a much bigger opportunity and threat out there, so embracing new, more efficient ways, and removing a lot of the burden from doing capital formation and the ongoing requirements around listing, is absolutely key. There are some progressive reforms in the UK and the EU on that, and we welcome it.

How do we react to that? The two things are interlinked. If you want to have digitalisation of markets to make things more efficient, you need to have the regulation that enables it. A lot of this is underpinned by cloud, which has had some time while we are here as well. The whole thing is interlinked: if we want more efficient markets, we need to digitalise, and if we want to digitalise, that is underpinned by cloud. Circling all of those squares is key, but our posture as a firm is, on the one hand, that we are guardians and stewards of systemic financial market infrastructure, so we take that very seriously and we are highly regulated, but we are not deaf. There are new technologies and methodologies out there, so we need to embrace those. We do not want to become Kodak.

How do we think about that? We have a cartilage role between what some people call the old and the new world, although I disagree with that. There is the existing world and the potential new world, and firms like ours – and there are others, too – have the opportunity to embrace sensibly and be the cartilage between bringing new capabilities in to help move us from an analogue world to a digital world and doing it in the safety and security of the regulatory framework that we have.

For us, that is the opportunity. How do we walk that tightrope and navigate that so that we are not just sticking to what we have always done? How do we embrace the future while protecting what we have today? That is our overall posture, hence you have seen a few things lately around this.

David Wright

It sounds extremely interesting. As a last question, in five or 10 years' time, we are going to see the tokenisation of all traditional finance being traded on the LSE. Is that what you think is going to happen?

Daniel Maguire

I think that is definitely one possibility. I just hope that we are not talking about active accounts in 10 years' time.

David Wright

Daniel, thanks very much for being with us.

EU-Latin America: areas of cooperation

Pablo Hernández de Cos - Governor, Banco de España

Carlos Fernández Valdovinos - Minister of Economy and Finance, Paraguay

Alejandro Pérez - Chief Administrative Officer, BNY Mellon

Pablo Hernández de Cos

Good morning. Thank you all for joining us for this panel discussion. Perhaps the main novelty of the informal Ecofin that is taking place today and tomorrow is precisely the presence of the ministers of finance of Latin America and the Caribbean here with us. The main reason for this is that Spain attaches great importance to the relationship with this region and the need to strengthen it, especially in an environment as complex as the one that we currently find ourselves in, with geopolitical tensions and high probabilities of fragmentation. Intensifying our links could, at least partly, help to avoid some of the negative consequences of this environment.

Allow me to mention that the Banco de España's research staff have produced several papers that try to put some numbers on how increasing the degree of integration could be very beneficial, not only for Latin American countries but also for Europe and Spain. There are indeed already some really large, cross-sectoral projects under way. However, we are going to focus today on two of the main priorities, for us and also for the Latin American countries, namely the green transition and digitalisation. As part of the informal Ecofin, a meeting with the Ministers will take place today to discuss precisely how to make proposals and projects concrete and how to monitor them, to reach agreement and to focus on what the EU-CELAC summit in Brussels agreed in July. Today, we also wish to consider what the private sector might do to help Latin America in this endeavour.

For this discussion we have two distinguished speakers. First, I have Carlos Fernández Valdovinos, who has recently been appointed Economic and Finance Minister of Paraguay. An economist with a PhD in Economics from the University of Chicago, he also has a Master of Science in Policy Economics from the University of Illinois. Carlos and I have been colleagues: he was chair of the Central Bank of Paraguay from 2013 to 2018. His vast professional career includes numerous positions, not only at the Central Bank of Paraguay, but also at the World Bank and the IMF.

Second, here is Alejandro Pérez, who has been the chief administrative officer of BNY Mellon since 2021. Prior to joining this bank, Alejandro spent most of his career in various leadership roles at Goldman, Bloomberg and other financial firms. He has a mechanical engineering degree from the University of Alabama and an MBA from the Stern School of Business at New York University. Welcome to both of you.

My proposal would be to divide the discussion into three blocks. First, you will give us your views on the macro environment and how this may influence the achievement of the objectives I have mentioned. Then, we can go from general to specific, to consider the funding of these investment needs, both for the climate and digitalisation. We will finish with a third block on how Europe could help in this endeavour. Carlos, what are the main challenges that you see economically and socially in the region? Do you consider that the macro environment may influence the objectives in these two domains?

Carlos Fernández Valdovinos

Thank you very much for the opportunity to be here and present the views from Paraguay, probably a common view that we have in the Mercosur at least. I usually say that the pandemic was like a tough soccer game, probably more like a rugby game instead of soccer, where we were injured. We suffered a lot of kicks and continue to be injured. We are still recovering. We are not fully recovered. I mean injured not only in the economic part but also in the social part and on the environmental side. The two last injuries were put aside, given the urgency in the health part and on the economic side.

As we continue to recover, at least in Paraguay, we really believe that, given what happened then, given what continues to happen, because shocks are still there – the Russia-Ukraine war is a shock. Rising commodity prices until recently were another shock. Logistical problems were another shock. Given all the shocks, the not so simple recipe but the one that we believe has to be the answer to all these problems is further integration. When I say 'further integration', I mean further integration regionally, in the Mercosur part, and more integration between the different economic blocs.

We are having a meeting today between ministers of finance. More than 30 ministers of finance will gather here to discuss, talk, exchange ideas and so on. It is important to talk, but more important than talking is doing the things. We have a great opportunity to do something, not as fully Latin America but at least the Mercosur part. We have a great opportunity to walk the talk. We are at the door of signing an agreement between Europe and the Mercosur. What better signals that we truly believe in integration than signing this agreement that was negotiated for 20 years? We are almost there.

True, there are some brand-new conditions that were a surprise for us in Mercosur, but we are convinced that this is the way to proceed going forward in order to secure more development in the economic, social and environmental parts, further integration. Even though we were taken by surprise by the new conditions, we are working in order to submit a proposal, probably a little bit different to what was proposed to us. We are convinced that we need to close this agreement as soon as possible to show the world that we can work together. That is going to be an answer for this transitional post-pandemic. It is going to be an answer for a better future for all, for Europe and for Latin America. It is going to be a strong signal of how to proceed going forward.

These are difficult times. All countries are deeply into debt, given the pandemic. Some of them are still trying to control inflation, especially here in Europe. They continue to increase interest rates in order to tame inflation here. In Latin America, inflation has started to revert to being more under control. If we have further shocks in the future, it is going to be more difficult to control or to try to do some counter-cyclical policy, given the lack of fiscal and monetary space. That is the reason why we need to devise new ways in order to secure strong growth in the future. Again, going back to the first topic, we believe that further integration between blocs will be crucial going forward. We cannot make any excuse. After 20 years of talking, we need to sign the agreement.

No, it is not the best option, but I am still optimistic that we can continue to develop and to contribute to the world development, not only from the economic point of view, but also from the environmental point of view. Latin America has a lot to do for the future of the world in all the different areas. I am optimistic about the future. These are difficult times, but, let me tell you something, sometimes people ask us in Paraguay, 'How do you do, because you are in the middle of Brazil and Argentina? That is tough territory.' We say, 'Yes, that is true. It is a tough territory, tough neighbourhood, but it has been tough during the past 200 years, so we are used to surviving in that hostile environment.' For us, the world, as it is today, is a difficult one, but we believe that we can survive. We can continue to develop in a sustainable way, and we are going to do our part. Hopefully we can do our part together with Europe and together we can contribute to a better world.

Pablo Hernández de Cos

Let us now consider the perspective of the financial industry. Alejandro, how do you see things from this macro perspective?

Alejandro Pérez

The comments offered by Mr Fernández are very candid and real. In the region, there has always been uncertainty, volatility and, unfortunately, a bit of a stigma when it comes to the sociopolitical circumstances. From a private sector point of view, we believe, operating in the region, that it is important to separate the politics from the financial policies and regulations. At the end of the day, we would really love to see – I am selfish, being originally from the region – policies and regulation that truly protect the investors and incentivise the flow of capital into the region.

We are going to talk about digital transformation and evolution and the green transition in the region. We truly believe that, while there has been advancement in Latin America, Latin America is not yet operating at its full potential. There is a tremendous opportunity for Europe, through this agreement, to support the levelling-up of the region, and then together be able to make an impact across the globe, as Mr Fernández pointed out. The private sector is eager to be part of that, but at the same time, it can only be done if there is true consistency and harmonisation across the various economic blocs—not separation and fragmentation.

Pablo Hernández de Cos

Let us move on now to the more specific part. Carlos, in these two areas, digitalisation and climate, how is Paraguay planning to finance the initiatives needed to achieve our goals. Also, to give Alejandro the opportunity to reply, what are your expectations from the private sector in this respect?

Carlos Fernández Valdovinos

Let me complement what Alejandro was saying with the way we see things in Paraguay. What should be the role of private sector versus public sector? Going again to the soccer example, the public sector is the one that has to make sure that the field is in good condition, that you have the net in good condition and that you have all the line markings, but it is the private sector that is going to play the game. The public sector has to ensure only that there are rules and the private sector can play by the rules.

This is the complementation that we are expecting to see between public and private sector. To give you some statistics, in Paraguay the public sector represents only 15% of the GDP. 85% of the GDP comes from the private sector. There is no way you can grow over time just relying on the public sector. It would be a big mistake. Going forward, we expect to see a game with the same complementarity between both sectors.

True, there were some not very easy or unfair experiences for some companies, especially from Spain, going to Latin America during the 1990s. At the end, they suffered some nationalisations. They were damaged by some politics, taken by governments in Latin America, and we have to take the responsibility for that. Even though we are quite a homogenous region, we are similar but not the same. The private sector has to see also the history of the different countries. They can get the knowledge of what every country did over time.

For sure, after knowing which country did this and what country did that, they will feel more comfortable trying to again embed in Latin America, or in some countries in Latin America where they can feel secure that, over time, they are going to invest money and be able to gain money. It is fair for you to put in the money as an investor and then take out the money, because you need to give returns to all the shareholders. There are some countries where you are not able to take out the money, or, even though you are able to take out the money, the value of the money, due to inflation, is totally different from the money that you put in.

We are open, especially in Paraguay, because I have to promote my country a little bit. This 5 October, we are celebrating the 80th anniversary of our national currency. How many countries in the world have a national currency that can celebrate 80 years? There are not many. Our country can offer stability. We have never had a single case of nationalisation, so we take the rule of law seriously over there.

Going forward, the private sector will be important for these two areas that you are mentioning: digitalisation and green policies. I can talk too much about both but let me just mention one thing regarding the green revolution. It is going to be very difficult for you to find a better country than Paraguay, for example, to produce green hydrogen. I am saying this because of the way it is being produced. What do you need for that? You need water and energy. Paraguay is situated in one of the largest water reservoirs in the world, the aquifer Guarani. We are right in the middle of that. Yes, we have to be careful regarding how we use that natural resource that is very valuable, but we have enough water to do that.

Regarding energy, 100% of our electricity is being produced in a clean and renewable way, using the hydroelectric power that we have, sharing with Brazil or with Argentina. One is Yacyretá. The other is Itaipú. The one that we have by ourselves is Acaray. There is no country in the world that produces 100% of electricity through this means, clean and renewable energy, but that is not enough. You need more energy. Paraguay is one of the few countries, and the only country in the region, that has excess energy. What does that mean? We are exporting energy. If you look at the numbers, we are the largest exporter of energy in the world. Is that the best way to use electricity? No, the best way to use electricity is to use it inside a creative industry that will create employment.

Going back again, there is no way that we can do an environmental revolution if we are not using that energy, complemented with water, to start producing an alternative type of energy, in this case green hydrogen. Going forward, we have the resources. We need the knowledge. We need the capital, because these are expensive, so we need the private sector to go and invest there. Europe especially has a lot of knowledge. European companies will find a stable environment on the macro side, on the rule of law, and all the materials that they need to produce green energy. We are expecting to see the European private sector going there to carry out this revolution.

Pablo Hernández de Cos

Turning again to the private sector, Alejandro, what role do you see for financial firms in financing the climate and digital transition, particularly in the region? Perhaps even more importantly, what could be improved in terms of the regulatory environment? You mentioned the issue of harmonisation, which is very relevant, but perhaps there are other issues that you would also like to stress.

Alejandro Pérez

I will continue on what Mr Fernández was talking about because it is very important, particularly I will continue on what Mr Fernández was talking about because it is very important, particularly when it comes to the green transition. It is very obvious that Europe has led the charge when it comes to the green transition and tackling climate change, and it has done a phenomenal job. It is also very clear that that discussion has been pretty much focused in Europe. It has been very intra European, and it is now time to extend that beyond Europe. Unfortunately, the US is not yet fully ready to engage, but Latin America is very much willing to do so.

It is important to do this for a couple of reasons. One is that the green transition discussion, when it comes to corporate disclosure rules, is creating some extraterritorial implications that will become a problem. Similarly, most important is the fact that climate change is a global issue and the solutions we need must be global in nature and not just regional.

When the discussion on green adaptation is taking place, there is a major emphasis on capital markets and capital markets policy. This is obvious. As we just heard, the public sector alone will not be able to finance the infrastructure needed to tackle climate change. In order to expand that, we need to focus on the financial markets ecosystems. Financial markets, by nature, operate well at scale, particularly when we bring diverse investors into the mix. I believe that it is important for Europe to give the benefit of its experience to the region of Latin America and for Latin America to provide its perspective to Europe as well.

As I was saying before, there are certain implications that are important to keep in mind. Between the two regions, there is a lot of momentum that can be created by collaborating and creating that harmonised policy that will exponentially increase the value of the proposition and then incentivise others to join as well, which is what is most important. This cannot just be a Europe and Latin American problem. This has to be, as I said before, a global mandate. The private sector is eager and willing to engage, we just need to make sure that it is done in a way that is consistent across the globe.

Pablo Hernández de Cos

I will give you the last word, Carlos. You were already touching on the final question that I had, which is precisely how you see the role of Europe in order to help you in this endeavour of digitalisation and, in particular, combating climate change. You know that Europe is leading some of the discussions, in particular on taxonomy and disclosure. Do you consider that Europe is playing a leadership role here, or do you feel a bit abandoned and that we are just walking the walk, but completely alone and losing the others?

Carlos Fernández Valdovinos

As I mentioned, we need greater integration between both. We have strong historical ties. There have always been, especially with Spain, since Spain is really the door to Europe for Latin America. It's not actually the door. It is the hinge: the one that actually opens or closes the door, so this is a different and more important role than a single door. Spain is the hinge towards opportunities.

This is in the interest not only of Latin America but also of Europe. Otherwise, if you are not taking the place, somebody else will. It is true, if you look at the stock, that European investment is larger, probably, than any other region in Latin America, maybe except for the US, but this is the stock. What about at the margin? At the margin, Europe is losing to China and Saudi Arabia. This is not to blame the two of them that are looking after their own interests. It is in the best interests of Europe also to, again, regain the position that the continent has had in the past and be a big contributor to the development of our region that is historically linked to Europe, and that is going to be beneficial also for Europe in itself.

Pablo Hernández de Cos

Thank you very much to both of you. That was a good discussion. Let me try to wrap up with four or five ideas that I have taken from our conversation. The first one, as you, Carlos, were mentioning at the very beginning, is this idea of integration as the main instrument to address the current challenges of the globalisation process: to fight them with further integration. You were referring to integration within the region and of the region with Europe in this case.

The second idea: Alejandro, I fully share this idea of harmonisation. This is absolutely crucial for the private sector. The banking sector is always asking us for more harmonisation and of course it is also particularly relevant in the region if we want the private sector to be involved in the financing of all its needs.

The third idea is complementarity. We cannot, and should not, see the private and the public sector as enemies, when the reality is quite the opposite. Carlos, you also made a very important point, which is this need for us to discriminate and differentiate. We tend, in Europe, to treat all Latin American countries in the same way. In my view, with this idea of discrimination, we can even create an incentive for countries to behave better. The market has always been an important incentive for doing so. This is at least what I would like to think.

Finally, we very often claim that Europe has a leading role to play, especially in the fight against climate change. Perhaps we should be a bit more modest. We might want to be the leaders in this area, but if we want other regions to accompany us in this endeavour and, in particular, in financing the transition that is needed, we have to listen more to their needs and specific situation. With this, I will end. Thank you very much, Carlos and Alejandro, for being here, and of course to you all. Thank you.

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The badly needed Single Market for capital requires actual investor protection and access

Nadia Calviño

First Vice-President of the Government of Spain and acting Minister for the Economy and Digital Transformation

Speech

I am delighted to address the EUROFI conference, taking place just before the informal ECOFIN meeting in Santiago de Compostela under Spanish presidency, which can be qualified as historical in many aspects.

For the first time in history, building on the role of Spain as the gateway between Europe and América, we will gather Finance ministers from the EU and Latin American and Caribbean countries.

Furthermore, discussions will lead to tangible and concrete outcomes, as we expect to agree on a list of strategic projects on which to focus our investment efforts. We have worked for the past year together with countries in the region, EU member estates, multilateral financial institutions and the European Commission, to identify investments that can make a difference in terms of the green and digital agenda development in Latin America and the Caribbean. The EU has committed to mobilizing 45 billion euros in investment and I am sure that coordinating our actions will lead to more efficient use of public resources, mobilizing private investment and bringing better results on the ground.

I think that there will be a "before and after" Santiago in terms of cooperation between the EU and Latin America and it is by this kind of down to earth, real actions, that we deepen our strategic partnerships, more important than ever in a context of geopolitical tensions and challenges.

Bilateral ties between the two regions are impressive. Often the noise and some headlines blur the real picture. Trade between the two regions has increased by almost 40 % in the last 10 years. The EU is the largest investor in South America, with 20 times larger investments than China.

Large investors in Latin America present here today know well how important the region is not only to Spain but also to other Member States. It is also a great destination for high tech products produced in the EU.

As a result of this ambitious programme, this informal ECOFIN meeting will gather 60 countries, representing 14 % of the world's population and 21 % of global GDP, not to speak about one third of the votes and the capital in the IMF and the World Bank, amongst other institutions.

This is a non-negligible part of the world that has a strong voice in shaping the new reality; the new world which is in the making as we speak. Since you are all into finance, let me just give you a number: 600 million persons speak Spanish in the world. This is an impressive asset in many sectors, including artificial intelligence, and shows also an extraordinary potential in many other areas.

Beyond the EU-Latin American and Caribbean summit, which is certainly one of the highlights of this informal ECOFIN, we will deal with intra-EU issues. Together with central bank governors we will exchange views on the economic outlook, coordination of monetary and fiscal policies, strategic autonomy and economic security in the EU. We will also have an informal exchange on the ongoing review of fiscal rules, also known as the Economic Governance Review. We will build on the constructive approach and the openness of all Member States to try to reach an agreement by year end. The Spanish Presidency will invest a lot of effort in trying to achieve this.

Spain is leading the Presidency from a positive position. We have done our homework and are leading some of the key debates on the table right now.

The Spanish economy is doing quite well, even in the current context of slowing down of the world economy. Economic analysts and international institutions are revising their growth forecast upwards, to around 2.3% this year, confirming that Spain will be the leading economy in the EU this year and the fastest growing large economy in the Eurozone next year.

Spain also features amongst those countries with the lowest inflation, thanks to measures taken since 2021. This is obviously an important driver of competitiveness for companies, that are gaining market share. The current account surplus is one of the engines of growth, together with consumption and investments, with the invaluable drive of the Next Generation EU programme.

Beyond growth and inflation, Spain is also in a comfortable position to lead debates on fiscal rules, as we have outperformed targets to reduce deficit and debt to GDP ratios. We also have responded to the challenge in international energy markets in a very proactive manner, leading the ongoing energy market reform. Finally, Spain is frontrunner in the implementation of the Next Generation EU investment and reform programme. This undoubtedly is a key factor underlying the outstanding economic recovery and current modernization process of the Spanish economy.

Our aim is to bring as many key files over the line as possible under our presidency. Time is of the essence as the Belgian Presidency will not have the full semester and therefore with the European elections it will be more difficult to reach agreements on these files.

What are the four top priorities?

1) First, deepening our economic and monetary Union. This encompasses a number of files, each of which would merit a monographic discussion: besides the reform of fiscal rules, we will try to reach agreement on the Mid-Term Review of the Multiannual Financial Framework: how to continue to provide financial support to Ukraine, how to design the new own resources to fund the investment needs at European level. And of course, two subjects that I am sure will be intensely discussed here at this forum -Banking Union and Capital Markets Union-.

The Secretary of State for Economy and the Secretary General of Treasury are attending trilogues day in, day out. In the first weeks of the Presidency, we already achieved success in some of these files and we will certainly continue to do our homework in the course of this semester.

You know well the ambitious position of Spain in the areas of Banking Union and Capital Markets Union, which I am sure will be discussed during the Eurofi conference.

We are also putting our money where our mouth is by directly participating in the European Tech Hub Initiative to try to also innovate in terms of private-public cooperation and funding for scaling-up start-ups in new technologies.

2) Our second priority is supporting the competitiveness of European companies. This is very directly linked to strategic autonomy, energy and competition policy, trade and economic security, some of the issues that we will be discussing tomorrow.

3) Third priority is digitalization. I am Minister for Economic Affairs and Digital Transformation. The final part of the title is actually a very important part of my job: how to drive the digitalization of the Spanish economy. There again we are seeing very clear results already in terms of job creation, in terms of public and private investment and leadership in some of these new high-tech areas, as well as exports of non-tourism related services.

The highlight of the Presidency will for sure be the Artificial Intelligence Act, a topical area, challenging but also extremely important if we want to get digitalization right and make sure that our European values are protected, not only in the physical but also in the digital world, without hindering innovation in this new digital economy.

4) The fourth pillar of our Presidency is reinforcing the role of the EU as a global player. In particular, deepening our ties and our cooperation with our Latin American brothers and sisters on the other side of the Atlantic.

On top of discussing this Global Gateway investment program, which is already an important milestone, in the coming days we will also address the ongoing reform of Multilateral Development Banks. In the run up to the annual meetings of the IMF and World Bank, it is key to reinforce the ability of the Bretton Woods system to provide financial support to most vulnerable countries and ensure financial stability throughout the world.

This exchange comes at a very timely point in time, following up on the G20 leaders meeting in India last weekend, in Delhi and just before the UN General Assembly next week in New York. President Sánchez will also participate very actively in that meeting. Then we will have mid-October the Annual Meetings of the IMF and the World Bank. And in November, COP28.

There clearly is a continuum, because all these matters are interconnected, and they all play a key role in shaping this new world order which is in the making. And we need to make sure that Europe has a strong voice in shaping it, so it does reflect our priorities and values.

Let me end with a message of confidence. It is important that policymakers and other important stakeholders and players in international markets convey messages of cooperation and trust between each other. There are many people who are interested in conveying messages of conflict, insecurity uncertainty, tension, dividing different parts of the world, calling for protectionism, calling for wrong solutions for today's very complex challenges.

But we have a shared responsibility to convey a message of confidence. It is lack of confidence that leads to financial turbulence, trade conflicts and economic fragmentation.

It is good that we highlight the fundamental value of international cooperation, multilateralism, rules-based and fair trade. This must be the fabric on which we shape the future at national, European and obviously at international level.

All meetings taking place in Santiago - EUROFI, meeting with Latin America leaders, and obviously the more traditional Ecofin meetings - are going to be a great success. They will be a great example also of these values, these principles that guide us and we must continue to build together.

Let me close with this positive note, wishing you all the best for the ongoing discussions and looking forward to seeing you next year under a different Presidency.

Thank you.

Pablo Hernández de Cos

Chair, Basel Committee on Banking Supervision
and Governor, Bank of Spain

Reflections on the 2023 banking turmoil

Good evening, and thank you for inviting me to speak at our dinner tonight.

I should start by wishing you all «una gran bienvenida» to Spain. And, in the event that some of you came to Santiago de Compostela by completing the Camino, let me say «felicidades» and «Ultreia et Suseia»!

A common expression in Spain is that «el Camino da más de lo que recibe» – the Camino gives more than it receives. While I cannot claim to offer you any more ecclesiastical insights this evening, I will be reflecting on the recent banking turmoil and the implications for the global banking system and the Basel Committee.[1]

For some of you, the turmoil may seem like a distant memory. Since the frenzied months of March to May, many banks have been reporting bumper financial results on the wave of rising interest rates. A cursory look at financial markets since that period would also suggest that the worst may be behind us. So why do I plan to look back at what may be regarded as some as a historical event?

Put simply, the banking turmoil that started in March is the most significant system-wide banking stress since the Great Financial Crisis (GFC) in terms of scale and scope. Over the span of 11 days – from 8 to 19 March 2023 – four banks with total assets of about $900 billion were shut down, put into receivership or rescued. This was followed by the failure of a fifth bank with roughly $230 billion in assets on 1 May 2023. To give you a sense of the order of magnitude, the total value of these banks' assets is roughly equivalent to Spain's annual GDP (leaving aside the stock versus flow nature of these numbers).

The distress of these individual banks, while having largely distinct causes, triggered an assessment of the resilience of the broader banking system. In response, large-scale public support measures were deployed by some jurisdictions to mitigate the impact of the stress, including significant central bank liquidity provision to banks, the activation of FX swap lines, government backstops or guarantees, and, in certain cases, an extension of deposit guarantee schemes. In many respects, today's stabilisation of the banking system is due to a combination of public support measures and the increased resilience provided by post-GFC regulatory reforms, most notably Basel III. We had hoped that we would not need to rely on the former so frequently.

Against that backdrop, the Basel Committee undertook a review of this period and conducted a stocktake of the regulatory and supervisory implications of these developments, with a view to learning lessons. I am pleased to inform you that, as recently announced by the Group of Governors and Heads of Supervision, good progress has been made with this work.[2] I will focus my remarks tonight by offering my personal views on some of the main takeaways and identifying some issues that may warrant further reflection.

Risk management and governance

There is perhaps a near universal agreement that one of the main lessons from the turmoil is the importance of banks' risk management practices and governance arrangements as the first and most important source of financial and operational resilience. The boards and management of banks should be the first port of call in managing and overseeing risks; these functions cannot be outsourced to supervisors. Jumping straight to discussions about the regulatory and supervisory implications of recent events is akin to forgiving banks for not fulfilling their primary responsibilities and likewise shareholders for not exercising due diligence.[3]

Yet the banking turmoil highlighted a series of weaknesses by some banks in this area, including:

- fundamental shortcomings in (basic) risk management of traditional banking risks (such as interest rate risk and liquidity risk, and various forms of concentration risk);
- a failure to appreciate how various risks that were building up were interrelated

and could compound one another;

- inadequate and unsustainable business models, including an excessive focus on growth and short-term profitability (fuelled by remuneration policies), at the expense of appropriate risk management;
- a poor risk culture and ineffective senior management and board oversight; and
- a failure to adequately respond to supervisory feedback and recommendations.

Many of these elements may appear obvious and quite basic in nature. So it is of deep concern to see that, in 2023, some banks' boards and senior management failed in their most elementary responsibilities of overseeing and challenging a bank's strategy and risk tolerance. More is clearly needed to shore up such responsibilities.

Consider the following historical anecdote.[4] In 1800, a French chemist by the name of Éleuthère Irénée du Pont set up a gunpowder factory in Delaware. He quickly realised that gunpowder factories have an undesirable property: they tend to explode frequently. In response, du Pont took two initiatives. First, he required that the director (himself) live inside the factory with his family, putting his life on the line – what you could view as «skin in the game». Second, he established a rule that every new piece of machinery had to be operated for the first time by the factory's senior management. If the machine blew up, the manager would suffer the consequences. Needless to say, the safety of the plant increased overnight.

I don't think I need to draw out explicitly the comparisons with today's banking system. But it is clear that the turmoil raises some fundamental questions about the current banking system.

Is it simply inevitable that there will always be «outlier» banks with serious governance and risk management shortcomings? Is this a «feature» of a banking model that combines leverage and maturity transformation with a focus on short-term gains? Have we optimised the alignment of incentives between banks' boards and senior management and broader financial stability objectives? I don't have the answers to all of these questions, but I think they certainly merit further reflection.

Strong and effective supervision

The banking turmoil also highlighted the importance of strong and effective supervision across various dimensions. These include recurrent issues that we've seen in previous banking crises in addition to newer elements. Either way, they raise important takeaways for supervision, which I've grouped into six categories.

First, the turmoil underlined the importance of supervisors developing a thorough understanding of the viability/sustainability of banks' business models as part of their supervisory process, including identifying any areas in which a bank is an outlier, so they can assess and take action to address any weaknesses at an early stage. This may all seem obvious to you, but there are clearly outstanding challenges for supervision, including: (i) how best to assess the viability of business models in a holistic manner (eg relying on a broad set of quantitative and qualitative indicators); (ii) how to proactively engage with outlier banks without «crossing the line» and «co-owning» a bank's business strategy; and (iii) how to monitor medium-term structural changes to better identify their impact on different business models.

Second, a core element of supervisory work is ensuring that banks have effective and robust governance and risk management. This includes, but is not limited to, the composition of the board and the extent to which its members have relevant experience, including banking and financial expertise; the board's ability to effectively challenge the bank's senior management, oversee the bank's risk profile and steer its strategy; the independence and empowerment of the risk management and internal audit functions; the enterprise-wide risk culture, including how embedded it is in corporate and business processes; and the incentives provided by senior management compensation schemes.

Third, the turmoil highlighted clear challenges in overseeing banks' liquidity risk. These challenges relate to: the speed and volume of deposit outflows and changes in banks' funding profile; the importance of banks being operationally prepared for liquidity stress scenarios (eg by having credible and tested contingency funding plans, and operational readiness to access central bank liquidity facilities); and the role of social media and the digitalisation of finance in hastening the speed and impact of a bank's distress. These developments, in turn, prompt considerations for supervisors around, among other issues, whether (i) their monitoring of banks' liquidity risk profile provides the relevant information in a timely manner; (ii) the frequency of monitoring can be increased, both during times of stress and business as usual; (iii) supervisory monitoring can leverage different sources of information and high-frequency data; and (iv) monitoring of concentration risks is warranted.

Fourth, we've been reminded once again that supervisory judgment is a critical element to ensure that the intent, as well as the letter, of regulation is addressed. A rules-based approach on its own is unlikely to appropriately identify, assess and allow the timely mitigation of key risks to a bank's safety and soundness and broader financial stability. This does not diminish the role of a rules-based approach in setting minimum standards. Rather, it prompts considerations for supervisors around how they can effectively complement such standards by exercising judgment – and therefore intervene proactively even when specific rules have not been breached – to make bank supervision dynamic and adapted to a bank's specific business model and operations, and the risks that they present.

Fifth, it is important to reflect on the role and scope of existing supervisory toolkits as complements to minimum global standards and to ensure they are sufficient to drive concrete action at banks, including in the light of any legislative/regulatory constraints on how or when they might be applied. A recent paper by staff at the International Monetary Fund finds that, while the importance of a sound institutional setting for effective bank supervision is widely accepted, many jurisdictions do not equip bank supervisors with the necessary powers and conditions for their work.[5] Supervisory authorities could also review whether the guidance and processes given to individual supervisory teams appropriately incentivise a willingness to act early, accompanied by a clarity of process on how to do so.

Sixth, while there were several positive elements of cross-border supervisory cooperation during the turmoil – including at the Committee level – consideration could be given as to whether broader information-sharing protocols at a cross-border level are necessary. Any such protocols would, of course, have to take into account constraints on authorities' ability to share confidential information, existing information-sharing arrangements and resource implications.

Robust regulation

Moving to regulatory reflections, let me be clear upfront: the regulatory imperative for the Basel Committee at this stage is to implement all aspects of the Basel III framework in full, consistently, and as soon as possible. Nevertheless, there are issues directly or indirectly related to the turmoil that I think would merit further analysis and reflection.

My starting point is that prudential regulation – and Basel III more specifically – is not calibrated to produce «zero failures», but seeks to reduce the likelihood and impact of banking stress, while facilitating financial intermediation and economic growth.

Moreover, most of the banks that failed were not subject to the Basel III framework in full.

Let me now offer some personal reflections on four regulatory issues that I think would benefit from further analysis.

First, liquidity. While each of the banks that failed during the turmoil had idiosyncratic features, they all ultimately succumbed as a result of significant liquidity outflows and an inability to maintain sufficient stable funding. To date, most of the commentary has focused on the significant scale and speed of outflows experienced by these banks – up to 85% of deposits over the span of two days for one of them – and whether the Liquidity Coverage Ratio (LCR) and Net Stable Funding Ratio (NSFR) are miscalibrated as a result. It is helpful to take a step back and consider a broader set of questions about the Basel III liquidity standards:

- What exactly are the objectives of these standards? The LCR requires banks to hold sufficient liquid assets to meet a 30-day stress outflow period. So, before reviewing the «denominator» of this ratio (ie the assumed outflow rates), a more fundamental question is whether we still expect banks to be able to survive a liquidity stress for 30 days without some sort of public intervention/resolution/private sector solution. Should the LCR be more focused on buying enough time for authorities to address a liquidity stress? What is its role relative to other liquidity metrics, both quantitative and qualitative?
- A second fundamental question is with regard to the design of the LCR and NSFR. Unlike capital standards, there is no concept of a «hard» minimum requirement supplemented by a «buffer» requirement. In principle, banks should be able to dip into their stock of liquid assets in times of stress to meet outflows, while also submitting a satisfactory restoration plan to their supervisor. Yet it would appear that banks continue to be reluctant, or unable, to fully use their liquid assets in the manner envisaged. A number of potential factors behind such behaviour have been suggested, including the calibration of existing liquidity requirements, perceived stigma, market expectations and/or operational constraints.

There is also the more topical question about the role of digitalisation and social media on liquidity outflows. Through the modern history of finance, advances in communication technology have sped up the flow of information, affecting the nature and magnitude of banking crises. In the Panic of 1873, financial stress that began in Europe spread to North America, facilitated by the transatlantic telegraph cable completed in 1866. In the Black Monday global stock market crash in 1987, contagion spread across financial markets via electronic communications. In the present, rumours can spread through social media.

At the same time, innovation has made it faster and easier to move money, from the creation of the ATM to modern digital banking apps, alongside faster payments and reduced settlement windows. When combined with advances in communications technology, these developments have further reduced frictions and allowed for rapid inflows and outflows. As recently as 2008, depositors at IndyMac and Northern Rock still formed long lines outside bank branches; as we saw in the recent turmoil, withdrawals can now be initiated online in a matter of minutes if not seconds.

And while fingers have pointed at the role of social media, it is important to further unpack what this means. In practice, there is a wide spectrum of «social media» communication channels. This ranges from public platforms that target a broad audience and can amplify bank concerns (eg X/Twitter, Facebook, LinkedIn, Instagram), specialist (public) forums (eg Y-combinator, Reddit, Discord), encrypted messaging applications (eg WhatsApp, WeChat, Signal, Telegram), internal corporate messaging platforms (eg Slack and Circle) and even telephone calls. These platforms increase the global interconnections among clients, which could foment the risk of herd behaviour in times of stress. As a result, these developments may be relevant not only for regulators, but, as I previously mentioned, also raise important questions for supervisors as to how best to monitor and respond to social media, in both «peace» and «crisis» times.

Second, interest rate risk. A recurring theme related to the distress of some banks during the turmoil was the common and concentrated exposure to interest rate risk in the banking book (IRRBB). Again, these banks were not subject to the existing IRRBB standard, but these events have once again attracted attention towards the current regulatory treatment of IRRBB in the Basel Framework. Some areas that have been mentioned for further analysis and evaluation include whether the current Pillar 2/3 approach to addressing IRRBB is still appropriate? Are there ways to further strengthen it, by providing more stringent guidance and requiring further disclosures? Or is there a need to move towards a Pillar 1 capital framework for IRRBB to promote greater international consistency and comparability?

The third category of issues relates to two aspects of the definition of regulatory capital. First, unrealised interest rate losses on fixed income assets held at amortised cost were an important driver in the failure of several banks during the recent turmoil. If banks need to sell such securities before their maturity date to meet liquidity needs, unrealised losses on those securities become realised losses and would reduce both equity and regulatory capital. Moreover, the large-scale and ad hoc fire sales by some troubled banks to meet large-scale and simultaneous deposit withdrawals may also require reflection on how best to reflect the risks from second-round fire sales. This is an area where further analysis and evaluation could also be performed but, equally importantly, is of critical importance for supervision and banks' own risk management practices.

Recent events have also highlighted the role of Additional Tier 1 (AT1) capital instruments in the capital framework. Investors and markets did not fully internalise the various trigger events that could lead to the loss participation of AT1 instruments, even though the Basel Framework contains explicit language on those trigger events and despite contractual documentation clearly highlighting the corresponding risk factors of such instruments. In addition, the fact that a distressed bank continued to make expensive replacement issuances and to pay substantial amounts of discretionary interest on these instruments (alongside dividend payments for common shares), despite reporting losses over several consecutive quarters, raises questions about the ability of such instruments to absorb losses on a going-concern basis. The Committee has previously evaluated the functioning of these instruments, but was unable to draw robust empirical conclusions regarding their loss-absorption capacity.[6] Future analysis and evaluation would need to be considered as part of a more holistic assessment of the role of different regulatory capital instruments and their functioning in crisis times.

The fourth category of regulatory issues to reflect on pertains to the application of the Basel Framework. This includes the determination of what constitutes an «internationally active bank». The Basel Framework intentionally does not define this concept, given structural differences in banking systems across jurisdictions. Yet recent events have shown that the failure of a bank can have systemic implications through multiple channels, including first- and second-round propagation effects. Put differently, factors such as size and cross-border interconnections are important considerations when deciding on the appropriate scope of application of the Basel Framework.

The flip side of this issue is the role of proportionality for non-internationally active banks. As you know, jurisdictions may opt to apply the Basel Framework for non-internationally active banks, including smaller ones. In such cases, they can apply the framework in some proportionate manner, commensurate with the risk profile and systemic importance of banks. Member jurisdictions are wholly responsible for deciding on whether and how to apply and design proportionate frameworks, and the recent turmoil highlighted how the distress of banks subject to domestic proportionality regimes could have cross-border financial stability effects.

The turmoil also highlighted how the design of proportionality frameworks can impede effective supervision by reducing standards, increasing complexity and promoting a less assertive supervisory approach.

There may therefore be merit in members continuing to share their experiences in applying proportionality, monitoring the scope of banks subject to proportionate approaches, and in ensuring that these objectives are adequately met.

Conclusion

I started my remarks this evening with a Spanish expression about the Camino. Let me end with another one: «Nunca es demasiado tarde para encontrar el Camino» – it is never too late to find the Way.

So what is the way forward for the Committee with regard to the implications from the banking turmoil? I am pleased to note that there is broad agreement to prioritise further work to strengthen supervisory effectiveness, including identifying issues that could merit additional guidance at a global level. In addition, the Committee will pursue additional follow-up analytical work based on empirical evidence to assess whether specific features of the Basel Framework performed as intended during the turmoil, such as liquidity risk and interest rate risk in the banking book. And we will continue to coordinate with other global forums and standard-setting bodies on cross-cutting issues.

Importantly, the already-implemented Basel III reforms helped shield the global banking system and real economy from a more severe banking crisis. So there is also an equally broad agreement at the Committee level, reaffirmed by the Group of Governors and Heads and Supervision, on the critical importance of implementing all aspects of the Basel III framework in full, consistently, and as soon as possible. Put simply, none of the follow-up work to the turmoil should interrupt the imperative of implementing the outstanding Basel III standards. In this respect, the Committee will continue to monitor and assess the full and consistent implementation of Basel III.

Thank you.

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1. See Hernández de Cos (2023a and 2023b) for initial reflections on the turmoil.
2. BCBS (2023a and 2023b).
3. Hernández de Cos (2023a).
4. This paragraph is adapted from Dellanna (2020).
5. Adrian et al (2023).
6. BCBS (2022).

Rodrigo Buenaventura

Chairman, Spanish Securities and Exchange Commission

Prospects of EU capital markets

Good morning. It is a pleasure to have the Eurofi conference in my home country, with the occasion of the Spanish Presidency and to welcome you to this edition.

I would like to share some thoughts about the prospects of EU capital markets.

We are at a critical juncture: one in which capital markets need to demonstrate their ability to serve the real economy and the preferences of investors. And this has to do with a rare combination of events: huge additional investment needs, for companies to transform their business models, public budgets with limited pockets and a very significant rise of debt costs.

We know that European companies have structuraly weak balance sheets, an overreliance on bank credit and poor access to long term financing and equity.

In this context, we need vibrant capital markets and especially equity markets, more than ever.

Private finance has, to some extent, taken a bite on the role that public markets used to play and we are witnessing an increase in public-to-private transactions. On top of this, IPOs are way less frequent across the continent. Hence, our markets are not growing: the number of listed companies has declined in the last 5 years and the weight of market cap over GDP has not increased either in Europe.

I have always believed in the superiority of public over private financial markets. I think that they offer the most democratic, open and accessible way of allowing citizens to invest their savings and also to influence those that manage them. I also believe they are an extremely efficient way of assigning capital. They also offer a long-term prospect for issuers, that cannot be matched by private finance.

The first obvious question is how we can revitalise public equity and debt markets in a way that helps European companies and issuers without compromising the protection of investors.

I am afraid there is no silver bullet for this but a series of reforms with incremental effects if we design them appropriately. The first one lies in making easier for companies to go public. Entrepreneurs, when faced with the pros and cons of becoming a listed company, do not always conclude on the positive. I think there are many reasons for this and regulation might not be the most important one.

For instance, the role of capital, it's importance on the modern company, has changed. Young entrepreneurs especially in the IT sector, do not place the same level of importance on capital as on ideas and technology innovations. They see shareholders' role and contribution very differently from how executives used to see them ten or twenty years ago.

But there might be other reasons behind the slow pace of primary public capital markets. Cultural factors and financial education might also play an important role. If you look at the distribution of total wealth of European families you find immense differences in how, for instance, Spaniards, Germans or Danish citizens invest their savings. But that has to do not only with culture and financial planning awareness. It has also a lot to do with incentives. If we collectively, as a Society of Europeans, agree on the absolute importance of having deeper capital markets for the success of our economies, we cannot avoid a serious debate around how to stimulate it through one of the most powerful tools that we have: taxes. For instance, we need to abolish the asymmetry between the tax treatment of interests paid and dividends, which is introducing an artificial bias to the financial structure of EU companies, causing overindebtedness.

We also can re-think how IPOs are conceived. IPO processes are not enshrined in regulation, they come from market practice, but they are very much the same than what they used to be in the 90s. They are excessively long, costly and difficult to predict: the risks of last-minute failure of IPOs are quite tangible. And the role of some participants shows clear conflicts of interest that can affect the price formation mechanism.

As you know, none of these elements have much to do with financial regulation and yet, they might be way more effective than upgrades to the financial rulebook. But I will not shy away from making some comments on the regulatory front, of course. There are three sides to the problem: attract more companies, attract more investors and improve the infrastructures in which they meet, prices are formed and assets are settled and registered.

I think the listing act proposal by the European Commission goes in the right direction to try to ease a bit the cost and the fuzz of becoming a public company. This is not easy to say for a financial markets' supervisor, who is typically more concerned with investor protection, but we need to be realistic and pragmatic. Prospectuses are too long, too complex and too few people read them. We need to adapt them to a more reasonable point together with other obligations of listed companies. That's 3 why I think that it is in general a proposal worth supporting, even if it's no silver bullet.

But besides the reforms on the listing act, it's important that we are vigilant about the rules imposed on listed companies on matters that are not strictly linked to the information or the interests of shareholders. We have some rules going from sustainability to gender equality or to important social matters imposed on occasions only on listed companies and not on equally large private companies. To my mind, if we are dealing with issues that are important for society, and those that I just mentioned are really important, we should not impose obligations on listed companies just because they are listed. We should treat equally large organisations irrespectively of whether they're private or public.

The other side of the equation is the attraction of more investors to our markets. This is linked to even more complex matters. The retail investment strategy tackles some of them and I think it is an overall balanced and adequate approach: increasing the protection for investors on elements unrelated to more cost for issuers. But we might need more than that. We need to improve the investment experience for the retail investor, make it simpler and cheaper. And for that, technology is a very powerful ally.

We might need to also use our imagination to unlock the enormous potential of institutional investment so that it also reaches the less liquid markets. SME Growth markets are lacking institutional investment and are therefore suffering from additional illiquidity. We should develop funds with non-daily redemptions, let's say once a week, once a month or even once a quarter, to offer retail investors the possibility to enter collective vehicles invested in not-so-liquid but potentially more profitable investment opportunities in the long run, in a diversified manner. This will not only benefit those investors, but also the underlying equity markets and the companies that tap them. This is more linked to an important dossier: the AIFMD/UCITS reform.

And finally, we need to improve and strengthen the fabric of markets, the meeting point and the infrastructures. Which is one of the topics that will be discussed in this conference. There is always in Eurofi an underlying debate on deepening the integration of EU capital markets. We use the word Union, single market, more integration to mean very different things and sometimes the debate is a bit fussy. Let me share my view on this, in the form of four possible questions.

1. If the question is whether we should harmonise legislation, and increase the use of regulations over directives, my answer would be a very neat "yes": to the fullest possible extent.
2. If the question is whether we should have more consistent and uniform supervision, with a stronger ESMA bringing real convergence to decisions by National Competent Authorities, I would also answer loudly on the positive.
3. If the question is whether we should have fewer players, more consolidation on secondary markets and CCPs and some European global champions, I would say that this should come naturally from consolidation and competition, not driven by regulation.
4. And if the question is whether we need a single supervisor to strengthen the EU capital market, I would not be so sure. There are a few areas in which central supervision is more efficient, like when you have very few and very large entities, with operations in many Member States. But for most of our daily supervision, I still think a local supervisor can do the job more swiftly and efficiently than a central one, provided that strong coordination and consistency are ensured by ESMA.

In any case, let's look at the bright side: capital markets are way more integrated than banking markets in the Union, even after the so-called banking union. The level of cross border investment is astronomically superior to the level of cross border lending by banks. Just an example: only 2% of AUMs of all Spanish UCITS is invested in Spanish equity. Spanish funds invest in non-Spanish listed companies (mostly European) 7 times more than on Spanish ones. Exactly the opposite of bank lending. So we already have integration of flows and a capital markets union: we "simply" need to make it bigger and more effficient.

And for the latter we will need tons of technology. I have to confess that a few years ago I thought that in 2023 we would be already at the peak off the incorporation of DLT technology into financial markets. That prospect has not happened. Maybe many of us were wrong or overly excited about the pace of the technological disruption. Or maybe we underestimated the resistance to change from the incumbent market participants.

But I am sure of one thing: that we have lost an enormous amount of time and efforts discussing about the less interesting part of these technological disruption, investment in so-called crypto currencies. Or, at least, cryptocurrencies in the way they exist today. At the risk of generalising, my impression is that most of the coins that are trading today do not offer any value to companies, investors or society as a whole.

DLT has indeed the power to change, for the better, financial markets, but not like this ! We don't need to reinvent a bond, a share or a fund unit, we simply need to make them cheaper, make it open to investors anywhere in the world and more efficient through the use of technology. We need to concentrate on how to incorporate that technology in a manner that is useful. And we need to be clear to citizens and investors: they will not be equally protected (even after MiCA becomes 5 applicable) if they invest in a cryptocurrency than if they invest in a financial instrument.

I conclude now. We have very exciting times ahead of us and lots of topics to discuss this week. Let's make sure that we improve the regulatory framework in a manner that serves the public interest.

I thank you very much for your attention and I hope you have an excellent Conference.

Valdis Dombrovskis

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

A strong economy in turbulent times: stimulating growth and investment, staying open and secure

Ladies and gentlemen,

It is a pleasure to be with you today in Santiago de Compostela. Thank you for inviting me.

When I was last with you in April, we talked of the difficulty of dealing with events of the previous few years.

How Europe's economy had shown remarkable resilience and agility in the face of some serious shocks.

Earlier this week, the European Commission published its Summer Economic Forecast. It finds that the EU economy remains on a growth path, which is commendable in itself.

Europe's strong, coordinated response has helped us to avoid recession and an economic crunch. Nevertheless, the high inflation rate has taken its toll, although price pressures are now easing.

After some weakness, we see more promising signs for 2024, when the economy should stage a mild rebound, underpinned by strong labour market and record low unemployment.

Still, it is slow progress. The EU economy remains at a critical stage and there is a lot of uncertainty and downside risk.

Our common recovery plan – NextGenerationEU and the Recovery and Resilience Facility – allowed us to achieve a fast recovery.

It is a boost of confidence for our economy, guaranteeing a constant stream of investment to sustain jobs and growth.

Looking ahead, our focus is on how best to secure sustainable growth for the longer term.

To keep the economy on the right track, it is all the more important for Member States to carry out the reforms and investments in the national Recovery and Resilience Plans.

More broadly, we are looking at how to boost the EU's productivity, competitiveness and creating the right conditions for businesses to flourish within the European social model.

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

As President von der Leyen announced in yesterday's State of the Union address, next month the Commission will present the first legislative proposals towards reducing reporting obligations at European level by 25%.

In addition, an independent board will conduct a competitiveness check for every new piece of legislation.

We are aiming for a conducive business climate, transparent and with legal certainty. And most importantly, helping to attract investment.

This is what I would like to focus on today. I cannot stress enough the importance of investment for economic growth.

Given the scale of the investment required, this will primarily have to come from the private sector. There are major structural adjustments: a large-scale economic transformation.

We need private investment to meet our key economic policy objectives: the green and digital transitions, the EU's greater competitiveness and its open strategic autonomy.

The EU has been tackling these challenges on many levels, including by partnering the public sector with the private equity and venture capital sectors.

For example, the European Investment Bank Group has played a key role in addressing SME financing gaps via investments in venture capital, private equity and private credit funds.

In particular, the European Investment Fund has gradually increased its equity activity in recent years, to reach a planned investment volume of more than €5 billion for 2023.

The bulk of this investment is for competitiveness and growth, innovation, sustainability and green transformation.

In many cases, these operations are backed by EU budget support, which allows these investments to be partially de-risked and thereby catalyse private investment.

Then, of course, we have the Capital Markets Union.

It is central to the work that we are doing to support investment in Europe and keep our economy competitive. This project is more important than ever, and we remain firmly committed to it.

Deepening and further integrating Europe's capital markets is the most cost-effective step that we can take to drive investment.

The Commission is well on track to complete the 2020 CMU Action Plan. Recent political agreements on key CMU initiatives show that all EU institutions share the objective of improving access to funding for our companies.

But we cannot be complacent.

We must stay ambitious and move fast with adopting the remaining proposals. And we will keep working to tackle the remaining barriers and frictions so that investments and savings flow freely across the EU.

The bottom line is that without the CMU, investment and growth would be more limited. So we continue to welcome input and reflections from all interested parties on how we can further develop the CMU.

Regarding investment from the public side, the RRF is an excellent starting point. Member States are now carrying out the reforms and investments identified in national plans. These are already making a difference on the ground.

The ongoing revisions of the plans, based on REPowerEU, will further orient resources to the right priorities.

Our proposals for reforming the EU's system of economic governance are designed to ensure sound public finances across all EU Member States.

They allow countries to moderate fiscal efforts in conjunction with carrying out reforms and investments in line with EU priorities that improve fiscal sustainability and potential growth.

The idea is for national policies to become more prudent so that countries can rebuild fiscal buffers, and to help us secure sustainable growth for the future.

Ladies and gentlemen

As I mentioned earlier, we need to look at Europe's wider business environment to generate the investments needed across a wide range of areas – especially for innovation.

Nearly all innovation involves investment and requires appropriate and sufficient financing to research and development of new products and processes.

If Europe is to stay competitive in the global marketplace, it means constant investment in innovation and technological leadership. For example, the Green Deal Industrial Plan for the Net-Zero Age sets out our strategy for uptake of clean technologies.

We also proposed a Strategic Technologies for Europe Platform to help support the technologies and value chains that are vital to the green and digital transitions.

It aims to channel more EU funding to support the development of manufacturing in the EU of critical technologies and supply chains, and to address related labour and skills shortages.

Investing in R&D, innovation and the right skills is crucial for Europe to succeed and to lead on the green and digital transitions.

To be honest, when the United States introduced its Inflation Reduction Act, this was a wake-up call. It focused our minds on the importance and urgency of securing investments in innovation in Europe.

We welcome its climate ambitions, but our concerns relate to the protectionism. The Act, as it stands, entails the risk of a drain of EU companies. Its approach also seeks to re-direct investments of key trading partners like the EU towards the United States.

Obviously, we do not want that to happen.

So, we have been working hard to find pragmatic solutions with the United States to limit the negative effects of the IRA, so we can instead focus on working closely on our common strategic interests.

At a time when the world is becoming increasingly conflicted and polarised, Europe needs a solid network of strategic, like-minded and reliable partners.

The shocks that I referred to earlier – the COVID-19 pandemic and Russia's aggression against Ukraine – led us to take a hard look at our economic dependences and risks to our established supply chains.

We also know of areas where trade and investment pose risks to our economic and national security, particularly in the context of China's fusion of its military and commercial sectors.

Just a further word on China. Here, the EU has an unbalanced economic relationship, with a very large trade deficit.

We have many areas to discuss.

To this end, I will travel to China later this month to co-chair the EU-China High-Level Economic and Trade Dialogue with Vice-Premier He Lifeng. This is scheduled for 25th September.

As key trading partners we should be able to discuss opportunities for cooperation, as well as irritants and challenges in our relationship.

While the preparations for the High-Level Dialogue are currently in full swing, I am cautiously optimistic about landing some specific deliverables in the area of financial services.

I will also use my visit to China to reassure my counterparts that the EU does not want any decoupling. Instead, the EU's economic security strategy is guided by the principles of proportionality and precision.

Our approach is to maximise the benefits of openness, while minimising our strategic vulnerabilities: in other words, to de-risk - by first gaining a deeper and exact understanding of the risks that we face.

It is based on three pillars:

- promoting the EU's competitiveness;
- protecting our economic security using a range of existing tools, while also considering new ones; and
- partnering with the broadest possible range of reliable partners to address shared concerns.

So how does this affect investment?

Businesses are the often first to suffer from crises. With geopolitical tensions clearly on the rise, they bear the brunt of the economic fallout.

Our economic security strategy aims to uphold a predictable business environment in Europe and to de-risk economic overdependences so that investing in Europe remains attractive.

And it aims to reduce the risks of geo-economic fragmentation, which can potentially have enormous ramifications for the global economy.

Research from the International Monetary Fund suggests that some fragmentation is already taking place, with changing patterns of foreign direct investment.

FDI flows are increasingly concentrated among geopolitically aligned countries, particularly in strategic sectors.

The more countries that move apart geopolitically, the more likely that geopolitical blocs in the world economy will emerge – and not only regarding FDI patterns.

The EU is open to foreign investment and capital flows – and will remain so. But this openness is not unconditional.

We put our FDI screening mechanism in place to make sure that the EU is equipped to identify, assess and mitigate potential risks to its security or public order.

As part of the economic security strategy, we will evaluate this mechanism based on three years of its implementation, with a view to improving its efficiency and effectiveness as needed.

Ladies and gentlemen

While our long-term priorities have not changed, sometimes we have had to adapt the means and methods for achieving them.

As I said at the start, our economy has shown remarkable resilience and agility. We should be proud of that, and of the EU's coordinated response to a series of harsh shocks.

This coordination is vital.

We can be confident for the future, as we continue working together to build a globally attractive business environment for innovation and investment, underpinned by a strong growth-oriented economy.

Thank you.

Mairead McGuinness

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

Finishing what we've started: priorities in financial services for the coming year

Good afternoon.

The title of my talk is to finish what we started, and I think that's really important.

Because it's extraordinary to think that we are during the final year of the mandate of this European Commission.

I came in frankly a year late, so I have to do five years' work in three effectively, or three and a half.

But when I talk now about what we've done and our mission for the rest of this term, I am really writing my own school report – but I've had it checked, so others know and agree with what I'm about to say.

It's also important to recall that this Commission mandate has been challenging to say the very least of it.

It's an overused word but the truth is it's been a very, very difficult time globally.

Whether it was post-Brexit, pandemic and the horrible war in Ukraine.

So it's been a busy and very eventful mandate.

And yesterday I'm sure you were listening to the President of the Commission Ursula von der Leyen in her State of the Union speech.

So despite all of the extra things we had to deal with as a Commission, we've actually delivered over 90 percent of the political guidelines presented in 2019.

I'm going to say that in FISMA, so my colleagues, my services, we've delivered 99.9%, so that's not bad as a track record.

It's also worth recalling the President's words when she said, "Together, we have shown that when Europe is bold, it gets things done."

And it's true that when Europe is under pressure, it gets things done.

We go beyond ourselves and we go beyond what we think we are actually capable of.

So my goal when it comes to financial services is to reach agreement on hopefully most of the proposals before the end of the mandate.

And really now we're waiting and working with the co-legislators – the Parliament and the Council.

As a Commission we are ready and are helping in that process and have reached agreement on a number of our files.

The ambition of our proposals should not be watered down.

We say that all the time, and we do mean it.

Because we think that our proposals are needed – for financial stability, for market integrity and for the competitiveness of the economy.

We are going through very uncertain times, and we do need the financial system to play its part in these challenging times.

I was listening in to the conversation about technology and the great transformation, and what might come is quite extraordinary – what we're already dealing with.

Also the climate crisis requires everyone to join in this transition to a low-carbon economy.

And that's more urgent now because of the invasion of Ukraine by Russia.

Because Russia's aggression, this war, has delivered a shock to the global economy, particularly when it comes to energy and food markets.

We can better respond to the challenges we face with a competitive and resilient European financial system.

So in my speech today, I want to take you through:

- The proposals we'll make in the coming weeks,
- Recent proposals across my area of responsibility,
- And some of the issues we're beginning to think about for the next Commission's mandate. Because you have to keep that process going.

Yesterday President von der Leyen put a strong emphasis on European competitiveness.

Every new piece of legislation will have a competitiveness check conducted by an independent board.

And next month, the Commission will make the first legislative proposals on reducing reporting obligations at the European level by 25 percent.

In financial services, we're contributing to the goal of competitiveness and simplifying reporting requirements.

And I know that's something that is asked of frequently and we will be delivering on that.

For instance, we will be proposing a review of the Benchmark Regulation.

We've extended the non-application of the third-country chapter of the current regulation for two years.

But this isn't a viable solution for the long term.

We need to reform the rules for third-country benchmarks for good.

We will reduce the number of third-country benchmarks that are included.

And we want to make sure EU and non-EU operators are competing on a level playing field.

So we will also reduce the number of EU administrators required to get a license.

By looking at where we can reduce reporting burdens, we can make the EU more competitive.

And it's a good complement to our work on the Capital Markets Union.

And here I'm glad to say that we are making good progress but we do need to keep the momentum going.

I'm happy to say we have now reached political agreement on all the initiatives in the November 2021 CMU package.

In July we reached agreement on the final part – the Alternative Investment Fund Managers Directive.

But the legislative work isn't over yet.

There are still structural barriers standing in the way of the single market for capital.

And this year is 30 years of the European single market, so we really do need to make sure that that world comes to the world of capital.

This Commission faced into those barriers head-on and proposed reforms on insolvency and withholding tax.

And now we need to see agreement on these proposals.

We also need agreement on the Listing Act, to make the listing of securities easier and less burdensome – particularly for smaller companies.

Companies that issue securities on public markets grow faster in terms of assets, sales, and employee numbers than companies that don't.

But the Commission's CMU indicators show that the number of IPOs in the EU is at an historic low.

One of the reasons – though not the only one – is regulatory barriers, and that's what we're tackling with the Listing Act.

Now we also need to keep the ambition high on clearing.

There will be no CMU without strong market infrastructures underpinning EU financial markets.

So we need a deal on the EMIR revision.

We also want citizens to experience the tangible benefits of CMU.

Being able to easily and safely invest their hard-earned money.

And that's what the Retail Investment Strategy is all about, and you've heard me speak on that topic.

And so we need to see progress on this Strategy too.

I'm hopeful that we can reach agreement on all these proposals before the next European election, and that's next June.

But even if we can achieve that and get things through, it's not the end of the journey on Capital Markets Union.

Because this is a long-term project.

And I do welcome the Eurogroup's work to look at what reforms we should focus on next.

And I think we can see here and right across Europe, at all levels, at the highest political levels, there is strong momentum to develop the CMU.

Banking Union is another long-term project where the Commission is keeping the momentum going.

The Eurogroup asked us to deliver a proposal on crisis management and deposit insurance.

And we delivered on that.

But, even with this latest reform, we still won't have a fully-fledged Banking Union.

I do hope the co-legislators will make progress on crisis management and deposit insurance.And I hope this progress will spark renewed efforts to complete the Banking Union in the next mandate.

Today our banks are in a better place than they've been for a while.

The economic climate, with rising interest rates, is more positive for them.

Profitability is important for the banking sector's resilience.

We saw that in the recent stress tests: strong earnings help restore capital levels more quickly.

Higher profitability is also a major opportunity for investment.

During the last decade, lower profitability meant that EU banks could sometimes not invest as much as they would have liked to, particularly in digitalisation.

So now that the opportunity is here, I encourage banks to use these profits wisely, to be ambitious and to invest in the future.

As has been said already, this world is becoming ever more digital.

The Commission continues to keep up with the pace of change.

In June we launched new digital finance proposals.

First, the review of the Payment Services Directive:

It tackles payment fraud, and this is an issue which I fear is going to grow unless we tackle it collectively.

It will help banks and other financial companies compete on a level playing field.

And it will improve the enforcement of the rules.

Second, we adopted a new proposal on access to financial data.

This Financial Data Access proposal will let people decide to share a wider range of financial information.

Customers get greater control over how their financial data is used.

And they will get better access to services that are more tailored to their needs.

But of course the key we need informed customers to know when and what they're giving consent to.

I'm sure many of you in the room here are thinking about how you will take advantage of this new proposal for new, innovative products.

Now we also adopted two proposals on the future of money: on a digital euro and on the legal tender of cash.

There are many good reasons to explore a digital euro. It's important for Europe's competitiveness.

We're heavily reliant on companies outside the EU for card transactions and e-commerce payments.

And if we don't have our own solution, private stablecoins and foreign central bank digital currencies could fill the gap.

But, more importantly, the digital euro offers benefits for people:

- Digital payments anywhere in the euro area;
- Offline payments with the same privacy as cash;
- Digital payments without a bank account;
- More choice alongside private digital payments.

But I do say all the time that the digital euro is not something we need to rush.

It needs a calm, thorough, democratic debate, between institutions, Member States and citizens.

And this will – I hope – counter the conspiracy theories.

People are afraid of what they don't know.

So it's really important for all of us to talk clearly about what the digital euro is – and what it's not.

Now to sustainable finance.

The climate crisis is not new, but I think we all know it's more urgent. In Europe, we saw wildfires in Greece, Italy, Spain, and Portugal, and terrible floods in Greece, Slovenia, and Austria.

So those images in recent days, particularly if you look to Libya, where sadly many thousands are feared dead and a rescue operation is underway.

These are real examples of extreme weather that are become more frequent and more serious, leading to the loss of lives and livelihoods, and if we don't address it, the consequences are horrendous. And indeed it impacts those who least can deal with them, as we are seeing.

So we do need to address climate change. We need the financial system and companies to work with us in the transition to a sustainable future.

In June, we proposed a regulation on ESG ratings providers.

And here we want to introduce new rules for ESG rating markets, we want to avoid conflicts of interest, we want to improve transparency – while also fostering competition.

At the end of July we adopted the European Sustainability Reporting Standards, as envisaged in the Corporate Sustainability Reporting Directive. We've adopted all the standards proposed by EFRAG.

Covering the full range of environmental, social, and governance issues, including climate change, biodiversity and human rights.

But we've made these standards more proportionate compared to the original drafts.

Here we aimed to strike a balance between limiting the reporting burden for companies and allowing them demonstrate their efforts in sustainability.

The standards also take into account developments at international level, by the International Sustainability Standards Board and the Global Reporting Initiative.

And I know many are happy to see that cooperation.

Companies that report to European standards should automatically meet the ISSB standards.

The focus now moves to implementation – indeed a topic of the previous conversation.

And here we want to support companies implementing this very first set of European sustainability reporting standards.

So this is a big moment, for the standards and indeed for companies that have to report.

Here I've asked EFRAG to focus on developing guidance on assessing materiality and reporting on value chains.

EFRAG expects to publish draft guidance for public consultation shortly.

And where appropriate, the Commission may decide to provide information on the legal interpretation of the European standards.

And I hope you hear that what we're trying to do is to make sure there is buy-in by companies and support for companies on their journey towards reporting.

So this may be the last year of the current Commission mandate, but it will be a busy one.

I do hope the co-legislators will reach agreement on our proposals.

Because they will make a real difference to the European financial system.

One example is the Anti-Money Laundering package, which we proposed in June 2021.

And the fight against money-laundering and terrorist financing is really essential for the integrity of EU financial markets.

I really would like to see agreement on this package as soon as possible – though the right deal is more important than a fast one.

We are also looking ahead now to the next five years, and considering what the next Commission will have to take on.

For example, non-bank financial intermediation is very prominent in the current conversation.

It will certainly be in focus in the next mandate.

Another topic we're reflecting on is T+1 settlement.

The US will shorten the settlement lifecycle to T+1 next year, and this will raise some questions for us here in the European Union.

But I know you are already asking those questions, and more importantly I'm hearing that you're answering those, and that's really important, that we work together on this.

We know the macroeconomic situation has changed a lot, which means risks to financial stability are evolving.

So this is something the Commission will be looking closely at – like how risks move from the banking sector to financial markets.

So let me finish with some words from President von der Leyen yesterday.

"In a world of uncertainty, Europe once again must answer the call of history. And that is what we must do together."

I think we all know in this room that where there might be differences, we're very clear that acting together is the only way we can build a stronger system that is fit for the future,

I was very minded by the end of the conversation before I took to the stage here about certainty and uncertainty, on confidence and lack of confidence which Scott addressed very clearly.

And I think in all of these steps we know that we cannot say that the world will be any less uncertain in the next Commission mandate.

So I think we'd better be prepared for whatever comes our way and plan now to deal with it, rather than being overwhelmed.

I think we've had enough warning in the last few years about what can happen, whether that comes to climate change or geopolitical tensions.

But I am convinced of one thing, that we need a strong financial system that serves people and business and that can work when the economy is going through difficult times and finances small and large companies.

And like I said on many occasions, the financial system the backbone of everything that we do.

And in my words I always mentioned financial literacy – they don't always put it into the script but I never miss a moment to say that if we have better tuned-in citizens on the financial system, we would have a better Europe and we would have a better financial system that will serve everyone.

So I hope you agree with me on that.

Thank you.

José Manuel Campa

Chairperson, European Banking Authority

Environmental risks and the role of banking regulation

Thank you for the kind invitation to deliver keynote remarks on environmental risks and the role of banking regulation.

I am very happy to stand before you in Santiago de Compostela for this new edition of the EUROFI financial forum, a fitting place to discuss this important EBA priority. Much like the *Camino de Santiago* (or *Way of St. James*), transitioning to a sustainable European economy indeed is a challenging yet eventually rewarding journey. However, most of us had a relatively easier way to come to Santiago than the traditional way of pilgrims: we did not walk for weeks to get here. Unfortunately, we cannot expect that the transition towards a sustainable economy will be so easily overcome by technology. Technological developments will help but the transition of our economic structure will not be painless.

Considering the Paris agreement and EU net zero objectives[1], banks have a key role to play when it comes to financing the transition and addressing financial risks driven by climate change and environmental degradation. On both aspects, the EBA stands ready to play its part in accordance with its mandates.

Hence, in my time with you today, I would like to start by providing key observations on the current situation of environmental risks management in the banking sector. I will then highlight the merits of climate risk stress testing in view of an upcoming, important one-off exercise to assess the resilience of the financial sector in line with the EU Fit-for-55 package. Finally, I will elaborate on the challenges of further incorporating environmental risks in the regulatory and prudential framework, also considering the ongoing revision of the CRR/CRD banking package.

Let me now address my first point: the current state of environmental risks management.

Sound environmental risk management is needed as only a robust banking sector that can properly assess the risks involved can effectively fund the transition towards a sustainable European economy. Accordingly, banks must keep taking steps in this area. In fact, recent assessments at BCBS or EU level[2] show that some progress is taking place but also the strong need for further advancing current practices.

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. For example, we observe an increasing consideration of climate risk drivers as part of credit risk management. Of course, collecting granular and reliable data remains a challenge. Nevertheless, some banks are proactively addressing it by relying on targeted questionnaires to their clients, engaging with external data providers or intensifying cooperation with peers and supervisors.

However, more needs to be done. Banks must continue to strengthen their organisational, risk management and quantitative capabilities. Examples include ICAAP, scenario analysis, risk metrics and indicators. Furthermore, current practices suggest uneven progress on the incorporation of environmental risk drivers in the management of risk types other than credit risk. Nature related physical risks and biodiversity impact remains limited, despite their increasing salience at international and European level. Finally, banks need to further build capacity and expertise internally to expand their capabilities to fully integrate environmental risks across their organization.

With these observations in mind I will now further elaborate on the relevance and challenges of climate risk stress testing and scenario analysis.

Indeed, climate change and environmental degradation require that we approach risk measurement with in a more forward looking manner, with a higher reliance on scenario assessments and less dependency on historical based information. In this regard, exploring the coverage of climate related risk in the EU-wide stress test framework has high priority at the EBA. In practice, past initiatives by both banks and supervisory authorities provide useful and concrete 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, particularly for client-specific information at the activity level. Moreover, there is a need to develop more comprehensive and forward-looking models and scenarios, covering all specific transmission channels, both for transition and physical risks, as well as the potential compounding of risks. This was one of the key findings of the 2022 SSM climate risk stress test[3].

We are currently working on a 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[4]. As you know, "Fit-for-55» stands for the EU's target of reducing net greenhouse gas emissions by at least 55% by 2030. The One – off's primary aim will be to assess the financial sector's resilience in line with that legislative package, while gaining insights into the capacity of the financial system to support the transition to a lower carbon economy even under conditions of stress. We will investigate how stress propagates through the financial system and how financial institutions' reactions might magnify it.

The value added of this unprecedented analysis will be its cross-sectoral and system-wide nature, as opposed to standard solvency stress tests which focus on specific sectors only. This will allow to focus on possible near-term implications that may affect the implementation of the package.

We will launch the exercise by the end of 2023, with results to be published by Q1 2025. We do not expect these results to directly feed into the setting of micro-prudential capital requirements. However, they may nurture future considerations on micro and macro prudential policy. 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.

This brings me to my last point: ensuring an effective regulation.

The incorporation of environmental risks in the regulatory framework is an on-going, challenging yet important, task for standard – setters. At the EBA, we published our new roadmap on sustainable finance in December 2022, covering all three pillars of the banking supervisory framework and outlining key objectives and timeline for delivering on our mandates[5].

Let me firstly briefly address transparency and market discipline (or Pillar 3). In 2023 banks began disclosing quantitative and qualitative information following the requirements in the EBA Pillar 3 package, with a first reference date December 2022. 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. At the same time, the EBA is closely following and contributing to the work being developed by other relevant organisations to ensure consistency and coherence across frameworks.

Going forward, as I said before, we also 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 policies and the supervisory review and evaluation process or SREP. Further, we will issue guidelines on ESG risk management. These guidelines will allow us to set requirements as to how institutions should account for ESG risks. We expect these requirements to include aspects such as risk appetite, internal controls, ICAAP, management of different financial risk types as well as requirements on transition plans, consistently with other provisions of the EU legal framework. In addition, we will review our EBA Guidelines on institutions' stress testing to incorporate ESG related risk.

Finally, when it comes to the prudential treatment of exposures or Pillar 1, our approach will remain grounded on risk-based considerations, aiming at accelerating the integration of environmental and social risks across the Pillar 1 framework, while preserving its integrity and purpose. Our Pillar 1 report set for publication later this month 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.

Let me conclude.

Advancing further risk management practices in the banking sector, leveraging upon climate risk stress testing or scenario analysis, and refining our prudential framework accordingly are three essential, mutually reinforcing milestones on the path to achieve an orderly and sustainable economic transition. I look forward to working together with all stakeholders to meet this important societal challenge.

Thank you very much for your attention.

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5. EBA Roadmap on sustainable finance, published in December 2022.

Andrea Enria

Chair of the Supervisory Board, European Central Bank

Banking supervision beyond capital

Introduction

It is my pleasure to be here with you today – my last time attending the Eurofi conference as Chair of the ECB's Supervisory Board.

I would like to pay tribute to Jacques de Larosière, who set up Eurofi in 2000 as the European think tank dedicated to the integration of European financial markets. And to David Wright and Didier Cahen, who continued the pursuit of providing a space for an open and candid debate between market participants and policy makers on European financial regulation and supervision.

I have benefited greatly throughout my career from the opportunities for dialogue that Eurofi provides.

We had a lot of fruitful discussions around the creation of the European Supervisory Authorities and the banking union. And since the global financial crisis, Eurofi has hosted an ongoing debate between regulators and the banking industry on the myriad regulatory reforms that have been proposed, discussed and implemented.

Much of this debate has pivoted, in one form or another, on how much capital banks ought to maintain in order to be safe and sound while continuing to support the economy. At the risk of oversimplifying, banks have always argued for lower capital requirements, and supervisors and regulators have always argued for higher.

Today I will humbly suggest that we put this debate to bed. As the final Basel III standards are now becoming part of the rulebook across the G20, both the industry and supervisors need to move on from the capital calibration discussion. Instead, as the turmoil episodes in March this year showed, supervisors need to focus more on the effectiveness of supervisory action. It is in the banks' own interest to engage with us in this debate.

Capital advocacy

I want to start with a recap of the various stances that the banking industry has taken over the years in its advocacy efforts to contain capital requirements.

After the very first Basel III reform package was published in 2010, some in the industry claimed that the newly proposed regulations would precipitate some sort of economic disaster. The quantification of the cumulative impact of the changes on banks' capital needs led industry bodies to warn of very damaging macroeconomic consequences, with a severe and long-lasting recessionary impact on global GDP and employment.

These arguments did not convince policymakers, who continued to support the tightening of the capital framework based on the solid body of theoretical and empirical research showing that the benefits of banks funding themselves with more capital greatly outweighed the possible costs.[1] Having a larger buffer of loss-absorbing capital reduces the chance of banking crises, which are historically associated with substantial economic costs. It also smoothens the negative impact of economic downturns when they inevitably occur, through allowing banks to lend in more sustainable way through the cycle. Studies showed that, while higher capital requirements potentially lead to higher costs of intermediation, these only have a small long-run impact on the borrowing costs faced by bank customers. As such, they do not offset the benefits of enhanced financial stability.[2] Nonetheless, the concerns raised by the industry did lead to a more gradual phasing-in of the new requirements.

A second battlefield was then opened up in the EU around so-called European "specificities" – supposed special features of our banking structures, markets and products that would justify significant deviations from international standards. This line of argument never made sense to me, as the specific features of EU banking markets are accounted for in the international standards, as a result of lengthy negotiation processes where several EU authorities sitting on the Basel Committee have a say. Empirical evidence has shown that prudential capital discounts targeting specific lines of business or categories of borrowers are not effective in promoting lending.[3] Deviations from international standards do reduce the safeguards for bank stability, while their benefit in promoting our "special" way of financing the economy is far from proven. Nonetheless, this argument proved much more successful and led to material departures from the internationally agreed yardstick. As a result, the Basel Committee assessed the implementation of the

Basel capital standards in the EU as materially non-compliant.

Finally, the industry has more recently turned its focus to international comparisons, making the argument that capital requirements are more demanding in the EU than in other jurisdictions, in particular the United States. They argue that the excessive conservatism of European regulators and supervisors makes the European banking industry less competitive on the global stage. The implication is that public authorities should look at capital requirements as a lever of international competitiveness to support their banks in the face of competition from banks in other regions.

I disagree with this on principle. International standards provide a common minimum floor to avoid regulators using less stringent requirements as a way of favouring national champions, but there should always be room for supervisors to apply higher requirements if they believe these are warranted by the risk profile of the banks under their responsibility. But more than that, the attempts to compare capital requirements internationally face major methodological challenges and might easily lead to unproductive discussions. So let me clarify some aspects of the much-discussed EU-US comparison, before moving on to what I think should be more solid and productive grounds of debate between banks and prudential authorities.

International comparisons

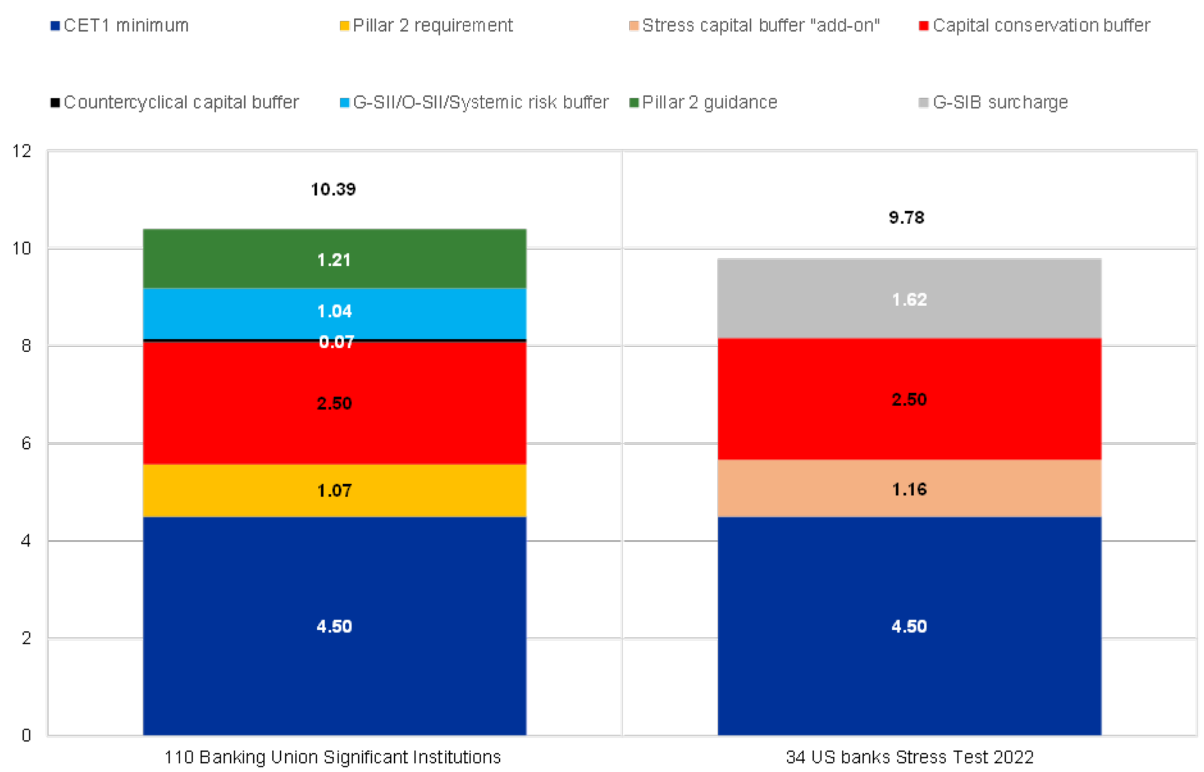
Comparing capital requirements across different jurisdictions is a complex task. The industry analysis that I have seen reaches what on the surface appear to be very clear-cut conclusions, but does so on debatable technical grounds.[4] First, there is an issue of sample selection. And second, the methodology may prove to be too simplistic.

The industry analysis compares the risk-based capital ratio of all European banking union significant institutions with that of large and mid-sized US banks accounting for a comparable level of total assets.[5] With that methodology, you do indeed find that the requirements for European banking union banks are slightly higher.[6]

CHART 1

Aggregate comparison of required CET1 risk-based capital ratios for banking union Significant Institutions and US large and mid-sized banks, as of Q4 2022

(Percentages)



Sources: for US banks, calculations on data from Federal Reserve Consolidated Financial Statements for Holding Companies - FR Y-9C, Federal Reserve Large Bank Capital Requirements 2022 (August). For banking union banks: calculations on COREP data and NCAs notifications to the ECB. The banking union sample includes 110 Significant Institutions; the US sample includes 34 banks which were stress tested by the Federal Reserve in 2022. Required capital ratios are weighted averages, with Risk-Weighted Assets as weights.

But the European sample includes many smaller banks than the US sample.[7] In fact, we should expect that smaller European banks tend to face slightly higher requirements under Pillar 2 than larger US banks, to compensate for their lower risk diversification. We also know that only the largest US banks are subject to full Basel standards, unlike in the EU where Basel standards apply to all banks.

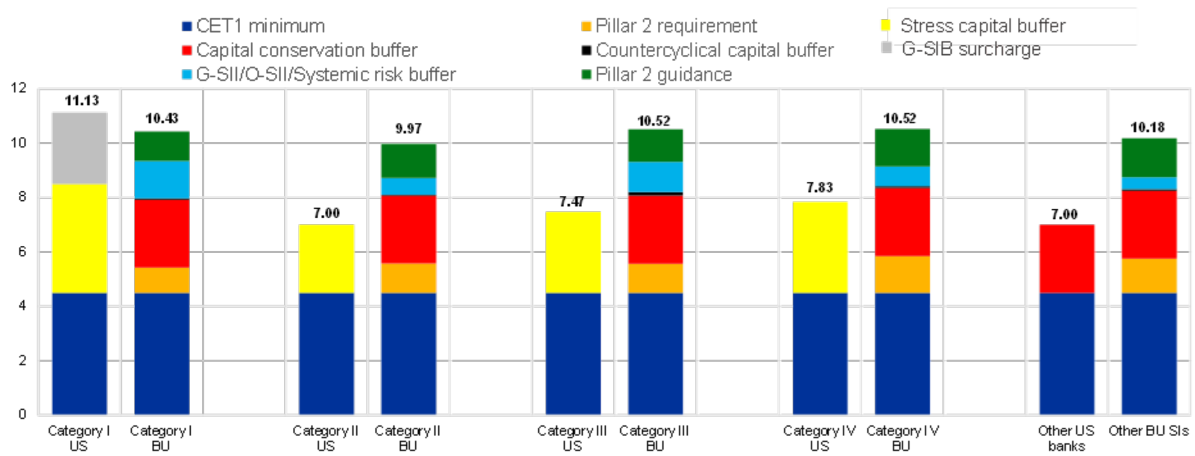
When we break those aggregate samples down, a more nuanced picture emerges.

Take the global systemically important banks (G-SIBs). We can see it is the US G-SIBs that are subject to the higher required ratios. On the other hand, if we compare the other European banking union significant institutions with US banks of a similar size, it is the European banks that face the higher required ratios.

Chart 2

Required CET1 risk-based capital ratios for banking union Significant Institutions and US banks, compared by US bank category size, as of Q4 2022

(Percentages)



Sources: for US banks, calculations on data from Federal Reserve Consolidated Financial Statements for Holding Companies - FR Y-9C, Federal Reserve Large Bank Capital Requirements 2022 (August). For banking union banks: calculations on COREP data and NCAs notifications to the ECB. The banking union sample includes 110 Significant Institutions; the US sample for Categories I to IV includes 34 banks which were stress tested by the Federal Reserve in 2022, while the last column for US banks applies to the other, smaller US banks. Required capital ratios are weighted averages, with Risk-Weighted Assets as weights. The allocation of banking union Significant Institutions into Categories is based only on the total assets criterion and does not take into account other indicators used in the US rules such as, for example, cross-jurisdictional activities or off-balance-sheet exposures.

However, comparing required ratios does not tell us the full story, even if we use like-for-like samples. Several factors are actually at play here: different requirement levels can be the result of different rules and different supervisory approaches, as well as different levels of balance sheet riskiness.

The more relevant question to ask is: would European banks face lower requirements under the current US prudential framework? Answering this question boils down to imagining a counterfactual scenario and making quite a few assumptions. Because of this, I do not want to make too much of the precise results, but I think the general picture coming out of this comparison holds. We have been looking into assigning the European banks to the size buckets adopted in US legislation, applying the US rules to them and mapping them into a "stress capital buffer" that is proportional to their risk profile, so as to include the Pillar 2 dimension in the analysis.[8]

When we perform this analysis, the tendency in the results seems consistent and goes in the opposite direction to the industry narrative. Relative to their actual requirements today, we find the average requirement for European banking union significant institutions as a whole would be somewhat higher under the US rules. The requirements would be significantly higher for the European G-SIBs, while they would be lower for most medium size and smaller European banks in the sample.

What drives this result? If we set aside the US gold-plating of international standards in the area of G-SIB buffers and leverage ratio requirements, this result stems from the way in which risk weighted assets are calculated. Here, EU legislation has several downward adj ustments relative to international standards, including the non-compliant application of the Basel I floor, which plays a key role in making the EU framework less demanding. Meanwhile, the US rules related to the Collins amendment impose a strict floor based on the standardised approach for credit risk.

Throughout the negotiations to finalise the Basel III reforms, as well as in the run-up to the political agreement that will implement those reforms in the EU, I have heard European banks claim that any form of standardised floor is particularly costly for them because, unlike the US banks, they hold all of their mortgage portfolios on balance sheet, and cannot offload the bulk of their mortgages to Fannie Mae and Freddie Mac.

But we haven't seen convincing evidence to support that view. On the contrary, under the very simplifying assumption that the European G-SIBs could offload the lion's share of their mortgage portfolios, our analysis finds that they would still face higher requirements under the current US rules in the counterfactual scenario.

The guiding star of global standards

Leaving the numbers aside, let me go back to principles. The focus on the comparison between EU and US requirements – and the intensity of the clash between banks and regulators on how capital requirements are calibrated – also reflects a bias. A bias that capital is the be-all and end-all of prudential supervision.

This bias prevails on both sides of the argument.

For banks, huge efforts are deployed to develop technical arguments and obtain reductions of capital requirements that are often worth a few basis points. For supervisors, there may be an underlying concern that even the higher capital requirements resulting from the post-crisis reforms might be gradually eroded by industry practices, and in a crisis could prove insufficient to ensure a smooth exit from the market, especially for large and complex banking groups. Indeed, respected academics such as Anat Admati and Martin Hellwig[9], advocate for a much higher level of capital requirements and are sceptical about the magnitude of the effects on the financing of the economy.

However, after a decade-long international debate, the final Basel standards are now being implemented in all jurisdictions based on a sound international agreement that has been subject to much discussion. We should now all accept that these international standards provide our guiding star. And we should put our efforts into ensuring that we effectively apply the regulatory framework that resulted from the implementation of these standards in each G20 jurisdiction.

Yes, there are local variations. First, jurisdictions decide on the scope of application of the standards. The current discussion on the US regime applicable to regional banks has brought this issue of scope back on everyone's mind. Second, jurisdictions are entitled to impose stricter requirements. Third, and much more worryingly, jurisdictions do make non-compliant choices, like the EU has repeatedly done. This is undesirable and damaging. To avoid the latter, I would personally prefer an international agreement leading to a direct and automatic implementation of Basel standards, or at least a key subset of them, into the regulatory framework of participating jurisdictions. This should follow a process with political safeguards similar to the one designed in the EU for the implementation of international accounting standards. But so long as the implementation follows very diverse processes across jurisdictions, we have to accept that deviations remain possible and, alas, likely.

Now the final Basel 3 implementation is close to completion in all jurisdictions of the G20, it is time to close this chapter of the discussion and live with the globally agreed rules that we have. The turmoil of March 2023 clearly showed that it is in the interest of both banks and public authorities to now focus the debate on where the focus of supervision should be best placed.

Beyond capital

The banking crises of March 2023 have taught us invaluable lessons. Capital cannot fix a broken business model, nor can it remedy deficient internal governance. These crises shed light on the stark reality that in times of uncertainty and structural change, such as those that characterise the ongoing global monetary policy tightening, both investors and depositors might very rapidly and abruptly shift their focus away from the traditional metrics of bank prudential resilience. And on the basis of assessments centred on economic – rather than regulatory – valuations and on the sustainability of business models, they might withdraw their support to specific institutions. When that occurs, a clear gap opens up between regulatory and market yardsticks and even high capital levels and liquidity buffers can be insufficient to prevent a run on deposits leading to a bank's failure.

Silicon Valley Bank and some other US regional banks were highly exposed to traditional interest rate risk. The surprising feature of these failures was the speed and coordination with which depositors reacted to the banks declining economic value triggered by very large amounts of unrealised losses on securities held to maturity.

In the case of Credit Suisse, a long stream of episodes that highlighted excessive risk taking, weaknesses in internal controls and concerns about the ability of the bank's governing bodies to restore profitability to sustainable levels finally led investors and depositors to rapidly withdraw their support.

High regulatory capital and liquidity requirements help in making failure less likely and do help in the resolution process if a bank eventually has to exit the market. But they cannot be the only tool to prevent banking crises. The effectiveness of the supervisory process is crucial. In a recent paper, Bruce Tuckman traces what I think is a key distinction between preventive, detective and punitive supervision.[10]

The first type of supervision relates to is preventive requirements. This involves putting in place standardised regulations applicable to all banks or specific subsets of them. This can include capital and liquidity ratios, stress testing, and standards for governance, controls, and risk management. The primary aim of preventive supervision is to curtail the discretion of banks in areas considered detrimental to individual bank stability and that of the broader financial system.

The second type of supervision is detective evaluation. In this role, supervisors closely examine individual banks, both to gauge the extent to which they are adhering to preventive requirements and to detect any practices that, while not explicitly infringing upon established rules, might undermine bank safety or systemic stability. The aim here is to unearth nuanced risks that might elude the rigid bounds of regulation.

The third type of supervision has to do with corrective action. When issues surface during the detective evaluation phase, this supervisory function comes into play. Its mandate is to compel banks to rectify any problems that have been detected. Supervisors should be able and willing to draw on a wide range of tools to achieve this, which include bank specific additional capital and liquidity requirements, business restrictions, board member reassessments and removals, sanctions and other penalty payments.

The entire discussion on the level of regulatory capital requirements and liquidity buffers is about preventive requirements. But we need to focus much more on detective evaluation and corrective action.

At the ECB, we have made considerable efforts since the banking union was established to put in place and maintain a strong evaluation function. We flagged the risks that rising interest rates would pose for the financial system, and we already incorporated these risks into our supervisory work programme already at the end of 2021, when the first inflationary pressures started to emerge. We made it a priority to ensure that supervised banks were adequately prepared to manage the impact from interest rate and credit spread shocks and to adjust their risk assessment, mitigation and monitoring frameworks in a timely manner, to focus on the economic value perspective and not only on the earnings one. Governance, another root cause of the March 2023 turmoil, is another area where we stepped up our detective activity.

Admittedly, just like other supervisors, we need to improve when it comes to corrective action. To ensure that the banks remediate problems in a timely manner once they have been identified, it is important that we can expeditiously use all the instruments available to us. Bank-specific capital add-ons are an important instrument at our disposal, but in some cases these are not effective enough in compelling banks to take the necessary corrective actions. We need to start using the full toolkit. And equally as important, we are working to foster a culture that encourages supervisors to propose strong actions where they identify weaknesses. This is crucial in areas such as governance and business model sustainability, where too many supervisory findings and measures have gone unaddressed for too long. I acknowledge that these may prove to be sensitive areas for intrusive supervisory interventions, as banks could feel that authorities unduly interfere with managerial responsibilities. But properly communicated measures, within a clearly defined escalation process, are essential to ensure that shortcomings are promptly remediated and the safe and sound management of the bank is restored.

So let's move on from the debate on the calibration of capital requirements. Let's implement the international standards we have all agreed on. And let's focus on making sure that banks take the right corrective actions to address the shortcomings that their supervisors identify. It is in banks' own interest to engage with us in in this endeavour and make sure that, the next time market confidence dwindles, no weak links can be identified.

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5. In other words, the US banks that are subject to stress tests.
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Ashley Alder

Chair, Financial Conduct Authority

Open markets and common causes: International collaboration and the modernisation of financial services regulation in the UK

The last time I spoke at Eurofi was as Chair of the International Organisation of Securities Commissions (IOSCO) Board and CEO of Hong Kong's markets regulator.

I passed the IOSCO baton into the very capable hands of Jean-Paul Servais last October, who you will hear from shortly.

This year I took up a very different role as Chair of the UK's Financial Conduct Authority. And notwithstanding the vast range of domestic issues falling within the FCA's remit, I know from past involvement with IOSCO and the Financial Stability Board (FSB) that the challenges facing all financial regulators – most recently the impact of artificial intelligence (AI) – require more international cooperation than ever before.

UK-EU MoU

It is with this mindset that we welcome the recent signing of the UK-EU Memorandum of Understanding on Regulatory Cooperation in Financial Services. And we especially look forward to the first Regulatory Forum later this year.

The scale and interconnected nature of EU and UK financial services sectors speaks for itself. For instance, around £2.4 trillion of assets are still overseen by UK based investment managers on behalf of EU clients. So, building a constructive relationship appropriate to this high level of interconnectivity will inevitably result in considerable benefits for all.

In fact, this is a main reason why I and my FCA colleagues are here in Santiago.

We also welcome dialogue on the broader international agenda, where more often than not the UK and EU have very similar views and ambitions. So, in the short time I have I'll touch on some aspects of global cooperation in which the FCA is playing a pivotal role, starting with climate. And I'll finish with some thoughts on the extremely significant regulatory reform agenda now underway in the UK.

Climate

The scenes we have witnessed across Europe this summer obviously speak to the urgency of inter-governmental climate action and underscore the FCA's commitment to strengthen the whole regulatory framework for sustainable finance.

A key area of focus has been the effort to build sustainability-related reporting standards at the real economy level. This aims to avoid a confusing, disjointed regulatory approach to a global climate emergency which doesn't respect borders.

The FCA therefore welcomes IOSCO's recent endorsement of climate reporting standards issued by the International Sustainability Standards Board. We are proud to have co-chaired this IOSCO work, helping pave the way for international adoption of a reporting framework which should limit greenwashing and underpin the credibility of the whole sustainable finance agenda.

Discussions aimed at achieving sufficient alignment between the newer International Sustainability Standards Board (ISSB) standards and an ambitious EU sustainability disclosure agenda were understandably challenging. But we were impressed by the willingness of the European Financial Reporting Advisory Group (EFRAG) and other EU authorities to work towards a sufficient level of interoperability to avoid companies being faced with reporting under conflicting rules. We now look forward to working with our European partners to embed the ISSB standards across international capital markets.

In the UK we also aim to take climate reporting to the next level by consulting on critical guidance for climate transition plan disclosures under a new framework developed by our Transition Plan Taskforce, which I'm helping to launch next month.

This recognises that companies need to provide financial markets with meaningful information on how they are adapting business models to whole-economy decarbonisation programmes.

The Taskforce is leading the way to define what a good practice transition plan should look like, and how this can be implemented in synchronisation with ISSB standards.

And we are of course keen to promote global alignment in this crucial aspect of sustainability reporting through close collaboration with our European and global counterparts.

Crypto

Switching to consumer protection and market integrity, we see similar co-ordination opportunities internationally, along with our European partners, on crypto. Because of the ways in which crypto businesses routinely transcend national borders and evade accountability, it makes sense to look at ways in which we can tackle the risks in this sector in lockstep with our counterparts across the globe.

Although many regulators are still in the early stages of developing their approaches we have already seen vital collaboration through the crypto and digital asset working group within the IOSCO Fintech Task Force.

Here the FCA has been leading 130 EU and global regulators to develop critical global standards, delivering a comprehensive crypto and digital asset consultation report earlier this year. In my view this could not have come soon enough following the extremely troubling circumstances in which many prominent crypto businesses failed last year.

NBFI

On the broader financial stability front UK and European regulators continue to act on lessons learnt from episodes of dysfunction. These include recent failures in activities broadly categorised as Non-Bank Financial Intermediation – or NBFI – ranging from the default of Archegos to problems in opaque nickel and Liability-Driven Investment markets. These examples further highlight how we can only properly manage risks in wholesale markets through close cooperation and data sharing among regulators and market participants.

It's therefore encouraging to see that the FSB and IOSCO are heading towards a set of concrete policy outcomes for NBFI activity informed by analysis and data drawn from both market regulators and central banks.

Once again, the FCA is closely involved in driving this work together with our European partners, co-chairing a key IOSCO group with the French Autorité des Marchés Financiers to develop a full suite of NBFI policy proposals. We are also looking forward to contributing to the FSB's upcoming Leverage Working Group.

And on a personal note, I was pleased to see an FSB report issued last week highlighting the risks of synthetic leverage in hedge funds and other non-bank sectors. I and other regulators voiced concerns about hidden leverage as the interest rate cycle started to turn back in 2021, so it's good to see that this is now a specific area of policy development.

UK REUL and a modern regulatory regime

Shifting to the domestic arena, the FCA's own remit has been fundamentally reshaped following July's passage of the UK's Financial Services and Markets Act. This legislation is a game-changer for us, formalising what will be a multi-year, intensive programme to tailor financial services regulation to UK markets.

In doing so we are committed to establishing an agile and coherent UK financial services regime that will boost investment and keep pace with the changing needs of firms, markets, and consumers.

And here I think it would be helpful to set out some basic principles on the international dimension of this in light of the UK's position as leading global financial centre.

First, we will ensure that any reforms are effective and proportionate, simplifying and standardising requirements where possible. And while I think we need to avoid talking about reforms in terms of "divergence" between the EU and UK, we will not be pursing change for change's sake.

Second, we will work alongside EU and global partners who are also pursuing pathways to sustainable economic prosperity whilst tackling the same financial sector risks, sharing and reflecting on best practice.

Third, we will contribute to and promote strong global regulatory standards.

Finally, in developing our rules, we will ensure that we consider the costs to firms who are globally active and are thereby subject to different regulatory regimes.

On which point, it is worth highlighting that in a number of key areas the EU and UK are pursuing similar reforms which, although not identical, signal common causes.

For example, the EU is seeking to introduce a consolidated tape in its recent MiFIR Review, which echoes the UK Treasury's announcement about legislation for greater trade transparency. The FCA's own consultation on a proposed framework for a consolidated tape for bonds closes this Friday, which also sets out criteria for how a commercial tape service provider would operate.

This single instance is sufficient to illustrate how EU and UK authorities can learn from one another. Others include ESG labelling and disclosure requirements for investment funds, the UK's recent consultation on a framework for the regulation of crypto assets alongside the EU's MiCA reforms, the regulation of ESG ratings agencies, and MMF reforms. There are many others I simply don't have time to mention.

Our ESG labelling proposals are a good example of our determination to ensure that UK regulation is internationally consistent but also works well for UK consumers and markets. In this instance firms will be able to build on much of their work under EU ESG classifications, but our requirements will go further by providing more clarity for consumers. But to help firms better understand the relationship between EU and UK approaches we mapped our proposals to EU – as well as US – ESG categorisations to show how they might interact. And we of course look forward to working with the European Securities and Markets Authority (ESMA) as it continues to develop its own naming and disclosure proposals.

Global outlook

So, I'll conclude by emphasising something that hardly needs saying: that UK markets will remain open, effective and grounded in world-leading standards.

We want to encourage efficient international investment flows based on strong cooperation and ensure that we can address risks which frequently know no borders. All of this will enable both EU and UK businesses to grow and thrive.

We therefore welcome closer collaboration, working in partnership when developing common standards to avoid unnecessary and costly regulatory fragmentation.

François Villeroy de Galhau

Governor, Banque de France

Monetary and fiscal policy-mix addressing the disease of inflation

Ladies and Gentlemen,

It is a great pleasure to be here for this final day of the traditional September Eurofi meeting, and I extend my warmest thanks to Didier Cahen and David Wright for organising this event, this time in the holy city of Santiago de Compostela. Let me start with good news about a favourite Eurofi topic: banking regulation and Basel 3. I say it as BIS Chair and former chair of GHOS: we had in Monday an important GHOS meeting in Basel, and we unanimously welcomed the decisive progress made this year in the implementation of Basel 3. By 2025, all jurisdictions – including Europe and – yes - the US – should have implemented it in a broad compliance with the standards. I know each banking industry, on both sides of the Atlantic, tends to consider that the other side has undue advantages. It's simply not right, and our motto is now straightforward: let us now close this page, and implement the European compromise, no less and no more. No less as some banks would perhaps still dream of, and no more as some theoreticians of regulation would perhaps imagine. And we should now turn to the priority learned from the banking turmoil: «strengthening supervisory effectiveness»i rather than focusing on further regulation. Let me now turn to my theme which is the policy mix to fight our main economic disease: inflation.

Well, Santiago has not yet produced a miracle for inflation, but there is indeed some encouraging news: headline inflation has passed its peak since the beginning of 2023, and it seems that core inflation is following suit. Indeed, the latter started to recede, to stand at 5.3% in August (down from 5.5% in July and 5.7% in March) in the euro area. Obviously, these inflation rates remain too high: we must and we will bring inflation back towards our 2% target by 2025. I reiterate this morning this clear commitment which is fully consistent with our latest ECB forecasts. Monetary policy is the first line of defence, and the main remedy for this disease. I won't make comments about yesterday's Governing Council and monetary decision. But our collective fight against inflation calls for a more appropriate policy mix: the revision of the European economic governance framework provides a major window of opportunity to realign fiscal and monetary policy.

Alongside high inflation, public debts have reached historical levels mainly due to unprecedented waves of shocks, but also, for several countries, to legacy debts. Now that these shocks are fading, governments must avoid an overly expansionary stance that would further fuel inflationary pressures. We therefore need a more coordinated and realigned fiscal and monetary stance.

Better alignment of fiscal and monetary policies would unleash greater efficiency of the policy mix: everyone agrees on this point. The question is how to ensure a better coordination between fiscal authorities – overseen by the Commission within the European Semester – and the ECB, which are both independent, and have specific mandates. Well: coordinating two independent and strong-minded personalities is always challenging, even more so with two independent institutions. In my view, they can be seen as travellers that have to take a journey together. They did not necessarily choose each other, but they can follow simple rules of cohabitation.[1] Agree on the destination, i.e. the respective «anchors» of the 2% inflation target over the medium term, and the medium-term debt reduction path[2] ensure a continuous dialogue to foster mutual trust and address divergences.

Moreover, the higher the inflation and interest rates, the harder it is to manage public debt. Attention is increasingly focusing on the sustainability of public finances, and rightly so. In this context, the July Eurogroup statement on the euro area fiscal stance, ii which highlights the need for fiscal consolidation, is very welcome. This is also true for France, which should avoid drifting towards a gloomy resignation about the constantly increasing government expenditure (58 % of GDP vs 51 % on average in the euro area in 2022) and public debt (112 % vs 94 %). Moreover, my country failed in the past to meet its commitments on budgetary targets. I strongly hope the next pluriannual public finance programming bill and the 2024 budget will demonstrate increased commitment and credibility.

The reform of EU fiscal governance underway is a key opportunity to re-establish a sound framework for public debt management. In April 2023, the Commission published its legislative proposals.[3] The sooner an agreement is reached – hopefully by end- 2023 –, the faster we can build on these tools to regain control of debt dynamics. Let me say upfront that the Commission's proposal is a step in the right direction.

That said, the «**fiscal rules trilemma**»[4] provides a useful matrix to analyse its merits relative to current rules. The trilemma states that it is impossible to fulfil simultaneously the following three objectives: 1) **simplicity**, which can also be understood as political intelligibility and ownership, 2) **flexibility**, i.e. the ability to adapt to specific economic situations or unforeseen developments, and 3) **enforcement**, i.e. the extent to which the rule is binding. In practice, the current Stability and Growth Pact includes too many – and too complex – flexibility provisions and escape clauses to compensate for the «one size fits all principle», while efforts to improve its enforceability proved ineffective. The reform must strike a better balance between these three features – simplicity, flexibility and enforcement – in order to make the fiscal framework more effective and operational.

As regards **simplicity**, the fact that the new framework is built around a single operational indicator, i.e. a net primary public expenditure aggregate, is a major improvement compared to structural deficits. In principle, this new indicator should be easier for governments to measure and oversee, and would entirely fall within their control. It is also simpler to use as a communication tool in the public debate, which would help to make the new rules politically intelligible and acceptable.

On **flexibility**, the proposal goes a long way towards better tailoring the efforts required to country-specific circumstances. The expenditure path would be defined in a pragmatic process, based on a debt sustainability analysis and after a thorough discussion between the Commission and Member States. Each country would commit to a national medium-term plan including structural reforms and public investment programmes. This process acknowledges that debt heterogeneity is too high between Member States to dictate a single debt reduction rule – 66 % of GDP in Germany vs 144 % in Italy in 2022 – while enhanced dialogue with national authorities should improve political ownership and hopefully compliance with the framework.

But this brings me to **enforcement**. We should nevertheless seek to ensure that the national plans do not turn into political negotiations and result in insufficiently ambitious fiscal adjustments. I must admit that I do not 100% believe in the wisdom of institutional processes or in enlightened economic debates for sufficiently steering national cycles.They must be complemented with common rules and anchors to ensure fiscal discipline. In other words, in the famous rules/discretion debate, we need indeed more discretion- but not too much; and we need less mechanical or obscure rules, but we still need rules. The set-up should indeed ensure binding thresholds for the minimal annual adjustment of public finances. Let me add that the more we progress effectively on national fiscal discipline, the easier we could envisage a common fiscal capacity – which we badly need. Mario Draghi eloquently advocated it recently,[5] and I wish it will be part of his new mission on competitiveness in Europe.

To conclude, let me borrow a fundamental principle from physics, stated by Isaac Newton: «when two forces unite, their efficiency double». Well, it is time to combine the two forces of our monetary and fiscal policy, towards a greater efficiency of our euro area economy and to the benefit of our citizens. Thank you for your attention.

1. Press release: Governors and Heads of Supervision endorse initiatives in response to the banking turmoil and reaffirm priority to implement Basel III.
2. Eurogroup statement on the euro area fiscal stance for 2024, press release, 13 July 2023.
3. C. Bouthevillain, S. Debu, Towards a much-needed reform of EU fiscal rules: the European Commission's proposals, Banque de France Bulletin no. 246: Article 2, 21 June 2023..
4. X. Debrun, L. Jonung, Under threat : Rules-based fiscal policy and how to preserve it, European *Journal of Political Economy.*
5. The Economist, Mario Draghi on the path to fiscal union in the euro zone, 6 September 2023.

Andrew Griffith

Economic Secretary, HM Treasury & City Minister

Open and Interconnected

Good afternoon, everyone, and thank you for being here. I'm delighted to be with you here in Santiago de Compostela – a city where the traditional and the modern meet and blend so well.

The combination of old, winding streets and new industries – not to mention the large numbers of tourists from around the world – reminds me in many ways of the financial services centres of the UK where I focus most of my attention, including Edinburgh and London.

Which makes this a great place for our conversations today.

Global Economy/International Cooperation

Because in the UK, here in Galicia, across Europe and in free countries throughout the world, storm clouds are brewing.

New challenges – from climate change and inflation to hostile nation states – are threatening our way of life. These challenges are international and complex, demanding that we work together to tackle them.

It is true that the global economy has been more resilient than expected over the last year, and that in July UK inflation fell to its lowest rate since March 2022 – a good sign for our commitment to halving inflation this year, on our way to our 2% target.

In fact, it is a positive development that new figures show the UK economy had a fast recovery from the pandemic.

Compared to 2010, there are now and extra 3.9 million people in work, and 4.7 million more in private sector employment.

In addition, there were 5.5 million businesses at the start of 2022, up by 1 million since.

But there is always more to be done.

In our recent Spring Budget, the Chancellor of the Exchequer introduced measures to boost the supply side of the economy.

Our independent Office for Budget Responsibility say there will be 110,000 additional workers by the end of the forecast period as a result, which is a promising start. But we know that simply getting people into work isn't enough.

We need them to be productive, so that we can reverse that decline that the IMF has forecast and drive our economy forward. So we've been looking at what we can do to boost growth in key sectors.

And as the City Minister, my major focus has been on Financial Services, and ensuring that UK markets are open, effective and underpinned by high standards.

The other sectors the Chancellor is prioritising, alongside financial services, include digital technology, life sciences, green industries and advanced manufacturing.

The International Standards

Each country's industry and financial needs have evolved slightly differently. Each has its own particular fact pattern – whether banks are regional or national, the mix of private or state pension provision, and how finance to buy a home works.

Indeed even within countries there are different needs and approaches, which we can appreciate all the more here in Galicia, with its own identity and long history of trade and travel.

What allows us all to thrive, together, is having productive working relationship with neighbours, as well as with friends around the world.

In the United Kingdom we are committed to working closely with our neighbours in Europe, and with international partners through the Financial Stability Board and other fora to achieve strong global standards.

Our financial services reforms will tailor regulation, so it is right for the UK's future.

Whilst our approach may occasionally differ to our friends in the EU, what will never falter is our commitment to the highest standards.

Recent events in the banking sector show our reforms since 2008 have strengthened the financial system.

As the IMF has said, the UK weathered the recent banking stress well.

Financial stability – within and beyond our shores – will always be the UK's top priority and, as the Chancellor to the Exchequer Jeremy Hunt and I have been clear, the UK will always be a partner in the important work of upholding global standards.

UK Financial Services Sector/ Reform

That does not mean to say that we don't mean to be competitive.

We have always seen ourselves as a nation which is part of a global market system, and we aim to be amongst the best places to do business where we can.

There are few places where this is clearer than in our financial services sector.

Together with related professional services, our financial services employ over 2.5 million people and generate around 12% of our total economic output. If any one sector could be said to be the engine of the UK economy, it's financial services.

London consistently ranks as the first or second global financial services centre and is tied with New York as the most competitive financial centre globally.

Unlike the US and China, it thrives on openness. It is an international market where the world comes to do business. But to maintain this means we cannot be complacent.

To that end, we launched the Edinburgh Reforms at the end of last year.

These reforms aim to make our financial sector ready for the future, and include launching an updated Sustainable Finance Strategy, and a future financial regulatory regime for Cryptoassets.

Through our Financial Services and Markets Act 2023, which passed through our Parliament earlier this year, we are taking further action including introducing new secondary objectives for our financial regulators, ensuring the regulators add considerations around growth and competitiveness to their existing primary focus on financial stability and consumer protection.

At Mansion House, the Chancellor announced further reforms to our pensions system, to boost returns for private pension holders while increasing funding for high growth companies simplifying our regulatory rulebook to help companies grow and list in the UK and delivering the Smarter Regulatory Framework for financial services to ensure we have an approach to regulation that is fit for the times we are living in.

The need to remain open & interconnected

This last point is key.

When we voted to leave the European Union, we did not do so in order to turn inwards, and exclude our friends from our markets.

On the contrary, the UK government understands financial services are globally interconnected.

I abhor unnecessary friction. It slows us down and makes our businesses less competitive at a time, geopolitically, when many would like to show that democracies can't deliver.

In the broadest sense, it is fair to say that every jurisdiction that wants to fully participate in global markets will need to rely on others' infrastructure.

Indeed, it is the norm for jurisdictions with developed financial sectors to rely on each other's market infrastructure.

Just look at London, where dollar-denominated interest rate swap clearing is heavily concentrated.

Therefore, whilst we all compete, at the core of every successful global financial hub is their open markets.

The UK's openness makes us the most globally connected banking hub, the world's largest centre for international debt issuance, commercial insurance and reinsurance, foreign exchange trading, and a leading centre for asset management.

An open, international approach avoids the downsides of market fragmentation, which come with increased costs for all firms, less consumer choice, and a much higher level of financial stability risk.

This success and the UK's reputation is predicated on a willingness to maintain existing valuable relationships with our European partners but also recognises that new relationships need to be fostered across both other advanced markets and fast-growing, emerging markets across Asia, Africa and Latin America.

It is an immense privilege to see so many of the world's experts in banking, insurance, investment management, accounting, legal services, consulting, and other related services both calling the UK home and doing business with us when they are based elsewhere.

And our aim is always to do all we can to help them flourish.

So I welcome the recent signing of the Memorandum of Understanding on Regulatory Cooperation in Financial Services with the EU.

We deeply value our relationship with the EU, which is ever evolving.

Indeed, just last week our announcement of the UK's association to Horizon Europe and Copernicus demonstrated exactly this, opening up new opportunities for UK scientists and business to collaborate with our European neighbours in the world's largest programme of research cooperation.

It is the priority of all our respective Governments to grow our economies, and this can best be done by working together as reliable partners, coordinating where we have shared objectives, engaging in mutually beneficial trade and mutually motivating competition.

Conclusion

It is only by working together, with transparency and honesty, that we can ensure we agree and uphold the highest international standards.

There is a clear value to financial markets being open and interconnected, and these are the foundations of the Chancellor's announcements at Mansion House and of the Edinburgh Reforms.

Implementing these reforms will be good for the global economy, and will help us to lower the cost of capital at a time when access to affordable and large-scale private capital has never been so important, while welcoming business from around the world.

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.

Jaime Lizárraga

Commissioner, U.S. Securities and Exchange Commission

Building on our Trans-Atlantic Partnership to Strengthen Market Oversight

Good evening, and thank you, Didier [Cahen, Secretary General, Eurofi], for your kind introduction and for your leadership in organizing this conference.[1]

It is a pleasure to join you in this beautiful part of the world, a UNESCO World Heritage Site.

This culturally and linguistically diverse region has special meaning for me. I grew up in a place called San Diego, in a Spanish-speaking home, with parents who immigrated to the United States from Mexico.

My mother and grandmother, both devout Catholics, once took me to another pilgrimage site near their hometown in Mexico. This site, originally given the name Santiago de Talpa in the year 1599, is located near a city named Compostela, in a region once known as Nueva Galicia.

So it is particularly special to be here in light of this personal connection and of the deep bonds and shared history and traditions between Galicia and Spain and the Americas.

And as an avid football fan, my congratulations to Spain's courageous Women's National Team on winning the World Cup. What a historic and exciting achievement!

It is an exciting time for us in the U.S. — admittedly in a different way than winning a world title.

Under the leadership of SEC Chair Gary Gensler, we are advancing a series of reforms to strengthen oversight of our financial markets.

Our reforms span the range of our mission — promoting fair, orderly and efficient markets, investor protection, and capital formation.

Having served as an SEC Commissioner for over a year, it's been rewarding to do my part in advancing this robust agenda. Looking back at what we have achieved so far, our agenda has been targeted, our approaches well-intentioned, and our execution well-informed by all interested parties.

There's much debate in our country about the scope of this agenda. Some argue that it overreaches; others that it's not enough.

But what matters most is whether our agenda is addressing the challenges of our time head on, and whether it is making it possible for us to fulfill our mission more effectively.

By all measures, it is.

Whether on digital finance, cybersecurity, transparency and market integrity, or decision-useful disclosures, our reforms will make our markets more resilient and ensure that investors — large and small — are protected.

Robust market oversight and updated rules that meet the needs of our times are necessary elements of strong markets.

On average, U.S. equity markets, 40 percent of the world's share, trade over half a trillion dollars per day. The current regulatory framework for U.S. equities has yielded deep, efficient, fair, and highly innovative public markets. Investors in these markets enjoy narrow spreads, low transaction costs, and fast execution speeds.

Last December, the Commission proposed reforms to improve transparency and increase competition in our equities markets.

Our reforms are designed to shed light on access fees and best execution practices — including by updating a nearly quarter-century old rule — and to promote competition between on-exchange and off-exchange trading.

These reforms also offer retail investors more competitive pricing, increase competition among trading venues, and provide more decision-useful information for all market participants.

As part of our general efforts to stay on top of market change, we have proposed a rule that addresses directly the conflicts inherent in technology-driven interactions with investors. Increased digitization of investment information, decisions, and interactions raises novel investor protection issues.

A recent study found that social media was a common source of information for new investors.

Our proposal on digital engagement practices would strengthen investor protections by preventing firms from misusing technology in a way that steers investors towards decisions that benefit the firm at the expense of the investor.

The Commission has also proposed a rule designed to improve transparency and lower systemic risk in the $23 trillion U.S. Treasury market.

In the U.S., the Treasury market plays a vital role in public finance and in monetary policy. Worldwide, market participants depend on the Treasury market to manage risk, post-collateral, set benchmarks for borrowing and lending, and for many other purposes.

By increasing the number of transactions subject to central clearing, our proposal is designed to make this market more resilient.

In the public company space, we have completed long-overdue rules mandated under the Dodd-Frank Act that address accountability of corporate executives.

We adopted a rule requiring public companies to claw back wrongly awarded executive compensation when a company restates its financials due to material errors.

The benefit of this reform is that it reduces the risk of costly litigation and preserves funds that from a shareholder's perspective could be put to better, more productive uses.

In this same vein, we completed a rule on pay for performance, making it easier for shareholders to assess the relationship between executive compensation and a company's performance.

This initiative addresses a key problem seen in the 2008 financial crisis — the stark misalignment of incentives that led executives to take excessive risks.

As all of you here know so well, the actions of executives can have a significant impact on the performance of a company. Conflicts of interest between their own incentives and their duty to maximize shareholder value can harm investors.

To address this, we took steps to strengthen investor protections around insider trading.

Another important development we have responded to is increased investor demand for more standardized ESG disclosures. This is particularly relevant for investment and voting decisions by investors with a longer-term investment horizon.

The SEC is in the midst of an effort to enhance and increase comparability of climate risk-related disclosures. Voluntary disclosures are fragmented, inconsistent, and lack comparability across the market. This is why investors with $130 trillion in assets under management have advocated for standardized corporate disclosures of climate risks.

But ESG is more than just climate.

We proposed reforms that would require funds and advisers to stand by their ESG claims, and accurately communicate to investors how they are incorporating ESG into their investment decisions.

To provide greater transparency around a type of risk that has increased significantly over the past decade due in part to technological developments, we recently finalized a rule that will require companies to disclose their material cybersecurity incidents, as well as information regarding their cyber-related risk management, strategy, and governance.

Prior to adopting this rule, public companies were not required to explicitly disclose cybersecurity risks, governance, or incident reporting.

Another key investor protection reform we advanced addresses problematic practices of advisers to private funds.

These practices have led to material, negative effects on investors.

Our recently adopted rule will provide all investors — not just the well-heeled — access to preferential terms. This will increase accountability and strengthen the bargaining power of investors who may have historically lacked such leverage. Advisers will also need to obtain investors' written consent in advance of engaging in practices that raise significant and problematic conflicts of interests.

Looking forward, enhanced disclosures regarding human capital management and the diversity of board members and nominees are part of the agenda. Today, an increasing proportion of public companies derive their value from intangible assets such as human capital — yet a very small percentage disclose their labor costs.

How companies respond to these types of risks, and the impact of these risks on bottom lines and strategies, can be very material to investors. We have a duty to make it possible for investors to have meaningful access to this information.

As is hopefully evident from the preceding discussion, our efforts to modernize our regulatory framework, so that it better meets the demands of our modern times, are wide-ranging.

These efforts also include several consequential rules on open-end funds, money market funds, SPACs, custody of client assets, securities lending, securities-based swaps, corporate share repurchases, and others.

Do you see now why this agenda is so exciting? Maybe not worthy of a world title but no doubt world class.

As one SEC Commissioner out of five, I approach our agenda from a utilitarian perspective: to aim for the greatest good for the greatest number, and to protect investors against harm, particularly working families who invest in our markets to build a brighter financial future.

As an independent capital markets regulator, we have an obligation to execute our laws as effectively as possible and to elevate and protect the public interest.

Modernizing our regulatory framework to adapt it to current realities, bringing transparency to the parts of our markets that are opaque, and harnessing our enforcement powers to fight and prevent fraud, market manipulation, and insider trading — all strengthen market integrity, protect investors, and build market confidence.

Regardless of the challenges we each face in our own jurisdictions, what remains constant is our shared goal of promoting fair and transparent markets through strong oversight. In pursuing this goal, we promote stable markets where capital formation can thrive and where investors can have confidence that they are protected.

It is my hope that the dialogue facilitated by this forum will continue to strengthen our relationships and advance our international cooperation efforts, while at the same time respecting the unique needs of each of our jurisdictions.

Thank you for the opportunity to deliver these remarks and best wishes to all of you for the remainder of the conference.

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1. I'd like to note that my views are my own as a Commissioner of the Securities and Exchange Commission, and I'm not speaking on behalf of my fellow Commissioners or the SEC staff.

Jean-Paul Servais

President, FSMA & Chair of the Board, IOSCO

Sustainable, Digital and Non-Bank Finance: IOSCO's achievements and perspectives

Good evening everyone,

Today, I would like to speak to you about IOSCO's recent achievements and perspectives on 1) Sustainable, 2) Digital, and 3) Non-Bank Finance.

1. In late June, the ISSB published their inaugural set of sustainability related disclosure standards.

Climate change comes with significant risks and opportunities that companies must disclose, and that investors need to know about. Most of you will know that, a few weeks later, IOSCO reached an historic milestone when we announced our decision to endorse the ISSB standards as fit for purpose for financial markets.

IOSCO's endorsement decision calls on 130 member jurisdictions, which 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.

A few days later, the European Commission adopted the final set of its own disclosure requirements (ESRS), which integrate the ISSB standards, in line with IOSCO's endorsement decision.

The EU may be the first regional **to adopt sustainability related disclosure requirements**, but with IOSCO's endorsement backing the ISSB standards, I am confident that many other jurisdictions will follow suit.

Sustainability-related disclosures are the starting point to ensure investors can price climate-related financial risks and opportunities on the basis of reliable, consistent and comparable information.

We anticipate up to 130,000 companies worldwide could eventually disclose sustainability-related information as informed by the ISSB Standards. But let me say this:

First: The benefits of producing these data points for investors outweigh by far the costs associated with it.

Second: This isn't a matter of doing everything, everywhere and all at once. It is a matter of starting the journey together, and with the same destination in sight.

In this respect, you can be assured that IOSCO will roll out an extensive capacity-building programme. IOSCO will also put its weight behind the development, by 2024, of high quality standards for Assurance of sustainability-related information to enhance their trustworthiness. Looking further ahead, IOSCO will need to consider the role of securities regulators in Transition Planning and the risks of greenwashing that come with it.

Last but not least, we are making headway in delivering robust guidelines to jurisdictions on carbon markets, as carbon markets have an important role to play in the transition to net zero.

2. Ladies and Gentlemen, how could I take the floor today without stressing IOSCO's commitment to financial stability in Non-Bank Finance?

In July, we submitted a paper on anti-dilution liquidity management tools, alongside the FSB report on structural liquidity mismatches in Open-Ended Funds, and asked for public feedback. We are now considering whether amendments are warranted in light of the comments received. And we and the FSB will finalise both reports before the end of 2023.

Besides Open-Ended Funds, let me flag two new important pieces of work on (1) Leverage and (2) Private Finance.

Tackling risks stemming from opaque leverage in NBFI requires facing the common denominator of the LDI UK gilt crisis, the fall of Archegos, and the source of dysfunction in the LME's nickel market.

There is now a consensus that the time has come to improve our ability to identify, monitor and contain systemic risk arising from leverage in NBFI. I am pleased to say that IOSCO and its members will be contributing significantly to this forthcoming work.

As you know, we had identified Private Finance as a new priority for this term. We will publish our first report on this in a matter of days. The report serves as a checkpoint for our concerns around the growing interconnectivity of private finance with regulated public markets and the risks they pose to financial stability. This first report maps out a path forward for further work on Private Finance.

3. Let me now turn to the issue of digital finance. In April, I told this audience that IOSCO would soon be delivering the first globally consistent framework for Crypto and Digital Assets and for Decentralised Finance.

Today, I am proud to announce that at the end of May, we published a consultation report on Crypto-Assets and last week, another one on Decentralised Finance.

Once finalised later this year, these recommendations will act as a global policy framework to address key risks to investor protection and market integrity in crypto and decentralised finance. Let me be clear, our existing standards are not relics of the past, they are just as relevant to crypto as they are to traditional finance.

Both reports will bring about significant change in the way crypto activities and Decentralised Finance arrangements operate. It will put an end to regulatory arbitrage and to the illusion of impunity.

Ladies and gentlemen, Thank you for your attention.

Tatiana Rodríguez

Governor, Central Bank of Ecuador

Green transition and investment opportunities in Ecuador

Good morning. As the Governor of the Central Bank of Ecuador, it is my pleasure to represent my country at this Euro Financial Forum and to share with you our progress and achievements related to digitalization, green technological transition, and investment attraction. These align with Sustainable Development Goals seven, nine, and thirteen of the Unite d Nations' 2030 agenda, to which we are fully committed. We firmly believe that these goals constitute the new axis of bilateral and multilateral relations among states, thereby enabling us to become a macro-region with solid progress based on inclusion and social justice.

In this historic city of Santiago de Compostela, where distant cultures meet thanks to its medieval path and where its stones, polished by history, leave us a lesson of perseverance and hospitality, we find an appropriate metaphor for the objectives of this international meeting between Europe and Latin America. The relationship between our regions should maintain these virtues of open paths for the exchange of ideas, the constant flow of people, goods, and services, and respect in building our national diversity and complexity. We come to Santiago with the aspiration not to end a journey in this welcoming city but to embark on an inclusive adventure that connects our economies with the necessary commitment to yield positive outcomes for our people, fostering fraternal bonds between cultures.

Ecuador is a beautiful country that I hope all of you will visit someday. Located at the equator, we have a population of eighteen million people and a land area of just over two hundred seventy thousand square kilometers. We are blessed with one of the world's greatest biodiversities and enriched by seventeen indigenous peoples and nationalities, the guardians of the cultural essences and ancestral knowledge of our Andean, Amazonian, and Pacific republic.

Regarding digitalization, in a complex global and regional context marked by multiple economic, social, and political crises, digitalization is one of the top priorities for global development model transformation. To achieve this, digital inclusion requires a set of actions and policies that facilitate use and adoption of digital technologies across all segments of the population, businesses, and government institutions.

The COVID-19 pandemic accelerated digitalization in Latin America and around the world, highlighting the significant role of the state in driving digital transformation. However, persistent connectivity gaps still hinder social inclusion.

In 2021, broadband penetration in Latin American and Caribbean households averaged only 72%, placing the region far behind North America and Europe, which have penetration rates close to 100% and 90%, respectively. Significant differences also exist in mobile broadband penetration, with 78% in the region compared to 105% in Europe and nearly 150% in North America.

In this context, with the Ecuador Digital policy, we aim to transform and lead our country towards a digital technology-based economy. This involves narrowing the digital divide, developing the Information and Knowledge Society, implementing e-government for efficient public administration, and adopting digital technologies across all social and economic sectors.

This policy consists of three pillars: Connected Ecuador, Efficient and Cyber-Secure Ecuador, and Innovative and Competitive Ecuador. Each pillar includes projects aimed at increasing accessibility to information and communication technologies, enhancing human talent capabilities, boosting economic sectors, and promoting entrepreneurship and innovation.

One fundamental pillar of Ecuador's digital transformation is technological infrastructure. In 2022, USD$900 million were invested in the country, with around 90% of these resources coming from the private sector. This amounted to a positive contribution of over 10% to the National GDP, given the crucial role of the communications sector in the digital economy, which also attracts future investments.

It is essential to highlight that this sector continues to grow, with the development of information technology, telecommunications, and related services industry. In the first quarter of 2023 alone, nearly USD$800 million in investments were made, contributing to a 4% growth in the National GDP. We project to surpass the USD$3 billion mark in technology investments by the end of the year.

The private sector has been at the forefront of adopting new technologies and digital transformation. For instance, Ecuadorian shrimp producers were the first to use blockchain technology to determine the origin, weight, quality, and distribution time of their products. Software that manages production processes in the cloud, simplifying and automating logistics, is also being utilized. Furthermore, the Integrated Aquaculture and Fishing System allows for fishing monitoring. The implementation of these technologies has earned the country European recognition through the «green card» certification for the quality of our seafood products. Six years after the trade agreement with the European Union, Ecuadorian shrimp exports have grown significantly. Predictability plays a key role in delivering aquaculture products in the quantity and quality required by our European partners, with the adoption of sustainable shrimp practices such as the Sustainable Shrimp Partnership promoted by the European Union.

Another fundamental aspect of digital transformation is e-commerce, which, to date, represents over USD$1.4 billion in digital transactions this year. Thanks to the Fintech Law, which facilitates the digitalization of financial services, there is now a regulatory framework in place that stimulates its growth. This step is crucial for enhancing transparency in transactions, as all exchanges can be traced, contributing to cybersecurity and serving as an additional tool in the fight against corruption and organized crime. Moreover, the Monetary Policy and Regulation Board recently approved the Fintech Resolution to promote innovation in the payments ecosystem and ensure proper oversight of its participants. This resolution establishes interoperability as a principle for all participants in the national payment system, allows electronic wallets to function as a regulated means of payment, creates an Interinstitutional Payment System Committee, and introduces sandboxes for those participants wishing to implement new business models.

We have connected the country to a micro-satellite network, a crucial factor in providing internet access to areas that cannot be reached by cables. This network will benefit businesses and economic sectors that operate in remote areas without physical network coverage. It can also be used by the tourism and hospitality sector in the Galapagos Islands, as well as in the Amazon to provide a better experience for the tens of thousands of tourists who visit us.

Through these measures, we have made significant progress, ensuring equal opportunities through connectivity, technology access, and coherent regulations, all in pursuit of genuine digital citizenship.

Regarding green transition, in terms of energy generation, Ecuador approved the update of its Electricity Master Plan expansion until 2031. With this decision, we expect to attract private capital of around USD$2.2 billion in Non-Conventional Renewable Energies from hydroelectric, photovoltaic, wind, geothermal, biomass, and other projects.

This is intended to ensure the country's electricity demand is met in the coming years, with a focus on utilizing renewable resources. Approximately 1,440 additional megawatts are planned for 2023 alone.

At present, the Ecuadorian electricity sector is executing four photovoltaic and wind projects, all fully financed by private capital.

Developments in this strategic sector will drive productive development in the country, promote electromobility, and enhance energy efficiency. Ecuador is committed to promoting the use of clean energy in power generation and transmission, as a vital resource to stimulate national economic recovery.

At this point, I would like to highlight that Ecuador has achieved a significant milestone in its public policy for ecological transition through the exchange of debt for nature conservation and biodiversity protection. This is the largest of its kind globally and results in a debt saving of USD$1.1 billion for the country, with USD$450 million of these funds earmarked for the protection of the Galapagos Islands.

To achieve this, cooperation between Ecuador and international organizations and entities has enabled the issuance of a bond linked to the marine conservation of the Galapagos: the Galapagos Marine Bond, valued at USD$400 million. This establishes the Galapagos Life Fund through debt conversion.

These efforts will strengthen Galapagos' protected areas, including its two Marine Reserves and National Park, prioritizing monitoring, control, and patrolling activities. This will ensure the integrity of the archipelago's key marine ecosystems, including critically endangered migratory species such as whale sharks and hammerhead sharks, as well as sea turtles, among others. The resources will also support Ecuador's efforts to monitor ocean health, promote sustainable fishing, and enhance climate resilience.

These resources will promote climate resilience and support sustainable fishing, marking a crucial step in the transition to an economy where diplomacy, conservation, and finance work hand in hand to generate well-being.

Furthermore, by completing the world's largest debt-for-nature conservation conversion, Ecuador protects its irreplaceable natural assets, reduces public debt, enhances fiscal stability, and creates opportunities to meet other basic needs such as healthcare and education. With this historic transaction, we continue to build global confidence among investors and lenders, potentially providing more opportunities for job creation and economic growth in the future.

This is a historic milestone that marks a turning point in the country's environmental and economic development. Thanks to the commitment of the Ecuadorian Government, conservation is no longer the sole responsibility of one ministry but has become a global, coordinated effort with the cooperation of everyone on this planet. Strengthening management in the marine reserve and other protected areas ensures that future generations can continue to enjoy the ecosystem that is the heritage of Ecuadorians and humanity.

Regarding investing in Ecuador, Ecuador is a country of opportunities that works to consolidate a robust legal and institutional framework and safe public policies for investments. Ecuador has also been recognized for having the highest biodiversity per square kilometer in the world. Since adopting the U.S. dollar as the legal currency in January 2000, Ecuador has achieved price stability for over two decades, strengthening its financial system and granting access to credit for millions of Ecuadorians who were previously in the informal economy. According to the latest projections by the International Monetary Fund, Ecuador will report an annual inflation rate of 2.3% for 2023, the lowest inflation rate in Latin America and the Caribbean.

Our actions and strategies to attract investments have led us to declare the facilitation of trade and investment as a public policy. We have established tax stability and incentives through investment contracts, with 228 investment contracts signed since 2021, totaling nearly USD$5 billion. It's worth noting that 60% of the signed contracts are domestic investments, while 40% represent foreign investment.

Among the benefits of investing in Ecuador are access to a market of 800 million consumers, thanks to the existence of eleven trade agreements and twenty-one double taxation avoidance agreements with major trading partners. Additionally, we have implemented the broadest and most comprehensive tariff reform in the last decade, benefiting eighty-one industrial sectors and over six thousand companies.

Ecuador presents significant opportunities for investment. National legislation includes incentives for investments and guarantees the rights of investors. Sectors with high investment potential include aquaculture, agribusiness, energy, infrastructure, fisheries, and tourism.

Ecuador has a sustainable investment management model, a true commitment to environmental protection and legal security. This allows me to invite you to invest in the country on the equator, a treasure waiting to be discovered and nurtured. Ecuador welcomes you with open arms.

Thank you very much, everyone.

Neil Esho

Secretary General, Basel Committee on Banking Supervision

Stick to the Core Principles

Good morning and thank you for the invitation to speak today.*

When asked how he went bankrupt, Mike Campbell, a Scottish war veteran who features in Hemingway's novel, ***The Sun Also Rises***, responded: «two ways: gradually and then suddenly». This description of financial failure – clearly not new – is also an apt description that sums up many an episode of banking distress. This includes the failure of a number of US regional banks earlier this year, and the merger of two large Swiss G-SIBs. In the US case, there was a build-up of excessive interest rate risk and a concentration of unstable funding sources, before the sharp rise in interest rates triggered a realisation that the banks' tech-focused business models were particularly susceptible and the capital and liquidity resources available to cover such risks were inadequate. In the case of Credit Suisse, the gradual build-up of issues was perhaps even longer and more public. They included large losses linked to Archegos and Greensill Capital, fundamental weaknesses in risk management and governance, various scandals, reporting weaknesses, and repeated changes in management and strategy. The final loss of confidence in the viability of the business model was also sudden.

Strong capital and liquidity buffers can buy bank managers and supervisors time to rectify weaknesses. But, unless weaknesses are addressed with sufficient urgency, that time can suddenly run out. So gradually then suddenly has been a common theme throughout the history of banking crises – the gradual build-up of vulnerabilities, followed by the sudden materialisation of losses. While the specific causes of banking crisis may differ, they drive home the same set of lessons: the need for strong and effective supervision and a comprehensive regulatory framework for banks.

The Chair of the Basel Committee, Pablo Hernández de Cos, will speak on Thursday about the implications of the banking turmoil for the work of the Basel Committee.

Today I will focus my remarks on the ***Core principles for effective banking supervision***, better known as the «Basel Core Principles». For supervisors around the world, the journey to compliance with the Basel Core Principles is something of a pilgrimage. Like the Camino de Santiago, it can be a long journey, but one which is well worth the effort.

The Committee issued a consultative document proposing revisions to the Core Principles in July this year.[1] Originally published in 1997, the Core Principles are the de facto minimum standards for the sound prudential regulation and supervision of all banks and banking systems. Their rationale, a recognition that weaknesses in the banking system of a country, whether developing or developed, can threaten financial stability both within that country and internationally, remains highly relevant given the turmoil earlier this year.[2] The Core Principles provide a framework for strengthening prudential supervision in all countries, and so are designed to be universally applicable – that is, unlike the Basel Framework, which is intended for internationally active banks, the Core Principles accommodate a broad spectrum of banks and range of different banking systems. To be capable of universal application, the principles aim to be simple, flexible and outcome-oriented rather than prescriptive on process.

In total, there are 29 core principles, which are broadly grouped according to the expectations of supervisory authorities (CPs 1–13) and those of banks (CPs 14–29).

The Core Principles are comprehensive, and so are used as a minimum standard by which banking supervisors can assess the effectiveness of their regulatory and supervisory frameworks. The International Monetary Fund (IMF) and World Bank also use them as part of their Financial Sector Assessment Program (FSAP) to evaluate the effectiveness of countries' banking supervisory systems and practices. Over 100 different jurisdictions have undergone assessment against the Basel Core Principles as part of FSAPs – and so they are a truly global standard.

The proposed amendments to the Core Principles

Why are the Core Principles being reviewed now and what are the proposed changes?

The Core Principles are intended to be a «living» standard that evolves over time in response to global financial developments, emerging risks and trends, and changes to the global regulatory landscape. Since their introduction, the Core Principles have been revised twice: first in 2006 and most recently in 2012.[3] Given that over a decade has passed since the last update, the Committee considered that it was time to comprehensively review the standard and started the current review about a year ago.

To ensure that the revised standard reflects the global experience of banking supervision, a Task Force comprising both Committee and non-Committee member jurisdictions, as well as the IMF and World Bank was formed to carry out the review.

The current review has been informed by a range of inputs, including:

- the effect of recent structural changes affecting the banking system;
- supervisory and regulatory developments over the past 10 years;
- lessons learnt in implementing the 2012 update to the Core Principles; and
- experiences gained from the IMF and World Bank's FSAPs since 2012.

A careful examination and consideration of these inputs has resulted in proposed changes to the standard that can be grouped into six thematic topics.

First, financial risks and macroprudential supervision, where the Core Principles have been strengthened to reflect key elements of many of the post-global financial crisis reforms. These include, in particular, the introduction of a leverage ratio to complement the risk-weighted framework; enhancements to credit risk management practices; the introduction of expected credit loss approaches to provisioning; and more stringent requirements for managing large exposures and related party transactions.

The last 10 years have also reaffirmed the importance of applying a system-wide macro perspective to the supervision of banks. As a broad financial system perspective is integral to many of the principles, the existing requirements have been strengthened based on lessons learnt. This includes the importance of cooperation between supervisors and authorities with responsibility for macroprudential policy, having a process to identify domestic systemically important banks, and the value of having flexible buffers that can be used in periods of stress.

Given that the Core Principles are outcomes-focused, the proposed adjustments do not require non-Committee member jurisdictions to implement the Basel III Framework in order to comply with the principles. Rather, the changes are intended to reflect key elements of the Basel III reforms, such as the leverage ratio and capital buffers, but they allow for these to be implemented in a simpler and proportionate manner.

The second thematic topic is operational resilience, where significant supervisory efforts have focused on ensuring that banks are better able to withstand, adapt to and recover from severe operational risk-related events. For example, disruption from pandemics, cyber attacks, technology failures and natural disasters. The proposed revisions aim to incorporate elements from the Committee's Principles for operational resilience and revised Principles for the sound management of operational risk. This includes enhancements to governance, business continuity planning and testing, third-party dependency management and resilient cyber security.

Third are climate-related financial risks, where changes have been proposed to improve supervisory practices and banks' risk management, reflecting elements of the Committee's Principles for the effective management and supervision of climate-related financial risks. We expect banks to understand how climate-related risk drivers may manifest themselves through financial risks, recognise that these risks could materialise over varying time horizons, and implement appropriate measures to mitigate these risks. Supervisors are also expected to consider climate-related financial risks in their supervision of banks and should be able to assess banks' risk management processes.

Fourth is the digitalisation of finance and non-bank financial intermediation (NBFI). Financial intermediation has evolved significantly since the last update to the Core Principles, prompted by rapid advances in financial technology and the proliferation of NBFIs. While the Core Principles are designed to apply to banks, supervisors should also remain alert to the risks arising from NBFI activities and their potential impact on the banking system. The proposed revisions reinforce the group-wide approach to supervision by ensuring that supervisors can access all relevant information (wherever records are located) and review the overall activities of the banking group, including those that may be undertaken by service providers. The proposals also recognise that risks can arise from a range of different NBFIs, and strengthen requirements for supervisory monitoring and for banks to manage their counterparty risks.

The fifth thematic topic is risk management practices, where the proposed revisions aim to reinforce the importance of banks instituting a sound risk culture, maintaining strong risk management practices, and adopting and implementing sustainable business models. This includes amendments to enhance corporate governance, including board independence, renewal and diversity, and to give greater emphasis to risk appetite frameworks and risk data aggregation.

And finally, the sixth thematic topic is lessons learnt since the last review, which has informed several of the proposed changes. Here, the proposed amendments seek to enhance supervisory transparency, decision-making and legal protections. We have also proposed a broader strengthening of the standard by upgrading several existing additional criteria to essential criteria, including those relating to corrective and sanctioning powers, consolidated supervision, corporate governance, interest rate risk in the banking book and liquidity risk. This proposal reflects our understanding that these requirements are no longer aspirational, but rather that practices have evolved sufficiently enough for these expectations to be reasonably embedded within the minimum standard.

Underpinning all the principles is the concept of proportionality. Here it is important to clarify – and we have also tried to do so in the standard itself – that proportionality does not mean lower or less conservative standards. Rather, it reflects the idea that rules and supervisory practices are commensurate with banks' systemic importance and risk profiles, and that they are appropriate for the broader characteristics of a particular financial system.[4]

Conclusion

The public consultation on the Basel Core Principles will close early next month. I encourage you to take advantage of the opportunity to provide feedback to the Committee. Given that the Core Principles are a global standard, the Committee is keen to hear from a broad range of stakeholders. After carefully reviewing all the comments received, we hope to publish the final revised standard around the middle of next year.

As I mentioned at the start, the banking turmoil of March 2023 has reinforced the importance of effective risk management and supervision. Despite the Core Principles now being in effect for over 25 years, some principles consistently receive weak ratings across jurisdictions. This is seen across institutional arrangements and supervision – for example, independence, accountability, resourcing and legal protection for supervisors (CP2) and corrective actions and sanctioning powers (CP11) – and banks' governance and risk management practices, including transactions with related parties (CP20) and problem assets, provisions and reserves (CP18).[5]

Our objective – and also our challenge throughout this process – is to raise the bar for supervisory and bank practices, while also keeping the principles universally applicable. While full implementation of the Core Principles by all countries is not a guarantee against bank failure, it provides a good basis for developing effective supervisory systems, and it would be a significant step towards improving banking system resilience and financial stability both domestically and internationally.

Thank you.

**I would like to thank Monika Spudic, Toshio Tsuiki, Marc Farag and Noel Reynolds for help in preparing these remarks.*

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1. BCBS, *Core principles for effective banking supervision* (Consultative Document), July 2023.
2. BCBS, *Core principles for effective banking supervision*, September 1997.
3. In addition, in 1999 the Committee also issued a Methodology to facilitate a more consistent interpretation of the Core Principles.
4. For practical considerations in implementing proportionality, see the Committee's «High-level considerations on proportionality», July 2022.
5. See L Dordevic, C Ferreira, M Kitonga and K Seal, «Strengthening bank regulation and supervision: national progress and gaps», *IMF Departmental Papers*, no 2021/005, March 2021.

Guillaume Prache

Senior Advisor, Better Finance

The badly needed Single Market for capital requires actual investor protection and access

Hello everyone.

I am very happy thanks to EUROFI to share with you today in 10 minutes my views on how to finally get to a badly needed European capital markets Union.

And not only the views from an advocate of individual investors - which is what several of you know me for - but also as a former CFO of a large listed issuer on NYSE and on Euronext, and also as former MD of a very large asset manager's European business. So a broader perspective.

We very much need a CMU indeed:

- for the European economy;
- for retail investors yes, in particular as pension savers: pensions are a key driver of their financial health**;**
- more generally for the people, the citizens, who need to adhere to capital market-based economics. Democracy as we know it is also at stake here.

But since its launch in 2015, (not to go back to 1957 and the Treaty of Rome which already required free movement of capital) the CMU has at best not progressed.

And the EU capital markets are less and less competitive, in particular for issuers and would-be issuers. Let's face it: Start ups, unicorns, growth companies are leaving the EU: US stocks accounted for 52% of the world (MSCI ACWI) market cap in 2015, 62% today.

This alone should be a major warning call.

So **what** can we do?

We must attract much more citizens to capital markets.

Why? simply because "households" (as economists calls us) constitute by far the main source of funding of the EU economy.

But, currently they are very little into capital markets : less than 20% of their financial savings are in listed securities and in investment funds.

So then the next question is **how** to foster retail investments into capital markets?

To answer that let me tell you 3 recent stories, one not so good, the two others much better.

1st story

One of my friends called me recently. He had been looking to save for retirement. He got a prescription from his financial advisor 2 years ago to subscribe to a personal pension product.

After two years he was not happy and asked me to look into it, I found that his pension product had lost 17% of its nominal value while the relevant capital market benchmark had gone up 17% in the meantime.

And "nominal" means that in reality he lost in two years already a quarter of the value of his pension savings and with bullish capital markets.

And I can assure you it is unfortunately far from being an isolated case.

Why such a disastrous performance and so disconnected from capital markets: at least 4 reasons:

1. **Retail investment is one of the most nationally protected consumer markets**: no competition within the so called single market: my friend had no choice of non domestic product (let alone the stillborn PEPP).
2. **Little or no access to simple products** He was only offered a Complex – very complex, personal pension product, and very indirectly connected via multiple wrappers to capital market instruments such as listed stocks and bonds. No US IRA (Individual Retirement Account) - like product where you can directly invest in stocks, bonds and funds for my friend.
3. **No relevant, clear and comparable key information**: nominal performance (let alone real – the most important and relevant one) and total annual cost were nowhere to be found, especially the performance of the corresponding capital markets. We had to try to compute all these ourselves.
4. And last but not least, **Lack of real (meaning fair) advice**: Among the investment options, the least performing and guess what the most expensive were selected, and no explanation of the perf could be extracted from the so-called "advisor" (in reality a sales person) apart from" it's the capital markets stupid" (it wasn't as we saw).

2nd story

A good one – The story of a man who two weeks ago, moved more than 20 billion from bank funding to capital market funding in 5 days, and only with people money - "retail money" as you would call it.

Late last month, tired of asking the banks to increase their rates on savings bank accounts still at 1 to 2% while short term market rates are around 4%, the Belgian Minister of Finance, Vincent Van Peteghem; issued a retail one year bond with a 3,31% interest.

In 5 days:

- He collected 22 billion euros, mostly coming from bank savings accounts. One of the key objectives of the CMU is to rebalance the funding of the economy between banks and capital markets: so well done Sir!
- It also generated a lot of interest from Belgians on listed bonds and many opened a securities account to get the bond (financial education that works)
- Cherry on the cake, it lowered the cost of funding of the Belgian State.

Imagine if all other EU ministers of finance do that and not only during 5 days and for only one maturity! Member States can do a lot for the CMU, starting for example by providing a much better and easier access for retail investors to their own bonds. The ECB could also do a lot to improve and "retailize" the Euro secondary Sovereign bond market as it now de facto controls it.

3rd story

We have no IRAs and 401ks (occupational) like the US, but France for example has more than 3 million employee shareholders. It is a very powerful tool to develop the understanding and adherence of citizens to capital market economics and funding. And surveys showed that many workers who were offered employee share ownership plans later opened a securities account: again financial education that works!

We are therefore very encouraged by the recent move from the German Minister of Finance Christian Lindner to facilitate and develop ESO in Germany.

Mr Lindner, why not be even bolder and transform it into a Pan-European initiative? Germany and the rest of the EU would benefit enormously.

Conclusion from these 3 short stories:

1. First, Remember Bob Marley (Inspired by Lincoln) when he sung: *"you can fool some people some time but you can't fool all the people all the time"*.So please treat financial health services users as fairly as for example physical healthcare ones: give them real access to independent advice (like to doctors for healthcare), select the lowest cost option (like generics), and ban hazardous and too complex products (like Public Agencies pre-approve or prohibit drugs)
2. Second, Give them Easy access to simple capital market investment products (listed securities), and to a simplified PEPP, this time not for Member States to shoot at, but on the contrary to help , especially by - for once - not using tax and other anti-CMU barriers
3. Third provide Relevant clear and comparable digitalized information and disclose benchmark performance and the product real long term performance alongside the largely fictitious product nominal one.
4. And lastly facilitate greatly their engagement: The brand new reform promoting ESO in Germany should be at last the opportunity for an EU-wide build-up of ESO. And other barriers to investor engagement should also be removed within the single market.

A much bigger involvement and engagement of people into capital markets is the only way for a free and capital-market based economy to survive in the future. **We need a capitalism that works for people, and to which people adhere.**

Union generates force, as the saying goes (*"l'Union fait la Force"*). So May the CMU Force be with you !

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Managing Director Securities Supervision

Autorité de Contrôle Prudentiel et de Résolution
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Secretary General
Olivier Fliche
Director of FinTech Innovation Hub

Autorité des Marchés Financiers
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