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Foreword

The Eurofi High Level Seminar took place in Ghent on the eve of the informal Ecofin meeting and was organised in association with the Belgian EU Council Presidency. More than 1200 participants from the public and private sectors followed the 40 sessions of this Seminar and the interventions of key representatives from the public and private sectors and the civil society.

The macro-economic challenges facing Europe and the main regulatory and supervisory developments in the financial sector at the European and global levels were discussed during this Seminar, as well as key industry trends such as digitalisation and the development of sustainable finance and the related policy implications. As a new political cycle is approaching, we also initiated during this Seminar a discussion 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 Seminar, providing a comprehensive account of the latest thinking on trends and issues affecting the financial sector and the policy actions needed to address them. We hope you enjoy reading this summary.

This report, as well as the different documents published on the occasion of this Seminar (Regulatory Update, Monetary and Macroeconomic Scoreboards and the February 2024 edition of the Eurofi Views Magazine) are available on our website www.eurofi.net.

Marc Truchet
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Secretary General

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Improving the EU's global economic competitiveness

Introduction

The Chair commented that improving Europe's competitiveness has long been a challenge. Since 2010, the euro area's economic growth underperformed its global competitors, particularly the US. In the last 15 years, potential growth in the euro area has been on average 1pps lower than in the US. The discussion focused first on the causes of Europe's weakness in competitiveness and then on how to address this weakness.

1. The economic gap between Europe and its main global competitors is widening

The European Union has been experiencing a structural shortfall relative to the United States and China since the mid-1990s due to structural weaknesses. This is also the result of economic policy choices.

1.1 Facts and Figures

1.1.1 Europe has fallen behind economically for more than 15 years

An official noted that Europe is massively underperforming on growth. There is a significant gap with the US in terms of GDP per capita, and emerging Asian countries are also increasingly challenging the EU in regard of competitiveness. In the period since the global financial crisis, the US economy on average has grown by 1.7 percent in real terms, meanwhile the European Union has lagged behind with a growth rate of 1.1 percent. This difference in growth rates has contributed to a shift in positions: while the European economy was larger than the US economy in 2008, but the US economy is currently 50% larger than the EU economy.

A policy-maker commented that, while the EU's overall performance as measured by trade indicators and price and cost competitiveness has been relatively stable over the past years, indicators on productivity and innovation suggest weaknesses. The slowdown in labour productivity since the 2000s has been more pronounced in the EU, with substantial heterogeneity across Member States. Sluggish investment dynamics, lower research and development spending and a lack of diffusion of new technologies are driving these differences. Additional challenges include access to finance, the regulatory framework, public administration, and investments in infrastructure and education.

An industry representative commented that there appeared to be general agreement that Europe is losing competitiveness compared to the US and China. There are very few European champions in the global top 20 companies by market cap. The US equity markets are the largest in the world and continue to be among the deepest, most liquid and most efficient, representing 42.9% of the $106 trillion global equity market cap in 2023. Discussion around competitiveness since the financial crisis has focused too much on regulation, supervision and stability and too little on growth. Europe has disadvantages, such as a lack of self-sufficiency in energy, but also has significant advantages, such as its savings and good, educated people. Despite having the preconditions for growth, growth is not happening.

1.1.2 Per capita incomes in all advanced EU economies are lower than in the US

An official noted that per capita GDP growth over the last 10 years in Europe is similar to that in the US. The European growth rate of output produced per hour is slightly higher than that of the US, but it would still take 80 years to catch up with U.S. income levels. Indeed, per capita income levels in the EU are on average around one-third lower than in the US after correcting for price and exchange rate changes that do not reflect changes in living standards. This difference is not only driven by less-rich European countries. With the exception of Luxembourg and Ireland, per capita incomes in all advanced EU economies are lower than in the US. This gap is driven by shortfalls in capital stocks, choices in working fewer hours, retiring earlier and lower productivity. Also, Europe is aging faster than the US. In this context, growth per capita matters more than growth per hour worked.

1.1.3 Convergence as an engine of growth has also been stuttering within Europe

An official commented that the larger income differences within the EU compared to the US should drive faster EU growth, given the growth opportunities that lower-income countries offer. The poorest US state has a per capita income level of around 80% of the US average. In the EU, there are eight countries with income levels below 80% of the EU average. However, growth in the EU's lower income countries has been insufficient to make progress on income convergence. The growth slowdown between the early and late 2010s in central and eastern European economies suggests that its convergence to average euro area living standards will not be achieved until after 2100.

1.2 The main reasons for this worrying gap

This gap is due to structural factors and different economic policy choices.

1.2.1 Less favourable demographics and lower labour and capital productivity in Europe

The Chair noted that only one-third of the difference in growth between the eurozone and the United States since

2010 can be explained by less favourable demographics in Europe, while two-thirds is due to lower labour and capital productivity. The productivity gap between Europe and the US has been widening because of differences in technological progress, market efficiency and institutional framework. Europe's underinvestment in innovation constrains technological progress, while market failures and excessive administrative burden prevent the economy from achieving its full potential. An International Monetary Fund (IMF) forecast states that Europe is expected to grow 0.9% this year, the US 2.1% and China 4.6%. There is a concern that current weaknesses are being driven by underlying factors that will affect Europe in the long term.

An industry representative commented that the US is largely self sufficient in energy. More work on this is required in Europe. The US labour market is historically more flexible than the more fragmented labour markets in Europe, with the exception of the UK and Ireland. Another difference is demographics. The US has grown its population 0.4% since 2000 while Europe has shrunk 0.1% and China has shrunk 0.2%. In terms of common public goods, there are opportunities to grow in defence, health and energy.

An official remarked that the medium-term economic outlook is concerning. Europe will need to address the old headwinds, such as demographics, the investment gap in eastern European countries and the slowing down of convergence and productivity. In addition, there are new headwinds, such as the Russian invasion of Ukraine and geo-fragmentation.

1.2.2 Europe depends on the United States for energy, technology, capital markets and the military

An official highlighted that the growth difference between Europe and the US is driven by four main areas: energy, technology, capital markets and the military. In the first two fields, Europe has significant competitive disadvantages compared to the US, while in the latter ones it depends on the US. Europe imports 62.5% of its energy need from abroad, while the US is a net exporter. The seven biggest tech firms in the world are US-based companies, while there are only two European companies in the top 20. European countries rely on US capital markets for large IPOs or acquisition financing, because Europe does not have a deep capital market. The military dependence on the US is self-evident. Strategic independence and autonomy will not be possible if there is a heavy reliance on the US in these four sectors.

An industry representative noted that, unlike Europe, the United States has bet on growth in the technology space. This area is largely underdeveloped in Europe and has huge upside potential for the future. The banking union and the capital markets union (CMU) are necessary for growth. Liberalisation of the broader services sector, not just banking, must also be considered.

1.2.3 Consequently, Europe has been hit harder than its economic rivals by the war in Ukraine

An industry representative commented that the EU has experienced a perfect storm. There is war in Ukraine. Global demand has been affected. Household consumption in the EU has moved sideways since the pandemic, while US consumption has increased. Capex, with the exception of Italy and perhaps eastern Europe, has decreased within the European Union. Economists are concerned about a potential scenario where growth and inflation are both at 1%.

1.2.4 Overly dispersed and complex regulations, high energy costs and the absence of dynamic and efficient capital markets help to explain Europe's lack of competitiveness compared to the US in particular

An industry representative stressed that industrial companies globally will be the drivers of growth. These companies like stability and have stated that the regulatory environment in Europe is too complex. For these companies, not only the absolute cost but also the volatility of the cost of energy is important. Companies need to be confident of long-term returns when investing. The current energy policy of Europe is unclear. Concerns around this lack of visibility are increasing and affecting clients' willingness to invest in Europe. Europe has a huge competitive advantage in the energy transition as it was ahead of the curve in terms of innovation. This competitive advantage must not be lost due to complexity, lack of stability, fragmentation and lack of pragmatism.

The US Inflation Reduction Act (IRA) is simple, long term and pragmatic. One big strength of the US is that it brings stability. There are similar issues with regard to the capital markets. The US capital market is not only bigger, more profound and has more depth and liquidity, but also offers a wider range of solutions. The leveraged finance market and the high-yield bond markets, for instance, have very few opportunities in Europe compared to the US.

The Chair (Rolf Strauch) agreed that risk culture needs to be nurtured.

1.2.5 The European approach to regulation treats the financial sector as more of a part of the broader social policy agenda, such as looking at double materiality assessments under CSRD or bonus caps

An industry representative commented that the European policy objectives regarding a net zero transition have led to a number of additional measures and requirements for European banks, such as the Corporate Sustainability Reporting Directive (CSRD) and Pillar 3 disclosures. These are more focused on advancing the policy objective than on the international competitiveness of European banks. Not having these requirements is a competitive advantage for other jurisdictions. Whether the ideal European bank is a social utility providing community service and financing for political objectives or a streamlined interface providing access to competitive international financial market pricing for consumers and companies should be considered.

When decisions are taken in Europe to suspend dividends without respect to capital strength or the strength of the sector, or when windfall taxes are taken due to the normalisation of interest rate levels, this creates a lot of bank sector investor uncertainty. This leads to a European policy and regulatory risk premia being assessed on European banks. The extent that the financial sector is viewed as an extension of the public sector in Europe reduces the attractiveness of the sector to international investors.

1.2.6 The lack of cohesion in the single market

An industry representative remarked that, since the beginning of the 1990s, small changes have been made in specific areas to resolve short-term problems. However, there has been very little structural reform. An excess of regulation can stifle creativity. There is no growth without taking risks. For example, the lack of venture capital is unsurprising and partly due to restrictions in the Markets in Financial Instruments Directive (MiFID). This has resulted in stability but no growth. Implementation time should be reduced at the EU level. The IMF expects growth of barely 1% in the next five to six years. This must be addressed urgently by freeing up the capacities of the private sector. The public sector is in too much debt, has no capacity and the savings are exported to the US.

The Chair summarised that a number of reasons why Europe is falling behind have been outlined, including demographics, lack of investment and productivity linked to technology. The energy market is relevant in terms of cross-competitiveness, but also in terms of volatility and risk culture. The single market is incomplete. However, there are also strengths.

2. The solutions to Europe's lack of economic competitiveness have been identified. All that remains is to implement them

The good news is that Europe has the tools to respond to these economic competitiveness challenges. Structural reforms and the single market are the places to start. Establishing a single market will include work on CMU, the banking union, harmonisation of taxes and subsidies and harmonising of bankruptcies. This will make it possible to operate across Europe at scale.

2.1 Europe has real strengths

2.1.1 The European Union's capacity to provide public goods is encouraging

A policy-maker noted that Vincent van Peteghem has alluded to the fact that there has been a natural shift towards cooperation between the private and the public sector. This started with the Juncker plan and evolved further with NextGenerationEU, which made public goods, such as health or defence, available through the provision of private goods. This was achieved by means of joint public procurement for private goods, vaccines or weapons, with the ultimate aim being public health or defence. The ability of the European Union to provide public goods rapidly when needed in response to crises, in spite of all its challenges, is very positive.

2.1.2 Europe's key advantage is that it has been leading on the green agenda

An industry representative stated that Europe's key advantage is that it has been leading on the green agenda. However, the US is catching up very quickly. Higher capital requirements for banks means less ability to lend and further capital requirements should not be included in any new rules. Non-banks are equally as important as banks, because non-banks help banks to provide the means to accelerate growth. Acceleration of the CMU is crucial.

An official pointed out that there are three main considerations with respect to European competitiveness: sustainability, inclusion and growth. If addressed, these three factors can result in a prosperous and green future for Europe. The factors could either reinforce or undermine each other. Europe is performing well on sustainability and inclusion.

2.1.3 The pricing model used by the EU via the Emission Trading Scheme is an efficient instrument to address the climate transition

A policy-maker underlined that there has been frequent comparison of Europe to the US. The European Emissions Trading System has delivered very well and provides very good incentives. It has been agreed that this will be enlarged and its scope broadened, which will be much more efficient. In contrast, continuation of the very expensive subsidies programmes in the US would raise real questions about the public finances and the stability of public finances in the US.

2.1.4 Reforms in Europe have become a central element of economic policy

A policy-maker commented that the perception of the word 'reforms' has changed dramatically in recent years. Instead of a euphemism for mass unemployment, layoffs and closure of companies, reforms in Europe have become a central element of economic policy. The NextGenerationEU agreement was possible not because of the investment it contains but because of the reforms. Ursula von der Leyen has commented that reforms are the engine of growth and investment is the fuel.

An official reported that world growth has been upgraded by 0.2% for the current year, driven by the US upgrade of 0.6% and China upgrade of 0.4%. There is little spillover for Europe from this external demand, with Europe being downgraded by 0.2%. However, there are some positive indications for the euro area. First, the disinflation effort works, with monetary policy and the unwinding of supply shocks playing a key role here. Second, labour markets remain strong. Real incomes are expected to increase in the current year, which will lead to higher private consumption. Easing of financial conditions as the disinflation effort gets traction will increase investment and produce stronger domestic demand. This means that the immediate outlook is reasonably good, facilitating fiscal consolidation.

2.2 Structural reforms must be implemented without further delay

2.2.1 Identifying what needs to be done at European and member state level

A policy-maker commented that it is crucial to consider what aspects are the responsibility of member states and what needs to be done at the European level. Spending on R&D in the EU is behind that in the US. Urgent action must be taken to close this gap through a combination of

additional public funding, leveraging of private investment in these areas and improving incentives. Regulations for private companies in these areas must also be considered to ensure that the incentives to invest are present. Europe must attract talent and reverse the trend seen in recent Programme for International Student Assessment (PISA) results in many member states.

A policy-maker remarked that countries are unable to address major emergencies alone. A Eurobarometer revealed that the number one thing that people want from the European Union is help in case of an unexpected event. What public administration can do is limited. It is too easy to put all the blame for this on the public administration. There have been 20 years of disengagement and a lack of investment. A recommendation of the high-level report on cohesion is to invest in the capacity of the public administration as if it were a physical asset. The more trust that there is between the countries and Europe, the more it will be possible to do things at the European level.

2.2.2 Reducing the weight of the state in the economy and recalibrating the size and complexity of the EU regulatory framework

An industry representative commented that the state in Europe represents over 50% of the GDP. This could be a root cause of low growth. The oversized state is regulating everything and crowding out the private sector and creativity. Despite 15 years of discussion there has been no progress on CMU and securitisation. Defence, border control and energy are all problems that must be addressed by the European Commission. With a 1.3% budget compared to the GDP, the European Commission will struggle to address these issues. To start growth, capacity in the private sector must be increased and advances made on the single market.

The Chair noted the suggestion that that the national governments are possibly too big at 50%, but also that the European level has too little money. If it is not possible to increase the envelope, resolving this will require a redistribution between the national and European levels.

A policy-maker remarked that, in the next five years, 30% of public administration staff will retire, so a change will be needed. However, the approach should not be 'Throw it away' but instead 'Organise the change.'

An industry representative stated that some regulations will also need to be reviewed if we want to foster investments in companies´ equity or more venture capital, for example the Capital Requirements Directive (CRD) and the Capital Requirements Regulation (CRR).. Furthermore, the European Central Bank has consistently been against leveraged finance. The risk weighting in these cases is so high that it is essentially forbidden. Regulation should be considered in the context of the results of the regulation. MiFID should be reviewed.

He also highlighted that although the single rulebook is of fundamental importance, the most common regulatory tool is directives and national rules play a key role. Different regulatory frameworks are the main barrier to European consolidation. This leads to a lack of potential synergies that could be achieved in a bank merger.

2.2.3 The success of structural reforms depends on their coherence, transparency and the quality and efficiency of national administrations

A policy-maker commented that an essential element for successful reforms is coherence, which the EU is very good at. The EU has been promoting the Green Deal and emphasising the importance of the green transition over the past five years. The response to the war in Ukraine, REPowerEU, is very green, because the two biggest elements are saving and a move to renewables. This coherence is very much appreciated by the market. Transparency is also important. For example, the transparency of the curve of the Next Generation EU bonds is crucial.

Public administration is one of the most important factors in making a country or a region competitive. In the past 10 to 15 years, public administration has suffered from a great deal of disinvestment, so there is a big gap between the demands placed on it and the resources that is has. Often, problems in public administration in Europe are due to ability and capacity, not political resistance. This is important because most crises now are supply-side shocks. A demand-side shock can often be resolved with money. However, public administration is needed to resolve a supply-side shock.

2.3 Completing the single market is the right response

An official pointed out that the big advantages in the US are a large single market and lots of flexibility in labour and product markets. The answer to economic resilience in Europe is the single market. The IMF has estimated that a reform package that reduces within-EU barriers by 10% could permanently lift real incomes by more than 7%. Such reforms include completing the banking and CMUs, for example, through greater harmonisation of national rules on taxes and subsidies, improving insolvency regimes, and reducing administrative burdens. IMF research shows that closing the gap between involuntary and desired working hours alone would increase EU labour supply by about 1.3%.

A policy-maker stated that, in order for the single market to fulfil its full potential, progress must be made on energy union, banking union and CMU. Proposals have been made on how to finance a smart industrial policy at the European level in order to minimise fragmentations in the single market.

2.3.1 Energy independence is urgently needed and requires more strategic thinking

An official noted that demography would be the focus of the upcoming Hungarian Presidency. In addition, energy independence is urgently needed. A third priority is to improve competitiveness. Energy prices in Europe are more affordable than they have been, but still very high. Next Generation EU and the Recovery and Resilience Facility (RRF) is a step towards the solution of this issue, but it does not fully cover the related financing needs. Furthermore, the pace of implementation leaves a lot to be desired. The facility amounts to approximately €650 billion euros, but only 35% has been disbursed so far, although we are past the halfway point to the 2026 deadline. The Commission's evaluation of the progress on the RRF

has stated that it is 20% behind schedule. Faster progress must also be made on the CMU.

An industry representative commented that there is a need for more strategic thinking. When the US makes a decision about shale gas, it takes everything into consideration, including environmental issues, the competitiveness of its industry and security of supply. This collective approach that should be taken on every topic. For example, when considering a specific bank regulation, the banks' role is to explain what the consequences for them, the market and investments will be. The private sector's role is to state what it can do and cannot do. Risk-taking between the private and public sectors should be optimised to leverage public funds and raise as much private money as possible. CSRD requires corporates in Europe to provide a level of information that their competitors do not need to provide, putting them at an asymmetrical competitive disadvantage. There will be consequences for this in terms of innovation.

2.3.2 Completing the Banking and Capital Markets Unions

A policy-maker remarked that it is hoped that both the Letta report and the Draghi report will contribute to completing CMU. Many things, such as single issuance of bonds, will not be possible if the capital markets are not large and liquid enough.

An industry representative emphasised that banks are ready to take the risk as long as they are able to match the risk. Optimal risk matching within the balance sheet requires securitisation, a CMU, a European Deposit Insurance Scheme (EDIS) and the same bankruptcy laws all across the European Union. To have a single market of retail financial services, depositors must feel that they are equally protected in all countries across Europe. These points have been made numerous times over the last 15 years.

An industry representative commented that the policy focus on the securitisation markets has the potential to be transformative. One reason why the US banking sector has been such a powerful engine for the US economy is that it is able to recycle risk and financial resources, rather than relying on warehousing traditional credit products on balance sheet. Financial market participation increases with securitisation. Banks are better able to use their financial resources and there is greater availability of credit into the real economy. The American securitisation market is more than 10 times the size of the European one. The originate to distribute model enables a great deal of investment without the constraints placed by the size of bank balance sheets. When policy and regulatory matters are being considered, there should be a very disciplined approach towards the cost-benefit analysis and bank shareholders must be considered as stakeholders. Banks price risk, financially transform it and then distribute it. It is a concern when banks are warehousing risk, because that suggests that there are no other willing buyers. The focus should be on making investments financially attractive to end investors.

The Chair noted there are good reasons for the regulatory burden and banks have been safer in the current crisis than in previous crises, but some adjustment may be necessary. Whether banks would be able and willing to take the risk of financing the green transition or whether another approach would be needed must be considered.

2.4 NextGenerationEU and the revised Stability and Growth Pact: models for the future?

A policy-maker commented that the RRF can be a model for the way ahead. Political agreement has also been reached in the trialogues on the reform of the fiscal rules in Europe. Member states are coming out of the succession of recent crises with an increased level of debt. There is now a balanced package in place that ensures that debt levels can be reduced over the medium term in an economically realistic way. The package is country specific and based on debt sustainability aspects. The new fiscal rules also include incentives for investment and reforms, including for expenditure for the increased needs for defence and security in Europe. It is hoped that the final formal agreement will be complete by April and that the new rules can be implemented in spring.

An official noted that with regard to climate, energy security and common public goods, a central fiscal capacity is needed. The most efficient way to progress on this in the near future would be a climate and energy security fund at the EU level. Next Generation EU was a breakthrough instrument, partly because it connects the requirement of national structural reforms with investment. It is positive that the element of structural reform is included in the new fiscal framework. Completion of the single market will increase living standards and help close the gap toward the US. This is money on the table; let's take it.

The Chair summarised the suggested reasons for the relative competitive weakness in Europe: demographics, investment, productivity, technology, energy and the cost of geoeconomic fragmentation. Europe's resilience is underpinned by its strengths, such as knowledge and creativity. Labour markets are working better than in the past. There are also advantages around sustainability and inclusion. The focus should not only be on growth but also on how this growth is achieved. There is a great deal of work for the next Commission to do. Focus should be on making the single market work and allowing for risk taking in order to unleash financing.

Open Strategic Autonomy in the economic and financial areas

Introduction

The Chair noted that open strategic autonomy (OSA) has been discussed at many of the previous Eurofi conferences, but a different approach might be required to make progress on this issue. The key question for discussion is whether there is a need for OSA in the EU financial sector in the context of rapidly increasing geopolitical tensions and the associated implications for globalisation. The financial sector might have less need for OSA compared to sectors such as critical raw materials. This is a question to be inserted in the context of the European Market Infrastructure Regulation 3 (EMIR 3.0) debate, where concern about additional cost outweighed concern about excessive reliance..

It also remains to be seen whether the EU financial system will be able to deliver the necessary industrial transformation. Given the current political focus on capital markets union (CMU), it will be important to develop the EU capital markets and strike the right balance between top down EU approaches and bottom up national ones.

1. Open strategic autonomy: what does it mean and what is at stake?

1.1 Balancing openness and autonomy

A public representative agreed that it is not clear whether autonomy is needed in the finance sector. In the Critical Raw Materials Act, the decision was made that autonomy was needed. The finance sector has not yet reached this conclusion. It is important to remember that liquidity always chooses the path of least resistance. It can be transferred across the globe in milliseconds. This is very different to a machine or a raw material, which has to be explored, produced and transported. However, the export industry relies on financial services to do business around the world. This means there are two conflicting priorities. There is a need to strengthen the European financial system and the CMU to create greater possibilities for the EU and a requirement for a degree of openness. There is global competition, and Europe must be successful in this global competition. Finally, there is also a question of scale. In a fragmented market, it will not be possible to deliver the scale effects delivered by other markets. Therefore, Europe needs to find a balance between autonomy and dependence on the market.

The Chair agreed on the need to find a balance between openness and autonomy, adding that openness seems to be implicit in the word 'strategic'. Indeed, it is not strategic to be closed.

An official emphasised that OSA is a slightly contradictory concept. The only way it makes sense is by recognising that the financial system is global. There will only be a strong European financial sector if it is well connected to deep global capital pools. Autonomy will emerge when people choose to do business in Europe. If this is the definition of autonomy, it is indeed necessary. However, the discussion must be broader than CMU and EMIR. It must involve a wider discussion about economic policy and obstacles to foreign direct investment.

The Chair observed that this is not just about the financial sector. The need for autonomy in critical raw materials is unambiguous, but it is not clear whether the financial sector is willing to make the same trade offs. As the US and the UK are the only other providers, onshoring will be needed to create the requisite level of diversification. This might look like protectionism, but it is in fact diversification. This is part of the contradiction.

1.2 Thinking about OSA in the current geopolitical context

An official stated that any discussion of OSA must consider the broader context: geopolitical landscape, global economic fragmentation and economic challenges in Europe. The concept of OSA encompasses many different policy fields, such as technology, trade and defence. If there were deep and liquid capital markets or even a single capital market within the EU, it would be much easier for Europe to create a more competitive and innovative economy and to mobilise funds for the green and digital transitions. Without the ability to access Europe's currently fragmented financial resources, it will be very difficult to achieve these goals. It will not be possible to achieve OSA without a functioning CMU. The CMU and the banking union cannot be separated from OSA.

The Chair considered that there are geopolitical concerns about over reliance on external partners. Any reliance on a single infrastructure, even in a friendly country, carries operational risk e.g. the potential impact of a cyberattack.

An IFI representative suggested that, in the current geopolitical context, it is logical to evaluate whether Europe's financial sector is over dependent – however given the current development of Europe's capital markets the region currently remains reliant on global investment flows to help fund its green energy transition. The issue of critical raw materials is different: there is a much greater need for autonomy in raw materials because the resources are scarce and in high demand for the green transition.

1.3 Creating a globally competitive market in Europe

An official emphasised the importance of creating a globally competitive capital market. In the current era

of de globalisation, competitiveness is the key issue. The capital markets finance around 30% of the European economy; in the US, they finance around 70% of the economy. The European economy is faced with unprecedented challenges, such as the energy transition. This transition will require an additional €700 billion, although €300 billion of savings flow out of Europe every year. Europe must create a globally competitive capital market.

1.4 Balancing EU interests with the need for open and international financial markets

An industry speaker noted that this is probably the seventh or eighth discussion of strategic autonomy at a Eurofi conference. There is now much greater convergence on how to interpret the idea of strategic autonomy and its key components. The term 'open strategy autonomy' is indeed slightly contradictory. A more appropriate term might be 'strategic resilience'. 'Autonomy' implies isolation or protectionism, which is the wrong approach to take. Indeed, the participation of global firms in the EU system brings competition and market depth, which is to the benefit of EU clients. Specifically, the involvement of US financial institutions in the EU capital markets supports the EU's aspiration to diversify the sources of funding in the economy. Financial markets gain resilience and quality by strengthening their networks. The strength of a financial market consists in how deep and geographically diverse it is. The strategic resilience of the European financial market will come from being deep and globally super connected. To achieve that, it must be attractive to the global financial community.

The Chair observed that there are many definitions of the word 'autonomy' but, in his view, autonomy is really about the ability to make decisions without being controlled by others. It is not about openness but having the ability to choose to be open. In this way, excessive reliance can be seen as sacrificing a degree of autonomy.

1.5 Financing the green and digital transitions while remaining strong and resilient

An official considered the key question regarding OSA is whether the financial system has the capacity to finance the green and digital transitions. If the profits from green projects were guaranteed, these projects would attract financing from outside the EU. This is not necessarily a negative outcome. If American investment finances a hydrogen power plant in the EU, it is not possible to shut down the plant and move it to America. To some extent, it does not matter whether the financing comes from inside or outside the union.

An industry representative noted that OSA is relevant to defence, energy, food and some parts of the supply chain. In all these fields, the US is much more self sustaining than Europe. In view of the huge levels of public debt, achieving the desired level of autonomy will require a huge amount of additional funding. The financial sector will have to 'fire on all cylinders'. Capital markets and the banking sector both have to play a role. It will not be enough to rely on European internal funding; the EU will also have to attract funding from the 'new wealth' parts of the world. An open, diverse, competitive, accessible and easy to consume financial sector will be critical to achieving OSA in all sectors.

2. The need to boost capital markets in Europe

2.1 Tackling the obstacles to investment

2.1.1 The development of funded pension systems is a prerequisite for CMU

An IFI representative opined that the EU has not completed its work on the financial capital markets. There is a continued over reliance on banking. Europe lags behind the United States and Asia in terms of capital market development. In 2023, Europe represented 10% of the global capital market; in 2006, it was 18%. Europe accounts for 14% of the world economy. There is clearly a gap here. There is a question about should be done and at what level.

One of the big issues is the use of savings and the incentives to move into long term products. This is largely in the hands of national governments because it is contingent on the organisation of the pension system. Pensions are the most important vehicle for long term investment. The countries with strong pension systems have a greater long term investment capacity. In other words, insufficient long-term capital is a critical issue. The average ratio of pension assets to GDP in Europe is 32%; in the US, it is 173%. This is further distorted by the concentration of 62% of all EU pension assets in the Netherlands, Denmark and Sweden. The systemic development of funded pension systems is a prerequisite for capital market development. The EU can help, but this is a national issue.

2.1.2 Addressing fragmentation in the capital markets: the consolidation of the Baltic market might provide a template for CMU

An IFI representative considered that there is also huge fragmentation in the post trading infrastructure in Europe. There are nearly 18 central clearing counterparties (CCPs) and 22 central securities depositaries (CSDs). This is contributing to increased costs and a lack of competitiveness in Europe. The rationalisation of CCPs and CSDs is a key priority. The Giovannini report identified 15 barriers, but after 20 years only five of them have been solved. This is a long term issue, but this seems like an excessively long time for reform implementation.

The EBRD has sought to help countries join and aggregate, particularly in Central and Eastern Europe and the Baltics. This type of consolidation can happen on a regional basis. The development that took place in the Baltics has been a big success and shows that the goals of capital market union are achievable. Index providers now evaluate the Baltic region under a single index, largely because there is one trading platform, a common CSD and reasonably aligned laws and regulations. This has improved liquidity and been beneficial for the region. But it also required the willingness and strong cooperation and commitment of the political leadership.

2.1.3 Making a difference for issuers and investors

An industry representative emphasised the importance of taking a disciplined approach as there is much to do. The key focus should be making a real positive difference to end-users who make the market: issuers and investors, rather than infrastructures. Supply does not create demand. Strong prioritisation and an outcomes-driven approach is needed in order to define what is truly needed and what is only desired. First, there must be a targeted approach to turn companies that today are borrowers into issuers. This will require a consideration of listing rules, governance rules and insolvency law.

Secondly, savers today should be encouraged to become investors. Financial literacy and culture will be very important in this effort. Capital markets in Europe should be seen as a force for good. Tax coherence is another key priority. It will be difficult to foster the capital markets when savings products receive a more favourable tax treatment than investments.

It is important that the analysis of Europe's markets is fact driven. By way of example, thefive largest national CSDs in the EU account for 83% of assets under custody; if the two international CSDs (ICSDs) headquartered in the EU are added, they represent over 90% of assets under custody. So references to fragmentation in the CSD sector, which some commentators have noted, need to be considered in this context.

The Chair noted that discussions about progress over the last 20 years raises the question of whether the glass is half full or half empty. However, it might be more useful to think about the quality of the glass. While the EU has made good progress, some of it might not be robust and may not be as effective as hoped.

2.2 There cannot be a fully integrated CMU with a fragmented banking union

An industry speaker stated that the primary requirement for strategic resilience is a single and deep financial market. To attract investors and investment in the financial sector, there must be a CMU. There is a new impetus to speed up the CMU project, but there cannot be a true CMU without a banking union. 10 years ago, banking union was the low hanging fruit; it is now much further away. The capital markets are complementary to banking. There cannot be a fragmented banking union and a fully integrated CMU.

An official agreed on the importance of discussing the connection between banking union and CMU. Banking union appears to be low hanging fruit because it could be regulated into existence; this is not the case for the CMU. The three pillars of banking union were established very early on, but there are no pillars for capital markets union. There are action plans and expert reports with many different components. There is no obvious endpoint to the CMU project.

2.3 Relaunching securitisation is an essential bridge between banking union and CMU

An industry speaker highlighted the importance of securitisation. Securitisation is one of the routes of transmission between banking and capital markets. Nobody wants to return to the old products that contributed to the global financial crisis (GFC), but securitised products are a necessary part of a well functioning capital market and banking union. Without progress on securitisation, the EU financial market will not be sufficiently attractive to institutional investors. Securitisation is one of the main instruments through which risk can be efficiently distributed and diversified across many agents in the economy. The CMU needs both banking union and well engineered securitisation

2.4 European banks face many supervisory constraints

2.4.1 Incentivising banks to finance investment

An industry speaker agreed that the financial sector's contribution to OSA will require a very large amount of money. Indeed, bank lending, securitisation and the capital markets will need to 'fire on all cylinders'. The banks will play a crucial role in providing this additional investment. Banks must be incentivised to lend in order to finance investment; they need to be able to securitise what they have originated and create a securitisation market; and they play a key role in the capital market. In the US, banks are originating and distributing products to meet investors' needs. They are ensuring liquidity by offering market making services, warehousing products, derivatives and securities lending and borrowing.

2.4.2 Defining the optimal level of bank capital: balancing financial stability and banks' ability to finance the economy

An industry speaker noted that the European banks are hampered by a number of capital and supervisory constraints. This goes back to the traditional question about the optimal level of bank capital. Capital requirements increase financial stability but limit banks' ability to lend and participate in the capital markets. There is a balance to strike here.

In 2008, the Common Equity Tier 1 (CET1) of banks in both the EU and the US was 6% to 7%. This was clearly not enough. In 2014, CET1 in both the EU and the US was around 12%. A 2016 study by the Bank of International Settlement (BIS) concluded that a capital requirement of around 10% provided the optimal balance between limiting annual growth and avoiding financial crises. Currently, the average CET1 of the large US banks has stabilised around 12%. The average for the Single Supervisory Mechanism (SSM) banks in Europe is currently 15.6%. This 3% gap equates to €250 billion of capital, which is the equivalent of €2 trillion of risk weighted assets and €5 trillion of loans. Over 10 years, this roughly equates to the €500 billion of investment that is needed over the coming years.

The growing capital requirements have produced greater financial stability, but there is a question about whether requirement increases should continue. As the European Banking Authority's (EBA) stress test exercises have shown, European banks are now extremely resilient. If the EU banks are above the optimal level of capital, it might be appropriate to prioritise funding for growth and for the green, defence and digital

transformations over further capital requirements. The EU financial sector has all the necessary ingredients. Europe has an extremely high level of savings. The level of excess savings is also very high. These savings must be channelled into investment. The banks can facilitate this, if they are allowed to do so.

The Chair observed that it is legitimate for policy discussions to pivot towards growth and competitiveness, but it is important to remember that the financial system only benefits the economy if it is stable. If it is unstable, it has a negative effect on the economy.

2.5 Rethinking the CMU approach

A public representative emphasised that good progress has been made on banking union. The SSM and the Single Resolution Board (SRB) are functioning properly. National deposit guarantee schemes (DGS) are working well. With crisis management and deposit insurance (CMDI), the Commission has outlined a way to overcome the problems in the third pillar. Hopefully, it will soon be possible to complete the project.

However, there are many goals to achieve on CMU. It might be necessary to rethink the approach to the project. Until now, there have been several small pieces of legislation, such as the Listing Act or the European Single Access Point. This might not be the right way to complete the CMU. The experience with EMIR 3.0 was disappointing. The Parliament tried to find a way forward. In the next legislative term, there should be more engagement to develop a comprehensive roadmap or way forward to overcome the problems with EMIR 3.0. This is nitty gritty legislation; there seems to be a lack of real engagement and commitment.

An official noted that the Eurogroup's four workstreams on banking union were an attempt to be smart and comprehensive, but it proved politically impossible to overcome the issues. Hopefully, this issue will be picked up in the next institutional cycle, perhaps by addressing it in smaller pieces. That might be the right strategy for CMU too: it might be more useful to find specific measures that will have an effect on the ground instead of producing broad plans with a lot of smaller measures. Indeed, the top down and bottom up elements could be combined. In some areas it is preferable for measures to be taken at EU level, such as the harmonisation of insolvency frameworks or tax incentives. In other areas, national authorities can react to and reflect the specific bottlenecks that exist on the ground. Ultimately, there are still 27 separate capital markets in the EU.

An official described how he had previously considered CMU to be the low hanging fruit. After entering government, however, it became clear that this was more difficult. There is no alternative to creating a globally competitive CMU. There is a need to finance the green and digital transitions and the defence sector. Currently, the European defence market is very fragmented, Given the present and geopolitical challenges that might emerge after the next US election, there is little time to address the issue. It is important to look more closely at the defence sector. There are good defence companies in many member states, but there is a need to create the right environment and to support the creation of value claims in Europe that will be globally competitive. The EU needs to engage the defence sector in the right way. The financial markets seem willing to make these investments, but this will require a well functioning CMU and a well-functioning defence market in Europe.

The Chair stated that he had three concluding comments to make. First, while the need for strategic autonomy may seem to be more urgent in food, energy and defence than the financial sector, any reliance on a supplier involves reliance on the regulatory and supervisory decisions taken in that supplier's jurisdiction. This is acceptable in finance if the international rules based system holds but this cannot be simply taken for granted.

Secondly, it is not possible to legislate banking union into existence. It is possible to put in place the third pillar of banking union, but the objective of banking union was not simply to create a Single Resolution Board or a European Deposit Insurance Scheme (EDIS); it was to create a properly integrated banking system. Even if EDIS were put in place, it would not necessarily have that effect. Too often, banking union and CMU are seen as vanity projects of Brussels. However, this is not the case and he real aim of these projects is to drive the direct and indirect financing of the economy and to strike the correct balance between those forms of financing as the economy transforms for the 21st century.

Finally, there is a trade off between openness and autonomy and a trade off between the EU level and the national level. If the wrong balance is found, there will be 27 well developed but separate markets, none of which are able to compete globally. The EU will not be able to be strategic if that occurs. In thinking about being open or autonomous and being EU or national, it will be important to think strategically about how to find the right balance. It seems probable that there will be a panel on OSA at the next Eurofi conference because the topic is not likely to go away any time soon.

Fostering long-term investment in the EU green and digital transitions

Introduction

Several points emerged from this discussion: Despite the implementation of NextGenerationEU (NGEU), investment remains very weak in Europe. The right way to restore competitiveness is supply-side economics, not tax policy. Rewarding risk-taking, encouraging equity financing, developing European projects financed by European companies, tackling the skills shortage and the high cost of energy are all essential elements. In addition, carbon pricing and the EU carbon border adjustment mechanism should give the right incentives for sustainable investment in the EU and beyond.

1. Despite the implementation of NGEU, investment remains very low in Europe

1.1 Investment in Europe is hampered by our collective preference for an ever-expanding set of norms to tackle the future

An industry representative stated that European measures have been quite effective during Covid. The EU's measures protected the economy during a major contraction and facilitated a rebound. Today, public finance measures focus more on public financing gaps or worthwhile social goals than solutions to economic underperformance. There is an aggregate private savings surplus and the financial means to act in Europe without taking on more debt.

The EU measures do not address the right issues. Indeed, there is a collective preference for standards over risk-taking.

European citizens are mainly risk-averse, so a limited fraction of their savings is allocated to risk capital. To make matters worse, a significant share of the savings they allocate to risk capital is allocated abroad.

Several additional key structural elements explain the low equity stake of EU citizens in their domestic firms. First, the way individual savings are funnelled in Europe leads to underinvestment in equity. The pay-as-you-go pension systems common in much of Europe rob EU firms of a major source of funds, while in the US individual pension savings such as 401(k) or ERISA accounts provide equity funding to the domestic economy. Where pension funds are set up in Europe, prudential constraints skew their allocation away from risky assets.

The recent introduction of the pan-European pension plans (PEPPs) has been ineffectual. In France, the situation is aggravated by the use of with-profits life insurance products as all-purpose investments and savings vehicles. Their capital guarantees and the Solvency II prudential requirements ensure that a large fraction of the monies invested go to sovereign credit and bank refinancing instruments rather than equities. The preferred alternative financial investment vehicles offered to French investors are regulated savings products with fixed returns used by their government to finance dirigiste social policies. In Italy, the investment return, reduced taxation and ease of subscription make domestic sovereign debt the financial vehicle of choice.

The labour force is another issue. There is a contracting working age population across the Eurozone. The numbers of available workers and hours worked are declining. It is difficult for regulatory or cyclical measures to address a context in which fewer skilled workers are working fewer hours.

1.2 NGEU making a real difference on the ground is contradicted

The recovery and resilience plans are already making a real difference on the ground

A policy-maker noted that NGEU is an unparalleled solidarity initiative that includes the Recovery and Resilience Facility (RRF). The purpose of the RRF is to support the EU's growth strategy towards a greener, more digital and more just economy. As part of the initiative, all member states were required to bring forward recovery and resilience plans, including possible reforms and investments. The strategy will be fully implemented by 2026.

The European Commission has adopted a communication relating to a mid-term evaluation and review of this initiative in an effort to strengthen ambitious reforms and investment. Labour market and education system reforms are particularly important in reskilling and upskilling workers to take advantage of new technologies. Some reforms will help reduce red tape by digitalising public administration and reducing bottlenecks. Reform is also key in creating the right business environment for companies to grow and attract investment. The RRF is made up of more than €700 billion divided into grants and loans. More than €250 billion of this investment is dedicated to the green and climate strategy. More than €150 billion is allocated to the digital strategy. Implementation by 2026 will not only provide public funding but create the right environment for companies to grow. In many member states, the use of financial instruments will be key.

In the RRF, member states have begun to implement real and transformative structural reforms to address country-specific recommendations. This is a key method of building the trust that investors need, but it is not the only factor. There must also be the right incentives, with

the addition of public money crowding in private investment, to ensure that public money is not solely going towards paying public debt. There is now a political agreement between the Parliament and Council on the economic governance review. New rules will enter into force by the middle of the year and reforms remain crucial. Private investment only comes when there is the right regulatory system in place.

1.3 Productive investment in the EU has not caught up despite the pay-out of one quarter of RFF funds

An official observed that the initial objective of NGEU was to close the growing gap between north and south by increasing productivity through investments. The increase in productivity is yet to be seen, though this does not mean it will never come. If NGEU meets its goal and creates a level playing field in terms of productivity, this would be a 'game-changer'.

The discussions about making NGEU permanent represent the opposite of the strategy's goal. The EU does not want a permanent subsidy mechanism, but rather to foster productivity. One problem is the lack of success in crowding in private investment. In a regular economy, private investment is significantly higher than public investment. In the EU, the shortfall from private investment can never be made up with public funds. Structural deficiencies and problems with the ecosystem must be addressed. The typical European approach is to address such deficiencies with public money, which does not lead to as large a multiplier as expected. Fiscal rules were suspended for three years during the pandemic. Even after three years without rules, the multiplier and increased productivity from investment was not seen.

In addressing the fallouts from the pandemic and advancing the green transition, the EU has fallen victim to the erroneous belief that public spending can undo structural deficiencies. Structural problems can only be resolved by structural measures. When RRPs were rushed through the Council, reform efforts relating to the green transition appeared disappointing overall. Many of the so-called 'RRF reforms' are in fact preparatory laws for investments. The positive assessment of RRPs has reduced the pressure to go beyond RRP reform agendas.

The Chair noted that the strategy is estimated to create 1.4% additional growth in 2026. It is important to consider what would have happened in the EU had a certain policy not been in place. NGEU is delivering on many reforms. Additionally, the public administration is changing the face of many member states, with EU public procurement rules helping to create a more competitive market place and with modern public administration human resource management approaches, that will contribute to a better business environment (less bureaucracy, better service). Structural reform is being delivered. In terms of potential solutions and reforms, some parties are relatively positive, whereas others note that initially promising progress has been stymied. If the strategy advances productivity, there is no need for it to become permanent. This improvement in productivity may still come at some point.

2. Main priorities to address the obstacles to the development of productive investment

2.1 The right toll to restore competitiveness is supply-side economics, not fiscal policy

A public representative observed that Ursula von der Leyen promised a green deal. Joe Biden also promised to make a deal in this regard and in terms of investments. Four or five years on, the Inflation Reduction Act (IRA) has delivered somewhat on the green side, but the European Green Deal falls short of the deal that was promised. A mixture of both public and private money can solve the problem, but the bulk should come from the private sector.

During the current legislative session in the European Parliament, insolvency law has been dealt with and some money from government bonds released. Insurance companies might invest in electricity, hydrogen or CO2 sampling. There is often more focus on getting the support needed rather than taking action. First on the agenda is attracting private money and investment. Second in terms of solutions is a focus on the capital markets union (CMU). Some work has been done on this area during the current legislative period. The Listing Act is delivering in this regard. Long-term investment funds are delivering more effectively than previous iterations, though progress is sometimes stymied by the need for a political majority. The European single access point is a good idea, but there is more to deliver to create CMU. The notion must be further developed. Variety is the benefit and added value.

The IRA discussion is unnecessarily limited to the amount of money invested in the US. New funds should not be created in Europe as long as it remains unclear how to refinance NGEU. The 'next generation' in question are required to finance the strategy but have yet to see its benefits. The figure of additional growth is mentioned clearly in the RRF, as well as NGEU itself, and there is certainly room for improvement in this regard.

At the recent Munich Security Conference, the German Chancellor was asked why Germany was not performing as well as it might be economically. He referenced the high numbers of employed people. However, the total hours worked are the same despite a higher level of employment. The private sector must be given incentives to invest in new technologies. The focus must be on the digital transition as well as the green transition. It is impossible to achieve these goals when hardware is made in Asia and software in the US, while Europe makes only the data protection and regulation. This adds value only for lawyers and consultancies.

A market expert added that the sooner public finances are brought back to order, the sooner states will regain the leeway they need to invest. Over-indebted member states must also revise the composition of public spending and carry out supply-side-oriented reforms to reinforce their production system. Success in achieving long-term investment in the green and digital transitions will be achieved through a genuine industrial policy,

replete with competitiveness, trust and remuneration of the investor. The current situation is a dangerous emergency, not only due to American competition, but because of shocks from China and beyond.

2.2 Rewarding risk taking and developing European projects financed by European companies

A market expert stated that long-term investment incurs risk and demands the immobilisation of resources in the long term. Risk-taking must be rewarded; otherwise, private savings will remain liquid, and the incentive will be lost. Progress also needs to be made on CMU. More savings should be allocated from the north to the south, and this is a matter of trust.

The context has changed in a very short space of time. With shocks and a complicated geopolitical situation, it is uncertain whether inflation will start again or remain for longer than expected. The available instruments are implemented too slowly. The IRA is dangerous for European economies and has already had an effect. Projects can be financed in a short timeframe as long as local conditions relating to the assembly line or raw materials are accepted in line with US terms.

Strategic investment previously present in Europe has been changed or removed, and competition is intense. The first goal must be competitiveness; the second is trust. There is general agreement on the supply-side policy and there are instruments, such as Important Projects of Common European Interest (IPCEIs), that might allow quicker movement in this regard. Projects in hydrogen and batteries have already followed this strategy, but there must be an overarching industrial policy to allow European authorities to interact directly with companies. Success in this area requires significant investment and strong leaders in the private sector, and there are too few companies willing to be investment champions. Protectionist measures could be considered in certain sectors. Although this runs contrary to the traditional approach, this is an emergency.

The Chair commented that competitiveness is an ongoing theme at Eurofi. One way to achieve this is through industrial policy. As there is no silver bullet, it is beneficial to consider the effectiveness of various measures.

2.3 Encouraging equity financing

An industry representative pointed out that there are developments in private, public and retail money in the Nordic and Baltic regions. Since 2017, Nasdaq has brought over 255 technology companies to market and helped over 500 companies in the areas of renewable energy and biotech come to market in Sweden, Denmark and Finland. Over 30% of the flow of SME financing is from retail money, meaning that Nordic households are taking risks with their savings. This is done through intermediated savings and mutual funds. Financial literacy and education in the area of equity investment are important steps forward. It is also a matter of taxation. There are huge taxation benefits for keeping savings in equity, but the creation of tax incentives facilitates the bringing to market of founder-led, entrepreneurial European companies. Public money cannot finance the entirety of the transition, and this is a way in which private money can bring new opportunities to market transparently.

The question remains as to how to proliferate this across all European markets. CMU is a method by which the conditions for success can be understood. An environment must be created whereby people are encouraged to try and fail. This is already the case in the US.

In terms of sustainability, people around the world look to Europe as a global leader. Despite the propagation of red tape and the difficulties of geopolitics, a successful use of the single market and the ability to use policy will cement Europe's leadership in this regard. Carbon capture is not solely for new startups; it is also for existing hydrocarbon industrials to repurpose their investments. It is also not solely about reporting. It is possible to make money with engineered carbon capture systems. The facilities and investment are in place. Industrials and mining companies in the Nordic region are thinking about how to use technology and renewables to increase productivity.

2.4 Addressing the skills shortage and the high cost of energy

An official commented that, according to the EIB investment survey, the skills shortage is the key obstacle to investment in Europe. Only €55 billion from NGEU is flowing into education. Technological developments are driven by highly talented people, not by funds being moved around.

A policy-maker agreed that addressing skills shortages and supporting labour market participation is important. One reason for deficiencies in this area is the fragmented tax system in the EU. A single market in this area has yet to develop, primarily due to vested interests. There must be consideration of the alignment of interests between member states and companies in order to seek common good in the form of CMU.

There is much to do in terms of labour and upskilling. 50% of revenue in public budgets comes from labour taxation, including personal income and social security. This does not accommodate for getting workers to work more. 25% of revenue comes from consumption taxes, while another 7% comes from corporate taxation. It will be essential to reflect on the tax mix in the context of competitiveness.

An official added that another issue is high energy prices. The uncertainty created through muddled policies is the main reason why insufficient private money is attracted. At the same time as seeking investment in green energy production, energy subsidies have not been allowed to fully expire. This naturally leads to uncertainty on the part of investors. Equally important is the uncertainty around the future evolution of prices for renewables, combined with the ambiguity created by Russia still delivering gas to some corners of the EU. The EIB Annual Survey shows that uncertainty around future returns is a major obstacle to green investment. This is reinforced by subsidisation schemes, which blur the relation between costs and returns and undermine the level playing field in the single market. The distortion of price signals and competition in the EU energy market is a key obstacle to private investment, but policy-makers' attention focuses more on the US and the IRA.

If you ask anybody, "Would you rather invest in a completely safe bond issued by the European Commission, paying 3% on a 10-year bond' – at the moment – 'or invest in a risky solar power project somewhere, where we do not know the energy price in 10 years, because we do not know what the subsidies may be or the access to the grid may be?'" You do not invest in the project itself, but you invest in the bond that the Commission issues. There is no better way to explain crowding out by the public sector.

2.5 Carbon pricing and the Carbon Border Adjustment Mechanism (CBAM) support long term investment needed for green transition

A policy-maker observed that there is success on the green agenda in terms of carbon pricing. This is one of the market-based instruments utilised in Europe. It is not a regulatory, prescriptive instrument. Incentives are given to the market in terms of CO2 pricing. Work is ongoing at the global level under the umbrella of the OECF IFCMA, to find common grounds on decarbonisation policies. CBAM has been created to incentivise companies to pursue sustainability when exporting to Europe and to incentivise countries to adopt carbon pricing. The first step is to convince countries to have some level of carbon pricing or tax, following which it can be gradually increased to an adequate level.

Market-based incentives are working, although it took time for this to become evident. 15 years ago, carbon capture and storage (CCS) was the strategy of the day, with €400 million allocated. After five years, the money was given back to the budget due to a lack of action. Now, private companies in heavy-industry sectors are seeking to invest in different CCS plans and technological solutions. The innovation fund is worth €3.4 billion and energy-intensive industry appears to be taking the idea seriously. One of the largest companies in South Korea has observed that BMW, a private company, already has stricter standards for aluminium production than the EU.

There must be an effective balance struck between regulatory instruments, market-based instruments and tax incentives in this area. The IRA poses several challenges. In Europe, there is a significant focus on subsidies. Tax credits are offered in some countries, but there is a fragmented market. It might be possible to work more on transferable tax credits or accelerated depreciations alongside structural reform efforts.

2.6 Adding protectionism to European public debt is not the correct way forward

An industry representative stated that adding protectionism to European public debt is not the correct way forward. Even in the form of import duties or a carbon border tax, this confuses promoting worthwhile social goals with the pursuit of growth. Part of the solution will be upskilling the labour force. The past 50 years of indiscriminate migration from failed states outside of Europe does not work economically or socially. In the coming election, it will likely become clear that it also does not work politically. A possible route forward is enlargement, bringing more workers to Europe. The next Commissioner must be dedicated to streamlining rather than adding to regulation.

The Chair summarised that there is a broadly convergent view on the objective of regaining competitiveness. The strength of Europe is in its economy. The organisation must be convincing in its economic terms, with competitiveness at the centre. The divergence in opinion is on how to regain this competitiveness and what its purpose should be. Innovation is an important element and there are a variety of policies under consideration, from capital markets to taxation and subsidies. Much has been achieved already and there is more to do in the future.

Global financial and regulatory fragmentation

Introduction

Financial fragmentation is unavoidable at the global in certain areas, but the real economy relies on a well-functioning financial system. It is therefore important that fragmentation is minimised. The first round of this discussion shows that financial fragmentation across the world is increasing, explores the reasons for this evolution and focused on its negative consequences. The session is then dedicated to solutions to address this key concern and the essential role of supranational institutions in this respect.

1. Financial fragmentation is increasing and has many negative impacts

1.1 The policy areas lack common structuring frameworks

An industry representative noted that the lack of common structuring frameworks is evident in the areas of sustainability and new technologies, where policymakers are regulating the space without the coordination previously seen in policy discussions, such as cross-border payments and banking resilience. This becomes problematic in the area of sustainability due to overlapping and contradictory requirements across jurisdictions, which risks hampering the rapid scaling of sustainable investment and channelling of capital to where it is most needed. The increasing reliance on extraterritorial clauses in certain jurisdictions can also create a potential conflict of rules.

In the area of new technologies, there have been a proliferation of different regimes, which differ by taxonomy, focus and timing. This does not make for a level playing field and increases the potential for regulatory arbitrage. In parallel, there has been the emergence of uncoordinated national restrictions on the cross-border flow of data risk, which impacts the capacity of regulated firms to deliver consistent services. This potentially inhibits the creation of an open environment that can fuel innovation.

In the current complex geopolitical environment, there is an additional concern that this trend could accelerate due to competition across different financial centres. Prudential regulation, sustainability, new technologies and increasing regulations in data will be impacted.

An industry representative agreed that sustainability regulation and reporting requirements is highly fragmented due to the implementation of frameworks by jurisdictions in advance of agreement on an international standard. This has reduced the positive impact of environmental, social and governance (ESG) frameworks as financial markets are less efficient at pricing climate related risks and opportunities, while firms operating globally face significant complexities and costs. It is important that the reporting standards now approved by the International Sustainability Standards Board (ISSB) are applied consistently in order to reduce fragmentation.

Another example of fragmentation is the implementation of Basel III. We continue to observe inconsistencies in implementation, such as the approach to risk-weighting unrated corporates. This is results in an uneven playing field and decreased comparability of capital ratios across banks, to the detriment of investors, while increasing operational cost and complexity for international banks.

Fragmentation can negatively impact the banking system's overall resilience, whether because certain risks are unaddressed, or due to harmful regulatory arbitrage, including where jurisdictions decide to go over and above international standards.

An official observed that there are parts of the sector in which it is not always the big jurisdictions that matter. In some areas such as crypto, some of the most important jurisdictions are relatively small. Jurisdictions will need to compare their regulations and decide whether they are similar enough in outcomes for cross-border business to take place.

1.2 Financial fragmentation is the result of many factors

An industry representative stated that there is currently an increase in financial fragmentation and regulatory divergence across the world, partly driven by challenging geopolitical and macroeconomic contexts. Regulatory divergence can be the result of many factors, such as different national financial systems, different policy choices by governments, diverse supervisory approaches taken by authorities in their local jurisdictions, and different local legal structures. Some regulatory divergence is inevitable, and arguably desirable, given specific local conditions. The fundamental question is where fragmentation is inevitable, and where it can be minimised.

An official commented that the fragmentation in recent years is not surprising. After the global financial crisis, various things were brought into regulation that had not been regulated before. There will never be identical rules in any given jurisdiction due to different political processes and ways of rulemaking.

However, most jurisdictions are active users and active participants in multinational fora. From a UK perspective, these fora are the right vehicles to reach a common consensus on what to achieve and solve through regulation and regulatory change. The way to ensure we reach interoperability of implementation is via bilateral government-to-government regulatory dialogues which our independent regulators also participate in.

1.3 The negative impacts of financial fragmentation

1.3.1 The negative consequences weigh on the ability of multi-jurisdiction financial firms to provide efficient financial services to the economy

An industry representative explained that unwarranted cross-border regulatory divergence remains a key concern, as this can create financial and operational inefficiencies. This can lead to inhibition of cross-border capital or trade flows, additional cost for consumers, and lower financial resilience as diverging rules impact the ability to move resources when needed during times of stress. This can also lead to increased compliance, legal and reputational risk.

1.3.2 Increased financial fragmentation leads to further risk

An industry representative commented that financial regulatory fragmentation has increased and is a critical issue, particularly for the international banks. For example, a Japan-headquartered bank that operates in the EU through a subsidiary must be compliant with the rules of the EU, UK, US and Japan. Japan is now implementing Basel III on 31 March 2024, in full alignment with the Basel Agreement. The EU is now aiming for January 2025, and the UK and US are aiming for July 2025, and they have not fully finalised their implementation. This fragmentation impacts not only financial institutions, but also corporate clients in the private sector.

Each jurisdiction has its own direct domestic issues, and fragmentation will lead to further risk. The Capital Requirements Directive VI (CRD VI) is finalising its language for third-country branches, which will further restrict activity in the region.

From the perspective of the international banks serving multinational companies, regulatory harmonisation is the key to providing a quality service for European clients which need fair access to the open market, and diversification of their capital and liquidity.

1.3.3 Financial fragmentation has negative impacts on growth and jobs

An official stated that jurisdictions need to understand that fragmentation is a cost that will ultimately be borne by the real economy. This sector will absorb the costs and pass them on, which is bad for economies, jobs and growth. In following this principle, it will become important for jurisdictions to avoid duplicative and conflicting requirements.

2. Promoting greater regulatory coherence at the global level should deliver more efficient markets and lower risks to financial stability

2.1 Ensuring common structuring frameworks at the global level is more important than ever

An industry representative stated that today's major regulatory challenges are global and interconnected. Large international banks have to navigate this interconnection among the various jurisdictions. There is a strong awareness and shared interest in sound, competitive financial systems, and close cross-border work. The recommendations are no different to those that have been expressed in terms of strengthening international cooperation through appropriate bodies, interoperability across regimes, and reliance on regulatory tools to encourage comparability and consistency. In the discussion on strengthening international cooperation and a common framework, there is a focus on timelines, as seen through the Basel III implementation.

The Financial Stability Board (FSB)'s 2023 global regulatory framework for crypto-asset activities is based on the principle of same activity, same risk and same regulation, and it attempts to provide that regulatory baseline. The ISSB's global baseline for sustainability disclosures and its endorsement by the International Organization of Securities Commissions (IOSCO) is also welcome. Expanding the standard-setting exercise to new emerging areas, particularly in digital and sustainability, is desirable.

In terms of interoperability, the key is for local regulators to continuously review the broader impact of their regimes to ensure that local requirements are consistent and interoperable with global initiatives. This way, regulatory frameworks can communicate globally, despite those local specificities which are inevitable. This will help reduce hurdles and the cost of fragmentation in the absence of a high degree of rule harmonisation.

Greater comparability of local regulatory regimes should be encouraged through mutual recognition agreements and equivalence mechanisms.

An industry representative noted that each jurisdiction has to be protected and has its own uniqueness. However, some banks which conduct international operations desire a level field in which to compete. The gaps should continue to be monitored and efforts should be made to harmonise them.

2.2 Aligning AML, KYC and financial crime in a consistent way

An industry representative suggested that fragmentation is essentially linked to deglobalisation: financial markets are a reflection of what is happening at a global level. There is a strong effort within the financial industry to try to achieve coherence within the important areas, particularly prudential rules. Successive waves of sanctions have shown that sanctions authorities are becoming increasingly aligned. There will always be fragmentation, but the most important areas for convergence should be identified in line with the priorities of the international bodies, as new rules are formulated in response to the US regional banks crisis and the Credit Suisse rescue, alongside new developments such as on virtual assets, ESG, and non-bank financial intermediation (NBFI). Avoidance of fragmentation also depends on whether there is discipline in aligned implementation across key jurisdictions.

Basel III should be implemented in a timely and consistent way. The focus will be on ensuring strong

financial resilience and market integrity and upholding investor protection.

Developments such as advanced technology and data protection are not agnostic to the financial industry. Ideally there would be a single law, but this is not possible. The focus will be to ensure that services are offered to clients across countries in the most efficient way.

UBS and Credit Suisse operate in more than 50 countries. To merge the group entity of Credit Suisse into UBS AG, approval needed to be sought from more than 150 authorities in over 50 jurisdictions. This is an example of fragmentation due to international licensing, and there is often more than one licence per country. This is the cost of doing business, and thus it is important to be clear about the business that it is intended to undertake.

Solvency and overall financial stability should be harmonised as much as possible to help efficiency in global financial markets and trade flows. On the conduct side, there will always be an element of national discretion. In terms of financial crime prevention and investor protection, there is a need for greater alignment. The Financial Action Task Force (FATF) does a good job in terms of reviewing countries.

2.3 Supranational organisations have an important role to play in ensuring interoperability in regulations for third-party risk management

2.3.1 Delivering interoperability in regulations for third-party risk management

An industry representative explained that Amazon Web Services (AWS) is the world's most comprehensive and broadly adopted cloud. AWS offers over 200 fully featured services across a number of different industries, including financial services. Regulation is increasing in third-party risk management, but whether it is fragmented remains uncertain.

In the EU, the Digital Operational Resilience Act (DORA) will establish a category of critical third-party providers (CTPPs) from 17 January 2025. In the UK, the critical third party (CTP) regime will bring direct obligations on third parties from early 2025. The European region is close to finalising formal regimes for third-party oversight, but there are many initiatives in other jurisdictions including Singapore, Japan, India and the US.

The principles of DORA and the UK CTP regime are similar in identifying CTPs or CTPPs that might impact the stability of the financial sector, and then identifying and understanding those material service providers. AWS expects to be part of these new regimes. Whereas DORA has a detailed compliance approach, the UK CTP regime has an outcomes-based approach and leverages self-assessment. AWS is working to ensure it meets the regulatory obligations of both regimes internally.

There is a real opportunity for interoperability and coordination. This will support the many customers in the financial services sector who choose to use cloud for the operational resilience, security and other advantages in the use of third parties. The supranational bodies, such as the FSB, the Basel Committee on Banking Supervision (BCBS) and IOSCO will be key in this, but regulators will also need to meet the specificities of their own jurisdictions.

AWS provides its services on an industry- and location-agnostic basis. There have been measures from regulators that may impact this model, such as the European Cybersecurity Certification Scheme for Cloud Services (EUCS), but a mandate does not currently exist. Such a mandate would negate the benefits of having an international and cross-border operable cloud service.

2.3.2 The role of international standard-setters

An industry representative stated that AWS wants to see the establishment of an internationally consistent, proportionate and risk-based approach to third-party risk management. Multilateral fora can help put together some of those principles to operate.

The FSB published a third-party risk management oversight toolkit last year. BCBS is reviewing its guidelines for outsourcing in financial services which were initially been published in 2006, and the operational resilience taskforce within the International Association of Insurance Supervisors (IAIS) is also working on this.

Ensuring that all stakeholders have a role to play is important, and not just policymakers, financial institutions or potential third parties, but customers and consumers. It is in nobody's interest to operate within a bubble. At Amazon more widely, there is a leadership principle to say that success and scale brings broad responsibility. There is a role to play as an active participant via supporting dialogues such as Eurofi, but also more formal dialogues such as stakeholder groups and consultations.

2.4 Global regulatory standards should be simplified and more rapidly implemented

An industry representative emphasized that regulation usually reflects good intentions, but the overall process can become highly complex, which increases cost. An outcomes-based focus is essential, avoiding complexity and aiming to fix what's necessary in a timely way.

The purpose of virtual assets is to democratise the financial system globally in an unregulated world. This is reliant on trust, and trust will be brought about by regulation.

Part of the complexity in the process is that regulation takes too much time to implement. There needs to be a sound framework, but at the same time it should cover both regulated and non-regulated parties. This is true for virtual assets and ESG, where there is much delegation to the unregulated parties. The industry needs to constructively contribute and take an outcomes-based approach.

On financial instability, there are many open questions across stakeholders on whether too-big-to-fail works. There is divergence between the experts claiming it works and politicians which do not have confidence that it does, partly due to the use of technical jargon.

2.5 IOSCO sustains its efforts on promoting regulatory cooperation and effectiveness at the global level

The IOSCO Board Chair stated that IOSCO is a community of national supervisors across 130 jurisdictions, whose

members are in various capacity in charge for the supervision of 95% of the global financial sector. Whenever it has capacity for consensus, IOSCO becomes a powerful influence as it presents a strong message for political decision-makers in those 130 jurisdictions.

As example, IOSCO's is cooperating with the FSB, International Monetary Fund (IMF), World Bank and FATF to ensure the implementation of IOSCO's recommendation for the regulation of crypto and digital assets.

2.5.1 Addressing emerging risks arising from digital finance

The IOSCO Board Chair stressed that the laymen who play with Bitcoin do not know or care about international standard setting bodies, but they expect to be protected against market manipulation risks, and against fraud, which is the reason IOSCO decided to launch its journey on digital finance years ago. In 2023, IOSCO has been able to publish two toolkits with comprehensive policy recommendations for the regulation of Crypto and Digital Assets and for Decentralised Finance (DeFi).

A global approach was necessary as soon as possible as that is what people expect. The speed of its release should not be at the expense of safeguarding the quality of the decisions taken.

2.5.2 Implementing a global framework for sustainability disclosures

The IOSCO Board Chair explained that one of the key added values of IOSCO's work on sustainable finance is about the transparency and disclosures of non-financial information by corporates. Disclosures need to be useful to investors, to help them take investment decisions that are in-line with their ESG expectations. This will be a long journey and it will differ amongst the various jurisdictions. But what matters to me is that the train starts on time. Jurisdictions are subject to different realities, which they must take into account as they consider their journey. From IOSCO's perspective, we feel that interoperability between regimes is key to ensure the comparability of disclosures, but the process will take time to complete. Eventually, we expect that up to 130,000 companies will either apply, adopt or otherwise be informed by the ISSB standards. The work of IOSCO provides an answer to the risk of fragmentation.

2.6 Additional way forward

An official noted that the UK has recently signed a mutual recognition agreement with Switzerland with the idea of deference embedded into it. Deference is a concept that dates back to the financial crisis and is very possible to achieve, supported by robust assessments.

The UK also previously announced its decision to allow EU funds to continue to market from the European Economic Area (EEA) into the UK without any additional requirements, which is an example of genuine deference. One of the final hurdles will be on sustainability disclosures. There is a Financial Conduct Authority (FCA) labelling regime, and discussions need to continue on how similar the EU's regime will be. The ultimate objective will be that they are sufficiently similar to allow efficient cross-border business.

Monetary policy issues: lasting low interest rates, quantitative tightening

Introduction

The Chair kicked off the discussion by observing that inflation seems to be falling as quickly as it rose. He explained, the first part of the panel would reflect on the monetary policy journey we have been on since the global financial crisis and whether it offers lessons for where we are going. The second part would then focus on central bank balance sheets, the question of how large they should be in the medium term, and their composition.

1. Central banks reacted swiftly and appropriately during the past crises

A Central Bank official stated that there were good reasons for low interest rates during a time of very low inflation after 2008. There were also periods of stress in the market, most recently during the pandemic, when there was a need for central banks to calm the markets, which was done successfully.

A Central Bank official noted that it is important to act without hesitation when it is necessary. Side effects need to be taken into account and learned from. Zero lower-bound issues are likely to come up if there are a series of shocks. There have been a series of negative supply-side shocks, but the stronger the system on a structural basis the easier it is to overcome such shocks.

There might be instances when there is a push into negative rates. The time element does matter. One should avoid staying in negative interest rates for a too long period of time. Financial stability risks via say search for yield are likely to be built up not only within the banking system, but also outside the banking system, which is less regulated, so the crisis elements may spark much quicker. To improve traction of a single monetary policy in case of negative rates, a common fiscal facility would be beneficial.

A Central Bank official observed that the response of economic policies has been extraordinary because of economic shocks such as Covid and the Russian invasion of Ukraine. That had some negative consequences, such as on how the transmission of interest rate policy is working. Monetary policy transmission is working almost completely on the credit side, but not on the deposit side. Other factors such as structural changes in the economy also cause effects. Central banks are shrinking their balance sheets while keep a watchful eye on the transmission mechanism.

A Central Bank official noted that monetary policy has been successful overall. Conditions have changed; various shocks hit European economies and monetary policy has responded in a rather satisfactory way. The monetary policy that was pursued avoided serious consequences, such as bubbles. Countervailing measures were also taken, for instance, to mitigate the profitability erosion of banks excluding some bank reserves from negative interest rates. The natural rate of interest (r*) fell and was potentially negative. Central banks determine nominal interest rates, not real ones. The lessons learned are important for the future.

A Central Bank official observed that if r* is low then monetary policy easier might be pushed into negative rates. The structural strength of the European economy is extremely important, and monetary policy works within the confines of that. If growth potential is higher through structural reforms and closer integration such as single market in goods and services, then the r* is higher and there is much less risk of moving into negative rates.

2. Lasting real interest rates have negative consequences for the real economy and financial stability

2.1 Prolonged monetary accomodation has contributed to indebtedness, damaged productive investment and exacerbated financial vulnerabilities

The Chair recalled the ECB's long journey from the Securities Markets Programme to the initial three-year refinancing operations, negative rates and quantitative easing (QE), the pausing and restarting of QE in 2019, and then the pandemic.

A market expert stated that it is repeatedly said that inflation is abating, and interest rates are going to resume their downward trend. That is puzzling, because for more than 15 years the consequences of low or zero interest rates in real terms have ben experienced, as well as the well-established consequences of that situation: The financial system is dangerously weakened when interest rates are kept at zero in real terms for a prolonged period. Money has a cost, and excessive borrowing takes place when a central bank creates enough money to make people think its cost is zero. That borrowing is then invested in short-term placements, not long-term productive investments. Asset bubbles are created, which are a manifestation of inflation. Long-term very low interest rates disincentivise member states to undertake structural reforms which could boost potential growth.

People are waiting for the next fall in interest rates. But a re-establishment of lasting low interest rates, would be unfavourable. It is not favourable growth-wise, because it has been demonstrated that the more that is borrowed and the more that money is kept in short rem placements, the less is invested productively and the less growth and more unemployment there is. Periods of high investment in economic history have been accompanied by positive

real interest rates: the ecological and digital transition cannot be financed by money creation, but by long-term savings that need to be remunerated in the market. It is not up to central banks to set medium and long-term interest rates.

2.2 Persistently low interest rates may create asset bubbles and lead to a misallocation of capital

A Central Bank official highlighted the side effects of having very low interest rates for an extended period of time. Policymakers need to strike a balance at any given point in time, but it is a problem when there are very low rates for an extended period, as it creates the risk of excesses in the financial and real estate markets. If funding is extremely cheap then firms can be kept alive that should not stay in business. Care is also needed to not distort market signals too much. Central banks sometimes need to act forcefully by lowering interest rates and the cost of money, but it is preferable to do it in a way that makes it easily reversible.

2.3 Ultra-loose monetary policy created inflation, which central banks reacted to slowly

A Central Bank official noted that he had dissented on the forward guidance on the last round of QE at the end of 2021, as he could not see what the end game was of 'low for long' with uncertainty on inflation going forward and no private over-leveraging in the economy. If real rates are negative, then unproductive investment is encouraged: negative rates pushed the economy to produce investments with a negative risk-adjusted value. Europe is quite safe due to actions on the supervisory and regulatory front. The US had bank failures, inflation and a financial stability issue.

A market expert explained that 'low for long' could return, but it would be a mistake. There were two big rounds of QE. The first was ineffective in lifting inflation to 2%, there was no deflation risk but there was sub-optimally low inflation. The second round after Covid caused more damage, because governments printed 25% of GDP in terms of fiscal transfers, largely funded by an equal size expansion of central banks' balance sheets. That created a significant positive demand shock on top of negative pandemic supply shock. Excess demand caused inflation, which went up to 10%, with very little initial pushback by central banks. It took the US 12 months to recognise that inflation was becoming a problem, and it took a further six months to react.

In seven of the last 10 cycles of interest rates in the US interest rates decreased because the US hit a recession. In the other three the US did not hit a recession.US interest rates also typically declined when the US had financial stability issues. Rates have increased further than may have been needed because central banks were late and acted in a faster way, so they needed to push back harder against inflation. Going back to the old, 'not normal' situation would be inappropriate.

2.4 Extreme policies work much better in models than in real life

A Central Bank official noted that the review of the operational framework is currently being discussed and argued that probably no firm commitment should be taken. The problem with extreme strategies based on state-dependent commitment is that if things turn out differently than expected, then the outcome is even more extreme policies. Some form of proportionality is needed in the use of monetary instruments, in particular forward guidance. The cost of inflation to the population has been completely underestimated by central bankers, and the cost of low inflation has also been exaggerated.

A market expert observed that the usual adjustment of the rate hike cycle will take longer than any previous one, as this has been the steepest, fastest and most globally synchronised rate hike cycle in post-war history. Goods price inflation is down, but service prices still run at 4-5% inflation. Nobody expects inflation to be excessive, but there is a 25% purchasing power decline in the balance sheet of households. There will be broad demand that this money needs to be recovered through higher wages. The adjustment process is taking place mainly through adjustments of real wages and the biggest impact will be on the housing market. Going back to the 'old normal' would cause significant damage.

A Central Bank official agreed that there has to be an adjustment in incomes from the inflation rate and price level. Incomes and purchasing power must recover. Yet, caution is needed that income recovery is not spilling over into further price increases. There is no reason to return to the interest rates that were seen two years ago, as money is not a free good. There is also no need to rush into oversized rate cuts.

2.5 Central banks have become fiscal agents

A Central Bank official stated that fiscal policy and monetary policy should be separated. The euro area has the Outright Monetary Transactions (OMT) programme and the Transmission Protection Instrument (TPI). The actions taken during Covid were necessary and the de facto coordination with the fiscal response was welcome. But in the post-pandemic world, the rules conceived when writing the Maastricht treaty – that monetary policy should be able to operate without consideration for fiscal sustainability –, should apply again and it is not currently the case. The current situation is one of weak fiscal dominance. The fact that the euro area has OMT and TPI shows that it is not in a situation where it can completely abstract from the impact of monetary policy on fiscal sustainability.

2.5.1 Monetary policy and fiscal policy are both cyclical

In reflecting on the QE experience in terms of possible barriers for some future use of such policy, a central Bank official noted that when central banks embarked on QE the common thought was that it was uncharted territory. a great deal of money was deployed through purchase of trillions of government bonds and other type of assets with limited effect in terms of marginal utility of these type of the policies as regards targeted inflation rate. European central banks took a huge amount of the duration risk onto their balance sheets, and in the end that duration risk has materialized.

How the long period of low interest rates impacted different countries is also important. Having low interest

rates should help to reduce debt, but if a country responds by borrowing more and increasing its debt then it is being wasteful. It is the incentive of the country/government that really matters. Some countries have reduced public debt while others have increased it. Macroeconomic stabilisation and structural reforms worked well in program countries. Monetary policy and fiscal policy are important in managing the cycle, but structural policies are the ones that increase the potential rate of growth rate and can vary substantially from country to country.

2.5.2 A favourable 'snowball effect' can favour the resilience of our economies

A Central Bank official highlighted that central banks are operating in a much more difficult world environment compared to the past, due to issues such as fragmentation, geopolitical tension, trade wars, tariffs and the Middle East conflict. One crucial factor to look at is the difference between the nominal interest rate on debt refinancing and the nominal GDP growth rate, the so-called 'snowball effect'. as it contributes importantly to the stability (or instability) of public and private sector finances and determines whether there is going to be a soft or a hard landing. Central banks being independent does not mean that they should not talk to finance ministers.

2.5.3 Governments often postpone structural reforms irrespective of monetary policy

A Central Bank official noted that there is always some background situation that is detrimental to the pace of structural reforms. Many factors affect the preparedness and readiness of various countries to implement them, such as the overall political situation, the inclination of each government, the overall situation in the country, how aware the general public is of the problems, and how ready it is to respond to and bear the costs of the reforms. Monetary policy also plays an important part in the decision-making process. The long period of low interest rates and a generally very stable macroeconomic environment pushed away the desire for structural reforms. But the opposite can also be true as fostering a favourable macroeconomic and low interest rate environment increases the fiscal space for the implementation of structural reforms.

2.5.4 Monetary policy cannot help in the adjustment of the public sector

A market expert observed that the fiscal situation has deteriorated under the easy monetary policy of the last 15 years. There is currently a fiscal crisis. Some European countries have a lamentable track record on the effective deployment of public expenditures. Analysis of the effectiveness of fiscal expenditures over the last 15 years has shown a lack of effectiveness and a dearth of productivity gains.

Adjustment is needed in the public sector, because excessive inflation in that sector needs to be reined in. Monetary policy cannot significantly help in the adjustment of the public sector but can help in the sense that it should not provide free money, which is the big enemy of structural reform. A country can be deterred from entering into structural reforms if it is given free money. The key is structural policies and an adjustment or reduction in the size of the public sector.

Examining the balance sheets of economies, there is an enormous increase in passive assets. The traditional IMF view is to look at the net domestic assets, the NDA of a country, and if they are booming too much it can become the IMF's role to reduce them. Net domestic assets are too high in certain EU countries and have to be reined in. A sense of direction is needed, and not to rush back to the paradigm of zero interest rates.

2.5.5 Market dominance is also a concern

A market expert stated that the Group of Thirty recently wrote a paper that called for a certain degree of humbleness in central banking. The whole perception of central banks being the only game in town was a non-starter because central banks stepped in where they felt governments were slow or reluctant to do so. As was seen in the pandemic, when governments are forced to take responsibility with fiscal policy for shocks that hit the economy, they do so. Central banks are currently being pushed by markets more than by governments; the noise of commenting on central bank policy is currently coming from the markets, as they are now very dependent on central banks. Central banks need to prove their independence from both politics and markets.

3. Quantitative tightening: challenges and way forward

3.1 Quantitative tightening and central banks' balance sheets

A market expert stated that the balance sheets of central banks is a monetary tool that needs to be understood. Through QE, central banks have replaced the implosion of the interbank market by central bank liquidity. Central banks are reducing their balance sheets but there will be a difficult situation, because on the way up they provided massive liquidity when it was needed at no notice. On the way down, central banks are very slowly reducing liquidity, in a very predictable way, in order to not disrupt the market.

3.1.1 The Eurosystem's balance sheets could decrease to the $4 trillion to $5 trillion range by the end of the decade

A market expert noted that when he joined the ECB governing council there was a balance sheet of €780 billion, and it is now just under 10 times that. By 2030 cash will be up from around €500 billion to around €3 trillion. The central bank balance sheet cannot shrink to €3 trillion because it would be composed only of cash. Excess reserves will come down, but not to zero, because central banks have a much more core funding role in the financial system than they used to have due to the decline of the interbank funding market

Europe used to be a bank-based system. Through the various crises many other players got access to the central bank balance sheet, which can be seen with the

market funding programmes in the US Fed and the ECB. The central bank can never again completely step away from being such a central counterparty (CCP) in the markets. The assumption is that the ECB's balance sheet will be down to a range around €4 trillion to €5 trillion.

3.1.2 Central bank profit and loss should not affect monetary policy

The Chair then turned to central bank net income. He highlighted that the IMF has argued that central bank profit and loss should not affect monetary policy and asked if participants agreed.

A Central Bank official agreed that central bank profit and loss should not matter for the conduct of monetary policy, but the reality is that central banks have to bear it in mind. A period of sustained losses where equity becomes negative opens the way for risks that might undermine central bank independence. The euro system is currently in a good situation because it has over €700 billion of buffers. In designing an operational framework, the financial footprint and the risks on balance sheets should be as small as possible.

A market expert noted that central banks now pursue a bigger role then they should. They should focus on monetary policy. Central banks are pulling themselves back from being very interventionist in the market, which is the right thing to do.

3.2 Quantitative tightening should be gradual and should consider financial stability issues

A Central Bank official stated candidly that central banks do not know exactly what the optimal balance sheet size is. The relevant issues are being discussed in the governing council and a realistic approach is being taken. The crisis has taught us various lessons. The Federal Reserve, for instance, has conducted open market operations using US Treasury securities for many years. Hence, it is not clear why some people in the Eurosystem react adversely to having a structural bond portfolio for liquidity management purposes. Appropriately, decision making should be characterised by gradualism and flexibility, ensuring that banks have access to liquidity, and delivering a smooth transition.

The Chair asked panellists if it is a problem that central banks have morphed into risk-free central counterparties, replacing the interbank market.

A Central Bank official noted that it is a potential problem that market forces are not pricing to risk. An effort should be made to have unsecured money markets operating in the way that they should. There should not be an expectation that the adjustment process is somehow to be over. The impact of higher rates has not yet been fully seen and the withdrawal of liquidity provided by central banks is gradual but ongoing.

A Central Bank official added that a too large balance sheet with ample excess liquidity sustained for a too long a period of time can cause problems, so the plan is to reduce it. Due to operational and strategic issues the level has not yet been decided. Monetary policy has to be agile in order to boost the balance sheet and to be consistently quick in reducing it to reduce unwanted harmful side effects and allow for future expansion of the balance sheet when new negative shocks hit the economy.

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Basel III implementation: global consistency challenges

1. The Basel 3.1 internationally agreed standard is being implemented to addressing weaknesses in the calculation of risk-weighted assets

The Chair stated that this is the third phase of post-global financial crisis (GFC) reforms. Two previous tranches have been successfully implemented. The quality and quantity of regulatory capital held by banks was increased, which was a critical step in fortifying the financial system. New requirements were also introduced for leverage and liquidity. Several jurisdictions are now at the threshold of implementing the final phase, and completing this phase is vital to fully realising the benefits of the other phases. Strengthening the accuracy and consistency in calculating risk-weighted assets (RWAs) will enhance the credibility and reliability of banks' risk-based capital requirements and bolster resilience in the system.

A policymaker added that in addition to the importance of the standards themselves, it is also important for the credibility of international as the Basel Committee, the International Organization of Securities Commissions (IOSCO) or the Financial Stability Board (FSB), that jurisdictions implement the agreed standards.

1.1 Progress is being made on Basel 3.1 implementation but at different speeds across jurisdictions.

The Chair explained that the UK is an independent rule maker after leaving the EU and is implementing Basel 3.1 rules in that context. The UK has published its near-final rules on many aspects of the reforms, such as market risk, credit valuation adjustment (CVA) and operational risk. The second near final policy statement is due Q2 2024, which will cover credit risk, the output floor, and other issues. Other jurisdictions are at various stages of policy development and implementation. There are going to be some differences in countries, in both the substance of the reforms and the timing. Those differences can be appropriate, especially where they reflect the specificities of local markets provided that the main thrusts of the Basel reforms are faithfully delivered.

An official noted that it took almost five years for the bill to be finalised by Switzerland's government, and Basel III will be implemented by 1 January 2025. Switzerland aims for a largely compliant implementation of Basel III, and has applied the rules to all its banks. Significant negotiation with Swiss banks took place to find a way to not have overall capital go below the levels seen before Basel III was implemented.

An official added that the banking sector put a price tag of about 1 billion CHF on the implementation costs, but Switzerland is interested in an efficient use of Basel III. Another condition that had to be fulfilled was to be in sync with other major jurisdictions that are also international competitors with Swiss banks. Switzerland is examining other jurisdictions to see if they will be able to meet the deadline.

A Central Bank official stated that Basel III implementation has already happened in Japan. Japan's regulatory agency, the Japan Financial Services Agency (JFSA), conducted public consultation and finalised domestic rules in 2023, and carefully monitored development in other jurisdictions to pick up the right implementation timing. Japan's general implementation date will be March 2024. Japanese rules are consistent with the international agreement, and the full package is applied to internationally active banks.

A Central Bank official highlighted that Japan's early and internationally consistent adoption could put Japanese banks at a comparative disadvantage. Financial Stability Board (FSB) members have repeatedly expressed that Basel implementation is important, and they have a strong expectation that the full implementation will be shown in all jurisdictions. If Japan should need to reopen its issues through its domestic process, that would end up weakening the case for having a globally consistent framework. Japan has been encouraged by the positive development in Europe and the US, and can now take the full benefit of the post reform package.

1.2 The EU has agreed to implement Basel III from 1 January 2025

A policymaker explained that EU started the process relatively early and put a proposal forward in October 2021. An agreement by the EU co-legislators was reached in 2023, and the text is now being finalised. The European Banking Authority (EBA) is working through many of the technical details to prepare for the implementation. The application date is 1 January 2025, which is a strong signal that the EU wants to stick to the internationally agreed timetable.

A public representative added that an agreement was reached to keep the initial transitional arrangement proposed by the Commission, but with a clear deadline. The agreement now has a clear end date in the regulation where the transitional arrangements expire.

2. Adaptations to the standards were made to cater for specificities of European banking markets

2.1 Key policy objectives included the package being implemented in time and being as close to the recommendations as possible

A policymaker highlighted that in addition to implementing the Basel III framework, the EU banking

package has the rules around environment, social and governance (ESG) and the processes that banks must have in place to deal with ESG matters and transition plans. The legislative text is a faithful implementation of the Basel agreement. Some small adaptations were done to cater for specificities of the European banking markets. Transitional periods are in place, which will give European banks more time to adjust to some of the new rules. The EU applies the Basel framework to all its 4,500 banks, which is different to some other jurisdictions.

An official added that global consistency is vital, as well as a level playing for the Fundamental Review of the Trading Book (FRTB), the net stable funding ratio (NSFR) and other special regulations.

An industry representative noted that the agreement is not yet officially published, and the lawyer-linguists are still working on the final text. The final text is needed before private banks can implement it, and if it is published in April then private banks will have eight months to get everything up and running.

A public representative highlighted that institutions are aware of the proposal. The regulation contains transitional arrangements to let banks implement the new rules in time. The ECON and Parliament passed the proposal, and after the vote in the ECON Committee the EBA can work to develop the level two proposals. The EBA has already started its work to develop some technical standards.

An industry representative stated that more time had been given in the past. Japan and Switzerland are up and running, and the UK is slightly lagging. Nobody knows what will happen in the US.

An industry representative noted that the output floor transition accounts for around 33% of the implications of implementing the final text. For many banks the other 66% will be due to the 2032 transitional period for reduced risk weights for unrated corporates and residential mortgages. Lots of elements will be material for banks. The key question is around the EBA technical standards and they will evolve.

An industry representative added that the Commission, Parliament, Council and the authorities have been clear that the implementation date will be 1 January 2025. Private companies had hoped that the date would be postponed, but banks are working hard to get there. Some technical standards are also outstanding.

A public representative stated that the European Parliament's view has always been to deliver Basel III quickly in order to have the new package implemented in time. One of the primary objectives was to have an agreement after the trialogue, with enough time to implement the Basel recommendation in a timely manner. The second one was to have a European regulation that is as close to the Basel recommendation as possible.

A public representative added that there are some European specificities; Europe applies the same rules to every bank, which is different to other jurisdictions. That introduced a clear problem in the negotiation, as the profile of banks and the diversity of Europe's banking system is relevant and its role is wider than in other jurisdictions. ESG was another relevant issue during the negotiation. More needs to be done in climate risk; stability needs to be increased to control banking activities to reduce that risk.

A public representative explained that political agreement had been reached at the end of June 2023. In recent months there have been many technical issues that needed to be fixed before the final deal. The ECON Committee voted for the package in December, and it is now at level two regulations and level two proposals. The EBA can work with the decision, with the vote taking place after the ECON meeting. Everything will be ready to support the package in plenary in March or April, but much work needs to be done.

The Chair agreed that it is clear that regulatory authorities and the industry have much more to do to ensure the full implementation of the reforms in practice.

2.2 Diversity of bank business models, their implication on SMEs lending and the application of the international standard required adaption in the EU

An official stated that the EU strikes the right balance with Parliament, Council and Commission, because it has a very heterogeneous landscape. Germany has many small and medium sized banks, as well as large banks. The EU applies the Basel standards to banks of every size, which is a huge difference compared to other parts of the world. It is important to have transitional regulations. For Germany it was important that the adaptations for specificities remain transitional, with a clear end date.

An industry representative recalled the first impact study by the EBA in 2019, which showed a 'horrific' 25% increase on average. Already in 2016 there had been resolutions by both the Council and the European Parliament. The first resolution has been around no significant increase on average in the European Union, and the second has been around recognition of EU specificities. The five 'pain points' that were at the core of the company's lobbying were: unrated corporates and how to deal with the rating shortage; trade finance; residential real estate; securitisations; and specificities around the Emissions Trading System (ETS). Good solutions were received on ETS, securitisations and trade finance. The other items are manageable within the transition period.

An industry representative noted that the implications for banks in Europe are dependent on the business model and the degree to which credit risk is being calculated by internal ratings based (IRB) models. There will be common equity tier 1 (CET1) requirements. There are certain areas where not much preparation can happen, such as in residential mortgages and unrated corporates. Using IRB models for that type of exposure will result in significant implications. The transitional periods help, but it is now dependent on how it is going to be implemented with the EBA technical standards. A vital technical standard on disclosures asks banks to disclose fully loaded figures, beyond the derogations, until 2032.

3. The current US proposal maintains a dual system which applies higher standards to the largest banks with tailored proposals for smaller institution. The proposal does not permit the modelling of credit risk and has raised industry concerns around the impact on an international a level playing field, SME financing and securitisation

The Chair highlighted the strong theme of a desire for overarching consistency in implementation from panellists.

An industry representative stated that the US is having a very vocal consultation period. Pressure on the US agencies at the start of 2023 was around the dual system in place between the globally systemically important banks (G-SIBs) versus the regional bank model. Since the GFC regional banks have not had the same attention and focus as the G SIBs. A recalibration was not done as part of the Basel Endgame proposal for the G-SIBs that had already had a stress capital buffer and a standardised floor introduced. Since 2008 the capital reserves of G SIBs have grown from 678 billion to 1.1 trillion, and their average tier one ratios have moved from 10.2% to 13.6%.

An industry representative explained that there is significant US opposition to the current proposal, for both level playing field concerns and the more fundamental principle of capital being priced and sized relative to the risk being taken. In the US proposal there is no modelling of credit risk RWA. Investment grade RWA levels can only be assessed where companies have publicly traded securities, which is a big problem for small and medium enterprises in the US as credit availability and pricing is worsened fora part of the economy that does not have many other options.

An industry representative added that operational risk is calibrated based on a business indicator component which only looks at the size of the revenues, which reintroduces a large differential between the G SIBs and the regional banks. The US does not have a problem with Basel market risk, but the market risk charging for Basel on the G-SIBs has already been incorporated under the stress capital buffer and the stress testing framework. There is a double counting and overlap between what would be proposed and what is already in place for the G-SIBs.

An industry representative added that there is a credit conversion factor being introduced for the unused portion of retail lines of credit, which will lead to an effective risk weighting for credit card loans of more than double what has been observed through quantitative modelling. Inflation Reduction Act (IRA)tax credits that are being introduced to help fund a carbon transition would have 250% to 400% risk weights assessed for US tax benefits in limited liability companies under the Basel III end game proposal.

3.1 The regulatory process raises concerns

An industry representative explained that the US has the Administrative Procedure Act (APA), which establishes clear procedural requirements that apply to all federal agency rulemaking, including the Basel III proposal. As per the Bank Policy Institute comment letter, the Basel III proposal violates both the procedural and substantive standards of the APA because it lacks a sufficient evidentiary basis, ignores evidence, fails to explain the methodology and assumptions, and improperly fails to disclose underlying data and analysis from the public.

3.2 US implementation dates may have significant impacts on international banking groups

An industry representative noted that the difference in implementation dates both does and does not impact their company, as it conducts business in a significant number of jurisdictions. Their company is used to operating under multiple different jurisdictions and tailoring requirements on all of its calculators for relevant jurisdictions, but it will not change a long-term business franchise decision based on something that is a transitory difference such as the EU-UK six-month differential. The question is whether structural differences emerge or not.

4. Global consistency challenges are being closely monitored by different jurisdictions to avoid unlevel playing field issues

The Chair summarised that panellists agreed that there is a great deal progress and a long way to go, and that there is a great deal of consistency and faithfulness to the standards, though with some deviations. The UK has its own specificities that take into account the unique nature of the UK market.

A Central Bank official noted that the unrated corporates issue is a big issue in Japan. One of the more fundamental challenges for Japan is FRTB, whose implementation hinges on the assumption that other jurisdictions are doing the same thing, in particular how to deal with so-called non modellable risk factors. Discussing the existence of market data becomes much easier if all jurisdictions, including the US, also implements it.

An official explained that there are dangers if capital is not being put where the risk is. Basel III is a fundamental contribution to the stability of the financial market, but if it is not implemented consistently across the major jurisdictions then there will be no level playing field. There will also be a struggle for internationally active banks to comply with all the different standards, which will be hugely cost intensive. Switzerland has a fallback position, and in mid 2024 it will evaluate the implementation stage of its major competitors. Switzerland will closely monitor the Regulatory Consistency Assessment Programme (RCAP).

The Chair observed that, based on comments from panellists, from the EU perspective it seems like it is 'full

steam ahead', even if the US takes longer to resolve some of the discussions that have been mentioned.

A policymaker stated that conversations are ongoing with the US regulators in order to better understand where they are in the process and what the next steps may be. Discussions in the standard setting fora are sometimes complex. However, once standards are agreed, it is important for the level playing field and the credibility of the international processes that the rules are implemented by everyone. Transition periods are in place for topics such as low risk mortgages and unrated corporates to give banks more time to adapt. More generally, after an intense period of legislation, there is a justified and legitimate call for legal stability, predictability, and knowing the direction of travel.

A public representative added that the Basel recommendations need to be consistently implemented across jurisdictions. If the belief is that the regulations can reduce the risk of a future banking crisis then the competitiveness of EU banks will be better than others.

An industry representative was of the view that US G-SIBs are already capitalised in a manner that is compliant with Basel III capital level requirements. The US has taken a very different view on things like the RWA density compared to other jurisdictions.

An industry representative stated that more of a holistic view is needed around discrepancy of timelines. There are Pillar 1 and Pillar 2 capital requirements, supervisory requirements around the use of internal models, and implications on capital requirements. It is necessary to bring all stakeholders together and consider the risk return profile and the underlying capital levels needed to deem the system as financially sound and stable.

An official noted that much work with the regulation was focused on financial stability. It is time for a legislative pause and to give time for banks to implement all the regulation. It is unlikely that there will be upcoming new regulation as a result of the Basel Committee report on the recent banking crisis.

Banking Union: how to break the deadlock?

Introduction

Beyond financial stability considerations, a genuine banking union is necessary because banks remain fundamentally unable to leverage the single market to the benefit of their clients. This has negative consequences for the economy: competition for savings remains largely national, opportunities to deploy capital where it can create the most growth are constraint, and lack of scale means European banks cannot compete in all aspects of global finance.

The Chair outlined that the banking union is in a deadlock situation, with numerous constraints and practices in the supervisory field that do not help progress. The session considered what measures could be taken to make progress and to overcome the lack of trust between supervisory and other authorities. The panel also considered the impact of digitalisation and other market developments.

1. A great deal of progress has been made but loopholes remain that make the Banking Union fragmented

1.1 Main achievements of the banking union to date

An official emphasised that banking union has been a successful story so far. It has provided economic benefits. The European banking sector is more resilient than in other parts of the world. This was demonstrated during the US mini-banking crisis in March 2023, when the EU regulatory framework and stringent Basel requirements proved to be the difference. However, the banking union is a long way from fulfilling its potential. Economically, the banking sector remains fragmented, and the expected consolidation has not happened Politically, the banking union has not yet attracted enough countries outside the eurozone. There are challenges relating to geopolitics and the transition, so the cost of inaction is high.

A Central Bank official observed that trust has been built in the system over the past 10 years. There is a sense of cooperation between the single supervisory mechanism (SSM) and the single resolution mechanism (SRM). This is particularly important at times of stress when it is necessary to act quickly.

1.2 The same risk carries a different capital requirement depending on where a bank is domiciled, due to the lack of harmonisation of macro prudential requirements

An industry representative stated that, in many cases, banks do not need new incentives; they just need to have the existing framework working. The purpose of the banking union is to have a transparent, unified, and safe environment for banks. A great deal of time has been spent on safety, but now that the economic environment has changed, more attention should be paid to transparency and unified rules.

Minimising political and regulatory uncertainties is key. Diverging macroprudential requirements across different jurisdictions is an issue faced by cross-border banks operating under a branch structure. National authorities can use a lot of discretion, leading to a scattered landscape with little predictability and an often-insufficient analysis of the overlaps between various requirements. On the microprudential side, there are many differences in interpretation. This is even more complex when banks operate both inside and outside the banking union. Even within the banking union, interpretations vary and there are additional local rules around privacy and conduct.

There should be further alignment between supervisors' division of responsibilities per CRD/CRR and the supervisors' practical say in banks' operations. Banks with operations in many member states face supervisory expectations to align practices at group level, while host supervisors may also prefer to extend a large proportion of their expectations to those entities. This makes operating cross-border banks increasingly complex.

1.3 Ad hoc taxes to the banking sector are a significant source of undue fragmentation

An industry representative emphasized that taxation is a very well-known source of fragmentation. The problem of ad hoc taxes has existed from the beginning. Currently, six European countries have windfall taxes; in four countries, a windfall tax is going through a legislative process; and five countries have made an announcement of some kind. Therefore, this is a material issue in about 15 out of 27 countries. Taxes vary in their design and scope. Some try to target extraordinary profits while also making contributions to specific goals. Some are a surcharge on new taxes, while some are completely new taxes. This is a clear source of fragmentation and contributes to the lack of banking union. The ECB has warned of the negative consequences for resilient capital, credit provision and market competition.

Finally, banks and the financial sector are subject to headwinds as well as tailwinds. The pandemic and future uncertainty is a reminder of this. All considered, there is a need for a fundamental rethinking of policy regarding windfall taxes to banks.

1.4 European institutions are tiny and much less competitive compared to their American counterparts

An industry representative commented that European banks have smoothly navigated crisis situations such as

Covid and the invasion of Ukraine. However, the market value of European banks has not traded above book value since 2014. European institutions are tiny compared to their American peers. The top 10 European banks combined do not match the market cap of the single largest American bank. In the long term, the industry needs diversification and scale to invest in order to compete with non-EU banks.

The Chair noted that the world outside the European Union is moving quickly. There are longstanding perceptions of a competitive disadvantage with US banks.

An industry representative observed that direct comparisons between the EU and US markets can be difficult. A recent ECB paper quantified the difference in return on equity (ROE) at 5% to 6%. One of the drivers of this is structural differences in the market. In the EU, there are challenges involving excess capacity. Differences in profitability also feed into the stock valuations, impacting capital retention capacity and financial stability. In sectors where there is truly global competition, there seem to be increasing economies of scale with strong US banks. An immediate action that the EU can take is to ensure that we do not shoot ourselves in implementing the fundamental review of the trading book ahead of global competitors. Overall, EU regulators should consider how emerging regulation will affect the global competitiveness of pan European banks.

1.5 The CMDI review is a step in the right direction, but more is needed

A Central Bank official stated that two-thirds of the architecture of the banking union are in place, but the last pillar - the European Deposit Insurance Scheme (EDIS) - is still needed. The proposal of crisis management and deposit insurance (CMDI) is a step in the right direction. There is reason to believe that the third pillar will be achieved, but even then, the banking market will continue to be fragmented. Countries have different macro contexts, bankruptcy laws, regimes and fiscal budgets. There is excessive complexity in the European regulatory framework, with multiple levels of capital. Uncertainty about regulatory evolution and messages from supervisors can lead to too much capital being held above the requirements. Supervisors do not like excess capital, which leads to suboptimal capital structures, lower profitability, low remuneration of investors and a lack of competitiveness in the banking sector.

The Chair stressed that, after the great financial crisis, it has taken 17 years to approve the Basel III standards. There are now 140 EBA mandates to further implement the rules. The challenge is to strike the right balance between waiting for regulations to be fully implemented while also needing to take actions to constrain undesirable business development and to preserve the safety and soundness of banks, in aforward-looking perspective.

On CMDI, combining all the available resources in national deposit guarantee schemes (DGS) and the single resolution fund (SRF) will provide the same available amount as in the US. It is not only an issue of funding needs. The problem is that these amounts cannot be used and result to be 'frozen' at the current stage. Some might argue that these funds can only be used for large banks, but there is no incentive for banks to continue to provide funding. This is where the CMDI could be beneficial.

2. Digitalisation will not be the gamechanger to break the deadlock

2.1 Digitalisation and technological innovation must be part of the bank's DNA in the way it does business

A Central Bank official stated that digitalisation is a priority within the SSM. A few years ago, the growth ambitions of retail banks were built on expanding branch networks and headcount. Thankfully, this is no longer the case. Digitalisation is part of how banks deal with their clients. There is the potential to scale up businesses when banks have good ideas, service propositions and platforms.

Digitalisation and technological innovation should also be part of how banks deal with information and risk management. Banks need to have good internal control functions dealing with third-party providers. This is an integral part of the assessment of the business model of banks in the supervisory review and evaluation process (SREP) carried out by the SSM. Senior management should have the skills and knowledge to deal with technological innovation and digitalisation. This is part of the fit and proper assessment for senior management.

2.2 All banks need to become digital, but regulation and differences in customer behaviour across member states make it more complicated

An industry representative commented that all banks will need to become digital in the medium to long term. In the short term, there is a distinction between cloud-native banks and other banks with more legacy items to digitise. For cloud-native banks, while it is relatively easy to provide basic banking services, more complicated products such as mortgages present a challenge. In theory, it should be easy to expand a digital business model across the EU, but regulation and differences in customer behaviour make it more complicated. Scale and profitability are needed in order to invest, especially in the current environment. It may not be as easy for neobanks to get funding for investments. If it is not possible to invest, there is the risk of a vicious circle.

An important issue to raise is the macroprudential element. The Commission's initiative to explore expanding the framework to fintechs and other entities is welcome, as instability in the non-bank sector has also impacted banking in the last few years.

2.3 Retail markets are different in EU countries. The more that compliance and GDPR rules are harmonised, the less optimisation banks will need to do

An industry representative stated that the distinction between a digital bank and a bric-and mortar bank does not exist anymore. Classical branch banks will no longer exist in Europe within five years. The market has moved quickly. But mortgages in some markets have

their own characteristic client behaviour and taxation, so fragmentation will not be easily solved. However, banks can scale in areas such as operations and IT if policy, regulatory and supervisory harmonisation is achieved. The more that compliance and GDPR rules are harmonised, the less optimisation banks will need to do. Fragmentation sometimes gives large banks a competitive advantage. Digital banks, fintechs and neobanks need to have scale across the eurozone, as they will not have millions of clients in a particular market. Harmonisation needs to work so that newcomers can succeed.

3. Possible ways forward

3.1 Top five to-do list for policymakers

An official outlined five key principles to achieve progress on banking union. Firstly, the political significance of banking union should be highlighted. Secondly, it is important to overcome the home bias or national concept. Thirdly, it is necessary to overcome the 'prisoner's dilemma'. Instead of competing within the banking union, with a lack of trust between member states, banks, regulators and EU institutions, banks and institutions need to be Europeanised. Fourthly, it is important to make use of the linkage between banking union and the development of the capital markets union (CMU). Lastly, a holistic approach should be followed. Progress is needed on the European deposit insurance scheme (EDIS), the Regulatory Treatment of Sovereign Exposures (RTSE), and on crisis management. Overall, there is a need for more speed, less resistance, and more honesty in discussions.

An industry representative agreed that a holistic approach is needed. Without a comprehensive solution, consolidation will not be triggered in Europe. There are small aspects that can be optimised in the short term, such as free flow of capital and liquidity among the banking subsidiaries of European banks. A single macroprudential policy across all European banks would also help. A European DGS system would be hugely beneficial, as this is one of the major components that makes M&A risky for banks. Banks should also diversify and limit concentration risk to sovereign bonds and, consequently, put an end to the sovereign bank doom loop risk. Lastly, it is important to ensure a credible liquidity backstop for resolvable banks.

3.2 There is a need for a rethinking of policy regarding windfall taxes to banks

An industry representative stated that windfall taxes are a pseudo-solution generating a real problem. One solution is to remove them. A second solution is to generate common criteria, guidance and coordination at the European level. Uncertainty and fragmentation affect investment decisions. Taxation impacts the possibility of obtaining the necessary scale to innovate and compete at the European and international levels. Clear rethinking on windfall taxes is needed, as this is already affecting some investment decisions connected to digital transformation and innovation.

3.3 National governments need to be neutral about how banks prefer to operate within the banking union (branch or subsidiary)

An industry representative commented that, when a bank is contemplating operating either as a subsidiary or branch model across the EU, the complexity of the landscape increases difficulty and unpredictability. There is no need for new regulation; the rules and the intent to have a unified setup are already there. National governments need to respect that spirit and to be agnostic about how banks prefer to operate within the banking union. This will lead to consolidation.

3.4 Improving the securitisation market in Europe remains challenging

An industry representative stated that securitisation is an area where further integration is needed. There is a need for end-to-end optimisation instead of regulating components separately. This is a very important component of the CMU. There are divergences regarding on-balance sheet securitisations; this is an area where more alignment within the EU would be welcome.

The Chair added that the US market for securitisation benefits from a public guarantee with government sponsored enterprises (GSEs). While there are some margins for improvement in regulation, it would not be appropriate to look for a perfect match with US securitisation. Regulation can attract investments and this is why it can be considered a competitive factor, in particular on innovative areas (such as AI).

Home and host bias is another issue to consider. The solo approach is still applied within the European Union. One question to consider is whether the solo approach can be considered from a different perspective, given all the improvements made on supervision and on resolution.

3.5 Competitiveness and modernisation of the single market should be the top priority for the new institutional cycle

An official commented that it is very likely that competitiveness and modernisation of the single market will be the top priority for the new institutional cycle. Europe has the largest single market, but benefits for banks and citizens are limited. The opportunity should be taken to fulfil this potential. The strategic discussions on the CMU are progressing significantly. The reporting burden is important to address, as it is interlinked with competitiveness. Europe cannot rely on crisis mode this time, as the cost of inaction could be very high.

On the home-host issue, more Europeanisation of institutions and banks is needed, including governance. This also includes the Single Resolution Board (SRB). There are possibilities to improve the setting of the SSM. It is also valid for banks. In the portfolios of banks, there are home buys but no host buys. Diversification of the portfolio is needed.

3.6 Continuing to wait for someone to make the first move is not the right approach

The Chair noted that there is a long list of interlinked issues, including the lack of coordinated macroprudential

policy. Indeed, macroprudential in Europe is now associated with fragmentation, as it is an additional tool that national authorities can use to ring-fence capital, which was not the original intention of the Basel discussion. Everyone is aware of the issues, but nobody wants to take the first step. Within the public sector, there is talk of the home-host issue and a lack of mutual trust between supervisors and resolution authorities. The problem is that the world is moving quickly. In Europe, there is self-confidence that the period of crisis has been dealt with, and wariness about addressing sensitive problems.

The only way to cope with this is to have a stronger Europe. A stronger Europe starts with the recognition that there are available resources to address a crisis of the banks. There should be allowances made for transfer strategies, the possibility for the investors to step in, a lack of preferential treatment for DGSs, and host authorities trusting the home. Europe cannot wait for the next great financial crisis, because then it will be too late.

An official stated that progress should be made on all elements of the banking union, as they are interlinked. The project should not be built at the cost to some, but to the benefit of all. It is not a question of whether the home or the host will make the first step. A holistic view is needed, with more clarity about the goal. Currently, even among the home member states, there is no shared goal for the banking union project.

EU bank crisis management framework for medium-sized banks

Introduction

The Chair noted that there are different views on the crisis management and deposit insurance (CMDI) proposal. There is general agreement on the high level goals: increasing resilience, improving the effectiveness of the toolkit, protecting financial stability, protecting depositors' and taxpayers' money and managing failures effectively. However, there are disagreements about the role of deposit guarantee schemes (DGSs) in facilitating the transfer of assets and liabilities to acquiring banks and the proposed introduction of a single tier depositor preference, i.e. the removal of the DGS super preference in insolvency proceedings.

The European Central Bank (ECB) supported both the CMDI proposal and the single tier preference. The concerns about the greater resource to DGS funds indicate that there is a need to further harmonise the least cost test.

Ultimately, losses must be borne by shareholders and creditors. This principle cannot change. The use of DGS funds in resolution is a highly sensitive issue. Extending the scope of resolution offers real advantages and should be coupled with adequate access to funding. At the same time, allowing DGSs and the Single Resolution Fund (SRF) to bridge the funding gap in resolution comes with a lot of strings attached.

1.Extending the scope of resolution offers real advantages

1.1 Resolution has several advantages over liquidation

A regulator explained why resolution is preferable to liquidation. Resolution does not use taxpayers' money and ensures continuity of service. The critical services provided by a bank can continue in resolution. In liquidation, the bank is closed, and customers have to wait to receive both their covered deposits and, potentially, any other deposits.

A regulator welcomed the broadening of the resolution framework to include medium sized banks. There are many benefits to resolution versus liquidation, especially for customers. In resolution, customers retain access to their funds. They do not suffer any interruption in banking operations. From a business perspective, it is more value protective to preserve a business as a going concern than to sell it in pieces. There is support for the proposal to use DGS funds. DGS funds can act as bridge funding for resolution. While there are institutional differences between DGS funds and resolution funds, the ultimate goal of both is depositor protection. However, there will be practical challenges if the DGS and resolution funds are managed by different entities. In Poland, the Polish Bank Guarantee Fund (BFG) manages both funds, which enables it to make overall assessments of cost.

1.2 Liquidation will continue to be the most appropriate choice for most bank insolvencies

A regulator explained that the proposal seeks to equip the resolution authorities with a stronger and more flexible framework. Previously, resolution could not be used in some cases due to the definitions used in the public interest assessment (PIA). One of the purposes of the CMDI proposal is to address this gap. The Commission's suggestion was to increase the number of banks which come under resolution by allowing the definition of the public interest to take account of systemic impacts at regional level. This does not mean all banks will be resolved. Even after CMDI, liquidation will continue to be appropriate for most banks. The Banking Union is home to around 2,000 small banks, the so called less significant institutions (LSIs). Even after CMDI, liquidation will remain the preferred approach for the majority of LSIs. Resolution will not be the standard approach.

1.3 The EU proposal will only bring two or three dozen banks into resolution

A regulator noted that the proposal will only affect a few dozen medium sized banks. These changes will not be costly for DGSs or the Single Resolution Fund (SRF). Indeed, any smaller banks coming within the scope of resolution will be subject to the same standards as their larger peers, although these rules will be applied proportionately. There will have to be a transition for these banks. The Single Resolution Board (SRB) will make sure they are in fact resolvable. These banks will have to respect the minimum requirement for own funds and eligible liabilities (MREL) rules, just like their larger peers. The SRB estimates that two or three dozen additional banks will be earmarked for resolution. The median impact on all types of DGS will be limited to 15%, according to an SRB study.

Secondly, if the funding provided by the MREL and the DGS is not enough, only then the SRF can be accessed. This will be subject to the 8% absorption of losses. According to the SRB study, the impact on the SRF would be limited to 2% to 3%. Clearly, resolution will have a cost for DGSs and the SRF. However, the alternative is liquidation, which also has a cost. The SRB does not predict any risk of destabilising the DGS framework or the SRF by broadening the scope of resolution.

1.4 The least cost test (LCT) should be holistic

A regulator highlighted the importance of the structure of operational cooperation on the least cost assessment. In some cases, the least cost assessment should take into account both liquidation and resolution, including the potential use of DGS funds. The proposed reforms will

make the least cost test even more relevant. It will become the ultimate criterion for resolution processes; therefore, it needs to be as holistic as possible. It should consider not only the direct costs but also the systemic costs related to the additional contributions from other banks and the opportunity cost of lost interest or other returns on DGS funds. Any future institutional setup should not make the least cost test impractical or difficult. A holistic approach will require a comprehensive assessment of the total cost, but it will also require smooth cooperation, including information exchange and joint modelling efforts, between the DGS and the relevant resolution authority. Any future regulations should seek to create a robust legal basis for this cooperation.

1.5 Abolition of the super preference or a different LCT?

A regulator stated that some changes need to be made to the current regulation to ensure that successful decisions can be implemented. In this regard, the super preference should be amended. For example, there is no super preference for the US Federal Deposit Insurance Corporation (FDIC) fund. However, the current negotiations on CMDI seem to keep some sort of preference for DGS. The SRB will try to implement whatever is decided by the co-legislators, but its resolution decisions need to be successful. If the resolution authorities cannot find funding at the moment of resolution to finance the sale of the business, the bank will have to be liquidated. An amendment to the least cost test could be another way to ensure funding for resolution. Expanding the scope of resolution without providing a source of funding will not work. If that happens, liquidation might end up being the only option.

1.6 CMDI makes the resolution regime more flexible

A regulator noted that the Polish Financial Supervision Authority (KNF) supports the CMDI package. Over the last few years, Poland has managed four cases of bank resolution. There is undisputable value in increasing the flexibility of the resolution toolbox. The CMDI proposal is not a paradigm shift; it is an attempt to increase flexibility. This discussion should be the starting point for a more general debate about the balance between resolution and insolvency. For many years, the default solution has been bankruptcy and liquidation. It is worth considering whether this should be the case. It should be possible to create a general alternative to liquidation or bankruptcy rather than something which is reserved for exceptional cases.

A regulator agreed that the CMDI proposal is not a paradigm shift; it is a technical reform giving resolution authorities more flexibility to implement successful decisions.

2.Allowing DGSs and the SRF to address the resolution funding gap has some drawbacks

2.1 The CMDI framework could have far reaching consequences for the EU's diversified banking sector, consumers and financial stability

An industry representative considered that, while there is a need for strong crisis management, the CMDI review fundamentally changes the architecture of the EU bank crisis management. The proposed changes cause confusion e.g. by introducing an unclear definition of "financial stability at regional level" that could assign virtually all institutions to the resolution regime. If the resolution regime is extended to all institutions, it will erode financial stability. It is not possible to apply regulations designed for large systemic banks to small and medium sized banks. In thinking about the crisis management framework, it is more important to ensure that the banking union is united in diversity. The demands of the green, digital and social transformations will require many different banks with many different business models. Banks have different customers; they take different risks. This should be reflected in the crisis management framework. Many savings banks use institutional protection schemes (IPSs). The combination of early intervention by the authorities at the least cost test stage and the preference for resolution would displace these schemes. This will damage customer trust and destroy a well functioning system.

Meaningful progress could be made by upgrading the existing framework. The European Banking Authority (EBA) has issued three opinions identifying potential improvements to the functioning of DGSs, including addressing the risk of failing institutions entering 'limbo situations' and improving the coordination between responsible authorities. The Commission's 2013 banking Communication finally needs to be aligned with the crisis management framework.

The Chair asked why, according to the panellists, the proposal will erode financial stability. An industry representative explained that the CMDI proposal seeks to use DGS funds to pay the cost of resolution. This depletion in the means of DGSs will erode financial stability. Additionally, the proposed changes will cause confusion by introducing an unclear definition of 'financial stability at regional level', which could mean that virtually all institutions are assigned to the resolution regime.

2.2 The proposed changes to the framework could weaken DGSs

An industry speaker highlighted the importance of legal certainty and financial market stability. Customers have confidence in the DGS system. The CMDI proposal differs quite substantially from the current system. The first key issue is the super preference. The super preference enables depositors to receive their money within seven days. Because the DGS is prioritised in the insolvency procedure, it receives all the backflows from that process. While it is understandable that the resolution authorities want more flexibility, the super preference is inherent to the functioning of DGSs. Giving resolution authorities greater discretion should not necessarily entail the abolition of the DGS system but would create big problems for the functioning of the DGS system.

Secondly, there is currently a liability limit of 0.4% of covered deposits for DGS funds in resolution. The Commission proposal increases this to 0.8%. This will negatively impact confidence in DGS funds, the working of DGS systems and financial stability. Indeed, some

supervisors have criticised this element of the proposal. Finally, DGS funds will be used to reach the 8% bail in amount. In the past, the resolution authorities have claimed that this bail in would solve resolution cases. If there is no incentive to reach the 8% minimum bail in using MREL, there will be a moral hazard. DGS funds, into which all banks pay, will be used to reach the 8% bail in amount. Weakening the bail in instrument will have very serious consequences.

A regulator emphasised that there is no moral hazard issue. DGS funds are private funds. The purpose of the CMDI proposal is to make it possible to finance resolution privately. The SRF and the DGSs are financed by the industry.

An industry speaker agreed that there is no moral hazard regarding the use of public funds. All banks pay into a DGS fund. The means of all banks will be used to reach the 8% bail in amount. Normally, the failing bank would have to reach the 8% bail in amount with its own MREL.

2.3 Ensuring orderly market exit irrespective of size

2.3.1 For small and non complex institutions, liquidation is adequate, reliable and proportionate

An industry representative opined that crisis management should stick to the core principle that an institution should only be resolved if its failure is not in the public interest. All other failing institutions should go into national insolvency. For systemic cross border institutions, it will be vital to ensure close collaboration between the responsible authorities at EU and national level. For LSIs, the responsible authorities will primarily be national. This is the best way to guarantee that the authorities understand the institution's business model and the local market and ensure proper risk management. When the distance is greater, there can be information asymmetry and a greater risk of poor decision making.

2.3.2 Small and medium sized banks must be guaranteed a smooth exit

A regulator stated that the experience of the recent past has illustrated the need to address the resolution of mid sized banks. The CMDI proposal is an attempt to close this loophole. However, it is important to avoid making resolution the default option. Insolvency should be permitted to happen whenever it does not disrupt financial stability. Moreover, it is important that these proposals do not weaken existing IPSs. Ex-ante funds are available in the event of a sectoral imbalance for approximately two-thirds of the Austrian banking sector and such IPS systems have proven themselves effective in the past. They should not be overlooked when trying to create a comprehensive framework for exiting the market or restructuring failing banks.

Secondly, it is costly to resolve a bank and to prepare it. Therefore, the costs for resolution authorities and banks should not be underestimated. If too many banks are brought into the resolution regime, their costs will increase dramatically. This might start to have an unintended effect on the banking landscape and the banks might only be able to earn these costs by becoming more concentrated.

A regulator emphasised that, according to SRB's estimations, the proposal will only bring two or three dozen more banks into resolution. The national resolution authorities (NRAs) have already decided that almost 2,000 banks will not be subject to the full obligations. These banks will not be earmarked for resolution. Aside from the approximately 70 LSIs which are already earmarked for resolution, only around 30 banks will be brought into resolution.

A regulator observed that there is an issue regarding the public perception of insolvency versus resolution. When banks enter into insolvency procedures, it might be viewed as a bad sign for the banking system. In fact, it is a sign of strength and therefore, the public perception of insolvency must be properly managed. There is also room for improvement on the issue of private liquidation. In some cases, the DGS prevented the execution of liquidation under a private regime, as the DGS favours insolvency procedures over liquidation to secure super seniority.

An industry representative noted that the SRB analysis does not take account of the fact that many LSIs participate in IPSs. A regulator stated that these institutions will not be put into resolution because they are not regionally systemic. Moving to the resolution regime will be costly for the bank, the NRA and the SRB. There is no desire to bring all banks into the resolution scope.

2.4 While a key step forward, the CMDI does not address all imperfections of the crisis management framework

An official opined that there is currently no sufficiently powerful tool to manage the failure of mid sized banks in an orderly way. There are three key challenges that the CMDI will help addressing. First, there is a need to clarify the distinction between resolution and insolvency and enlarge the scope of resolution. Secondly, it is essential to operationalise sale of business resolution strategies. This is the most appropriate way to manage the failure of mid sized banks. This lesson has been learned from the approach used in other jurisdictions, such as the US. The additional funding for this would be provided by expanding the contributions to the DGS and eventually the SRF. Thirdly, MREL must be properly calibrated. Under the current legislation, the SRB calibrates MREL on the basis of the preferred resolution strategy. This is also the approach taken in the CMDI proposal, which further clarifies the criteria the SRB will use to calibrate MREL for banks with a sale of business resolution strategy.

There are several ways in which the proposal could be improved. First, despite the efforts of the European Commission, there has been no progress on the European Deposit Insurance Scheme (EDIS). This is unfortunate because one of the aims of the EDIS proposal is to increase the funding available for sale of business resolution strategies by using national DGS funds. While this proposal will increase the efficiency of the crisis management framework, it will not contribute to deepening the banking union because it will increase the reliance on national funding.

Secondly, while the resolution framework is becoming more flexible, increasing the scope of resolution and

consequently reducing the scope of insolvency and liquidation aid might make the system less able to cope with situations where resolution does not deliver the desired outcome. In resolution, there is no systemic exception or public backstop to use in extreme circumstances if the resolution tools do not work. It is important to understand how this kind of public backstop has been used in other jurisdictions, such as the US and Switzerland.

2.5 A consistent and floored MREL is the cornerstone of a fair resolution funding system

2.5.1 MREL's role in facilitating sale of business resolution strategies

An official emphasised that MREL plays a key role in facilitating sale of business resolution strategies. MREL is not transferred to the acquirer. This frees up assets to be transferred to the acquirer as compensation for the deposits they are going to take. When there are more assets to use to compensate acquirers, it increases the feasibility of a sale of business strategy. The other main source of support is the DGS. There is a clear interaction between the internal resources provided via MREL and the external resources provided via the DGS. This interaction should be fully recognised in the calibration of MREL.

Without this recognition, there is a risk that some institutions will have too much MREL, and some institutions will have too little. For instance, a bank with a large proportion of non covered deposits will receive little support from a DGS as the least-cost constraint will become particularly tight. Without sufficient MREL, there will be no way to operationalise a sale of business resolution strategy. This is why MREL should be calibrated by taking account of its role in facilitating sale of business in conjunction with the available DGS support.

2.5.2 There must be a clear MREL floor for the banks earmarked for resolution

An industry speaker noted that the CMDI proposal does not close the loopholes related to flexibility and the lack of discipline at national level. The proposal leaves it to the national authorities to decide between resolution and liquidation. Ultimately, however, there should be no resolution without MREL. If the calibration of MREL considers the intervention of the DGS, there will be a 'free lunch' for the small banks that come under the resolution regime. The same remedy requires the same constraints.

The CMDI proposal does not set a clear floor for MREL. A floor of 16% of risk weighted assets (RWAs) plus a combined buffer would ensure that failing banks are able to be recapitalised to the minimum requirements and sold at no cost. The large banks have built up an extreme amount of MREL compared to their international competitors. This is a permanent drag on their ability to fund the economy. It would be more logical to develop a simple, understandable, and predictable system with a floor and a cap. It is also important not to forget the quality of MREL. As a benchmark, total loss absorbing capacity (TLAC) has subordination requirements which are relatively clear. If similar rules and clarity existed for MREL, it would improve the quality of European MREL.

Finally, it seems dubious to disrupt the reasonable balance achieved through the Bank Recovery and Resolution Directive 2 (BRRD II) if the only effect of the proposal will be to bring 30 medium-sized banks into resolution. While reviewing the CMDI, it would be preferable to create a simple, efficient and predictable system for all banks, with a TLAC like calibration of MREL for banks earmarked for resolution and alternative to liquidation for the other institutions.

An official agreed on the importance of MREL quality. Quality could also be increased by restricting the amount of MREL that could be covered with equity, in line with the TLAC standards. It is very important to avoid offering a 'free lunch'. The contribution of the DGS should be taken into account when calibrating MREL. This is fully compatible with the idea of establishing an MREL floor. The aim is to improve the accuracy of MREL calibration. The criteria set out in the CMDI proposal could be improved to ensure that the MREL will be sufficient to facilitate sale of business.

A regulator emphasised that allowing the resolution authority to take account of DGS support when calibrating MREL would require a legislative change. The size of a bank also does not directly affect the calibration of MREL. The driver of the MREL calibration is the selected strategy, e.g. bail in or sale of business. Today, there is a defined calculation for sale of business strategies, which involves a rebate after the bail in calculation. This approach is taken by all resolution authorities, including NRAs. There is also no risk of a lack of discipline. The SRB and the NRAs define and implement the rules collectively. If the rules are not adhered to, the SRB enforces them. The NRAs are not keen to move many banks into resolution because, while it delivers better in terms of financial stability, it is costly and complex for small banks and authorities. Ultimately, resolution is about resolvability. MREL is a key element of this, but it is not the only one. If more banks are earmarked for resolution, they will have to be resolvable. That is why resolution is not appropriate for the vast majority.

The Chair remarked that there is broad agreement about the need to avoid offering 'free lunches'. However, there is clearly not enough mutual trust to reach consensus. Further discussions will be needed to ensure that everybody understands what can be achieved in order to reach the high-level goals.

Diversity in the EU banking system

Introduction

The first part of the panel takes stock of where things stand, including risks, benefits and how supervisory authorities and regulations have tried to take bank diversity into account. The second part is around whether digital innovation and digital transformation might impact diversity positively or negatively. It is also tries to anticipate possible developments. The key strategic trade-off is whether it is possible to take account of the diversity of business models without underestimating the risks associated with banks' activities.

1. Diversity is a key strength to be preserved

Diversity of banking business models is a risk-reducing asset which can take many shapes. Digitalisation brings new challenges into the market.

1.1 Diversity is an asset

The Chair stated that business model diversity is a value that allows banks to support the real economy in different ways.

A Central Bank official commented that the ECB values diversity. Diversification is one of the most basic prudential rules. What is true at the level of individual banks is also true at the level of the system. The Single Supervisory Mechanism (SSM) is part of that. The Europeanisation of supervision has led to a reinforced emphasis on a level playing field. The SSM steps out of the consideration of the structures of the different banking systems between countries and sizes and creates a level playing field by creating detailed and prescriptive rules. The perception of the banks is there are more uniform rules.

An official added that diversity is risk-reducing for countries with a strong cooperative sector. They benefit from a good insolvency system, deal with crises efficiently and have brutal bail-in under national insolvency rules. Intervention starts early to prevent crises. Having a stake in others' businesses beyond equity exposure means there is an obligation to help. Taking that into consideration is sometimes tricky because of colleagues on the other side of the debate who do not understand cooperatives banks. Equal treatment is a precondition. But specificities should be considered. The ECB recognising the security of a cooperative structure has been valuable.

1.2 Diversity can have many forms

An official stated that diversity can have many forms. A historical way of thinking about cooperative associations and banks is as capital societies. New diversity comes from platforms stripping the traditional banking model and using it for their own purposes. The ECB recognising how cooperatives and their structures can be risk-reducing is overdue, because in every negotiation of prudential regulation on the banking sector there has been nastiness in the direction of institutional protection schemes (IPSs) and cooperatives, from Basel II to Basel III. Some countries developed cooperative models for historical reasons, whereas in others they are poorly understood. Cooperatives are sometimes viewed as hidden ways for bailout so are viewed with suspicion and believed not suitable for favourable special treatment.

1.3 Is diversity declining? The subject is controversial

1.3.1 Diversity is not declining

A Central Bank official commented that regulation on the proportionality side and supervision on the individual side should be able to capture the specificities of the different banking models. This diversity is not declining in terms of the market share of cooperative and other banks. The number of banks is declining, but they regroup.

1.3.2 Diversity is declining in Europe following a decade of uniformization of supervisory practices

An industry representative noted that diversity declining is not a market share issue but a question of flexibility, pressure from the SSM to behave in a mainstream way, and alignment of different business models. The intention of the SSM is to preserve diversity, but in day-to-day supervision it is not the case. The SSM is a process-driven organisation, so procedures are needed to protect the diversity. The aim is to take on board all business models in benchmarks in order to have more representative samples.

1.4 The formula of 'same risks, same regulation and same prudential requirements' should apply for each model

An official commented that there is a need to understand the reasons for diversity in certain markets and the legislation implemented by supervisors. The overall trend in policy discussions is to support consolidation of the banking groups to make them more resilient and better equipped to be competitive in the internal market and globally. On the other hand, bigger groups and bigger banks pose new risks and issues and boost the necessity to have adequate rules for recovery and resolution. Diversity is important in that and there are different types of diversity. Cooperatives in the past proved to be resilient in many countries, recovered fast from crises and kept growing

in several markets. They were crucial to financing the economy and development of member states.

But not for all countries as there are also examples of countries where credit unions haven't proved to be well functioning. This was illustrated by a concrete example of a domestic sector where such institutions report poor economic indicators such as low ROA or high NPLs), thus not indicating to be resilient, sustainable in mid- and long term and contributing to the national market developments. If such entities, in addition, represent only an insignificant share of the credit institutions' assets but require the supervisor to devote energy and capacity to understand the specifics in order to exercise the supervision properly, it is questionable if this is efficient. Banking diversity is beneficial but should not be protected at any price. Regulators need to understand and analyse the reason for a model. What needs to be preserved is the reputation of the whole financial sector. The formula - «same risk, same regulation, same requirements» - must obviously apply to prudential requirements. Long-term sustainability should be required for every model, along with data protection standards and operational resilience. Those optics should be fine-tuned with proportionality. Supervisors should understand the different models and how to handle them, but still keep the main requirements for all, respecting the existing diversity as well protecting the stability and credibility of the whole financial market.

2. Diversity of business models requires striking a balance between horizontal comparisons and paying attention to the specific characteristics of each bank or group of banks, which is not sufficiently the case in Europe

2.1 It is questionable whether there would be the same diversity in business model in Europe if the SSM had existed for 40 or 50 years

An industry representative was not completely reassured by the reality beyond the intention of diversity being encouraged by the supervisor. If the SSM had existed for 40 or 50 years, it might not have been possible to develop cooperatives and other banks outside the classical commercial frame. Today the collective responsibility from regulators and supervisors for a proper risk control framework and profitability is to ensure diversity and encourage it in new players.

2.2 Adapting the EU regulatory and supervisory framework to the diversity of the banking sector is key but challenging

An industry representative added that the SSM needs to encapsulate new metrics in its benchmarks that reflect business models and gave some examples. These new metrics could incorporate the diversity of a bank's client base, such as underserved communities, associations, small and medium-sized enterprises (SMEs), but also the geographical repartition of activity; diversity of activities; and the share of social and fair financing. For example, the Joint Supervisory Teams (JSTs) believe social housing activity is not profitable, but it remains a core activity for some banks. This needs to be encapsulated in the benchmarks as the first step, and then a business model adequacy test should be designed. The SSM could assess the impact of its recommendations according to these new metrics in order to determine if they lead to reduced diversity of geographical activities and communities served. A bank controlled by the JST could then raise whether this is endangering their business model.

The 2024 Supervisory Review and Evaluation Process (SREP) is an opportunity for European policymakers and supervisors to make a difference in the real economy by reviewing how the SSM assesses banks' profitability and sustainability, designs its benchmarks and makes recommendations will be key to ensuring cooperatives have the capacity for local stakeholders. Supervisory tools and indicators should heed cooperative banks. On profitability, an indicator could be the residual income after distribution, and the actual capacity to endogenously create Common Equity Tier 1 (CET1). Supervisors should recognise the specificity and adapt to the samples of banking models. JSTs should not be guided only by standardised benchmarking for banks' profitability, cost and risk management, and governance. Cooperative performance and community impact metrics should be included in the benchmarks.

An industry representative agreed that considering and understanding business models is a precondition for ensuring that risks are properly assessed. The main purpose of cooperatives is to serve members, not to maximise shareholder value. This leads to fewer risks, especially compared to an investment bank. It may require supervisors to invest in assessing and understanding a business model.

2.2.1 Keeping diversity in the current EU supervisory context is challenging

An industry representative highlighted that benchmarking can cast doubt on intentions to preserve banking diversity. Benchmarking is useful but becomes a problem when it becomes rigid. Another drawback is that there is less room for discussing horizontal considerations from the supervisors and understanding their rationale, because it is more complicated to have a contradictory process when the JST is the intermediary between the bank and the SSM horizontal functions. This should evolve with constant dialogue and explanation to better understand what the supervisor wants. The new supervisory risk tolerance framework should be a shift in the right direction, but care will be needed because the usual trend is to go to something that is more standardised. Therefore, it is complicated to keep diversity in this context.

2.2.2 Translating flexibility in day-to-day supervision remains challenging

A Central Bank official noted that Europe has different economic environments with different customer behaviours, financial traditions and history. The single market makes it important to approximate regulations, but flexibility must be allowed. The question is how to translate those ideas into everyday practice. The key is supervisors better understanding the business models. Local authorities could enhance and keep the diversity because they better understand the differences of the banks and can evaluate the tasks. Regulations provide a good or common framework, but the tools a supervisor can use are key. Innovation of local authority tools is also important to understand the risk and keep or enhance the diversity. Local authorities or the EBA could create a bottom-up stress test, collecting granular data and loan data, but it takes time. It is key to show other competent authorities these tools.

2.3 Proportionality is essential to maintain bank diversity

An industry representative observed that diversity is closely related to proportionality. The volume of regulation issued over the last decade is impossible for a small bank to fully consider. Thus, one of the main reasons for German cooperative banks merging and giving up their own business is they cannot find or afford enough people to deal with this regulation. There should be a discussion of whether the concepts of a single uniform rulebook and proportionality fit together. There should not be lean supervision and regulation for small banks, but simple can be strong. Proportionality and diversity should come from the supervisor as well as from the industry. A Central Bank official agreed that proportionality is important, but not at the expense of safety. It is the supervisor's job to find the right balance.

2.4 Striking a balance between horizontal comparisons and paying attention to the specific characteristics of each bank or group of banks

A Central Bank official stated that the approach of the SSM is on three levels. There are general indicators to follow for all banks. The benchmarks need to treat all the 110 groups under the remit of the SSM in a comparable way. The ECB's reorganisation tried to reinforce the intermediate benchmark. This groups Global Systemically Important Banks (G-SIBs) with other G-SIBs, to be sure the pure horizontal and the pure individual banks are together at an intermediate level. This has been done without looking at the legal side. Some G-SIBs are cooperatives, some are intermediate banks or specialised banks. More leeway is being given for the individual. The multi-year assessment process means not doing everything for each bank every year. This can only be done by creating a guarantee that more diversity means an additional layer of benchmarking to prevent divergence. It is trying to both go more into the specificities and keep some space. The key for the future is to keep using these three levels of dialogue at the ECB. Mistakes can be made but diversity is valued, and the plan is to give it space.

3. Digitalisation will have a significant impact, but less on the diversity of European banks and more on the individual banks based on their ability to innovate and adjust

3.1 Digital transformation and technical innovation foster diversity as they bring new players with new business models

An official observed that there have been many revolutions from the digital world proclaimed as destroying traditional banking. The situation is now different because of big data. Banks are information enterprises, making money by being delegated monitors, able to extract a yield by dealing efficiently with asymmetric information. There are portals that can collect more data, including credit quality. It is not inconceivable that relationship banking may be less valuable in the future, which is normally a value of small institutions.

Payment used to be a banking business, but now there are payment service providers. The same might be true for lending. Traditional banks could be back-office providers for the uninteresting and least profitable parts of platforms. That may be a different kind of diversity. It is beginning in some parts of the world where financial systems are less developed. It may arrive in Europe via competitors that act on a global level.

3.2 Two types of new entrants (fintechs and GAFAMs) with specific legislative challenges

An official stated that there are two types of new entrants to the market. The first are small fintechs that do not have the capacity to understand and comply with all regulation in order to decide which type of licence they need to obtain in order to operate in the market and to succeed in the licencing process. A 2023 study by the Organisation for Economic Cooperation and Development (OECD) concluded that is why small fintechs do not develop in some countries. New entrants also do not have the data to test their solutions. They do not have clients and their data yet. Those may be attracted quickly online but not without a licence. So, pre-testing may be an issue for a newcomer to the market.

The first question is whether it is to the benefit for the whole market and economy to have these new entrants and help them, for example by creating regulatory sandboxes, and whether the legislative framework in the EU allows all the sectors to operate in a regulatory sandbox. In the payment sector, there are some exclusions from the Payment Services Directive (PSD) based on operating a limited network. But in traditional banking, there is not much space for a regulatory sandbox. The other solution could be a data sandbox allowing prospective market entrants to test their solutions well in advance.

Another type of new entrants are GAFAMs - Google (Alphabet), Apple, Facebook (Meta), Amazon, and Microsoft. They have the data to test solutions and the

capacity for IT, regulation and compliance. They can quickly enter the market and become competitors to banks. There were concerns that GAFAMs would come up with digital currencies and regulators had to react. Google and Apple are dominating in the way payment cards are used and have the potential to go further. For legislators, it is about deciding whether to react, for example whether to help the small companies to also enter the market in order to contribute to diversity or say that there are crucial requirements that everybody should fulfil and leave the big players to dominate the market.

3.3 Digitalisation is not a gamechanger for the diversity of the banking sector

An industry representative stated that over the last 15 years regulation has had a bigger impact than digital innovation on the European banking sector. European banks' assets are basically the same but more liquid. The lending book has been de-risked. Much of the riskier lending business has gone into the non-bank financial institution sector. This has led to the price book ratio remaining at 0.6, which is significantly lower than American institutions.

A couple of years ago there was still a belief that digital models would disrupt the traditional banking world and branches would not exist anymore. The nature and the value that branches deliver is changing. In some countries, branches are increasing in number. JP Morgan in the US is a good example. It could be argued Europe is over-banked, but there is innovation in the branch model of serving clients in a differentiated way. Digital is of an enablement factor in terms of reducing costs, improving customer service and analytics. Banking-as-a-service solution platform models are multiplying in the banking world. This impacts banks in general but less so the diversity in business models. The ability to adapt to new innovations and alternative models is more driven by governance and ability to adjust than the type of banking model. There are pockets where others have come in on the payment side, which will go more into the investment space, where traditional banks are at risk of losing fee pools. It has happened less on the credit side, but there is more to see.

An industry representative agreed that digitalisation is not a target per se, but rather a means. Not all clients will switch to GAFAMs, fintechs and online-only services. There is still use of cash in Europe. It is not about switching to a new world but expanding the current world. The needs of customers should not be forgotten by focusing too much on digitalisation.

3.4 Level playing field issues between banks, fintechs and GAFAMs

An industry representative pointed out that banks must have the opportunity to fail in their efforts to innovate. Sandbox approaches should be discussed for new companies, for fintechs but credit institutions as well. This would allow them to experiment with solutions without immediately facing the full regulatory burden. A second example for the dangers of a competitive disadvantage is in the context of financial data access (FiDA). FiDA could allow banks to become a financial home for their customers. Currently, banks are required to open their data stores for GAFAMs, but not vice versa. This is a competitive disadvantage and threatens to further concentrate power and increase strategic dependence on GAFAMs. The third point is the joint impact of EU regulation in the context of AI, which needs good technology and lots of data to train. This impact has to be assessed. With the AI Act and GDPR, companies in the EU might not be able to keep pace with other jurisdictions.

An industry representative underlined that a sandbox should be for all. All institutions can be newcomers in activities and business models and need to be helped.

3.5 Regulatory frameworks need to be technology-agnostic and ensure fair competition

A Central Bank official commented that the starting point is neutrality and trying to foster innovation. The ECB favours the incumbent banks rather than fintechs, but there needs to be a surface to invest in technology to keep pace. This can be an issue for small traditional banks rooted in local identities. Technology is delocalising and favouring scale. A cooperative bank is not only a brand but an identity with heritage values that need to be transposed into an investment for the future, with the ability to scale up.

A Central Bank official observed that innovation is the source of progress and helps competition. The question for supervisors is how to secure the safety of customers equally to traditional banks. It is not an ideal environment if the answer of newcomers is regulatory or supervisory arbitrage. The European Commission Deposit Guarantee Scheme could be important.

3.6 The sandbox approach needs to be rethought to serve the underserved clients

An industry representative stated that what is happening in other industries is often lost. In healthcare, not enough investment happens for a variety of diseases, but healthcare regulators do not ask for more so they can approve earlier because health is impacted. Financial services are about financial health. It is important to keep in mind what the sandbox concept is for. Most digital players that have operated in the financial sandbox world go after attractive and overserved customers, not underserved SMEs or customers in rural parts of Europe where banking services are not as prevalent. The sandbox approach needs to be rethought to serve them.

The Chair concluded that diversity will help address the financing need of the European real economy, but there is uneasiness in the market, despite efforts on the supervisor approach. There have been helpful suggestions on incorporating indicators. Profitability should not be the target, because there might be excess profitability based on commission driven by complex transactions, or revenues from risky activities might be unsustainable. Sustainability of business models should rather be looked at. The benchmarking and how it is implemented is key, but it should not drive the final decision and the supervisory approach should be flexible. Banks' business is changing, as it might be a by-product of something else. Digitalisation can be a game changer, as everything is driven by information and data. Issues also relate to the incomplete and changing regulatory framework. The Digital Operational Resilience Act (DORA) will help to deal with digital challenges.

Challenges facing insurers

1. The challenges of the insurance sector at the global level

The Chair detailed that the insurance sector is a particularly globally interconnected industry, given the nature of the business model of diversification, and many of the challenges facing the insurance sector demand global solutions.

1.1 EU insurance sector resilience despite a challenging global economic environment

The Chair noted that despite its resilience, the insurance sector is not without its challenges. In the short term, there are the macroeconomic environment and liquidity risk, credit risk and structural shifts in the life insurance sector. In the longer term there are climate and sustainability risks, which nonetheless demand immediate action.

An industry representative added that the challenges include economic growth, inflation, interest rates and the volatility of investments. However, the resilience of the insurance sector is striking. It has fared the challenges well, and is still weathering many risks. It has shown its ability to adapt through management actions, and there are still strong capital surpluses within insurance undertakings, particularly in Europe. Some elements, like the duration gaps in balance sheets, have been key, given the interest-rate changes. The low and negative interest rate environment had motivated insurers to reduce their fixed income asset durations which translated in increased negative duration gaps while both decreasing asset sensitivity to upwards movements in interest rates and allowing fast paced reinvestment once in higher rates environment. More than 300 basis points was the shock to absorb.

During the low interest rate period, long-term investments were not remunerated correctly and therefore discouraged. It was not worth investing long-term, and this hit investment in the productive economy. Furthermore, the spreads were not remunerating risks well. Long-term investments are equal to savings in the long run, which require an economic return over time capable of compensating for the risk taken and rewarding the patience needed for value creation. Positive interest rates were sought, so the interest rate increase is welcome for relaunching the financing of the economy and restoring a more appropriate level of risk remuneration. It is difficult to remunerate any life insurance and any savings without minimal financial returns. The positive interest rates were also welcome for non-life because any financial remuneration helps dampen premium increases and cost of covers.

A flip side of the increase in interest rates was the soaring inflation, which came in the wake of the low for too long interest rates era which created massive liquidity in the markets. Inflation is particularly costly for non-life insurers. It primarily hurts claims but also operating costs. In life insurance, liquidity has been abundant both in the market and in insurers balance sheets as underlined by rating agencies. This was due to the positioning of the fixed income assets on shorter durations. This has not served the productive economy and growth has stagnated, leading to increased uncertainty and vulnerabilities. Consequently, there is a great deal of volatility in the financial markets, which requires closely monitoring each asset, especially real estate, private debt, and equity ones.

In the meantime, on the prudential side the review of Solvency II, which is at an advanced stage, is expected to bring about approaches better adapted to the features of the long term, and for accurately capturing long-term risk profile specificities. Prudential tools must not distort the economic reality or amplify phenomena. They are helpful only when they do not blur the decisions that insurers have to take. Long-term investments in equities, the volatility adjustment and the risk margin were important for unleashing a better capacity for investing. Another consequence of the recent economic and financial environment has been challenges triggered by certain correlations with interest rate evolutions, observed in the standard formula market risk. However, with very few exceptions, there have been no widespread mass lapses observed.

A regulator remarked that the shift in the financial market changed the investment conditions and insurers' investment behaviour. In Germany, the increase in interest rates was welcomed. The solvency situation is now much improved. On the prudential side, Solvency II has been a constraint in the past but no longer is. For German life insurers with their long-term guarantees, higher interest rates are a release.

1.2 Lasting issues and the status of insurance companies in Japan

An industry representative detailed that the environment surrounding Japan's life insurance faces structural factors, most importantly the declining and ageing population. There is also a problem of sluggish growth in households' real income.

Companies are generating strong profits, but whether wages will strongly increase or not is yet to be determined. There is also a low insurance penetration rate, especially among young people. With the ageing population, the low participation rate and the weak household real income, the value of new life insurance contracts has been on a gradual downward trend for the past 15 years. There have been various negative factors in recent years, such as a decline in sales due to the Covid-19 pandemic, a large amount of repayment because of natural-disaster-related deaths and conduct risk for sales staff of companies, which is not necessarily easy to completely eradicate.

Against this backdrop, life insurance has a huge stock of long-term insurance contracts from the past. There are

stable, long-term investments, mainly in government bonds but also in other conservative investments. There are no acute solvency issues in the sector. There is a growing possibility that Japan will be lifted from the zero-interest rate environment. However, the rate rise will be limited in scope in the near term, and most insurance contracts in Japan come with a protection feature. So, given the difficulty of re-enrolling to a similar contract, rising interest rates will not cause an extreme increase in contract cancellations, though there should be vigilance on the potential liquidity risk.

Listed insurance companies are pursuing capital efficiency and governance reforms. The investment capacity is increasing, and capital is being invested in new areas, such as IT. That has the potential to dramatically transform business efficiency. There is also investment in a service platform to expand the business into areas adjacent to insurance, so as to become lifelong partners for customers. Additionally, overseas markets that are expected to grow in the future are being invested in.

1.3 The financial strength of the sector in the US

A regulator remarked that despite the ups and downs due to Covid, the 2023 banking crisis, and ongoing inflationary pressures, the U.S. insurance sector remains resilient and financially In the early 1980s, the US saw a string of insurer insolvencies, which prompted state insurance supervisors to adopt a risk-based capital regime in the 1990s. Supervisors review that regime on an ongoing basis in an effort to capture new and evolving risks and maintain a strong market.

2. Structural shifts from the low for long environment

A regulator noted that in the past the insurance sector invested in highly illiquid assets in order to have higher yields, and now there are some insurers with quite a high share of illiquid investments on their balance sheets. This could lead to problems in the statutory profit and loss account. There is no liquidity problem overall, but there is a question about the price of liquidity. There are many hidden losses in the balance sheets, which is something that has to be managed properly.

A regulator noted some structural shifts, also highlighted in the IAIS's Global Monitoring Exercise (GME), are increased investment in alternative assets and the use of asset-intensive insurance.

These shifts could be a source of risks, but they are also a direct reaction to the economic environment. That should be considered when thinking about the supervisory or regulatory response.

Alternative assets could hide the actual exposure of insurers to market, credit, and liquidity risks, and could entails asset valuation issues. Asset intensive reinsurance, if not well implemented, could unduly decrease the level of protection of policyholder and create hidden accumulation of risks at global level. As highlighted in the GME, alternative assets and asset-intensive insurance could be concerning under both micro and macro perspectives. However, if those perspectives are addressed within appropriate internal risk governance systems, with insurance companies able to understand the consequential risk exposure, and within appropriate oversight by supervisors, these practices could be useful and should not necessarily be blocked.

Alternative assets could help by increasing the risk diversification of the asset portfolio without resulting in exaggerated exposures. They could also help to match assets and liquidity in terms of duration. Asset-intensive reinsurance is preferable to the actual transfer of life insurance portfolios from one company to another, which obviously has consequences for policyholders.

Overall, supervisors and regulators should take a selective approach. Regulatory adjustment is not needed in Europe or the US. Their frameworks already include principles that should lead to an appropriate use of these instruments. However, supervision should be enhanced in order to understand what the right exposures are, and when a company is not appropriately valuing the assets or is not aware of risk exposures.

In Italy we have checked, for example, several non-traditional reinsurance treaties that cover the mass lapse risk, which is the loss that a company could have in case of massive surrender. Some of these treaties actually transfer the risks and represent a genuine risk mitigation. Overall, there should be a bespoke approach, and innovation coming from the market should be looked at with both openness and a critical eye.

2.1 Monitoring actual emerging risks

A regulator indicated that with Solvency II, market valuation, explicit recognition of risks and co-operation with EIOPA work. While the industry was working on this, it was also implementing International Financial Reporting Standard (IFRS) 17. 75% of the industry uses Solvency II valuation curves there.

There should not be complacency. The industry and supervisors can help each other. There are more positives on sustainability risk. There will be work on macro risk. From a supervisory perspective, there will be a great deal of easing. The industry is above a 200% solvency ratio and is robust, but after the implementation of the SII Revie that same number will mean something different. There will be billions of euros less behind the number. That is the reality of the change, and it means that supervisors need to focus on risk management and what is happening in the companies. That is part of the framework. There is no need for any change for that to occur.

2.2 The US market taking advantage of structural shifts

A regulator stated that some of what is seen in the US market is in response to structural shifts and changing business practices, such as a focus on complex ownership structures, like private equity and complex investments. The private equity piece was one of the driving forces for some of the enhancements and review assessments that were undertaken in the US in recent years. Through the National Association of Insurance Commissioners (NAIC) a list of 13 considerations were developed to formalise a

review of insurer activities, look at existing guidance and consider appropriate updates, such as to the holding company system, cross-border reinsurance, and investment management agreements.

The American Academy of Actuaries released a paper that talked about a number of these matters. This was a good reminder of how work is co-ordinated among the states in the US, and the importance of stakeholders' engagement. Participation in meetings like Eurofi allows for further engagement, which is important because the sector is global.

Through the relevant NAIC groups, there is ongoing work on the list of 13 regulatory considerations, which are intended to address a variety of insurer practices. For example, Consideration 13 related specifically to offshore reinsurance vehicles, and indicates that, 'Insurers' use of offshore reinsurers (including captives) and complex affiliated sidecar vehicles to maximise capital efficiency, reduce reserves, increase investment risk, and introduce complexities into the group structure.'

As illustrations of work, after the issuance of those 13 considerations, the NAIC Life Actuarial Task Force (LATF) adopted an actuarial guideline known as AG53. This went into effect at the end of 2022 and included a range of requirements related to the considerations, including increased disclosures. In early 2023, the NAIC Macroprudential Working Group (MWG) held various meetings with stakeholders, including insurance industry representatives and international regulators. As a result, a worksheet was developed that state insurance supervisors could use to evaluate reinsurance transactions involving offshore jurisdictions. After receiving comments, the MWG adopted that worksheet, and it now serves as an additional tool that supervisors can use when reviewing such transactions.

3. Integration of the industry in the EU

The Chair remarked that there are developing issues that need to be better understood. Their impact on supervisory practices also needs to be understood. That is the journey that the IAIS is taking with its work on its global monitoring exercise.

A regulator added that further supervisory integration should occur alongside the integration and concentration of the insurance industry in the EU. in the insurance industry, over 12% is cross-border in Europe, and over 50% of what is written is done by 20 companies. In contrast to banks, it is already quite an integrated European market. With one licence, an entity can sell throughout Europe. However, that is not the reality of the insurance supervisors in Europe. For supervision, there is national competence with maximum harmonisation on the prudential side, but minimum harmonisation on the conduct side. There is a need to talk about that, particularly if there are cross-border issues to solve.

Questions can be asked about how much knowledge and understanding there is of the insurance market in the horizontal legislation that is coming out. A mechanism is needed so that there is a role for insurance knowledge when legislation or regulations come into being.

4. Climate risk in the EU insurance market

A regulator detailed, regarding a prudential treatment of sustainability risks, that EIOPA had a discussion with many stakeholders including the European Systemic Risk Board (ESRB). There is consultation on a dedicated treatment. Sustainability risks will be considered. There are risks with climate change, and quantifying will be done in Pillar 1 under Solvency II. Rather than talking about green or brown, there is just talk of risks.

The methodology and data set were already consulted on, which provided good feedback. The data was put into the methodology and there was an outcome, which is very balanced. For many categories, a differentiated treatment is not seen to be necessary. One exception is fossil fuel stocks and bonds. It is not huge, and through the risk modules it is diversified, but ultimately this is an area where it would be appropriate to have a differentiated treatment.

There is a need to be risk managers and to recognise that being in certain categories of assets means having an impact in terms of climate change. There is a risk, and it needs to be measured and included in the overall risk calibration.

A regulator reported that Italy is working to fill the protection gap. A legislative intervention introduced compulsory insurance for commercial industrial enterprises, and the insurer is obliged to accept the request for coverage together with the possibility to reinsure part of the risk to a state-owned entity, within certain limits.

Building this system presents many challenges. One of them is the need to combine the benefits of mutualisation, which requires a large base of policyholders, with risk-based incentives, which reduces the base of policyholders but lead to the introduction of preventative measures.

The supervisor will also have to define the prudential consequences for the companies that underwrite those risks. There are also market conduct issues related to the definition of what is covered and what is not covered.

If all these problems are addressed, however, the system will introduce incentives for preventative measures and the possibility to leverage the operational capability of insurers to speed up the liquidation of the claims. This goes in the good direction.

5. Finalisation of the Insurance Capital Standard (ICS)

The Chair highlighted that there was recent endorsement by the Financial Stability Board (FSB) of the IAIS's holistic framework for assessing and mitigating systemic risk in

the insurance sector and that the finalisation of the ICS by the end of the year is well on track.

A regulator emphasised that it was positive to see the ICS enters its final year. Adoption by the IAIS can be achieved at its meetings in South Africa in December once some final issues are cleared up. It is also very positive that Solvency II can be an implementation of the ICS in Europe without adjustments, including the changes that come with the Solvency II review.

Currently, the IAIS and the US are putting tremendous effort into the comparability assessment of the Aggregation Method, including delivering data in order for there to be a technical assessment. A regulator added that there has been a great deal of work on the comparability piece and ongoing collaboration and communication among IAIS members in order to reach a successful conclusion of the whole ICS project.

The Chair welcomed these messages of harmony, the commitment to finalisation in December in Cape Town, and the shift to future discussions on ICS implementation.

Insurance protection gaps

1. The figures for losses due to climatic events and cyber-attacks are alarming, and they are increasing all the time

1.1 Climate-related losses: dozens of billions of losses yearly, of which 70% are not insured

An industry representative explained that there have been roughly $260 billions of economic losses from natural catastrophes during 2023. Of this, over $100 billion was insured, and it was the fourth consecutive year of insured losses greater than $100 billion. $100 billion represents around 40% of $260 billion, so this amounts to an insurance gap of around 60%, which compares favourably to a gap that is typically about 70%. The biggest insured loss was from the earthquake in Turkey and Syria, at around $6 billion. However, there were also notable climate-related losses, as last year for the first time they reached about $60 billion from severe convective storms. This is almost double the amount that has been recorded on average over the last 10 years. It is concerning that, over the last 30 years, there has been an annual increase of 7% from these types of events.

The floods in Italy and New Zealand, Hurricane Otis in Mexico and the wildfires in Hawaii all resulted in record insured losses. When looking at Europe for a few additional data points, the average expected uninsured loss for a country such as Italy is around $5-6 billion each year, for Germany it is around $2 3 billion, and for Belgium it is $0.5-1 billion. The gap is increasing.

1.2 The intensity and the frequency of cyberattack risk are unknown, but the figures are concerning.

The Chair commented that the economic losses pose a risk to financial stability if they are not dealt with.

An official provided a breakdown of France's cyberattack costs in 2022. This covered a direct cost of €887 million, ransom payments of €888 million and production losses equivalent to €252 million. In the last finalised numbers for 2020 and 2021, cyberattacks accounted for around €200 million damage to just the financial sector. Since then, it has only grown. Economic damages caused globally by cybercrime rose from $3 trillion in 2015 to $6 trillion in 2021, with the potential to reach $10.5 trillion annually by 2025.

This is harder to calculate and to plan for because the intensity and the frequency is unknown and there is so little experience of these risks. The risk and the intensity of cyberattacks has kept growing in the last few years. There is an insurance gap there because only large companies are taking this very seriously and it is most of them which have insurance on this. The level of coverage is around 98% of large companies but much lower for small and medium sized enterprises (SMEs). For small companies, it is around 0%.

1.3 The impact is compounded in developed economies

The Chair summarised that it is not only the data that is coming in on natural catastrophes (nat. cats) that is concerning, but the increased data in relation to cyber.

An official stated that more attention is being paid to insurance due to climate change and novelties like digitalisation making events more dramatic. A recent analysis in the US reported that, in just 2023, there were 28 strictly weather-related disasters that alone resulted in losses of more than $1 billion. For comparison, between 2000 and 2009 there was an average of only seven such episodes per year.

As well as climate-related insurance, there is also cyber insurance. In the geopolitical context of the last years there is increasing concern over cyber-attacks related to cyber warfare.

1.4 Broader insurance coverage limits economic contraction and accelerates recovery post-disaster and dampens the impact on public finances

An official noted that a recent article in the Economist addressed how ransomware can not only cripple companies but also countries. Insurance markets are critical to helping fund the rebuild of a damaged property and the rebuild of lost revenues and income. A higher level of insurance or reinsurance coverage for disaster risk shows three things: a smaller contraction in economic activity, faster post-disaster recovery and more limited impact on public finances.

It is important for everyone to push for a higher level of coverage, especially to avoid insurance and reinsurance either becoming unavailable or unaffordable. In California, three out of the 10 largest US property and casualty insurance companies simply withdrew from the market in 2023. In Australia, households highly exposed to flood risk faced insurance premiums increases that exceeded 50%. The issue needs to be tackled.

2. Possible risk quantification and mutualisation challenges, and the wide range of protection gaps may reduce the insurability of certain of these risks, limiting the insurance sector's room of manoeuvre and affecting citizens' trust in the insurance sector

An official commented that, whereas climate-related losses tend to relate to higher frequency or high-intensity events, cyber tends to relate to new risks.

An industry representative commented these developments in cyber risk and stated that there are limits to insurability of risks. An insurance organisation aims for a diversification of risk and an understanding of the concentration of risk. There are then limits to concentration exposure, affordability and what makes sense to insure in terms of its nature.

Systemic risk tends to be thought of in two ways. If there is something that can be modelled, and if an expected loss scenario can be quantified, then that would be quantifiable and acceptable for an insurer. Even within systemic exposures, things such as malware can still be quantified; it is a quantifiable systemic risk. However, there are things like cyber terrorism or cyber warfare which are unquantifiable systemic risks. It is not something that is transferable from a risk perspective to the insurance industry.

The industry establishes trust by being clear on what is being done and what is being offered. There needs to be increased education in risk awareness, and at the same time, addressing behavioural bias and affordability. The ultimate focus is on loss prevention and increasing resilience.

3. The industry is shifting from an indemnification focus to risk prevention and awareness

The Chair stated that insurers can play a role in building resilience, mitigation, and adaptation.

An industry representative commented that the industry is shifting from focusing on indemnification to risk prevention and risk awareness. A great deal can be done on both nat. cat risk and cyber risk. When it comes to nat. cats, the insurance industry has decades worth of understanding and of modelling the risks. This expertise and insight can not only be provided to public authorities but also to the public to steer collective behaviour and help to mitigate the risks.

The insurance industry has much less experience and much less data to enable it to quantify cyber risks. However, the insurance industry is in the business of risk management and risk mitigation, so even though the models are not yet at the required level, the industry has identified ways to strongly reduce the risk.

The Chair summarised that it is essential to adapt because it will at least ensure that the number does not go up as high as it otherwise could.

An industry representative stated that there can no longer be a standalone conversation on developing new insurance schemes and increasing insurance penetration. It needs to be held in the context of how the industry can reduce risk at the same time.

4. The role of supervisors is evolving in order to better combine financial stability, risk prevention and insurance coverage development in the context of raising risks

A regulator and the Chair of the IAIS Executive Committee emphasized that Japan has been playing a leading role in this work. The IAIS issued a report last November which noted that the issue of the protection gap has become more important. Insurers and the supervisors need to think about how to address this issue, given its societal role. The report highlights that, while there are differences of mandates among supervisors, they have a role to play in narrowing the natural catastrophe protection gap, citing the potential impact on financial stability, policyholder protection and financial inclusion.

The IAIS's report highlights five roles that supervisors can play. This encompassed assessing the gap, improving financial literacy and risk awareness, incentivising risk prevention and reduction, creating an enabling regulatory and supervisory environment to support the availability of insurance and uptake of coverage, and advising stakeholders on how public and private sectors can partner to narrow the gap.

5. Improved data and a comprehensive disaster risk assessment are key.

5.1 A comprehensive disaster risk assessment including the financial impacts on public finances is necessary to establish coherent resilience strategies

An official commented that disasters have no borders. Like with environmental, social and governance (ESG), it is important to have international standards and dialogue of cooperation. Last year, the OECD issued its Recommendation on Building Financial Resilience to Disaster Risks. This is built on obvious principles for members to put in place the conditions to promote comprehensive disaster risk assessment. Then it is about effectively assessing and managing this risk. There needs to be an understanding of the financial impacts of disasters on public finances in order to help establish coherent strategies for building financial resilience to disasters.

5.2 In some cases, improved data makes it possible to design protection for risks that were previously impossible to insure against

An industry representative stated that, on top of the knowledge that insurance and reinsurance can bring to the table in terms of risk reduction, there is also relevant innovation in the technical field to provide cover in areas where it had not been possible in the past because of a lack of data or a lack of techniques. Regarding public assets, which are typically uninsured in continental

Europe, parametric cover makes it possible now to design insurance protection for the rail or road network, or infrastructure. There is innovation in data analytics and distribution that can be taken advantage of.

6. Public-private partnerships are key to facilitating insurability of hard-to-insure risks

An official noted that a great deal of analysis is also undertaken on insurance and reinsurance. Public-private partnerships (PPPs) in this field are important, not only for tackling losses which can be otherwise uninsurable but for preventative work and exchanging data. Hopefully this will be advanced further in 2024.

A regulator and the Chair of the IAIS voiced their appreciation for the OECD's contribution to the IAIS report, particularly on PPPs. The Japan G7 presidency last year stressed the importance of the IAIS work on nat. cat. protection gap and the Italian G7 presidency is also keen to take up this issue. Japan has always been hit by natural disasters, and its government supports and reinsures earthquake insurance. Work is taking place to form a new organisation to promote financial literacy. Promoting financial literacy in the insurance space could be very important.

An official stated that mutualisation is at the core of what insurance brings to its clients and to society in general. The bigger the pool, the easier to price and lower the premiums. This means the benefit is widely shared. That works well for easy, predictable, and quantifiable risks. However, this is much more difficult in a rising risk situation. There has already been an attempt to strengthen these kinds of mutualisation elements at a national level.

In PPP there are elements for each side to do. On the public side in France, there was first the question of strengthening the existing system, such as reinsurance, that is guaranteed with an unlimited guarantee on the nat. cat. system. Part of it is to ensure mutualisation continues with a basic measure intended to raise the top-up premium that is on every contract in France to pay for stabilisation and the enduring of this mutualisation system. It is also about looking at the elements that are putting mutualisation into jeopardy. One paradox is that better data can be detrimental to mutualisation. Data is getting better and better, but any use of data to do more selectivity and less mutualisation presents a problem.

6.1 Sound assessment, balanced sharing of the cost underlying risks, adaptation, as well as limiting possible moral hazard are prerequisites for a PPP to reduce the insurance gap and dampen disaster negative impacts. Supervisors have a role to play

An industry representative highlighted PPPs as one of the solutions. However, the underlying risk still needs to be priced. PPP encompasses three core ecosystem players, which are authorities, insurers, and the policyholders. All three need to have equal skin in the game because the aim is not to have just an insurance mechanism but to also build resilience. If there is no resilience and there is a continued increase of these losses, the continued viability of the PPP could fall into question.

The Chair commented that it is likely if more data shows that there is more risk the price will go up. Yet, insurers will need to price the risk. So, this is not a problem that can only be solved within the context of the insurance industry.

An industry representative highlighted moral hazard as a major obstacle to increasing insurance penetration. Italy has made a big step in the right direction with the passing of its budget law, Article 24, which makes it very clear that a corporate or an enterprise must have insurance otherwise it will not be reimbursed.

On the public side, particularly in respect of continental Europe, every level of administration tends to pass the risk onto the next higher level of administration. If the higher administrative level bails out the municipality or the Landkreis, there is absolutely no incentive for that municipality to be self-sufficient, self-reliant, and to manage risk accordingly.

A regulator noted that on PPPs, the European Central Bank (ECB) and EIOPA paper was comprehensive, and it touched upon the importance of addressing moral hazards.

He also noted that PPPs can take various forms across jurisdictions. First regarding financial literacy or risk awareness, there is a common goal that the public sector can share with the private sector.

The second area is risk prevention. The role of insurers could be important by-offering risk-based premiums, to incentivise policyholders to be more resilient in terms of their property. The public sector can also help to identify what resilient infrastructure is. They have expertise to point out what kind of infrastructure would be desirable in the future.

The third area is tail risk. What kind of risks the private sector can cover and what would be difficult. There could be tension between the public and the private sectors on how to structure this in the most desirable way for a PPP. There is no one-size-fits-all and there could be jurisdictional differences. Supervisors can play a role by being involved in the design of the PPPs.

6.2 One of the main challenges in setting up PPPs is managing effective public-private discussions: supervisors have a role to play

The Chair stated that supervisors are the catalyst of a public-private discussion that certainly need to take place. The sooner that consumers and industries are back up on their feet and back into economic activity, the less of a second round of effects these events will have. Smaller companies not only want insurers to help them when there is damage, but also to be helped to prevent damage as they lack the knowledge. This is a new area for insurance.

An industry representative stated that the aim is for insurers to raise risk awareness and work on risk

prevention. Policymakers are extremely powerful in steering and incentivising collective behaviour. It is helpful to provide understanding of the risks, prevention and mitigation to public authorities, customers, and society. It is not always complicated, but it needs to be clearly shared so public and private are working together to influence and steer customer behaviour.

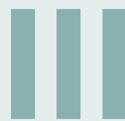
The Chair summarised that there is increasingly integrated dialogue with key players from the markets, public authorities, and international organisations on how to approach the insurance protection gaps. There is an understanding that individuals need protection, but also societies, and even parts of the world, jointly need mechanisms to deal with these risks. Governments need to tell the policyholders that they should not rely upon help from governments.

Market knowledge, innovation and more data will help the industry to understand more, to do more and to insure things that could not be insured before. Dialogue on PPPs is now taking place in the IAIS, EIOPA, OECD and the ECB. There will continue to be examples and principles for PPPs. This will require a joint approach.

6.3 An EU level mechanism addressing possible insurance market failures may help to reinforce national (normally) self-sufficient PPPs

An official stated that, while the EU level is also very important and could present a solution, it must be targeted at the last resort. That means that national levels should be developed, functioning and self-sufficient, and that there is a higher level developed for specific cases, such as very high impact transnational events and when there is a demonstrated market failure, because it is known that some elements of risk have chased private reinsurance from some risks.

Sessions



DIGITALISATION AND TECHNOLOGY

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Digital finance: key priorities for the incoming Commission

1. Trends and opportunities from the use of technology in the financial sector

An industry representative noted that the use of technology in finance is driven by the objectives of increasing profitability and better meeting consumer demands, including working towards more financial inclusiveness. Focus to date in the market has primarily been on profitability and cost savings, a trend which has been amplified recently by inflation and macro-economic challenges. As a consequence, there has been less emphasis on customer-related evolutions. However, over the last 20 years, insurers for example have being using technology to improve their algorithms and customer data analysis to optimise pricing accuracy and risk mitigation. Progress on reducing exclusion and enhancing the personalisation of insurance products has been more limited. Policy measures might be needed to foster initiatives on financial inclusion.

A second industry representative agreed that digitalisation can enhance customer experience, accessibility and product innovation, as well as foster efficiency, profitability and risk management in the financial sector. Technology also supports new models of collaboration and new ways of providing financial services to clients, such as Banking as a Service (BaaS), which enables the provision of banking products to non bank third parties or platforms through APIs. Technology also leads to a more competitive landscape, which may be profitable for all market stakeholders provided there is a level playing field. The industry representative considered that financial exclusion is not a pressing issue for banking services in most developed European countries, where the number of unbanked citizens is limited. The Chair noted that, although there are few unbanked people in these countries, there is a risk of digital exclusion if people find it difficult to use banking apps.

A regulator highlighted that tokenisation, the digital representation of financial or real assets on distributed ledger technology (DLT), could be a major trend in the market in the coming years. Tokenisation offers significant potential advantages in terms of efficiency, transparency and accessibility for investors, allowing, for example, fractionalised ownership of real assets. However, the uptake of DLT has not been as fast as initially expected. This is partly because it is still an emerging technology with scalability issues remaining to be tackled. In addition, issues around operational resilience and how the governance framework may work in decentralised environments remain to be clarified. It is hoped that the European DLT pilot regime, which came into force in March 2023 and aims to encourage the uptake of DLT for securities trading and settlement by both established and new players, will support a further uptake of DLT in the securities market, together with the implementation of the Digital Operational Resilience Act (DORA).

A second regulator noted that in the insurance industry, technology is mainly used to enhance the processing of data. This is logical since insurance involves a great deal of data analysis, notably for pricing based on claim data. Most new developments in this area relate to artificial intelligence (AI) and data analytics. A recent EIOPA survey revealed that 61% of insurers are using AI daily. AI is still primarily being used for efficiency in the back office and to support claims management on the basis of photos, but is moving towards front office applications as well, such as price setting and risk assessments

The survey showed that digitalisation is still limited in other areas. Online sales are very low in the EU insurance sector, although this differs by market and is expected to change in the coming years. There are also limited open insurance developments in some markets in Europe. There is not a great deal of activity around blockchain or DLT in the insurance sector, although there could be applications in the area of parametric insurance for example, which involves automatic payouts triggered by pre-determined events. A move of big techs into the insurance market was anticipated by policy-makers, but has not yet happened. Insurance for damages related to crypto is another emerging area, although crypto is not yet used that much.

2. Challenges and risks associated with digitalisation

2.1 Customer protection and interconnectedness risks

A regulator stated that, while digitalisation is expected to play a critical role for the greater engagement of consumers in the capital market, this may give rise to new risks, for example related to increased cross-border offerings of investment products supported by digital channels, gamification, the role of influencers and social media, AI and crypto. ESMA has recently launched a survey of retail investors to assess how digitalisation is changing the relationship between financial market actors and consumers and how retail investor experience has changed with digitalisation in recent years. The outcome of this will feed into the thinking about future legislative developments.

The Chair observed that, although younger people are comfortable with digital channels and very digitally engaged with social media, they are possibly at a greater risk than older populations because they may be more

exposed to finfluencers and are used to scrolling quickly through information. Therefore they may not fully evaluate the risks of products to which they are exposed.

An official outlined several risks posed by digitalisation. First is the difficulty of keeping pace with the constant changes brought about by technology. Ensuring customer protection requires constant evolution in terms of skills and mindset on the side of financial intermediaries, supervisors and customers. Secondly, digitalisation generates a huge amount of capturable data, which increases security and privacy risks for consumers and operational resilience risks for financial firms. Thirdly, the increased interoperability of IT systems as a result of digitalisation increases the interconnectedness of different actors in the financial market, creating potential systemic and spillover risks. Finally, digitalisation also increases cross-sectoral risks, such as digital fraud.

2.2 Cyber and digital operational resilience risks

An industry representative emphasised the importance of addressing cyber risk and digital operational resilience risks. Many reports, for example from the World Economic Forum, the Bank of England and the Single Supervisory Mechanism, have highlighted cyber-risk as a critical global risk. To address the ever-evolving cyber threat landscape, the very best technology is needed. Cloud services can enhance the safety of financial infrastructure and services while supporting innovation, with access to greater analytical capability and computing power.

An industry representative noted that cyber-risk is being addressed by the implementation of the new Digital Operational Resilience Act (DORA) regulation. A regulator added that there is currently a gap in terms of insurance against cyber-risks which needs addressing also. The Chair noted that it is also important to raise awareness among financial services users about the various risks in the digital space including cyber-risks and the risks from phishing or spams.

3. Regulatory priorities for the next European political cycle related to digitalisation

3.1 Focus on the implementation of existing regulation

The Chair noted that a number of new legislations that may support further digitalisation and the mitigation of related risks have been adopted under the current legislature. These include the DLT pilot regime, the Payment Services Directive 3 (PSD3), the DORA framework, the Markets in Crypto-Assets Regulation (MiCA), as well as horizontal frameworks such as the AI Act and the EU strategy for data. These policies require adequate implementation and there is also the question of whether further policy intervention is needed.

An official stated that the priority is to properly implement the legislation that has already been adopted and to monitor its effects, before identifying the need for any additional or new rules. Digitalisation can have many positive impacts, but in order to harness them effectively it is important to also mitigate the challenges and risks that stem from it. How the financial sector is coping with the changes brought by digitalisation in its internal processes and in customer interaction and with the regulatory requirements aiming to ensure resiliency needs to be closely monitored. In some cases, existing regulations can be amended or their scope can be extended to increase their effectiveness. For example, extending the scope of the well-functioning anti-money laundering (AML) regime to unauthorised payment transactions would reduce the harmful effect of online fraud, allowing a suspension of these transactions and a gain of time to investigate the transactions.

A regulator agreed that continuous market monitoring is needed in this fast-developing area to identify possible gaps and determine whether they require additional legislation or amendments to existing rules. This monitoring is conducted at EU level in the joint committee of the ESAs together with the national competent authorities (NCAs) and cooperation is also needed at the international level to ensure sufficient regulatory convergence. There are individual dialogues for example with the UK and with the US regarding work on AI and DORA like projects.

Another regulator emphasised that much of ESMA's focus is now on implementing the rules that have been adopted, which need to be applied in practice in a timely manner. Establishing the regulatory technical standards for these new regulations is quite a challenging task. For example, MiCA will require significant policy implementation work with more than 30 mandates for ESMA.

An industry representative agreed that the focus in the next European political cycle should be on implementation and not on proposing new regulation. A large number of regulations have been adopted but have not yet been implemented, with many mandates and delegated acts to draft and implement. Interlinkages between the different digital regulations should also be carefully considered in this implementation work, for example between DORA and the Financial Data Access regulation (FiDA). There should also be consideration of interactions between regulation and private initiatives, such as between the digital euro and the European Payments Initiative (EPI). A consolidated view of the whole set of regulation is needed as well as a collective understanding of its implications for market stakeholders and of the possible challenges that need tackling.

3.2 New areas to address from a policy perspective

A regulator noted that two legislative proposals that are relevant for the digitalisation of financial services – FiDA and the Retail Investment Strategy (RIS) - are still being reviewed by the co-legislators. FiDA which aims to facilitate the sharing of personal and non-personal customer data held by financial sector intermediaries with third-party providers has many potential applications in terms of new online services and the RIS addresses social media engagement and finfluencers. Beyond the finalisation of these proposals, further

guidance may also be needed in areas such as the AI Act to better take into account the specificities of financial services. Concerning crypto-assets, more work will be needed on how to address decentralised finance (DeFi), depending on how it will develop in future. The possible need for a proper transaction reporting regime in MiCA should also be considered.

Another regulator agreed that DeFi should be further assessed to determine whether and how it may need to be addressed by legislation. Concerning AI, horizontal legislation makes sense, because there is no reason to treat technology differently per sector, but it may have different implications for different sectors. Guidance for the application of the AI Act to financial services will be drafted in 2024. As financial services are already heavily regulated, the implementation of the AI Act could lead to overlaps or gaps, both of which must be avoided. For this reason, it is very helpful that the AI Act incorporates the provision that the current sectoral supervisor will continue to supervise the requirements in the AI Act. Further clarification may also be needed in some areas of FiDA. The safe sharing of consumer data can lead to the improvement of online services and products and to more efficiency, but clarity is needed notably around whether the data to be shared concerns just raw data or potentially also intellectual property in rich data.

The Chair commented that the precise implications of the AI Act for the financial sector will need to be assessed over time, given the likely increase of AI use in the coming years. Concerning FiDA, an industry representative added that the practical modalities for implementing the financial data sharing schemes that are foreseen in FiDA also need careful consideration.

3.3 Key areas of focus for the implementation of adopted digital regulations

Some areas of focus for the upcoming implementation work on adopted digital regulations were suggested by the panellists.

A regulator suggested that the focus concerning the AI Act will be on the quality of the data and ensuring the fairness of processes using AI. For example, if AI is used to set the price of an insurance, the price should be set considering the customer's risk, not the likelihood of the person cancelling the policy if the price is increased. The process should also be inclusive, which means that it should be simple and understandable. This is already detailed in the principles for ethical use of AI that were drafted with industry and will be incorporated in the AI Act requirements.

An industry representative noted that in relation to the implementation of DORA, an important issue that needs considering is the highly sensitive nature of cyber-security information and of the information that technology providers such as cloud service providers (CSPs) handle. How supervisors and regulators will deal with this information is critical. This information is not just financial data but can also relate to national security or can be of systemic importance to the financial sector. In 2025, critical third-party providers (CTPPs), most likely including major CSPs, will need to start adapting to the DORA framework. CTPPs will need to consider how the risk management framework adapts to their activities.

4. The need to adapt policy-making and supervision to the digital world

4.1 Key principles needed for driving policy-making in the digital world going forward

An industry representative commented that regulation should follow four principles to support the digitalisation of the financial sector. First, EU competitiveness should be preserved. It is hoped that digitalisation challenges will be a significant part of Mario Draghi's upcoming report on the competitiveness of the European Union. Second, the safety of customers should be preserved. Third, the stability of the financial sector should be ensured. Fourth, the successful business models already in place should not be threatened by an unlevel playing field or irrelevant requirements.

Another industry representative agreed that strengthening the competitiveness of Europe vis-à-vis other regions such as the US should be a key policy objective in the next political cycle. This would involve facilitating investments in start-ups and ensuring that existing business models that work can be sustained. New regulations and supervision should contribute to an evolution of the financial industry, rather than a revolution. Some financial firms are concerned that FiDA might lead to a revolution if data sharing becomes mandatory, but this is unlikely. It is more likely that FiDA will aim to increase consumer outcomes in an evolutionary way.

The industry representative added that while protecting consumers from these new market development is an important objective with frameworks such as the AI Act or the Digital Markets Act which addresses gatekeepers, these 'reactive' approaches need to be combined with more pro-active regulations that aim to remove barriers to innovation, such as FiDA. Data is the key asset driving innovation in the European financial market. It is crucial that consumers own their own data and are free to share it to obtain improved service. Timing is a further aspect to consider. There should be caution around reacting to innovative changes in the market too early because regulating a new technology too quickly often may limit innovation and utilisation. Regulation must not be too slow either, as this would lead to negative impacts for consumers or other stakeholders. The right balance needs to be struck in terms of timing and also proactivity in order for Europe to lead the way in terms of digitalisation. If regulation is not proactive enough, other states will have a faster pace of digitalisation. The financial industry should be allowed to evolve and innovate, while ensuring that appropriate guardrails around consumer protection are in place.

A regulator emphasised that policy actions must remain customer-centric. An appropriate balance must be found between competitiveness and objectives such as providing consumer protection and access to finance. Competitiveness may also mean that some business models might not be sustainable.

4.2 Adapting supervisory and regulatory approaches to the digital world

An industry representative stated that supervision and financial regulation must also evolve with digitalisation and the authorities need to think 'outside the analogue box'. Regulatory frameworks and supervisory practices must be adapted to the new digitalised world. For example, operational resilience in a digital world is cross-sectoral and does not recognise geographical borders. Coordination at the international level is essential to ensure cyber resilience, as well as a collective effort from technology providers, the regulatory community and financial entities. DORA also requires that supervisors deal with information beyond the financial sector. In addition, there are a great deal of opportunities for the regulatory community to use technology for their own activities. Live surveillance of markets is already being used in the US. Upskilling will be critical and collaboration between technology providers and the regulatory community is crucial in this perspective.. The Digital Finance Academy is a very successful endeavour for example.

A regulator emphasized that cooperation at different levels among supervisors is essential to address digitalisation. Coordination between the European supervisory authorities (ESAs) and the NCAs is necessary for the implementation of MiCA, as the NCAs will be in charge of day to day supervision. A broader cooperation with authorities beyond the financial sector will be necessary to enforce AML requirements or ensure digital operational resilience and cyber-resilience in the context of DORA. Cooperation is also needed at the international level to address AML and cyber-risks and tackle the risks posed by financial players that operate on a global scale.

The regulator added that the implementation of certain rules will be challenging, particularly in areas where supervisors and industry players have limited experience, such as MiCA. In addition, effective consumer protection requires using the different levers available including regulatory standards and effective supervision and enforcement, which is a current area of focus for ESMA and the NCAs. Any potential for regulatory arbitrage must also be eliminated, which will require a common European regime for MiCA that addresses authorisation, supervision and enforcement in a common way.

Another regulator noted that supervisors will need to be trained and have a dialogue with innovative fintechs in order to fully understand the implications of new digital evolutions and have a sufficient level of comfort when considering these innovations. Some new developments can be confusing at first, but once they are better understood they can, in many cases, be related to existing activities and processes that they are attempting to improve. The Digital Finance Academy which was set up by DG Reform and the three ESAs for delivering training courses focusing mainly on the use of AI, is a good example of cooperation. An industry representative agreed that there is much value in training supervisors on new activities in a collaborative mode.

An official emphasised that digital risks, such as digital fraud and cyber-risks, are cross sectoral and require a cross-sectoral solution. Cooperation is needed between members of the financial intermediary system, supervisors, authorities, the IT sector, fintech and social media firms.

Conclusion

The Chair summarised that the panel had many common views. Business and consumer behaviour is changing because of digitalisation. A great deal of work has been carried out, but many of the rules still need to be implemented. The interaction between the different frameworks must be considered. A balance between giving space for innovation and making sure that consumers and investors are protected must also be sought.

Cyber and digital operational resilience: DORA implementation and international cyber-resilience initiatives

1. Ensuring cyber and digital operational resilience is increasingly challenging

The Chair emphasised that cyber risk and resilience are live topics for regulators and industry executives. Among their main concerns is the risk of a major cyber-attack. This is a challenging area of work. It is highly technical and possesses complex risks. The environment is also rapidly changing. As financial activities become more tech-driven, cyber and digital operational resilience challenges become ever greater. The attack surface is very large and the vectors are very fast moving. These risks are cross-sectoral as well, requiring an evolution of traditional risk management approaches. The growing importance of outsourcing and of third-party service providers presents a further challenge.

An industry representative remarked that delivering trust to consumers and businesses in Europe and around the world, which is the objective of payment schemes in particular, is increasingly challenging. The first level of trust for payment schemes is ensuring that the system works every time a customer executes a payment domestically or across borders. To deliver that consistently on a global basis requires significant infrastructure and systems operating in triplicate. Moreover, it is crucial to safeguard the system against cyber threats, ensuring its availability and the integrity of the data processed, in a landscape that is perpetually evolving. Substantial investments in cybersecurity are imperative, covering both IT and staff aspects. A global outlook is needed also, as most cybersecurity threats are cross-border. In addition, customers have to be protected from fraud. The debate on fraud predominantly focuses on what needs to be done after it occurs but the priority should be prevention. In Europe, thanks to the Payment Services Directive (PSD2), fraud rates have come down by about 20% over the last couple of years, but fraudsters continue to innovate.

A supervisor noted that though there has so far not been a major destabilising cyber-attacks directed at the European banking sector, the risks are real. The geopolitical situation has led to an increased threat level. In certain countries, there are frequent attacks by certain governmental parties. The highest increase is in distributed denial of service (DDoS) attacks. There is also an increase in attacks on third-party providers (TPPs) as attackers have managed to exploit vulnerabilities. Ransomware is a major threat as well, as it can disrupt critical services.

2. DORA implementation progress

2.1 Objectives and specificities of DORA

A regulator emphasised that the Digital Operational Resilience Act (DORA), which aims to enhance the operational and cyber-resilience of the financial sector is a ground-breaking regulation, which adopts a cross-sector approach and covers about 20 different types of financial entities. DORA addresses areas that are critical for firms, like information and communications technology (ICT) risk management, ICT incident management, resilience testing, management of third-party risks and stress testing.

That involves strengthening the approaches and the risk management capabilities of the financial entities concerned. An oversight of the most critical TPPs (CTPPs) that service financial entities is also being built across sectors. For those TPPs, the oversight task will be devolved to the European Supervisory Authorities (ESAs).

2.2 Progress made in the drafting and adoption of Level II requirements

A regulator detailed that there has been extensive consultation on the first batch of regulatory standards, which was submitted to the European Commission in January 2024. This involved close consultation with the private sector and all of the competent authorities. The first consultation on ICT risk management and incident reporting led to the identification of a number of issues in terms of proportionality, complexity and the level of prescriptiveness in the requirements. ICT risk management is a broad topic, so being proportionate is not easy. The consultation on incident classification was very beneficial and allowed a revision of the thresholds to ensure that smaller and non-complex entities are subject to proportionate requirements. Detailed work is needed on the register of information which concerns the contracts that financial entities have with TPPs. Designating the CTPPs, which are critical from a systemic perspective, will be key. This designation is being prepared gradually, with the objective of starting the oversight in January 2025.

The second batch of regulatory standards will be consulted on until the end of March 2024 and then submitted to the Commission in July. This covers aspects such as incident reporting, subcontracting and threat-led penetration testing (TLPT), which require fine-tuning. In terms of how this guidance fits with existing ESA guidance, the setup will supersede the entire set of existing guidelines and requirements in order to avoid duplications and overlaps.

A Central Bank official noted the importance of on-going consultations involving market participants in

order to identify the issues on which further clarity is needed. Different tools, such as Q&As will be provided to achieve this.

2.3. Conditions for the success of DORA

2.3.1 Future-proofing

A regulator noted that this is a fast-evolving environment. Requirements must be designed to be future-proof, in order to accommodate future developments in a smooth and easy manner.

An industry representative agreed that the regime must be future-proof and also practically implementable which requires sufficient proportionality. The regulatory standards are a moving target and it is expected that there will be many questions remaining to be tackled and provisions that will need tweaking to ensure consistency, harmonisation and proportionality following the on-going consultations, notably concerning threat-led penetration testing.

Another industry representative suggested that common objectives should be set in terms of levels of availability and fraud to be reached over time. Much time is spent focusing on standards, but an equal amount of time should be spent on making progress towards improved outcomes, because standards evolve. With a joint goal to work towards, there will be more innovation in the space.

2.3.2 Regulatory certainty

Regarding possible concerns that CTPPs may have with the proposed oversight regime, an industry representative emphasised that the main concern is regulatory uncertainty, in terms of how to interpret the framework, which is very technical. That is especially likely to happen during the first implementation of DORA requirements. Policy dialogue should take place during this process but after it as well, so that the learnings of the first iteration of DORA can be taken into account to achieve a practical, implementable solution for the whole ecosystem with sufficient certainty. The on-going dialogue between the ESAs and the industry will also contribute to this objective.

A regulator observed that the ongoing consultations and meetings organised by the ESAs can be taken advantage of. This will allow ICT TPPs and financial entities to express views on the proposed standards, before documents are sent to the Commission for adoption. That should help to solve interpretation issues, and a Q&A mechanism will contribute to clarify matters further.

The Chair noted that there is also a need, within the framework, to focus on what matters the most and is most material, which requires pragmatism, proportionality and not losing track of the bigger picture. DORA is cross-sectoral, involves firms of all different shapes, sizes, and business models and has to work with different levels and chains of outsourcing, which creates complexity. Financial firms must not ignore either that they are responsible for the business they outsource.

2.3.3 International consistency

An industry representative noted that, for global players, it is important to have a harmonised regulatory regime, that looks at matters from a global perspective as well as a regional one, to make sure this regime is compatible with other jurisdictions. Good regulatory practice is also essential to encourage other regions to follow the benchmark that the EU is setting in terms of digital operational resilience regulation.

2.4 Areas that require further clarification

An industry representative observed that certain aspects of DORA need further clarification, for example, TLPT and how that will work in practice, and pool testing and whether it is feasible, especially in cloud environments.

The Chair noted that TLPT, or red teaming, is a new part of the framework, which is being extended beyond the European Central Bank's (ECB's) Threat Intelligence-based Ethical (TIBER-EU) approach. There is much to learn in that process, including how it fits with the chain of outsourcing.

2.5 Implementation work at industry level

A regulator observed that the preparation for DORA in the financial sector is progressing well, but implementation is approaching quickly, and involvement is needed from all stakeholders to ensure they are prepared for the start in January 2025.

An industry representative remarked that there is less than one year left for the DORA implementation. The main financial institutions have at least activated a gap analysis on DORA, and half of them also have a concrete and actionable roadmap. However, few of them have already implemented the contents of this roadmap in a practical way. Though there is some stress about that in the market, there is also a strong commitment, because there is a recognition of the importance of DORA for reaching an adequate level of protection and sufficient financial stability. The possibility of having an open dialogue with the authorities is also valued.

A Central Bank official noted that the CTPPs in particular, need to prepare and not wait for the beginning of 2025 to prepare for the oversight regime. Contractual arrangements need to be reviewed in the coming months.

Another industry representative stated that all cloud providers have been preparing very diligently and thoroughly for the implementation of DORA scheduled for January 2025. Different cross-functional teams have been set up to analyse the impacts of DORA and prepare for its implementation. This includes mapping out existing capabilities in many different areas such as ICT risk management, threat-led penetration testing to fit with DORA requirements and working on various legal and contractual aspects. This process should ensure that the necessary operational changes are made in a robust way and that the customer perspective is adequately taken into account.

Cloud service providers are also looking at how to apply the DORA requirements in different service models, the

industry representative noted, including software as a service, platform as a service, infrastructure as a service and on-premises models. Depending on the environment, each necessitates a differentiated approach, which is a layer of complexity in itself. The control and responsibility inherent to each model is also being considered. The larger cloud providers are also working under the assumption that they will be classified as CTPPs. That involves preparing for the responsibilities and accountability towards customers mandated by DORA, as well as incorporating DORA principles in governance frameworks concerning all functional product and service layers. That will ensure that all cloud services and the associated potential risks are managed according to the DORA standards.

3. Challenges raised by the implementation of DORA

3.1 Challenges at industry level

A supervisor highlighted that there is a lack of IT expertise across financial institutions, including at board level. This is an important problem, because banks that have the proper expertise also manage to better identify risks. In addition, questionnaires, on-site inspections, cyber-incident reporting and targeted reviews, have shown that there are still gaps in risk control and failures in identifying risks and incidents, as well as an insufficient protection of IT assets.

An industry representative remarked that the additional budget needed for implementing DORA is an issue for many entities, as well as the timescale of the implementation. For smaller entities, the estimated cost is one or two million euros in the next couple of years, but for mid-size entities it is 10-20 million and for the biggest entities it is 40-100 million. Such additional budgets need to go through lengthy authorisation processes and the implementation is driven by tenders that take time to complete.

There is also an issue of skills and resources. The successful implementation of DORA requires firms to review their organisational model, with a more proactive approach of boards to cyber and IT risk management and also an empowerment of the second line of management. These organisational changes constitute the basis for an effective DORA roadmap, but there is at present a lack of skills for implementing them. The regulatory technical standards (RTSs) also detail the expectations in terms of technology, which is helpful, but implementing new skills and new technologies takes time. Companies are trying to leverage as much as possible existing solutions and processes to improve their cyber and digital resilience capabilities and reach the DORA target and are endeavouring in parallel to implement a new streamlined target architecture, leveraging new technologies.

A second industry representative agreed that budgetary concerns are an obstacle. There is a need to be mindful of smaller players and how they will manage to cope, because cyber and digital operational resilience must be implemented throughout the entire ecosystem.

3.2 Challenges for supervisors

A Central Bank official observed that the ESAs and national competent authorities (NCAs) face challenges in preparing for the implementation of DORA at three levels: IT, staff and establishing priorities. A first issue in the short term is properly setting up the reporting systems, which is challenging in terms of IT and timing. This has to be fixed in the most pragmatic and simplest way possible. The other two aspects concern the CTPP oversight regime. There is a need to have the adequate staff to conduct the oversight of CTPPs, which will primarily involve inspections. However, there is a scarcity of IT experts, which will require pooling resources and using a collaborative approach notably via the Joint Examination Teams (JETs), the new joint teams due to be set up between the ESAs and the NCAs for overseeing the CTPPs. Thirdly, priorities will need to be established for running the inspections, which will require a risk-based approach.

Responding to a question from the Chair about how resources should be best used, the Central Bank official indicated that some existing tasks, which will remain, might be streamlined or better prioritised, but supervisors will have to decide about recruiting new resources to increase their competence pool and plan ahead to ensure that the experts available can be mobilised for the most important tasks. Prioritisation is important to allocate resources in the best way.

A regulator explained that work on the oversight framework was initiated by the ESAs in the autumn of 2023, as the objective was to concentrate first on the development of the policy aspects, in order to allow the industry to start planning for implementation. Work on the oversight regime is proceeding quickly under the aegis of the ESA Joint Committee. A high-level group was created gathering experienced and high-level supervisors from all member states and across sectors to prepare the oversight setup. Oversight methodologies are being worked on and the resources needed to conduct this oversight on the ground are being evaluated. ESA resources will need to be complemented by resources provided by the NCAs for conducting the oversight. The objective is to leverage existing structures as much as possible in the context of the JETs. Other institutional arrangements created by DORA include an oversight forum and a joint oversight network.

4. Success factors of the CTPP oversight regime

An official welcomed the direct oversight regime of DORA, but stressed that it will not replace, but complement, existing due diligence obligations. The banks that use CTPPs will have to continue doing their own due diligence, in order to properly manage operational and third-party risk. Moreover, the direct oversight regime must not be considered as a bilateral dialogue between the CTPPs and the regulator. Financial institutions have to be involved. All relevant parties should be brought into the framework in order to identify collectively potential vulnerabilities and

supervisory priorities and define the actions that the CTPPs need to conduct in order to address these vulnerabilities. This is quite complex, as CTPPs offer services to many different types of firms in different countries around the world. Ways therefore need to be found to make this system effective and sufficiently economical, which may involve co-operation across financial institutions and joint audits. There should be continued exploration of the possibilities for optimising current supervisory processes and inspections that concern the same providers. Some developments in Europe are also quite promising, such as the certification regime for cloud service providers.

The official added that international co-operation is quite a challenge in this field, because there are different regulatory regimes in different jurisdictions. In most countries the oversight regime largely relies on the due diligence performed by the entities themselves. The DORA direct oversight regime is still unique, but there are other regional arrangements, for example in South East Asia, to consider, although they do not have the same degree of concreteness and prescriptiveness. Beyond the implementation of DORA, efforts must be made to foster more co-operation and consistency at the international level. Consideration should be given to put in place a common supervisory regime for some global CTPPs along the lines of the regime employed to oversee SWIFT.

A regulator suggested that, with regard to the CTPP oversight regime, the thinking in terms of organisation and resources is in three main areas. One is staff, meaning the amount of people that can be put on the ground, but there are also skills and technology. Many experienced supervisors have been dealing with ICT risk in the past, so their skills can be leveraged. Initiatives can also be put in place to upgrade skills. There is an arrangement with the Directorate-General for Structural Reform Support of the Commission to upscale some of the skills of the supervisors for example. Technology can also be leveraged for this new type of supervision. Due diligence through surveys is conducted to better understand the characteristics of CTPPs and anticipate the needs in terms of the supervision of the 15,000 TPPs identified in the last survey. Not all of them have the same size, but many are relatively important for financial entities.

5. Measures needed to ensure cyber and digital operational resilience

5.1 Stress testing

A supervisor detailed that a stress test is being carried out currently in the EU banking sector by the ECB. The cyber resilience stress test is a severe but plausible cyber-related scenario. The purpose is to evaluate with detailed questionnaires the capacity of banks to respond and recover after an attack, rather than assess the controls preventing cyber-attacks. 28 banks are also participating in an IT recovery test. The ECB has assessors who will validate the answers. The governance and communication of the banks are also evaluated, because after a serious cyber-attack the way in which banks are able to communicate to the outside world is important. The objective is to identify possible weaknesses in the cyber-resilience framework of the banks, resulting in bank specific findings and recommendations to mitigate these. This will be a learning exercise for banks and supervisors.

5.2 Tackling systemic cyber-risks

An industry representative stressed that there must be a systemic approach to operational resilience, beyond resilience at firm level. All parts of the ecosystem, including regulators, consumers and firms, must work together to fight fraud,. Organisations must also assist each other. Such defensive work never ends, because fraudsters are very skilled. Whenever something is found that is supposed to stop fraud, the fraudsters will evolve to attack that too. The Chair noted that the ecosystem dimension is taken into account in DORA implementation preparations.

A supervisor highlighted that the European Systemic Risk Board (ESRB) has been doing a great deal of work on the systemicity of cyber crises. That is an important and very challenging area. The tools and approach needed to tackle these still need specifying. There is also a need to be agile to adapt to the changing risk environment, which means that the approach should not be too rule-based. Public-private partnerships are also needed.

AI in the financial sector: trends, challenges and policy approach

1. Expected impact from AI and generative AI in the financial sector

1.1 AI uptake in the financial sector

The Chair stated that the use of AI by fintechs and incumbent financial firms is increasing and can contribute to enhancing efficiency and offering better products. Further uptake of AI can be expected due to the increase of analytical capacity and computing power and new generations of AI such as generative AI.

An industry representative noted that AI and advanced analytics in general have been growing in recent years. In the speaker's bank the number of full time employees (FTEs), projects and budget dedicated to data and AI have tripled in the last five years. This concerns most areas of the bank. Fairly sophisticated models can be found for customer identification for opening an account. AI and algorithms are also used in most commercial activities, as well as market-making, fraud and anti money laundering (AML) activities. The uptake of AI for risk assessment, for example for granting credits, is slower given the high risk nature of AI use in this case.

A policy-maker agreed that the EU financial sector is already largely using AI for different tasks, such as risk management, fraud detection, customer service and investment analysis. The use of AI is expected to rapidly increase in all areas and activities of finance. Generative AI has made the public more aware of the development of AI recently, but it has been an ongoing trend for many years in the financial sector.

Another industry representative observed that the level of AI adoption and the sophistication of AI-based systems used varies across financial sectors, but increasingly larger players are engaged in the adoption of AI systems to a certain degree. The large players in the banking sector have adopted AI slightly faster than insurance. Differences depend for example on whether the companies are already involved in dealing with the implementation of other technologies that take up their innovation capacity or new regulations.

1.2 Prospects of generative AI

An industry representative noted that only around 3% of AI projects in their bank are based on language-focused applications at present, due to the complexity of language data and its interpretation. However, the advent of generative AI and large language models (LLMs) have captured the structure of language, allowing any application based on language to be built. LLMs understand and interpret human language, which paves the way for revolutionary applications in customer interaction and internal process optimisation. These innovations are happening at a very high speed and could be quite transformative for the financial industry in the coming years.

A second industry representative agreed that generative AI can bring many changes because of its conversational element and the fact that it can generate content. Industry leaders are now experimenting with AI due to the interest in generative AI, which has made them realize better the potential of AI. The speaker's firm for example, a provider of financial intelligence and analytical tools, has launched a tool that allows analysts to ask highly complex questions and get a rapid response based on the analysis of multiple datasets. Credit memos can now be created in seconds, which would previously have taken hours. Early warning systems can also be put in place in commercial real estate thanks to AI.

The industry representative observed that the level of sophistication of AI-based systems that companies use and their ability to leverage generative AI often depend upon the experience that they already have with AI. Those that have no structured AI team find it harder to catch up with innovation because of the scarcity and cost of resources. Having access to robust data and a sufficient volume of data is also essential.

1.3 Expected impacts of AI

An official noted that Silicon Valley technology and venture capital firms anticipate that as many as 80% of current job functions could potentially be automated away with AI. That concerns mostly repetitive functions, but the novelty with generative AI is that it has the ability to impact knowledge workers such as legal functions or consulting, which have been relatively sheltered from previous waves of automation. There could be significant shifts in workforce deployment in as little as five years due to the impact of AI. Financial companies need to plan for workforce development and transition in many functions beyond operations and technology, including risk, finance, HR, legal, compliance and internal audit. Regulators could also find significant gains from AI in their capabilities for monitoring, testing, surveillance and horizontal reviews. Generative AI could be helpful for example in compiling the results of various compliance reports and testing results and data gained from market surveillance.

The official added that the integration of various new and emerging technologies with AI holds the potential to markedly enhance capabilities, foster developments, and transform work processes. A combination of generative AI with other technologies such as cloud, Web3, blockchain and satellite internet could have transformational impacts that may open the way to further changes as other new technologies emerge and are combined.

An industry representative observed that generative AI has accelerated AI developments but the change in the

market is not yet transformational. There is a great deal of interest and work taking place around AI in the industry, but there are currently not that many live commercial projects. The focus at present is also mainly on cost savings and efficiencies, rather than on new growth opportunities. The fast pace of AI innovation compounded by further intersectional opportunities offered by other technologies such as quantum computing, which is expected to be a major driver of AI in the future should change this, but how generative AI applications will evolve is difficult to anticipate. Generative AI is still at a very early stage, so collective work will be needed to monitor developments and identify possible needs for guardrails. Education will also be needed within firms to learn to use generative AI and better understand its implications.

2. Challenges and risks from AI

A public representative highlighted the main challenges from AI that need to be addressed by the public authorities. The first challenge for regulators is the speed of innovation. AI is not new, but it is difficult to say whether the financial services sector has reached a tipping point with AI and machine learning, because as technology continues to advance, many new applications and innovative products are continuing to appear.

The second challenge that regulators are facing is addressing a variety of customer protection issues related to AI use. Data security and privacy is always going to be the main factor when drafting any technology-related legislation, and financial institutions need to put a strong emphasis on that when dealing with private data. A second aspect is the need to ensure that a consistent framework is in place to ensure consumer protection with quite variable levels of understanding of AI and trust in technology across European member states. Issues to address include the appropriate management of customer data by financial institutions and digital and AI literacy, which needs to be improved in order to bolster consumer trust. A third aspect is the necessity of maintaining human oversight and ensuring continuous human involvement in the development and use of these innovations.

An official emphasized the new risks associated with generative AI, including disinformation and deep fakes. AI combined with other technologies however has the potential to enhance risk management capability, which may contribute to mitigating technological risks. Blockchain for example can be used to provide digital watermarks to identify that the information comes from a verifiable source.

3. Objectives of the EU AI Act and future priorities

3.1 Objectives of the EU AI Act

The Chair stated that the AI Act is a cross-sectoral and risk-based legislation aiming to protect fundamental rights with AI use and to support the uptake and fair development of AI in the EU. In combination with the Data Act, the Data Governance Act and the Financial Data Access (FiDA) framework, the aim is also to provide a safe environment for the use and sharing of data.

A policy-maker explained that the Parliament and the Council have come to a political agreement on the AI Act proposal in December 2023. The AI Act is currently being finalised. The objective is for it to be adopted before the end of the current political cycle, meaning that it will become applicable from summer 2026. Once the AI Act is in force then the EU will be the first major jurisdiction to have a comprehensive framework for the use of AI.

The AI Act complements the EU strategy for data set out in the Data Act and the Data Governance Act, which tackles issues such as access to data and provides a governance framework for data. Data is the basis for AI, so having an adequate data policy is essential. The FiDA framework will contribute to this, because FiDA supports the sharing of financial data and will therefore increase data availability. The AI Act adopts a risk based approach and will provide for specific requirements for activities identified as being high-risk. In the financial sector notably two activities are concerned, namely credit scoring and credit worthiness assessments, and also risk assessments and pricing for health and life insurance. Those activities will be subject to additional requirements under the AI Act, even if they concern processes that were put into place before the AI Act was enacted. Other, non-high risk, activities will be subject to transparency requirements, which will also contribute to improving industry knowledge and citizens' trust about AI.

3.2 Expected impact of the AI Act

An industry representative noted that the developments related to AI can be difficult to grasp for users, given the speed at which they are happening, therefore risk mitigation is needed. The AI Act is welcome in this regard, but care must be taken that the regulation should not impede transformations in the financial sector or limit the full leveraging of AI, otherwise there will be profound consequences for Europe and its financial sector in terms of competitiveness.

The industry representative supported the risk-based approach of the AI Act and highlighted some aspects of the text that still need to be fine-tuned. A reference is made to bias, but bias can be described in many different ways, so will have to be defined more precisely. With the advent of ChatGPT some controls for general purpose systems were also introduced in the legislation, regardless of their use, which goes against the initial risk-based philosophy of the law. The text moreover mandates transparency obligations, ensuring users are duly informed about the use of AI in technology-based systems they interact with. This should contribute to fostering trust, but developing AI literacy is also needed, because it is a very complex and fast evolving area. A greater understanding is needed around how AI can be leveraged and controlled so that Europe can become a leader in this space.

A second industry representative considered that the clarification brought by the AI Act about the requirements that will apply to AI is very important. Market players

were very cautious previously about investing in AI systems, which hindered innovation. The questions are now around implementation of the regulation and how balance can be maintained in practice between risk mitigation and innovation. Innovation must not be discouraged, otherwise AI implementation will focus more on efficiency and job reduction than on generating new opportunities.

A public representative noted that the AI Act aims to tackle the main challenges posed by AI in terms of transparency, accountability and fairness. Fairness in particular is important to ensure sufficient competitiveness in the technology-driven financial ecosystem.

3.3 Future priorities concerning AI policy

A public representative stated that when speaking about AI and the different European data frameworks, the assumption is that more data can be made available and that the data market can be extended. The EU data framework should ensure that the data market opens more opportunities for everyone. This is essential in particular for smaller players and newcomers in order to maintain a sufficient level of competition.

A policy-maker detailed that the Commission's first priority for the next European political cycle is to properly implement the AI Act, which includes providing support to startups and small and medium sized enterprises (SMEs) for implementing the legislation. Market developments are being closely monitored. The overall intention is to regulate innovative developments, but not to hinder innovation. A predictable and reliable framework will allow market participants to plan their investments and manage operations.

The Chair agreed that fostering innovation is important, while maintaining safety and customer protection. This is the goal which will be pursued by the European Supervisory Authorities (ESAs) in the implementation of this legislation.

4. Policy approach to AI in the US and at the international level

An official considered that an ex-ante approach is needed for AI, with jurisdictions working collaboratively together to ensure that the benefits of AI are available for all jurisdictions, as opposed to there being divergence among jurisdictions which could spur an arms race. The same objective should be pursued in other areas related to technology such as cloud computing. A balance is needed around access versus protectionism at the international level. There is also a question about how to combine a cross sectoral regulatory approach to AI and more functional applications for example for financial services.

It is critical that there is an ethical framework for AI. In October 2023 the Biden administration released an executive order on AI which directed a whole of government approach to analysing and understanding the impacts of AI and providing guidance. Each agency has a rolling set of deadlines to produce its deliverables. A key deliverable for the financial services sector is the best practices report from the US Treasury for financial institutions, which is due to be released on 28 March 2024.

Regulators in the US have also spent much time assessing how financial institutions are developing and deploying AI, particularly since AI is a continuation of existing technological developments like machine learning, robotic process automation, natural language processing and big data analytics. A request for information from the US prudential regulators in 2021 focused on ensuring understanding of how financial institutions were deploying AI and considering it, not only across business lines, but how it was also being used for risk management and other operational processes. US prudential regulators are working with each of the supervised institutions on their governance risk and control frameworks and the deployment of AI.

The Securities and Exchange Commission (SEC) recently put out a proposal on the use of predictive data analytics by SEC registrants. Although some feedback indicated that it was overly prescriptive and may hinder the responsible use of AI, this proposal is tackling important risks such as bias. It is vital to ensure that when supervised entities are deploying AI there is no bias that impacts access to products and services.

The Commodity Futures Trading Commission (CFTC) also recently made a request for comment on the use of AI by its registrants, which include banks, asset managers, exchanges and clearing houses. The CFTC is keen to understand how its registrants will be deploying AI, particularly in markets, trading and other use cases. There is significant concern about the possible use of AI for market manipulation and it is important to evaluate this risk in a factual way. Financial firms are still reluctant to deploying AI in a client-facing manner, so very strict governance and risk management is needed to make this possible.

Crypto regulation: MiCA implementation and global convergence

1. Progress on the implementation of the Markets in Crypto-Assets Regulation (MiCA)

The Chair indicated that the implementation of MiCA is well underway in Europe. A large number of regulatory technical standards (RTS) have already been drafted and there is a first implementation deadline at the end of June 2024.

A regulator noted that a very intensive phase of policy development began when MiCA entered into force in June 2023. The EBA is working on the regimes for asset referenced tokens (ARTs) and electronic money tokens (EMTs), for which the application date is the end of June 2024. The policy work on ARTs and EMTs is advancing actively. The EBA has closed 18 of its mandates,. Feedback has been received on the proposals, which covered topics such as internal governance arrangements and issues related to reporting, colleges and the prudential package. The 19th consultation paper on redemption plans will be published shortly.

The EBA is encouraging the industry and supervisors to prepare the implementation of these regimes in a consistent and timely manner using the implementation documents published by the EBA. Guiding principles for issuers have been published aiming at fostering an alignment with MiCA rules, especially regarding the fair treatment of potential buyers of ARTs and EMTs and the implementation of sound governance and effective risk management. The EBA's Q&A tool should also be used to answer any outstanding questions regarding interpretation. Separately, the EBA has established a group for supervisors to facilitate the sharing of experiences and develop a common approach to ART and EMT projects. The EBA is also developing a supervisory handbook to foster a consistent approach to MiCA implementation at national and European levels.

A regulator stated that there has also been good progress on the rules for crypto asset service providers (CASPs) and crypto assets beyond ARTs and EMTs. ESMA is in charge of several mandates in these areas. These rules will apply at the end of 2024. Guidance is being provided on the scope of MiCA to facilitate a common understanding of issues such as the difference between crypto assets and financial instruments structured under MiFID rules, the definition of decentralised platforms and reverse solicitation.

The peculiarities and nuances of the crypto sector need to be well understood to calibrate the requirements adequately and proportionately. In this regard, consultation with the private sector is very helpful. One key specificity of crypto assets compared to traditional financial instruments is custody. There are operational and legal segregation issues that need to be considered in the regulatory framework at both national and European levels. Due to the level of complexity and extent of integration of existing crypto groups, it is also critical to understand where business is being played out and where decisions are being taken. The objective is also for the Level 2 requirements to incorporate the lessons learned from the market failures that happened in the crypto sector, particularly regarding conflict of interest and operational risk.

In a recent statement, ESMA set out several important elements relating to the implementation of MiCA, the regulator stressed. First, member states need to prepare for implementation. This involves designating a national authority to supervise CASPs, which not all member states have done, and consulting on how MiCA will be implemented domestically. The member states that already have a domestic crypto regime will need to plan the transition to MiCA and define the amount of time that will be needed that should be as short as possible. Secondly, the designated national competent authorities (NCAs) need to prepare for the implementation of MiCA, which is a new activity for many of them. The NCAs will need to be properly equipped and to understand the business fully. Thirdly, crypto firms need to be ready to make changes to their internal processes, as most of them have not been regulated previously. They will need to adopt an internal compliance culture and ensure full compliance with the regulation. Finally, investors must be informed about the risks inherent to crypto products that do not exist with other regulated products. To some extent, this should be part of a broader education campaign.

2. Industry perspectives on the MiCA implementation and outstanding issues to clarify in the MiCA requirements

An industry speaker highlighted the importance of the clarity that MiCA should provide for the industry. The established multinational CASPs need to have the ability to plan, raise capital and deploy capital over a years long time horizon, which MiCA will allow.

One important area where clarification is still needed is white paper requirements. A white paper is the body of facts which describes a digital asset protocol. The white paper discloses to consumers and investors the fundamental facts about what an asset does, how it works, the participants that exist on its network and what degree of trust and faith an investor should have in that network. Traditionally, issuers are required to make these disclosures. However, MiCA does not make the issuer

responsible for producing the white paper. Instead, offerors of crypto assets or trading platforms can prepare the white paper. This can create confusion among practitioners around which party should assume the burden of ensuring the information in the white paper is correct. In the scenario where several offerors draft white papers for the same asset, consumers may receive different levels of information in different versions. This risk is exacerbated if the information in the white paper relies on estimates such as sustainability metrics.

While MiCA clearly places a white paper obligation on newly issued tokens, there are ongoing debates about whether the tokens that are already trading will also require a white paper. Some of these hold a significant share of the crypto market today. This question will become even more relevant after December 2027, when this requirement will come into force irrespective of whether a token was trading prior to MiCA. The ongoing Level 2 consultation is an opportunity to clarify this issue, however. One solution could be for all industry participants, including exchanges, investors and issuers, to come together to establish the standards in the same way that the International Swaps and Derivatives Association (ISDA) Master Agreement has established a standard for derivatives.

An industry representative emphasised that the European MiCA framework is very welcome from the perspective of digital asset service providers (DASPs) and custodians. There are many different crypto regulations across Europe at present, which makes it difficult for DASPs to operate cross-border. However, it is important to ensure that DASPs can interact with supervisors who understand their business and their technology, notably during the registration process. These firms will need to be compliant with many new requirements, such as those around Know Your Transaction (KYT) and Know Your Address (KYA).

Some issues also still require further clarification, the industry representative noted. It is not always easy to understand what comes under MiFID or MiCA. For instance, there is still a doubt about which regulatory framework applies to some utility tokens. There are quite different requirements between MiCA and MiFID in terms of reporting processes, tax treatment and so on, which creates legal uncertainty and harmonisation and security issues that require high legal fees to clarify. Hopefully, greater clarity will emerge as a result of the ongoing implementation process of MiCA.

A second industry speaker considered that with the implementation of MiCA significant progress is being made in the EU on the regulation of crypto assets and CASPs. During the next European cycle, it will be important however for crypto regulation to go beyond the mitigation of risks related to speculative crypto investment and seek to create a comprehensive vision of a broader tokenised ecosystem. This should be part of European policymakers' upcoming five year vision for the modernisation of the European financial system and the EU's strategic autonomy agenda.

This requires pursuing three key priorities. The first is the regulation of CASPs. These centralised intermediaries must be regulated because they safeguard customer assets and their platforms must be managed in accordance with customers' best interests. The second is the regulation of stablecoins, which are critical for the viability of the crypto ecosystem, as they facilitate on chain payment mechanisms. The third key priority is the treatment of the decentralised ecosystem, including DeFi (decentralised finance) and self hosted wallets.

The two first priorities are addressed in MiCA. CASP requirements are well defined, the industry speaker felt, with a forward-looking understanding of the importance of these service providers for the broader digital asset and tokenised ecosystem, despite some outstanding issues remaining to be fine-tuned and clarified at Level 2, concerning notably white papers and custody rules.

The treatment of stablecoins in MiCA is more ambivalent and cautious and there is a risk that the Level 2 work may exacerbate the challenges present in the Level 1 requirements. Caution about how to integrate stablecoins into the current financial ecosystem is understandable, since stablecoins are a potential source of risk. At the same time, they are a key tool to facilitate the development of a tokenised economy, which may lead to significant cost reductions and efficiency gains and reduce dependency on large central intermediaries. This also raises other public policy questions, notably in the area of competition law.

Concerning decentralisation, Europe has rightly decided to postpone the regulation of DeFi. The development of the DeFi ecosystem is still in the early stages and is difficult to anticipate. There are financial use cases, but the potential of decentralised tools extends well beyond this, including applications for gaming, event participation and storing government records such as ID documents.

3. Policy approach to crypto assets and CASPs in other jurisdictions

A regulator stated that Japan has one of the most comprehensive regulatory and supervisory frameworks on crypto and stablecoins. The Japanese framework for CASPs, which was established in 2017, has three key objectives: providing certainty for new entrants; mitigating risk while promoting responsible innovation; and ensuring that retail and wholesale investors are adequately informed before they decide to invest. CASPs are required to register with the Japanese Financial Services Agency (J FSA) and are subject to prudential requirements, customer protection requirements relative to e.g. the segregation of assets and the protection of information, advertisement restrictions and KYC requirements. So far, the experience has been positive. The number of CASPs registered in Japan has doubled since the framework was implemented.

Japan also implemented a new framework for stablecoins in June 2023, which involves a registration of e money stablecoin issuers with the J FSA. Some non bank institutions, such as trust banks and money sender service providers, are also allowed to issue stablecoins

with a proportionate approach, which is a specificity of Japan. In addition to issuer regulation, entities providing stablecoin brokerage and custodial services are required to register with the J FSA and are subject to the same regulatory requirements as CASPs.

The activities of foreign issuers and service providers in Japan are also governed by tough requirements. Providers that wish to solicit investors residing in Japan have to store the assets of Japanese investors in locally regulated entities. This approach shielded Japanese investors from the collapse of FTX for example. The J FSA permits foreign issued stablecoins to be traded in Japan under the condition of equivalence. Foreign issuers must be supervised and regulated in their home country to the same level as they would be in Japan. CASPs that trade foreign issued stablecoins must also hold the necessary resources to facilitate redemption in the case of an issuer collapse. The Chair observed that the creation of domestic regulatory touchpoints makes sense so long as there is not a sufficiently aligned set of requirements at international level.

A Central Bank official explained that the UK has taken a phased approach to regulating stablecoins and unbacked crypto. A first phase of work has started on sterling denominated stablecoins and other crypto assets will be considered more broadly in a second phase.

The focus in the UK so far has been on stablecoins, as these are most likely to be used for payments and they can expose users and the financial system more widely to risk if they are not regulated safely and sustainably. Their use could also grow very quickly if they were to be deployed by firms with large customer bases and they could quickly become systemic, as anticipated in the Libra/Diem model.

Last November, the Bank of England published a discussion paper on a proposed regulatory regime for systemic payment systems using stablecoins. The requirements set out seek to achieve the same regulatory outcomes as with existing forms of money and payment systems, in accordance with the principle of 'same risk, same regulatory outcome' and provide legal certainty. The regulation will aim to ensure that stablecoins are in fact stable with requirements on backing assets to eliminate credit, liquidity and market risks and enable coin holders to make robust legal claims against issuers. Stablecoin arrangements will also be subject to a comprehensive risk management framework and have to demonstrate a level of resilience equivalent to what is required of traditional payment systems. Rules will moreover be established to ensure that consumers are protected when they interface with stablecoins via wallets. In particular, it is important to address the issues related to custody. Under the UK framework, legal rights will be protected through beneficial ownership.

An industry speaker welcomed the UK's approach to crypto, which considers the broader applications of crypto technology in a range of societal use cases. Understanding this broader perspective can help to answer some of the more tactical questions on the implementation of crypto requirements. As for the US, no clear approach on stablecoins has yet been set out. There is a strong push happening between Congress and the current US administration to develop clear rules for stablecoins. This would probably support the US dollar denominated stablecoin market, which represents 98% of the total market. It remains to be seen however whether the US will be a pathfinder in this market.

4. International consistency and coordination in crypto regulation

The Chair observed that significant progress is being made on international coordination in the crypto asset space, which is a topic of focus for international standard setters. IOSCO in particular has responded to the developments happening in the global crypto market. Policy recommendations for crypto and digital asset markets were published in November 2023 and policy recommendations for Decentralized Finance (DeFi) in December 2023.

A regulator emphasised that international guidance is required in the crypto asset sector due to its borderless nature and the rapid pace of technological innovation in this area. Japan's regulation and supervision of crypto assets and stablecoins is increasingly aligned with other FSB countries. However, the FSB must also engage with other countries not part of the FSB via standard setting bodies like IOSCO and the Financial Action Task Force (FATF) to ensure there is a truly global regulatory framework. FATF is working to identify concentrations of activities or investors in jurisdictions with regulatory gaps. This is not about naming and shaming; rather, it is about capacity building and exchanging views on how these countries can further align their regulatory frameworks.

A Central Bank official agreed that international guidance is essential. Continued international regulatory and supervisory cooperation will reduce policy gaps and minimise regulatory arbitrage. The cooperation in this sector can build on the collective international achievements in existing sectors of finance. Looking ahead, it will be important for international partners to continue to seek consistency in implementing standards and address any outstanding gaps. Custody and vertical integration are two key areas where further progress is needed. There is a consensus on the international standards that have been adopted, but there is a long way to go on implementation.

The proposed UK stablecoin regulation is designed to support safe innovation in the payments space, while addressing potential financial stability risks. While the UK proposals generally align with the principles that have been developed at international level, there is some deviation. Systemic stablecoins would be required to be fully backed in unremunerated deposits at the Bank of England in order to eliminate the credit, liquidity and market risks associated with other choices of backing allowed by international standards. Making the deposits unremunerated will also encourage issuers to focus their business models on payment related activities.

A regulator agreed that international consistency is extremely important in this area. Fully implementing MiCA will require a disciplined journey at EU level. The regulatory picture is well advanced and currently, much of the effort is being directed towards ensuring supervisory convergence in Europe in order to avoid regulatory arbitrage. There will also be in the short term a transition process towards MiCA for member states that have already implemented a domestic regulatory regime for crypto-assets. Looking beyond Europe, an impressive amount of work has been done at the international level in a limited timeframe. A consensus has been reached on the requirements; it is now a question of implementation. Looking beyond the membership of the FSB is important because otherwise, with players operating in this market on a global scale, there is a risk of loopholes. In addition, there is a risk that platforms with inadequate business or governance models will chose to operate from countries that are less regulated and not fully cooperative.

5. Interconnection between crypto assets and traditional finance (TradFi)

A regulator considered that there is currently only limited interconnection between crypto assets and TradFi. However, this connection is being monitored by regulators and supervisors, as the situation might evolve in the future. Supervisors will need to have access to adequate data to assess interconnectedness and related financial stability risks. In this regard, some measures have been taken in the banking space. The Basel Committee on Banking Supervision (BCBS) has issued a prudential standard on banks holding crypto assets, which assigns a very high risk weight to these assets if certain conditions are not met.

Generally speaking, TradFi institutions have so far taken a conservative approach to crypto assets, but this may change with the development of stablecoins. Caution is needed on the part of regulators and supervisors, as banks may decide in the coming years to increase their engagement in crypto asset businesses or activities such as brokerage or custody or invest directly in crypto assets. There are many multifunction crypto asset intermediaries operating in the market providing a range of services, which could also make it attractive for TradFi providers to enter this space.

Blockchain and DeFi technology in traditional finance

1. Opportunities from blockchain and decentralised finance (DeFi) technology

The panellists highlighted the opportunities associated with blockchain and DeFi technology in terms of efficiency, cost reduction and speed. The expected impacts in the securities markets were particularly emphasized.

An official highlighted that these technologies can enable a streamlining of some of the basic activities that happen in securities and derivatives markets. This includes record-keeping, reporting, transaction processing, trading, clearing, settling, reporting, real-time reporting and real-time transparency. An industry representative added that these benefits include greater clarity and reduced operational and commercial dependencies on intermediaries. Another industry representative also noted the potential benefits in terms of liquidity and custody and the greater efficiencies and cost reductions that these technologies allow, which should translate into an increasing use.

1.1 Composability and programmability

An industry representative outlined that DeFi technology is still in the business-case-making phase. Multiple uses and concepts for the technology are starting to emerge. For market infrastructures, these include institutional DeFi and on-chain centralised finance applications. It is likely that over the next year, most market infrastructures and financial institutions will be exploring use cases in different areas to find appropriate business cases. A priority will probably be given to use cases that may provide a real impact in terms of balance sheet and use of capital, for example in areas such as collateral management or repo.

The composability of DeFi seems most promising, as it provides an opportunity for offering financial services in a more programmable way. Different data models and business logics can be pieced together to create new processes aligning with market participant needs. This can help to increase automation and straight-through processing for assets that today have complex business rules, are paper-based and might not have made their way into an efficient market structure.

Alternative and private assets present the biggest opportunities in the near term in terms of improvement of transaction execution processes. The technologies behind DeFi, namely smart contracts, can help automate many of the processes related to those assets. Other areas where programmability may have a significant impact include collateral management and repo markets. Project Spruce led by Citi, which explores the tokenisation of private equity funds, is an example of the application of DeFi technology. The project tested a variety of use cases, including automated securities lending, aiming to increase automation and lower costs for parties involved. It is also a good example of how a market infrastructure is able to operate a lending pool and play a governance role without mandating that the information should flow through the infrastructure. The information can live on a public chain, private chain or a distributed ledger, and different actors in that ecosystem can play different roles. This changes the perspective from a purely centralised system to a private network governed by one institution playing different governance roles across different layers of the stack (e.g. the blockchain itself, applications and assets).

1.2 Tokenisation and digital assets

An industry representative stated that tokenisation is a very substantial development that may reduce the cost and facilitate the issuance and transacting of securities and assets. In 2023, Siemens tested the issuance of a digital bond on a public blockchain with a volume of €60 million and a maturity of one year. These bonds were directly distributed to the investors. In the future, tokenisation should allow the issuance of securities in smaller portions which could help medium-sized corporates in particular to finance themselves on the capital markets. Digital assets could also facilitate the execution of cross-border trades in line with the objectives of the capital markets union (CMU).

There are less direct benefits from tokenisation on the investor side. Investors are looking for appropriate investments with a reasonable risk return profile, but do not care whether securities are digital or traditional paper based. It is therefore expected that issuer needs will mainly be driving these developments, but if processes become more efficient, competition will hopefully lead to passing on some cost reductions to the investors. Presently, processing costs along the value chain for investment funds amount to nearly 4%. A reduction to 1% or 1.5% of these costs could make a real difference for investors. There is less benefit for retail investors from the instantaneous settlement of orders that blockchain allows, as most of them invest for the long term. For that to be possible, there is also a need for a digital currency to settle payments in digital form.

The industry representative was more sceptical about the potential of DeFi and smart contracts in the short term. DeFi aims to establish a financial system without any central infrastructures or intermediaries. However, it is unclear how an exchange can be run without a central entity operating it, how complex financing can be undertaken without specialised players judging the counterparty risk and pricing it accordingly, or how liquidity can be ensured without market makers. The use of smart contracts will moreover be limited so long as existing market infrastructures persist in a centralised

form. Another industry representative disagreed, noting that smart contracts are already in operation in the market and allow the provision of liquidity without any central party.

An official concurred that there are many promising use cases from blockchain and DeFi technology including for private assets and bond issuance. It is important to remember, however, that distributed ledger technology (DLT) is mainly a way to improve the efficiency and safety of the execution and recording of transactions, but it is not going to fundamentally change the functioning of markets, the nature of the instruments transacted or user incentives.

For example moving bond issuance and trading to DLT platforms will not have a major impact in terms of market liquidity, because the limited liquidity of bonds comes from inherent characteristics such as the average size of transactions which are many times larger than average equity trades and the nature of the investors who are large institutional buy-and-hold investors. The limits of DLT were observed with proxy voting some years ago. DLT was expected to greatly enhance the paper-heavy and complex proxy voting system, leading to increased shareholder engagement. However, the actual impact was limited because while technology can boost efficiency, it does not change incentives for institutional investor engagement.

A regulator noted that wholesale central bank digital currency (wCBDC) is the safest asset for the settlement of digital asset transactions as CBDC poses no liquidity or counterparty risk.

2. Challenges and risks from blockchain and DeFi technology

2.1 Operational and technical challenges in terms of scalability, interoperability and customisation

An industry representative outlined scale as the key issue that the industry needs to solve to get value from blockchain and DeFi technology. Experimentation has been conducted on a small scale and standards that may help to drive scale are being elaborated, but the point at which the entire industry can shift to this new technology has not arrived yet. The business cases that can drive sufficient scale still need to be identified. A second industry representative added that improvement is also needed in terms of interoperability of different types of blockchain platforms.

A third industry representative considered that there are no major technological limitations. The technology needed in terms of tokenisation and on- and off-ramp blockchain solutions to support improvements and greater efficiency in the financial sector is available and is continuously progressing. It is up to the industry to build the appropriate applications and use cases on top of the available technical layers. Work is underway to solve technical interoperability issues whether that is through cross-chain, interoperable connections, or through digital identity solutions to make sure that know your client (KYC) and anti-money laundering (AML) processes function seamlessly. The main challenge is in terms of implementation to make the technology that is at hand usable and accessible in a way that can meet existing and future compliance rules.

A fourth industry representative agreed that the technical challenges associated with the technology are being solved, but there is still a gap in application. The potential advantages of blockchain and DeFi technologies - such as cost reduction, increased speed, transparency, and less reliance on intermediaries - are partly realized in the public blockchain environment, which offers less customization possibilities for specific business needs than permissioned blockchains. Open-source and public infrastructure solutions that allow more customization and interoperability are due to appear in 2024, which should help to bridge this gap. These solutions will enable the coding of specific requirements into smart contracts, catering to different assets and unlocking new use cases for public blockchains. Foreign exchange, especially among medium-sized institutions, is an example of use case that may develop with the ability to customize various elements across the lifecycle of trading - like participation rules, trading hours, and issuance timings - making it easier to leverage DLT and blockchains in this area.

2.2 Compliance and accountability challenges

A regulator observed that, while this technology can bring huge opportunities, there are several challenges to overcome for newcomers and traditional finance players trying to enter this field. The first is the need to master this new technological environment and the specific risks that come with it. The second is the ability to enshrine this activity into a legal and compliance environment respecting anti-money laundering (AML), combating the financing of terrorism (CFT) and customer protection requirements.

An official noted that the opportunity of using DLT compared to traditional mechanisms needs to be closely evaluated considering the potential benefits, challenges and cost implications. Some specificities of blockchain technology that have regulatory implications also need to be considered. Firstly, in most cases, traditional financial institutions will be using a third-party provider for providing the blockchain solution. This outsourcing raises questions in terms of operational resilience and accountability. In the US, the basic principle applied is that, when activities are outsourced, the regulated institution has to manage the risks as though they remain in-house and remains accountable vis-à-vis the regulator, even though it is relying on a third-party provider. More generally, this accountability should be maintained whether a traditional or blockchain-based platform is being used, which might require regulated financial institutions to adapt to the specificities of blockchain platforms notably in terms of governance. The accountability of issuers should also be maintained when using a blockchain platform for the issuance of digital assets.

A second aspect to consider relates to the immutability of transactions executed on a blockchain, the official added. While this provides advantages in terms of security and

traceability, it is unclear how a transaction can be reversed if there is a mistake. The third question concerns privacy, which is difficult to ensure in a permissionless blockchain environment, unlike permissioned blockchain platforms, and it is uncertain how this can be done if interoperability between these two types of platforms develops. A fourth question relates to surveillance, which relies on exchanges in the traditional financial markets. A different approach will be needed in the DLT context with the development of smart contracts that execute transactions at a high speed.

2.3 Financial stability risks

An official commented that the risk from a widespread implementation of blockchain technology is not fundamentally different from other digital security risks and the tools needed to manage these risks are available. These include effective corporate governance. The 2023 update of the OECD's corporate governance principles specifically mentions that digital security risk is a board responsibility and must be part of the overall risk framework of a company. Currently, market infrastructure providers are not the main source of financial stability concerns. Crucially, that is because they are heavily regulated entities – their centralised presence in the financial ecosystem is a feature and not a bug, and any attempts to disintermediate financial markets must proceed with this in mind. Moreover, the financial stability risks potentially posed by DeFi may be overplayed. The risk that is usually put forward is that a run on stablecoins may disrupt the short-term funding market, similarly to what might happen if there was a run on money market funds. However, stablecoins are a much smaller market, with a market cap of $140 billion, and total value locked in DeFi protocols amounts to around half of that, compared to money market funds that amount to more than $9 trillion dollars in assets under management.

Another official noted that a key financial stability risk that could arise from DeFi comes from the speed at which transactions can take place in a DeFi setting with smart contracts, if these platforms become more widespread. The financial stability risks posed by a rapid run were demonstrated in the SVB case. At the same time, DeFi provides greater and faster access to information that may facilitate a quicker detection of financial stability risks before they actually arise. The Chair observed that a corollary of systems being interconnected and more efficient is that risks may spread around the globe very fast.

3. Regulatory and supervisory approach to these technology developments

3.1 A balance between innovation and risk mitigation

The regulators and supervisors on the panel emphasized that their role is not to constrain or limit technological development, but to provide a framework that can allow innovation to develop while mitigating potential risks. The market should be allowed to seize the opportunities provided by technology within such a framework.

A regulator highlighted that regulators should not hinder these developments but ensure that their potential is realised in a safe way. The European Markets in Crypto-Assets Regulation (MiCA) aims to achieve this balance. The European DLT pilot regime is also a powerful tool for experimenting with practical applications of DLT technology in a safe environment.

An official emphasised elements of a recommendation issued by the OECD in 2022 on blockchain and DLT. One is the recommendation that regulators should create an enabling environment for innovation in general, and for blockchain and DLT in particular, which involves engaging with market stakeholders at an early stage of development of the technology. Self regulation from the industry can also play a role as a first step towards more formal regulation, as regulation always develops at a slower pace than the market. In addition, any new blockchain-specific regulation needs to be coherent with the existing regulatory framework and aim to achieve the same objectives in terms of financial stability, consumer protection, market integrity and fair competition. There should be no compromise on those basic objectives whatever the potential efficiency or economic gains.

An industry representative stated that, although Europe has made positive steps in regulating crypto assets, some clarifications are still needed. Digital securities should come under MiFID regardless of the underlying technology and other digital assets under MiCA. How to define and address DeFi and smart contracts still needs to be clarified. This has not yet been done in MiCA, which has rightly focused on what is currently most significant in the market.

A second industry representative stated that, for a technology business to survive, it needs to serve its consumers and users as safely as possible, which requires mitigating market integrity and financial stability risks. This can be challenging to achieve because different assets and different financial actors have slightly different risks, and adapting on-chain public blockchain technology to those different needs asset by asset is quite hard. However, more open-source software kits are coming out this year that will make it easier to address specific risks such as privacy and scalability issues and provide real-time reporting.

A third industry representative agreed that appropriate regulatory guardrails need to be clearly set out for innovative technologies to develop. A good example is the DLT pilot regime which sets out clear guardrails, providing clarity for market participants as to how they can experiment with and drive forward use cases.

The Chair concluded that there needs to be a common understanding of responsible technology and an informed management of risks. IT risk management should not be confined to specialised departments but really spread around financial institutions. Supervisors must also break their internal silos and work with other authorities in order to leverage existing competences which are in limited supply. For example prudential and AML supervisors should collaborate with the market authorities and central banking departments to tackle these new risks.

3.2 Technology neutrality

The Chair suggested that regulators should adopt a neutral approach with respect to technology, but maybe a less neutral attitude with respect to how the governance of technology might be considered, as the way technology is managed might impact the risk.

A regulator stated that, while regulation should be technology-neutral to allow the market to innovate, it should not be technology-blind. The specific risks coming from new technologies must be understood and need to be assessed in order to contain them. MiCA is a useful first step, but there will, at some point, be a need for MiCA 2.0, to take into account the most recent developments. Blockchain and DeFi are evolving technologies that regulators need to remain at the forefront of. For example, specific requirements may be needed for the certification of smart contracts, the concentration of the validation capacity must be monitored and measures may be needed to ensure the reliability of blockchain infrastructures. These different aspects need to be addressed potentially in a review of MiCA.

An official noted that technology neutrality should go both ways. The fact that blockchain and DeFi are intertwined with cryptocurrencies should not create a regulatory bias against the use of those technologies in traditional finance. In addition, when taking stock of experiments to implement DLT platforms, it is important to distinguish between technology and implementation issues.

An industry representative stressed that, while risks in the emerging blockchain and DeFi spaces are not new, the operations are different. The framework and the rules to address them and to manage those risks may need to be adapted, possibly in a minor or technical way to specificities, such as ensuring that reporting requirements are digitally native, which is not the case at present.

3.3 International consistency

An industry representative highlighted the dangers of regulatory arbitrage risks in this area. While the risks posed by crypto-asset activities and stablecoins are being addressed in several regions including the EU and certain countries in APAC and Latin America, this is not yet the case in all jurisdictions, including the US. The development of the industry is dependent on an appropriate and consistent regulatory framework. Collaboration should be increased between industry and policymakers to achieve a greater regulatory harmony at the international level

An official agreed with the importance of international cooperation in this area. Beyond technical interoperability, it is also important to think about interoperability in terms of regulation across jurisdictions to facilitate global capital flows.

A regulator stated that to enable the smooth development of this technology there needs to be an international level playing field and an avoidance of regulatory arbitrage between jurisdictions. Several Financial Stability Board (FSB) recommendations that have laid the ground for this level playing field must be followed.

3.4 The need for a dialogue between regulators and industry

A regulator stated that these new technologies also present an opportunity to review the way markets are monitored and the supervision of financial markets and financial actors, with a constant dialogue maintained between regulators and industry..

An industry representative suggested that business based on blockchain technology will not develop if there is not enough security and investor protection, which shows that the interests of policymakers and the industry are aligned.

3.5 Supervisory implications of public blockchain platforms

An industry representative stated that it is possible to provide supervisors with real-time data when using a public blockchain infrastructure. When using an automated market maker based on a smart contract protocol for example, every transaction that happens is available at the time it settles on a publicly available site.

The Chair queried whether there are boundaries in terms of sharing information and data for public blockchains, between what is proprietary to the infrastructure and what is shared on behalf of clients.

The industry representative acknowledged that there are technical challenges in terms of privacy that are part of what limits the adoption of platforms based on public blockchains. The upcoming improvements of public blockchains should help to alleviate those issues, but that remains an area for technical innovation. Centralised exchanges batch different accounts in a single account and obscure specific details which requires offline off-chain reporting, but it is hoped that more real-time digitally native reporting will be possible with improvements in terms of privacy.

FiDA Open Finance proposal

1. Expected opportunities from open finance and the FiDA proposal

The panellists generally welcomed the Financial Data Access (FiDA) regulation proposal which, with the Payment Services Directive (PSD2), will provide a common framework to support the development of open finance and data-driven innovation in the European financial sector.

A regulator highlighted that open finance provides many opportunities, as it represents an effective way to enhance the provision of financial services for consumers and firms, provide customers with more choice and more innovative products and empower customers in the use of their data.

An industry representative considered that open finance may have a significant impact in many financial markets. Some of these markets are quite large, such as the savings market which represents €9 trillion in Europe and corresponds to 30% of household assets. Judging by PSD2 and the development of open banking in the European market, the uptake of open finance will likely be progressive. The biggest opportunities lie in areas where open finance can help to develop contractual cooperation between different players to provide customers with new services. Consumers and financial institutions may both benefit from FiDA. Consumers may have access to new products, banks may be able to diversify the products they offer and new open finance providers can also emerge.

A second industry representative stated that Europe has the opportunity with FiDA to strengthen its position at the international level in the digital transformation of the financial sector. FiDA may improve ease of access to financial services, while offering customers a more tailored and wider choice of products. There are many applications of FiDA in different sectors of finance, including for mortgages and loans, investment products and insurance. At present about 5-10% of European citizens use open banking under PSD2, which is a limited success. A higher uptake can be expected for FiDA, which is a more ambitious proposal, applying to a broader scope of financial services and extending the options for sharing data, which will provide greater opportunities for the financial industry to innovate. Other potential indirect benefits of FiDA include greater data and application programming interface (API) standardisation and opportunities to enhance customers' financial information and literacy.

An official agreed that the FiDA proposal has some potential to foster innovation and competition in the financial services market but warned there is a need to carefully balance opportunities and challenges. Key principles regarding consumer protection and market practices need to be looked at to ensure the setting of proper safeguards and regulatory guidance and to ensure a level playing field. Expected benefits for consumers include better tailored financial products, more choice and empowerment to make better choices. FiDA proposes a structured framework, which is likely to reinforce trust between stakeholders for the sharing of data and play an important role in the interoperability of products and services with more standardisation.

A public representative concurred that open finance is a driver for innovation, competition, improving product offering and empowering consumers. These are the goals that the EU should be focusing on to meet its ambition of developing a data-driven economy and strategy. The overriding architecture of data legislation in the EU also forms a good basis for this.

Some panellists underlined the potential efficiency benefits of open finance. An industry representative noted that open finance can bring lower costs and increased efficiency, as banks can work together on product development. An industry representative added that FiDA should also contribute to streamlining financial processes by facilitating the connection of different players operating in the financial value chain.

A third industry representative noted that reaping the full benefits of the data-driven economy would require progressively opening data sharing to other sectors beyond financial services.

2. Consumer-protection and fair competition challenges raised by data sharing

A regulator noted that, while FiDA presents more opportunities than concerns, the latter must be tackled. Open finance aims to further empower customers to share their data in order to have access to improved financial services. This must be accompanied by improved information and education about how customer data is shared and providing customers with the tools for using open finance effectively. Empowering customers involves four main conditions. The first is better knowledge of how data is shared and the benefits that can be obtained. The second is better control over which data is shared and how. The third is security and safety, guaranteeing that data is used only for the purposes disclosed. The fourth is that there must be clear consequences if data is misused or used in a different way than the consumer has been led to expect.

FiDA focuses primarily on the first two points, the regulator stressed. There is progress to be made on the third aspect of data security also and lessons to be learned from PSD2, which provides both open access and enhanced security. Strong customer authentication is one of its key successes. It is also important to avoid data being misused to the detriment of the consumer. The General Data Protection Regulation (GDPR) addresses these concerns, but it is necessary to verify the new implications of FiDA. Another area where additional clarification may be needed is liability. PSD2 clarifies who is liable if something goes

wrong with open banking, but this needs to be further specified for FiDA.

An official emphasised the challenges raised by FiDA in terms of personal consumer data protection and the need for robust safeguards and a consumer-centric focus. PSD2 was a good experiment in this regard and highlighted areas for improvement, particularly concerning the need for clearer regulatory guidance in terms of safeguards and dispute resolution mechanisms, given that the sharing of personal data is a highly contentious matter. The reluctance of many customers about sharing their personal data over the internet must also be taken into account. This is why it is of the utmost importance to clarify the scope of personal data that can be shared under the proposal and consider its potential sensitivity to exclude some personal and sensitive data. If this is not done properly and if consumers do not have a clear view of the purpose of sharing their data and of the legitimacy of doing so, they will not trust the framework and not give their consent. In addition, there must be a proactive approach taken to data protection to mitigate risk, including mounting cyber threats and risks from the misuse of consumer data by market players, before the proposal enters into force.

Establishing a level playing field in the application of FiDA requirements is also essential, the official stressed, to maintain fair competition, also considering the role of BigTech, and an adequate mutualisation of risk in the market, which also has implications for customers. For example, in the insurance market, if new open finance providers can select the risks they want to cover, they likely will select the lowest risks and leave the others to incumbent insurance companies who will no longer be able to conduct an effective mutualisation of risk. In addition, the risk of reverse engineering by open finance providers potentially able to pick certain parts of existing portfolios must be taken into account, which relates to the scope of data due to be shared.

An industry representative noted that for FiDA to be beneficial for customers, they must understand the implications of sharing their data, which requires education. The lessons learned during the implementation of PSD2 can be taken advantage of in this regard.

A second industry representative observed that there is still a degree of uncertainty as to whether consumers will be favourable to their data being accessed by different companies. To ensure this, adequate tools must be available for consumers to control their data. Whether the permission dashboards proposed in FiDA will allow this still needs clarifying. The industry speaker agreed that upskilling will be needed for consumers to fully understand the implications of data sharing. This upskilling should also concern market practitioners. A further question is whether a price tag should be put on data. The risks of data leaks and misuse are addressed in FiDA. Supervision can play an important role in this regard, but the current approach mostly focusing on individual entities will have to evolve with increasing data sharing.

A third industry speaker explained that the permission dashboards that data holders are required to implement aim to allow customers to see which data access rights they have granted and to manage them. Existing open banking platforms that are based on cooperation between financial institutions and allow customers to have access for example to different saving solutions must also be taken into account in the FiDA approach, so that customers can use one dashboard with all the relevant information.

A public representative noted that data protection concerns not only financial supervisors, but also other authorities such as data protection offices and cyber-security authorities. All these actors will have to be brought together with the industry to ensure an adequate implementation of FiDA. This will take time but should contribute to creating a better cooperation culture in the market, which is essential as data sharing and the digital economy develop. A further question relates to the actors that will have access to data and in particular the potential role that big techs may play in open finance. The potential implications of this need to be discussed by the co-legislators in the context of the on-going negotiations.

3. Effectiveness of the market-driven approach proposed for the establishment of data sharing standards and incentives

An industry representative was supportive of the industry-driven process proposed in FiDA to establish data sharing and API standards and liability and compensation standards. Financial data sharing schemes (FDSSs)[1] involving data holders and users are due to be set up to develop these standards in a collaborative way, which will allow considering the specificities of the different products and players concerned. Ensuring that different schemes do not bring different technical standards will be necessary however. The goal is to encourage broad data sharing and interoperability across the financial sector, which requires sufficient standardisation. Two additional positive elements of the FiDA proposal are the liability regime and the compensation model, which are essential elements for the development of open finance services.

A second industry representative noted that FiDA takes into account the learnings from PSD2 open banking measures in terms of incentives, which should support further uptake. The collaborative and two-step 'carrot and stick' approach taken in FiDA for the definition of standards and incentives with the proposed setting up of FDSSs and the possibility for the Commission to step in if progress is insufficient, seems the right way forward. Achieving effective data sharing for the benefit of financial customers is indeed a multi-stakeholder endeavour that requires adequate incentives to encourage all parts of the ecosystem to take part in the development of open finance solutions, while ensuring data protection.

1. Data sharing and API standards and liability and compensation standards are due to be established in the context of FDSSs involving data holders and users. However, in the event that no FDSS has been established for one or more categories of customer data within 'a reasonable amount of time', the Commission will be empowered to adopt a delegated act for the category of data concerned.

An industry-driven process at the outset seems preferable, as this will likely lead to more creative solutions than a process led by the public authorities.

A third industry representative stressed that, as with PSD2, one of the main challenges of FIDA will be the proper incentivization of data holders such as banks. Solely cost-based remuneration will not be sufficient to incentivise participation. There must also be qualitative benefits for market players and consumers. These issues, including compensation standards, are due to be determined in a collaborative way within FDSSs in which consumer associations should also be represented. This is the right way forward, since cooperation is essential for the success of open finance. A difference however compared to PSD2 is that membership in a FDSS will be mandatory. A further issue is ensuring that the FiDA implementation process involving multiple FDSSs effectively leads to uniform market standards across sectors and Member States.

A public representative agreed that a market-driven process to define data sharing standards is the right way forward. However, the two-step approach proposed in FiDA for the definition of these standards, starting with a market-led definition and with the possibility for the Commission to step in, could be adjusted,. An alternative would be to blend the two stages together, with a market-driven process led in cooperation with the public authorities from the start in a sandbox environment.

A regulator considered that the approach for determining standards should depend on the degree of urgency for implementing FiDA. If the objective is to implement FiDA quickly, then standards will need to be prescribed by the public authorities to kickstart the process, although these standards may not be optimal at the outset. This is the choice that was made for sustainable finance where making progress was urgent. However, if there is less urgency to implement open finance and a strong desire to avoid unintended consequences such as adverse selection or the financial exclusion of certain customers, then it may be preferable to let the dynamics of the industry play out rather than imposing standards up-front. This will be part of the decisions that the co-legislators will have to take.

4. Data, API standardisation and quality issues

An official emphasised that data and API standardisation are essential for an effective delivery of FiDA. If there is not sufficient standardisation, this proposal aimed at interoperability in the financial sector will not achieve its goals.

An industry representative added that data and API standardisation must be sufficient to ensure a streamlined user experience with data portability from one software or website to another. This notably requires imposing standards on vendors holding financial data and on how the data is stored. Much data is indeed locked into databases managed by vendors that have their own schemes and standards, which needs to be addressed by the FDSSs.

A second industry representative noted that one of the aspects of FiDA that will need to be fine-tuned to facilitate its implementation is the requirement for data sharing to be executed via APIs. Some of the products and institutions in scope of the regulation do not have data that can be shared this way. For example, data concerning credits or savings accounts held with traditional banks may be kept in a format or system that is not compatible with the use of an API. It should therefore be clarified in the regulation that implementation of an online banking system is not required in all cases.

A third industry representative emphasised the importance of data quality, which is essential for speeding up the time-to-market of open finance products and for allowing cost-effective solutions to emerge with streamlined KYC. There must also be a single market for data in the EU, because scale is needed to leverage data effectively in an open finance environment and compete with the US, China and India. This is one of the objectives of the EU strategy for data, which is a founding element for PSD2 and FiDA.

5. Implementation approach

A public representative considered that the implementation of FiDA will be quite challenging because of the broad scope of products and services covered, which are quite diverse in terms of nature and functioning, contrary to PSD2 which focused mainly on payment services. FiDA might therefore work better in some parts of the industry than others, which must be taken into account in the preparation of its practical implementation. In addition moving from open banking to open finance is quite a significant leap forward, which is not fully taken into account in the FiDA proposal. A more progressive implementation of FiDA would leave more time to prepare this evolution, as there is no immediate urgency from the market, though there is a general desire to move forward. This would provide the opportunity to think through the practical aspects of the proposal more thoroughly and have a more stable long term solution. In addition, bringing all the actors together needed to achieve sufficient standardisation and data protection will take time and the Commission must be able to step in if the progress made with the market-driven process is insufficient.

An official agreed that the timeline proposed for the implementation of FiDA seems short to achieve sufficient standardisation, because many issues still need to be discussed and properly designed. Some attention also needs to be given to the supervisory mechanisms required to support the implementation.

A regulator observed that the absence of API standards slowed down the implementation of PSD2 initially, before EBA was asked to put forward a solution. For FiDA, the objective is to set data and API standards upfront which should facilitate its implementation

Sessions

IV

PAYMENTS AND THE DIGITAL EURO

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Digital Euro: key success factors and likely timetable

1. Digitalisation highlights the need to consider digital forms of cash. In this context the European Central Bank (ECB) is now focusing on the technical design of the digital euro

The Chair noted that, for many, electronic payments are the payment method of choice. Central banks around the world have therefore been looking into digital forms of currency in order to complement the existing form of public money. The digital euro is an opportunity to reimagine the future of money. The ECB Governing Council gave the go-ahead for the launch of part one of the preparation phase in the autumn of 2023. This phase will consolidate the initial findings of the preceding investigation phase and focus on the technical design of the digital euro.

1.1 The digital euro is a retail central bank digital currency that provides privacy, enabling citizens to pay online and offline

An industry representative suggested that, in order to make the digital euro a success, the focus on the wholesale side should be increased. Only one ECB working group is considering the wholesale side, in contrast to the 15 or 20 working groups on the retail side. There is much more benefit to be achieve from the wholesale perspective.

A European Central Bank official explained that the digital euro is a retail central bank digital currency (CBDC). Three use cases are foreseen: peer-to-peer payments, payments in a physical shop and online payments. Online payments will be comparable to current debit or instant payment transactions and will be instantly settled. Offline payments will be the closest to the current form of cash. Offline digital euros will be held in a secure element, such as a phone or card. When these elements are held together the transaction is done without the need for an internet connection, unlike an online transaction where the transaction always flows through a number of systems.

Design of the digital euro has focused on the importance of privacy. Offline transactions will remain on the secure element. Therefore, these transactions are very private. Online transactions will fall under the same AML or CFT procedures as a current online transaction. The design of the digital euro would be such that it would not be possible to connect any digital euro transaction to a private individual by the euro system and it therefore offers a higher level of privacy than current payment solutions.

1.2 Digital euros will be made available by credit or payment institutions, while paying in digital euros will take various forms

A European Central Bank official stated that the digital euro will be distributed via intermediaries, such as credit institutions or payment institutions, which will enable people to make payments either via a proprietary app or payment card or via a digital euro app that will be provided by the euro system. This will facilitate one way to pay across Europe. Currently, someone can pay with a banknote from any bank or country within the euro area. The digital euro aims to provide the same experience. It is currently possible to pay digitally, but not in one way across Europe, for example with a German shop only accepting an EC-Karte.

2. Expected benefits of the digital euro

2.1 The promoters of the digital euro are aiming for a consistent payment experience in the euro zone, including for people who are financially excluded or less comfortable with technology

A Central Bank official suggested that people who are already used to paying digitally will find using the digital euro very easy. The aim is for a premium user experience that is consistent across the whole euro area. However, the digital euro should also cater for the needs of digitally or financially excluded people. If people do not want to or cannot pay with a phone or an electronic wallet, physical cards that can be funded or defunded at an ATM-like machine with cash will be provided. The possibility of leveraging the existing services of public payment service providers (PSPs) should be explored in future. For example, the Belgian postal office has been given a formal mandate by the Belgian government to increase digital literacy and confront digital exclusion. To do this, it issued a payment card that people can fund and defund with cash at the counters of the postal services.

An industry representative noted that the perceptions of financial exclusion or the digital divide have rapidly reduced over the past three years. The new digital euro should be easy to use and understand and be linked to the existing range of products.

2.2 Respect for privacy is a valuable asset

An industry representative stated that offline wallets, the tiered know your client (KYC) that is potentially enabled and even the fact that it will be possible to do KYC with a third party will increase privacy for customers. A very interesting synergy with digital identity and the eIDAS regulation can be enabled over the next few years.

Innovative payments, for example conditional payments, are another benefit for customers. In this case the technology would enable payment under a specific condition, such as when an item is received at someone's door or when multiple signatures are obtained.

2.3 The digital euro will rely on a classic four-corner model and target reduced costs for merchants

A Central Bank official explained that the compensation model of the digital euro will be based on a classic four-corner model, with two of these parties being public parties. The euro system will be the scheme owner and do the settlement of transactions. If a merchant fee is charged for using the digital euro, two of the four parties will not have to be paid by that merchant fee, thus reducing costs for merchants. In addition, by offering merchants another, possibly cheaper, digital option for payments to be made to them, they will gain more bargaining power with the existing payment providers.

An industry representative noted that competitive forces drive innovation. The system should be made financially sustainable so that competition can thrive, and the private sector can innovate. Without this, competition and innovation will be stifled, and the promised outcomes will not be delivered. The private sector must be embraced as part of this project.

An industry representative remarked that the underlying technology of the digital euro provides key benefits. The cost of in-store settlements for merchants will be lower because the digital euro, in contrast to existing payment methods, is built on a public infrastructure. It requires fewer intermediaries, enabling lower settlement costs.

2.4 Micropayments, universality, and the availability of a European public option to pay are identified as the main expected benefits

An industry representative commented that micropayments will be the biggest advantage.

A Central Bank official remarked that the main advantage will be universality. It is possible to pay for a taxi in Vienna, for example, with central bank currency cash but not with digital commercial bank money or a non Austrian domestic scheme debit card. In future, it should be possible to pay with digital currency from the central bank.

A European Central Bank official stated that the main advantage of the digital euro would be that it would ensure people's digital access to central bank money in the euro area.

2.5 The digital euro should be a significant contributor to EU's strategic autonomy

A Central Bank official commented that the digital euro will strengthen the strategic autonomy and resilience of the entire European payments industry. It will also reinforce the foundational role of public money in an ever digitalising society. There are advantages for all the many stakeholders in this project.

An industry representative noted that making the euro system stronger makes eminent sense to a European. Having a digital option of paper money makes eminent sense to a digital nerd.

3. Key success factors to consider

3.1 Though the situation is specific in each member state, it is essential to define a clear and differentiated added value throughout the euro area if the business case for a digital euro is to be successful

An official stated that, although privacy is always one of people's top priorities for a digital currency, it is not a big legal issue. Value added is a bigger issue as this determines whether there is a successful business case for a digital euro. All the three use cases that have been outlined, namely peer-to-peer payments, payments in shops and payments online, are possible with the existing apps or means of payment. A card from a bank in Belgium or the Netherlands may not be usable everywhere, but in Austria it is possible to pay anywhere and withdraw money at every ATM with a bank card. Austrians are surprised by the concept of a digital euro because they think that as they pay digitally, they already have it. The ECB states that the digital euro is safe because it is on the ECB balance sheets, but Austrians question why their e-money is not already safe. The concerns of these countries with developed payment systems must be considered and the value added should be explained.

An industry representative stated that the digital euro should aim for a high level of customer experience. Any compromises on user experience will make it very difficult to scale up the digital euro. The digital euro should be ubiquitous, and people should not need to consider where it will be accepted. Systems that handle payments with merchants should be leveraged. The digital euro should be interoperable with what is already in existence and address any current gaps.

An industry representative advised that the remuneration model needs to incentivise the value added services rather than replicating an old system. The movements are going from ECB ledger to ECB ledger, and this should not replicate an interchange model. There needs to be a lower implementation burden for merchants. The fact that merchants cannot hold any digital euro will be an issue. This is not in the context of holding savings but instead in the context of holding intraday and sweeping overnight, such as a supermarket would do with cash currently. Not having this ability would multiply transactions by two or more and create accounting reconciliation issues. The questions that have been raised throughout the session demonstrate that more discussion is needed. More PSPs, banks and merchants working groups should be formed to consider solutions.

An industry representative stated that the digital euro should be made into a success. Europe can't afford not to, as it has not succeeded in making other projects into a full success story: the Banking Union as clear example. In order to make the digital euro a success, we should step away from the idea that the digital euro is the holy grail and build the infrastructure/provide the technology based on which banks can further build.

An industry representative noted that Austrians are not particularly enthusiastic about the digital euro. It is

important that criticism and the call for a clear answer is not an opposing story. The relevant topics must be considered in depth.

3.2 The success of the digital euro will require a high level of citizens' trust and a high level of service

An industry representative noted that the text implies that people, acquirers, and acceptance places will all be obliged to use the digital euro. In addition, certain money from authorities will be in the digital euro wallet, which is then controlled by ECB. That leads to some level of control and obligation. Control is important in the context of money amounts and certain European standards, but when convincing people to use something, trust is the crucial factor. For example, it took over 25 years to bring people into using current accounts. Even if people have the freedom of choice, they tend to only use one payment type, because they are happy that they understand it, can use it, and know where they can view their transactions. If a certain liquidity goes to the central bank from local banks, and if the customer should use it for free, a service free of fees must be provided. It will not be possible to provide a high level of service in this case.

An industry representative recommended that the ECB, the Parliament, and Council should invite industry to participate to make the project a success. Trust is critically important. Security and resiliency are needed to build trust. Data breaches, scams and the various forms of social engineering have increased markedly over recent years. All the understanding and expertise of cryptography, authentication, tokenisation, and data science in the entire system will be needed to ensure robustness and trustworthiness.

An industry representative commented that widespread acceptance among merchants and clear, tangible benefits will be necessary for people to change their behaviour on checkout. Another challenge is how to enable customers rather than constraining them. Holding multiple wallets will be essential, in a similar way as people today have multiple cards or bank accounts. The direction taken by the EU Parliament in the last report regarding enabling privacy is welcomed. However, the scheme rulebook still does not allow multiple wallets or porting, which will limit customers.

3.3 It is essential that the liquidity that underpins the maturity transformation role of banks and enables lending is preserved and that avenues facilitating deposit runs are avoided

An industry representative stated that, if liquidity is removed from the markets, it will not be possible to provide as many loans to people, for example for buying homes or founding businesses. Issues around financial stability have been experienced in Switzerland and the US. Events can move fast if there are alternatives outside. Stating that local banks are not safe enough is an important topic. If it is said that Swiss or US money is at the ECB very quickly, so that limits can be increased, things are done. Intermediation means that the ECB is then taking a place in the competition. This should be discussed thoroughly in local, international, and European institutions. It is uncomfortable that the project has already proceeded so far without this discussion.

The Chair noted that the political discussion at the European level started in June 2023. There have been many more discussions since then, at least in some euro-area member states. These discussions now need to gain momentum.

3.4 The possible consequences and costs of the digital euro for the EU payment landscape must be anticipated in order to make all the necessary trade-offs

An industry representative reported that cash payments in Europe have reduced from 72% to 59% over the last three years and have been replaced by digital payments. It is important to understand the trade-off between the launch of the digital euro solution and the existing digital payments. Collaborative work must continue in order to identify the right trade-off. There are different kinds of PSPs in Europe, and the European payment landscape is steadily growing. The digital euro will boost that landscape. How the existing PSP platform could be transformed and connected with the digital euro platform without leaving its existing platform must be investigated.

An industry representative remarked that the digital euro will require a great deal of investment in operational changes, while ongoing legislative files and the existing workload of banks must still be addressed.

The Chair commented that there are currently a number of ongoing initiatives in the European payments market that aim to reduce the high level of fragmentation in the market, such as the European Payments Initiative (EPI).

An industry representative commented that Europe needs big success stories such as the digital euro to increase strategic autonomy. This will require a framework. EPI and Bizum are well situated to address the lack of European payment across Europe and make the existing systems more interoperable.

3.5 The digital euro must have a clear business case and drive growth and new business opportunities

An official commented that, if it was clear what the biggest advantage of the retail digital euro would be, the ECB would not need to provide business cases.

An industry representative stated that the digital euro will be a success if it drives growth and solves real problems for real people.

An industry representative commented that the digital euro will enable new business opportunities, such as conditional payments.

EU payments: priorities for the incoming Commission

1. The EU retail payments market

1.1 Ambitious and challenging objectives for the European retail payment system

The Chair detailed that the panel concerned the broader perspective on the European payments market, what can be expected from the new Commission and what the priorities should be. One aspect is how to become independent of international players, and how to persevere with consumer protection, security, innovation and competitiveness. It is also about pushing concrete projects, such as the Payment Services Directive (PSD) 3 and Payment Services Regulation (PSR), the recent regulation on instant payment, the digital euro and financial data access. These are supposed to make Europe more competitive, better equipped against fraud, and provide stronger rights for consumers and increase transparency.

1.2 Innovation, competition and fraud prevention

A regulator highlighted that Europe is leading the way, much of which is due to PSD2, which was instrumental in striking the right balance between stability and efficiency for payment services. There are more than 4,500 banks providing payment services, and 1,500 non-banks and 400 entities that are also authorised to provide new open banking services. That is a significant change compared to 2018. An EBA database was created, which allows the market and general public to gather information on who the newcomers are, access to which facilitates entry into the payment services market. Fraud has been reduced. The EBA was working on the standards for Strong Customer Authentication (SCA). Having that in law was a key element in fostering market confidence.

1.3 Security in retail payments

A Central Bank official emphasised that there is an appetite for innovation, driven by market participants and the public sector. An important achievement has been the security of payments. Vital steps have been taken over the last 10 years, and PSD2 has been instrumental in that respect, through the development of strong authentication techniques. Nonetheless, the fight against fraud is an endless one.

1.4 Progress and leadership from Europe in the payments sector

An industry representative emphasised that Europe is a very competitive market for payments, and has created the environment for innovation. Much of that is due to the regulatory track over the last 10 years. The number of e-money firms, including new entrants, are a testament to the vision of creating regulation that can enable innovation, even when it is not known what the innovations will be.

Open banking has received some bad press, because it has not changed the world overnight, but it also creates an environment for innovation. An industry representative's firm has launched unsecured lending products in seven European countries, which is possible thanks to open banking.

Technology innovation has been very rapid in the past 15 years. Payments innovation is catching up somewhat with that, but the regulation needs to try to be ahead of some of the unintended consequences that can happen, such as the rise of digital fraud.

An industry representative remarked that Europe is leading the way in terms of modernising its payments infrastructure. It is also playing a key role in the global payments ecosystem. Europe represents about 40% of the flows on Swift, for example. Europe has embraced digital payment and its growth is expected to continue. Europe is also leading the way for having a harmonised payments ecosystem that is secure and open to innovation.

Instant payments were voted on by the European Parliament a few days previously and are part of the retail payment strategy. This regulation will raise the bar in terms of access to instant payments and upgrading fraud detection and prevention thanks to the IBAN and name checking services. There should also be a reduction in fragmentation, because many of the providers that exist today provide different IBAN and name check services.

An industry representative highlighted how innovative Europe has been with its legislation, such as with the Single Euro Payments Area (SEPA) and the General Data Protection Regulation (GDPR). GDPR was an excellent learning experience, because whenever there was the need to transpose across the globe, the experience of implementing in Europe is leveraged. Europe should continue to take such steps, and try to influence and work closely with the G20, because there is a roadmap for cross-border payments. Europe is ahead in terms of having legislative tools that allow the financial service industry to prosper, that protect consumers, that create jobs and that help in building a better world for everyone.

2. Issues with fragmentation and efficiency

A Central Bank official noted that the picture is more mixed in terms of efficiency. The digitalisation of payments brought many benefits from an end user perspective. The creation of a SEPA for credit transfers and direct debits is an important achievement, but important payment instruments, including card payments, were left out. Additionally, innovation is increasing fragmentation. There is also a rising sovereignty issue that needs to be addressed. For

efficiency, there needs to be more integration. Sovereignty is a new issue that has to be addressed. There are a number of regulatory texts on the table. The issue is fine-tuning them and adapting a number of provisions.

An industry representative stated that there is still the question of whether the EU is one market or 27. There are very dynamic and competitive national markets, with some diverging user habits resulting from how the banking industry and other financial institutions have matured over time. There is sufficient consistency of regulation driven by the EU rules and the EU has excellent payment sector infrastructure. Although there are many caveats and challenges, the EU single market is something to celebrate.

An industry representative noted that directives that leave too much interpretation to individual states do not create the harmonisation for the industry to grow or create a level playing field. Best practice from each country should be leveraged. It is also important to have continued growth in the payment industry, particularly in the remittance industry. Bank de-risking has been addressed in PSD2, but probably not with enough practical tools put in place. PSR is a major step in that direction, however, some improvements are to be made in order to reduce de-risking practices.

An industry representative added that PSD3 moving part of the directive into regulation, in the form of PSR, is a positive move, as it will drive consistency. Consistency is very important because differences in how the law is applied creates complexity for businesses.

A couple of items can be addressed in the new regulation. One concerns passporting. Currently, a payment institution cannot passport offer credit cards on a pan European basis because there is a 12-month limit for credit ancillary to a payment. This is an anomaly and should be removed. That would promote competition, because it will allow other payment institutions to compete with local banks and offer credit cards.

The way the surcharging is applied for cards not in scope of the Interchange Fee Regulation in Europe also varies across the countries, driving inconsistency and providing a very bad experience for the consumer. There are very few cards that are eligible for surcharging in Europe. They are not in a dominant position, so the merchants have a choice to accept or not. When a merchant chooses to accept, it can be extremely deceiving and deceptive for the card members to have to pay for paying at the end of the shopping experience. The regulator should make things simpler for consumers and ban surcharging on all cards across the EU.

3. Combining fraud control and the customer

An industry representative detailed that, for merchants, PSD2 equals SCA. SCA has led to a reduction in the level of fraud but also more technical complexity. It is, therefore, important to strike the right balance between fraud control and the customer experience.

The current regulation is not clear about whether behavioural biometrics can be an inherence factor or not. Regulator should clarify that behavioural biometrics can be recognised as an inherence factor as the technology exists today to allow for the authentication of the buyer with a very high level of certainty. Currently, for example, elderly people might struggle with entering the passcode and going to their bank application; by contrast, this alternative works completely in the background, is safe, and very user-friendly. It is also a good way of preventing spoofing fraud. With behavioural technology, it is very hard to steal identities or to replicate an identity since the authentication is based on hundreds of data points.

More clarity is also sought on exemptions. There is an opportunity in the PSR to allow the passporting of corporate exemptions on SCA between countries. The risk-based and result-oriented approach is positive. Transaction risk analysis (TRA) is a good example of this. If an issuer or acquirer has a low fraud level, then it is eligible for a higher threshold, below which it does not have to apply SCA. Although that logic is valid, the thresholds are arbitrary. A transaction of €1,000 is more likely to be fraudulent or suspicious than one that is at €500. A higher threshold should therefore be considered and should be conditioned to a certain level of fraud, which would allow for striking the right balance between fraud control and a frictionless experience.

A regulator remarked that more than 200 suggestions were submitted to the Commission for the initial proposal on how PSD2 could be improved, based on the experience gathered over the years. Most of those recommendations have been taken into account when writing PSD3, PSR and financial data access (FiDA). Guidelines on the authorisation of payment institutions, all prudential requirements, own funds, safeguarding of funds and notifications for banks will be developed. There are also many aspects related to fraud. There are about 35 mandates that the legislators have given to the EBA with this new package.

Market confidence is essential. The whole chain should be involved, including the merchants, the payment service providers and the public. Data protection aspects and inclusion aspects should be taken into account from the beginning. Customer experience is important, but issues around individual liberties must not be forgotten. Consumer protection in general should be taken to the highest possible level in order to obtain the trust sought for the products to be successful.

A public representative reported that there have been significant efforts to finish the European Parliament procedure as soon as possible. It is the end of the mandate of this Parliament, and the nature of the next Parliament is not known. The European Commission has proposed PSD3 and PSR so payments can be cheaper, safer and more user-friendly. Those objectives go in different directions, and a compromise had to be found to strike the right balance between them. The notion of authorisation has been better defined. The scope of who is responsible for tackling fraud has been

enhanced to include digital platforms. Although digital platforms should not spy, they should react to information about fraudulent advertisements and accounts.

Europe is in a race against its global competitors and technological progress. It will always be somewhat behind in that respect, and has to close the gap between state-of-the-art technology and state-of-the-art solutions from China and the US. The European payment system is still quite fragmented. The non-bank champions are mainly local. However, Europe has a relative advantage in the fintech industry. As free as is reasonable access to the banking infrastructure should be offered to fintechs.

An industry representative remarked that the strength of the EU regulatory framework is that there is collective willingness to revisit it and optimise it. Other parts of the world are taking inspiration from PSD2, the Digital Operational Resilience Act (DORA) and GDPR. PSD3 and PSR could take greater account of other business models, especially in large tech companies where there might be anxiety about the provision of certain services in this space. Likewise, SCA measures could better embrace innovative approaches alongside the focus on safety to make sure users get the best outcomes, while being protected and having as frictionless and trustworthy an experience as possible. With these issues, together with some of the other competition issues that the Directorate-General (DG) for Competition and the DG for Communications Networks, Content and Technology are looking at, there are important steps forward that need to be taken.

An industry representative noted that there is an opportunity to help European champion firms become global players. Aspects of the single market are not working well. Three blockers to business are IBAN discrimination, the proliferation of alternative payment methods (APMs) in various countries and fraud.

Regarding IBAN discrimination, the SEPA scheme has not worked in terms of adoption and enforcement. Regarding APMs, although SEPA wiped out many of the existing legacy schemes, new ones have arisen due to technological innovation, and it is quite difficult for organisations to join those if they are not local. That does not help the situation. For an industry representative's firm, 75% of the fraud it encounters originates from one social media platform. There is a need to keep pushing big tech to become part of the solution.

The Chair agreed that considering competitiveness outside of Europe is important to consider. One area that needs to improve is co-operation, because there are many diverging views and concrete ideas. The question is how to bring all of that together efficiently. An interplay between the public and the private players is needed to succeed.

4. Co-operation between market participants, and the public and private sectors in a global context

4.1 Adopting the payment standard and fostering interoperability and interconnectivity

An industry representative noted that the retail payment strategy and its four pillars should be implemented. The first pillar is the rollout of the instant payment regulation, which includes mandatory IBAN and name-checking services. Banks need to be compliant with this regulation. It will ensure connectivity and interoperability with the existing solution. Providers that exist today will provide IBAN and name-checking solutions, and it should be ensured that banks can connect easily and do not have to connect to each individual solution. Banks can then also pre-validate at the cross-border level.

The second pillar of the Commission's payment strategy is to offer the best services for citizens with a high level of protection. An industry representative's firm is working on increasing the cross-border payment experience, not only for wholesale but also for retail and small and medium-sized enterprises (SMEs). It is working with the banking community to make sure that it can offer instant (or quasi-instant) payments that are transparent, and traceable. Banks are being encouraged to upgrade the front-end od retail SME applications with these capabilities.

The third pillar is interoperability with instant payment systems. An industry representative's firm offers connectivity to TARGET Instant Payment Settlement (TIPS) and Real Time 1 (RT1). It is also a key component of the One-Leg Out Instant Credit Transfer (OCT-Inst) of the European Payment Council (EPC). The firm is innovating with central bank digital currencies (CBDCs), with a focus on ensuring interoperability with existing networks. The fourth pillar of the retail payment strategy in Europe is supporting the cross-border agenda from the G20.

4.2 Developing integration and sovereignty

A Central Bank official highlighted, regarding integration and sovereignty, that there is more of a role for market players, both private and public, and including central banks. It is something that market players and market forces should address. That is where partnership comes into the picture. A number of initiatives need to be undertaken. For example, there is the European Payments Initiative (EPI), which can contribute to the integration agenda and the sovereignty issue. For the sovereignty issue, there is also the digital euro, which is the central bank contribution. That project requires a strong partnership between the central banks and payment service providers.

Cross-border payments and global infrastructures: G20 roadmap and remaining challenges

1. The challenge is now to keep the momentum of the project to achieve the ambitions behind the G20 roadmap while addressing challenges

The Chair noted that cross-border payments are slower, more expensive, less transparent and less accessible than national payments. Cross-border payments have improved over the years, but there is still a significant gap. Emerging countries will probably benefit most from cross-border payment enhancement. While there is room for improvement in cross-border payments, the good news is that this problem has moved up the list of priorities, with G20 leaders deciding to act. Currently, the situation is at the midpoint before the final goal of 2027. The hard work starts now. The authorities and the private sector are making great efforts to meet the G20 targets.

A Central Bank official highlighted that the aim of improving cross-border payments is to help people on the ground. The cross-border programme was initiated by the G20 in 2020, with the idea of making cross-border payments faster, cheaper, more transparent and more inclusive by 2027. The assignment was given to the Financial Stability Board (FSB). The first step was to consider the underlying problems. In 2021, the FSB published quantitative global targets with respect to three areas: wholesale, retail, and remittances.

1.1 After the groundwork, it is now time to follow with a myriad of individual or collective concrete actions

A Central Bank official commented that significant progress is being made. If this work is done correctly, it will help everybody across the globe. The work done in recent years has laid the foundations, so it should be possible to begin moving more quickly with practical, impactful actions. There has been a focus on understanding why cross-border payments are so challenging. The G20 roadmap has set out what needs to be done by the public and private sectors. Best practice guidelines have been set out so that central banks can assess the need for improvements in their areas.

The groundwork is done; now is the time to push forward with concrete actions. To meet the targets, it is necessary for jurisdictions far beyond the G20 to act. Some actions lie with individual jurisdictions. The European Central Bank (ECB) brought in ISO 20022 global messaging standard last year, as did the UK, Australia, and others, and this should be done on an institutional and jurisdictional basis. The payments industry must make use of enhanced data content of ISO 20022 messages. These messages ISO have fantastic capabilities for industry in terms of understanding customers better, facilitating straight-through processing and allowing greater harmonisation. Currently, access to payment systems is limited to key financial institutions, principally banks, although in some jurisdictions such as the UK and Switzerland, access has been opened to non-bank payment service providers as well. To address cross-border payments, more participants need to be able to access directly core parts of the payment infrastructure.

There is much that central banks can do. The industry clearly wants more progress on legal, regulatory and supervisory frictions. A public-private taskforce has been set up. More work must be done on bank and non-bank supervision, data and privacy. In terms of digital assets, it is important to understand what is happening domestically and how this can also work for cross-border payments.

1.2 Significant concrete progress has been achieved in the EU

A Central Bank official stated that the replacement of TARGET2 with T2 in March 2023 was significant. The new TARGET services are important as a preparatory mechanism for the G20 cross-border goals. The euro system also played an important role in the uptake of the ISO 20022 financial method. Market players in Europe are going to take an important step in this respect in March. Lastly, there is an increased uptake of instant payments. From a European point of view, the latest EU regulation on instant payments is extremely important. It was adopted by the EU Parliament two weeks ago and will make instant payments the new normal by the end of 2024. Overall, the project is not yet at its endpoint, but there is reason to be optimistic about the progress so far.

1.3 Globally much progress has been achieved

An official observed that some measurable and significant progress has been made towards achieving the G20 goals. There have been some real improvements in speed. Within wholesale, according to SWIFT data, 89% of payments are made available to beneficiary banks within one hour. Within the retail channel, more than three-quarters of providers make funds available to the ultimate recipient in less than a day. The target for both of those across the G20 payments roadmap is 100%.

Costs are also falling. The global average cost of the $200 remittance has fallen from 9% to 6% over the last 10 years; the target is 3%. For the lowest-cost and simplest form of remittance payments, the World Bank's

SmaRT index, the cost is already down to 3.5%. That is a 50% decrease within the last six or seven years. The adoption of ISO 20022 in some form has extended to more than 100 countries. The Committee on Payments and Market Infrastructures (CPMI) has been working to create a harmonised standard, which has the potential to increase adoption even further. Using the richer data set that ISO 20022 adoption allows can provide the level of automation to deliver on speed and cost goals.

1.4 The many examples of emerging challenges and ongoing innovation, particularly in the field of instant payments and Central Bank Digital Currency (CBDC), add to the challenges of interconnecting payment systems where the target is to provide choice while avoiding fragmentation and complexity

An official highlighted that, in 2022, a framework of key performance indicators (KPIs) was developed to measure progress. Last year, data on most of these KPIs were published for the first time. In some areas, the KPIs demonstrate that the situation is not bleak. The G20 roadmap cannot take credit for all these developments, but it is at least putting a good foundation in place. There are still some areas to focus on. Progress will become more difficult from here. There will be fewer technical issues with stock adoption and more difficult political trade-offs.

An industry speaker stated that there is some positive momentum in the existing models, but there are also many new models coming into play. The interlinking of faster payment systems is one area in which momentum is building towards the G20 goals. SWIFT has been working to interlink market infrastructures for many years already. As momentum moves towards instant capabilities across the domestic space, there should be an increase in the number of bilateral and multilateral interlinking projects. As these schemes are set up, there are some common challenges to consider, including compliance practices, governance models, managing the FX and ensuring the same levels of cybersecurity and resilience that are within existing systems today.

One challenge relating to these models is that there can be roadblocks to scalability. The more corridors are added, the more complexity and cost potentially enter these models in the future. This could constrain closed-loop systems in terms of the liquidity flow to support trading relationships and the movement of capital. These are all areas that are being overcome. These models are also generating many positives in terms of choice and optionality, stimulating the acceleration of progress towards the G20 goals. Many other innovations are being considered, including CBDCs or distributed ledger technology (DLT) based networks.

It is important to consider what the ecosystem of the future looks like at the infrastructure level, making sure that choice and optionality does not lead to fragmentation or complexity. This involves considering how to seamlessly connect DLT-based networks and CBDCs to the existing financial system and fiat currencies. In areas such as payments pre-validation, cross-border services can connect to domestic confirmation of payee schemes. Progress is being made in a multitude of areas. The aim is to enable operational effectiveness and to maintain coherence in the global financial system.

2. Implementing the payment versus payment (PvP) mechanism requires further risk awareness and alignment of legislation across multiple jurisdictions

2.1 Addressing the specific challenges faced by the evolutions witnessed in wholesale transactions requires further monitoring of risk

An industry speaker emphasised that the challenges faced in the field of wholesale are different from those in other segments such as remittances and retail payments. The G20 cross-border roadmap fully acknowledges these differences. In October 2023, the FSB published KPIs that either directly or indirectly measure the extent to which the targets are being met. In relation to wholesale payments, the October FSB report refers to SWIFT Global Payments Innovation (GPI) data which looks very promising. 89% of all payments go from the sending to the receiving bank within one hour and 99% within one day. Currently, there is no effective way of measuring FX settlement risk. The triennial survey conducted by the Bank of International Settlements (BIS) is a rich source of information, but the methodology is currently measuring trading activity rather than settlement risk activity. The methodology is being reviewed to better cater for the FX settlement risk dimension. Even without a precise KPI, there are clear indications that risks are increasing. This is driven primarily by the rise of emerging market currencies such as the Chinese renminbi.

There are also other developments to note, such as the acceleration of the settlement cycle in the securities market. The US and Canada are moving to T+1 settlement in May 2024. This will likely impact the execution of FX trades and post-trade processes as it creates pressure on market participants to submit FX transactions to custodians within certain cut-off times in order to meet settlement systems deadlines. There is more discussion about reducing the settlement cycle in other major currencies. It is necessary to anticipate how potential increases in settlement risk in this space could be measured and mitigated.

2.2 Full alignment of legislation across multiple jurisdictions is of the essence

An industry speaker stated that onboarding currencies into a PvP system is a medium- to long-term endeavour as solutions need to be found for a wide range of topics. For example, laws must be completely aligned with an appropriate framework for participation and recognise the finality of payments and the enforceability of all netting processes. The

regulatory framework must adapt to the principles for financial market infrastructures (PFMI). Hurdles could also be geopolitical in nature. Entities in different jurisdictions must be both interested and able to collaborate on a common mechanism to settle cross-currency payments.

3. Multiple success factors to gather and areas for work

An industry speaker commented that there should be continued progress in the wholesale space. While it is positive that 90% of payments are going cross-border within an hour, there is more work to be done to improve the end-to-end picture. This involves trying to overcome other frictions in the chain, such as opening hours, batch processing, or capital or currency controls. There is more to be done in the wholesale space to continue advancing towards the 2027 goals.

3.1 Legal, regulatory, supervisory, and ultimately policy alignments, notably regarding data (privacy, AML, data enrichment)

An official stated that the challenges in managing the G20 roadmap project are not predominantly technological; they are predominantly legal, regulatory, supervisory, and ultimately policy changes. A great deal of experimentation with new technology is occurring within both central banks and the private sector. This has the potential to help the goals on cross-border payments to be reached, but the predominant obstacles are related to underlying policy considerations.

CPMI delivered an interim report to the G20 at the end of 2023 on decisions relating to interlinkage. The report suggests a precursor set of steps for jurisdictions to follow. The first two steps are high-level policy alignment and alignment on goals. The political will align frameworks is a precursor to progress.

Consideration of data-related standards is also important. This is one of the priority building blocks that the G20 has identified under the Cross-border Payments Roadmap. An FSB technical workstream is considering improved alignment between different data frameworks. Frictions may arise from the financial regulatory space, the privacy space or the anti-money laundering and combating the financing of terrorism (AML/CFT) space. There is often uncertainty or risk aversion in understanding how to reconcile obligations across different frameworks.

There is an underlying need for more data to move across borders in order to make cross-border payments cheaper, faster, and more accessible. There is much uncertainty about how to extend data availability into automation. Data restrictive policies can interfere with the cross-border regulation of financial services and have significant effects in potentially impeding those goals. It is hoped that there will be some policy recommendations in the year ahead.

3.2 Efforts made in terms of cooperation and governance need to be continued

A Central Bank official highlighted the importance of cooperation between the public and private sectors. Most central banks run payment systems, but bodies such as the FSB and CPMI do not. So far, the initiatives have been quite successful and there are several groups where the public and private sectors come together, but it is important to continue that. The most complicated part of the project is governance rather than technology. That includes the governance of interlinking, including with supervisory regimes and legislation. AML is another area where interlinking is a significant challenge.

3.3 Combining technical progress and business case viability is essential

A Central Bank official emphasised the importance of a viable business case. The public sector should acknowledge that some elements that might seem easy from a technical or regulatory point of view may not work from a business point of view. Lastly, regional disparities are still significant. It is important to invest more in regions where there is less progress.

4. To extend the work already done, we need to involve countries beyond the G20, increase the number of cooperation forums, and structure technical assistance

An official observed that there is still significant regional variation with regard to both speed and cost metrics. There is a strong case for regional engagement outside the G20, where there is a lag on some of the key goals. It is incumbent upon the G20 to undertake that engagement together with the private sector. Currently, some significant intra-regional variation might be missed. This is particularly true in East Asia and the Pacific, where some economies are heavily invested in improvements in payment speed and may be drawing the overall average numbers up. It is important to focus on jurisdictions that are still struggling.

A Central Bank official stated that much of the work that needs to be done within the G20 also applies outside the G20. Some areas are far below the targets and need to improve. The IMF and the World Bank have been working on providing technical assistance. The Financial Action Task Force (FATF) is working on refining its recommendation on the information that must be attached to cross-border wire transfers. There is a community of practice for central banks, which is open to anyone in the world. Collaboration between the private and public sectors in the G20 is key.

There are several taskforces, including the payment interoperability and extension (PIE) taskforce. There are taskforces on legal, supervisory, and regulatory frameworks, as well as application programming interfaces (APIs), ISO 20022 and data. The private sector

can provide more detail about what needs to change. Payment systems have different access requirements, hours, and approaches. Industry should try to shape the systems, as some of this is becoming more jurisdiction specific. Industry also needs to start planning for investments, including the impacts on staffing and infrastructure of greater moves to 24/7. Greater use of ISO 20022 will make it easier to benefit from the changes that are being made. Spreading the word to people from other countries is important. Many of the actions that can be taken to enhance cross-border payments can also help increase efficiency within businesses.

4.1 Here again public-private collaboration is necessary

An industry speaker observed that the progress made so far is a result of public-private collaboration, so it is important to continue that. This collaboration has been a good catalyst for setting up working groups and workshops. As new capabilities are introduced to help move towards greater speed and transparency, it is important to work with small and medium-sized users across the world to make sure they can also access the benefits. ISO and cross-border payments and reporting plus (CBPR+) are important. It is necessary to support communities worldwide in reaching the end of this journey. The benefits of this are foundational for the future transformation journey. Innovation of future services will only be possible with better data quality.

An industry speaker agreed that partnership between the public and private sectors is key. Such a partnership delivers value to the market, facilitating safe and stable services. The challenge for the taskforces is to ensure that they are pragmatic and that ambitions are realistic. Key challenges do not necessarily lie in the area of technology. The choice of technology is a question inferior to governance or regulatory and legal aspects.

Sessions

V

EU AND GLOBAL SUSTAINABILITY AGENDA

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Reduction of the greenwashing risk: product classification, ESG data and rating

1. Inadequacies of the EU framework

The Chair asked how EU standards and labels can help to prevent greenwashing, whether it is necessary to regulate environmental, social and governance (ESG) data more, and whether the current frameworks are sufficient to limit the risk of greenwashing.

A regulator detailed that the European Supervisory Authorities (ESAs) have produced a report covering the status of the sustainable finance regulatory framework in combating greenwashing. There is intense work underway to design the sustainable finance framework. The whole value chain of sustainable finance is covered by various pieces of legislation. That is bound together by the taxonomy. However, there is more work to do for there to be good standards that combat greenwashing.

Retail investors are vulnerable to greenwashing. They have difficulties understanding even the simplified Sustainable Finance Disclosure Regulation (SFDR) disclosures. The regulatory technical standards (RTS) that ESMA has provided create dashboards to alleviate the problem.

Article 8 and 9 products are seen as labels, which is not helpful. The advice in the Markets in Financial Instruments Directive (MiFID) sustainability preferences also unhelpfully incorporates jargon from the sustainable finance regulatory framework. The SFDR revision can be used to explore the possibility for labels.

A regulator highlighted that it is often not clear what greenwashing exactly is. A set of rules and regulations is needed. The current SFDR does not give clear guidance to suppliers. Some fear so much for their reputation that they under-represent the greenness of their products. SFDR provides no guidance for investors, so they rely on marketing and fund names. The existing framework information needs to be clear and fair. Instead of Articles 8 and 9 there should be a focus on consumer-friendly labels.

An industry representative remarked that their firm has a corporate mission for all its decisions to be directed towards building a more sustainable society. It does not want to greenwash, but help is needed to allow it to give underwriters of insurance contracts and investors clear and transparent information about sustainability. Recent regulations are a first step, but they are not precise enough and their scope is insufficient.

There is a lack of understanding about what the ratings under SFDR mean. SFDR 9 does not provide a clear definition of what is sustainable at the European level. Many actors withdrew from SFDR 9 because they feared an accusation of greenwashing due to SFDR 9's imprecision. For a fund with 40% sustainable components, it is unclear whether that is because all components have an average of 40% sustainable or because only 40% of the total is sustainable.

There are multi-option products in life insurance in Italy, Sweden, and France. They have a euro component and are unit linked. Looking at SFDR only for unit linked, there will be difficulty explaining the contract. A methodology that covers all markets is needed.

An industry representative indicated that, from an ESG rating perspective, SFDR is a step in the right direction in terms of increasing the quality and level of transparency. Banks use the EU taxonomy extensively. It is the basis of how they identify something as being green. That requires them to know certain things about their clients, and the level of technical expertise goes beyond what banks normally would be looking at, which limits application. The Corporate Sustainability Reporting Directive (CSRD) is increasing transparency. There will be more data and comparability. However, there is a need to focus on how these different standards talk to each other, particularly the International Financial Reporting Standards (IFRS) and CSRD.

There are ways to prevent greenwashing through how ESG data is handled. Applying traditional data governance will work well, in terms of ensuring there is quality, and that the source and lineage of the data are known. Banks are increasingly putting ESG product guidelines in place, to have a more clarified definition on how to apply the taxonomy and to guide the company in terms of consistency and comparability.

An industry representative emphasised the importance of having a US-EU dialogue. Greenwashing is potentially corrosive to the financial system. It is about fraud and deception. There are rules in the financial markets to pursue fraudulent or misleading behaviour that should be used. The question is whether greenwashing is fundamentally different to any other type of fraud on the market.

The EU has built a radically different set of regulatory frameworks around the question of sustainable finance. However, there is a first mover disadvantage in that context as well, and the EU did not get everything right. The UK has developed relatively straightforward greenwashing rules that require fair and clear disclosures that are not misleading. The EU has created a very complex piece of architecture with the new frameworks, and not everything makes sense. Entities accidentally and unintentionally fell into Articles 8 and 9, and that is a form of greenwashing itself.

Market abuse laws are about price. If an entity is disseminating misleading information that influences the price of a security, then that is considered market abuse. In the Sustainable Finance Disclosure Regulation (SFDR), there are so-called labels that need to be replaced with real labels. A higher level must be reached to demonstrate being deserving of the labels. In that respect, the EU green bond standard (EUGBS) is a much better template.

Greenwashing can happen anywhere along the value chain, so data is the starting point. The sequencing of the EU policy agenda is unfortunate in that regard, as it started with disclosures for financial products and financial market participants. Before ending up regulating all data everywhere, the results of the CSRD in the following year should be considered. That will help set a new benchmark in the quality of data in the system.

At the global level, $4 trillion must be found every year to invest up to 2030. That increases to $4.5 trillion from 2030 to 2050. Greenwashing must be eradicated as soon as possible to get to the next phase.

An industry representative agreed that the problem is not greenwashing; the problem is transition and getting there faster. For the European taxonomy to work, data is needed to test the significant contribution aspect. That data was expected in CSRD, but it is not there. Mandatory Public Interest Entities (PIEs) were expected in CSRD, but they are not there. The CSRD consists of more than 1,000 metrics, which is difficult to manage. Consistency on materiality is needed.

2. ESG rating agencies and data providers

An industry representative detailed that the EU is at the forefront of having a general sustainability framework. Almost all parts of the value chain are covered from a regulatory perspective. There was recently political agreement on legislation covering ESG rating providers. The missing piece in the value chain for ESG is data providers. ESG data products are composed of two parts. First is the data coming from issuers' reports, which are re-disseminated by ESG data product providers. The second is estimates, calculated by ESG data product providers themselves.

These are fundamental to the framework for preventing greenwashing. ESG data being wrong, or ESG data estimates being unclear in their methodologies, have later impacts. Asset managers and asset owners must report sustainable investments through SFDR. If the underlying data provided are not reliable, asset managers will be caught from a regulatory perspective. Regarding the taxonomy regulation, there is supposed to be investment in sustainable investments, based on data received from providers. If the underlying data are not reliable, asset managers may also be caught from a regulatory perspective by not fitting with that investment intent.

There is also a fiduciary duty to clients. If asset managers promise ESG investment to clients, and it appears that there was reliance on external data that do not fit with the intent on ESG investments, clients could sue the asset managers.

Obvious mistakes or errors are frequently identified in the ESG data received from providers. Any issuer has a scope 1 emission of greenhouse gases above zero. Individuals also have scope 1 emissions above zero. Nonetheless, scope 1 information coming from data providers that are equal to zero, and supposedly coming from issuers, are regularly identified. The most obvious mistakes from providers can be identified by asset managers when receiving them, but there is no guarantee that everything is caught. There is a need to report subsequently, and to invest, preferably in ESG investments, so it is critical that the ESG data are made reliable when re-disseminated or estimated by ESG data providers.

ESMA issued a report on greenwashing in May 2023, asking for regulation of ESG data providers. One month later, the European Commission issued a proposal capturing ESG rating providers but not ESG data providers. There is some inconsistency between what ESMA proposed and the actions of the European Commission, the European Parliament and the Council. The EU pretends to be at the forefront, but not tackling ESG data providers is a major missing piece in the EU framework.

The International Organization of Securities Commissions (IOSCO) asked for a regulatory framework on ESG data providers in 2021. This was followed in Asia. Japan applied a code of conduct. It was followed by Singapore last year. It is going to be applied by Hong Kong. A few months ago, the FCA in the UK, with a working group composed of industry professionals, developed a code of conduct for ESG data providers. There are still two regions not following IOSCO's request for action yet. One is the US, though that is understandable from a political perspective. It is probably difficult to replicate and apply IOSCO's request on ESG data providers considering the current Congress' positioning on ESG. The other region not applying IOSCO's request is the European Union. The EU has not adopted or even proposed any code of conduct or regulation on ESG data providers up to now. The European Commission and/or ESMA should initiate such an EU code of conduct. That has to be done urgently.

3. The SEC approach to climate-related disclosures

A regulator agreed that Europe has been far ahead in terms of developing rules and regulations around this topic. The US has a very straightforward, principled enforcement approach, called truth in advertising. Entities cannot make false or misleading statements, or statements that would be false or misleading without certain omitted information. For example, one asset manager stated that it would do an ESG quality score for each position in its portfolio but, in fact, only did so for a third of the positions in its portfolio. The simple requirement is for entities to say what they do and do what they say.

One difficult issue is that there are many different views about what ESG and sustainable finance are. For example, how one weighs the G factor in the ESG calculation can differ as whether there is dual class stock or whether there is an independent board chair. This could extend to other G issues like succession planning.

Financial materiality in the US is generally what a reasonable investor would think is important when making an investment decision. One way of looking at that is whether it affects stock price or enterprise value. There have been several proposals and rules adopted in recent years. On the fund or financial product side, one was about fund names. If there is a name that suggests a particular area, including sustainable finance or ESG, then 80% of the assets in that fund need to be invested in those types of investments.

One pending rule concerns what a fund manager should do with the disclosures when offering ESG products. One proposal is to look at whether it is an ESG integration fund, an ESG focus fund or an ESG impact fund, and to provide various disclosures. Some have suggested that this might increase the risk of greenwashing. Others suggest that the increase in transparency would help combat greenwashing. Over the coming 12 months there will be continued attention given to these matters.

4. Implementing the EU framework

A regulator recommended using resources to generate a better system, to explain that system, and to help investors and suppliers, rather than using them on enforcement for the rare cases of intentional greenwashing.

An industry representative emphasised the need to act in a coherent way internationally, respecting the long history of how efficient financial markets work, while moving to a system that takes account of externalities not currently being priced. There should be clarity regarding the principles that will apply to the future system. There should be a system that enables truth, transparency, and full and fair disclosures along the value chain.

An industry representative remarked that the European taxonomy has already indicated what materiality consists of. By starting with strong, validated, and audited data that is available when the companies report the data to the financial sector, the domino effect will be much stronger. Data is needed to ensure that data providers can help investors drive money to the right companies.

The UK and US have taken a pragmatic approach to ESG ratings. Rules must be simple and easy to implement in order for progress to be made. In Europe, investors highlight that 80% of their time is spent on compliance. There is a need to lead with success, which does not start from creating litigation concerns and fears about what data will be disclosed. It instead starts by identifying what needs to be done to ensure that more people devote more time to finding green investments that can help reach the target faster. Rather than managing from fear, greenwashing issues or litigation, there should be consideration of how regulation can be an enabler for businesses to create value. 50% of the global market cap now is in the US, and the question is what Europe can do to ensure that it can lead the transition, not just in terms of regulation, but also value.

There should be simplicity when significant changes occur in the economy. The space is currently extremely complex. There are different rules, which do not talk to each other, and that creates confusion. Confusion then results in greenwashing, which creates fear and therefore slowness and paralysis. Simplification is needed, along with a global leadership mindset, so there can be a single rule that everybody can understand, and which only has a handful of data points. The Chair noted that the challenge is that the world is becoming increasingly complex.

An industry representative highlighted the importance of international convergence and consistency, particularly for global players. An industry representative remarked that CSRD and other regulations are expected to help with making the right choices when voting in general meetings, and for not forgetting that being 100% green will take longer than a single day. There must be help with the transition. An industry representative noted that clear, consistent, and simple legislation is sought for greenwashing prevention. In the social area of ESG, that would also cover social washing prevention. More clarity is needed on the definitions for social and the social taxonomy. Banks looking at ESG are trying to balance the E and S. That is an area of the legislation where there are gaps.

Conclusion

The Chair summarised that what is sought is simplicity, coherence, and clarity. A regulator noted that the ESG ratings provide a step forward. It is hoped that they will move capital in the right direction. Having minimum standards on transparency and governance around ESG ratings is positive. However, the data providers are missing from this exercise. They also play a very important role in combating greenwashing. It is also important for market participants to fulfil their due diligence requirements.

Transition planning in the financial sector

1. Transition plans: one of the hot topics of the climate and finance agenda with ongoing developments

The Chair noted that transition plans have been one of the hot topics of the climate and finance agenda since Glasgow in 2021. In the past two years, there has been progress on the consideration and delivery of transition plans. This includes the foundational Network for Greening the Financial System (NGFS) report in spring last year, and the work at the Financial Stability Board, the Basel Committee and the International Organization of Securities Commissions (IOSCO). Transition plans already feature in the legislation of some countries. Some private sector institutions have prepared transition plans.

2. First observations from recently issued transition plans

2.1 Main aims, features, reactions and benefits

An industry speaker highlighted their bank's recently published transition plan. So far, the plan has been well received. The aim of the plan is to provide a rationale and to explain how the set goals will be achieved. Previously, it was difficult to understand how all the pieces fit together, but this is a robust plan to help achieve the net zero commitments. All staff should understand what the organisation is doing and how to play their part. The plan is a powerful way of galvanising the organisation.

The document is structured in three parts. The first part looks at the vision; the second part is about the sectors' transition; the third part is about implementation. The vision is an opportunity to articulate the strengths of the organisation. Articulating those strengths and how to use them is a useful place to start. As a bank well embedded in the world economy, the first job is to work out how to reduce emissions. There is a focus on catalysing the new economy and helping newer technology to scale. The report is structured around the decarbonisation of trade and supply chains. It also tries to quantify the opportunity, clarifying that there is potential financing to be done and money to be made.

2.2 Banks must be able to adapt since they are dependent on economic sectors' transition path and public sector continued support

An industry speaker stated that banks are dependent upon the real economy moving, clients' willingness to decarbonise and there being the right incentives in the economy for them to do so. Banks can support this through finance, while clients must provide the ambition.

The middle chapter of their bank's report, which focuses on sectors' transition, is interesting and unique. It has been critical to articulate where emissions come from. A transition plan must first describe what and where the problem is. The chapter starts with a technical description of emissions sector by sector, looking at the timelines for technological change. Some sectors will move faster than others. Policymakers face the challenge of trying to enable banks to stay at 1.5-degree pace. To achieve a low-carbon future, scenario curves must be followed. Critically, those scenarios are dynamic. It is necessary to be flexible, pivoting as the world progresses so that banks remain relevant and able to support clients.

An industry speaker highlighted their bank's first transition plan, published at the end of January. This is the first version and needs further development. It has been important to integrate transition planning work into the bank's business strategy. The bank has four home markets, with a focus on the retail segment. About 80% of the bank's lending portfolio is related to real estate. In its four home markets, it is estimated that there is an opportunity to release up to 90 terawatt-hours by making buildings more energy efficient. The focus is on enabling clients to seize opportunities by offering lending to invest in solar panels, heat pumps and insulation improvements. The Energy Performance of Buildings Directive is directly linked to this, so it is also up to governments to play their part.

2.3 Rather than withdrawing, banks closely engage with each client after strictly cross-referencing their sector's level of sustainability risk with the client's own transition plan and the government technology roadmap

An industry speaker explained that their bank disclosed its transitional plan concept two years ago, together with its exposure to high sustainability risk sectors. The system seeks to identify and monitor high-risk areas by evaluating risk along two axes: clients' sectors and the status of clients' responses to transition risks. On the vertical side, the significant high-risk sectors were listed. The bank has also introduced horizontal approaches, plotting risks depending on customers' transition plans. If companies have a 2050 carbon-neutral business plan that is appropriate and practical, they can be regarded as low-risk companies even in a high-risk sector. If a company has no transition plan and no intention to make one, it will be regarded as high-risk.

The transition plan will be achieved not by divesting, but by engagement in investment. The agreement made with management is that the bank will achieve carbon neutrality by 2050 with its clients. The emphasis is on how to evaluate appropriate transition plans for each client in each sector. About two years ago, the Japanese government came up with a technology roadmap for certain sectors. The bank did a similar exercise internally. Conceptually, an assumption was made

about the 2050 ideal in each sector in terms of achieving carbon neutrality and sustainable economic growth. The assumptions compared what the industry looks like today with what would need to be done to reach the ideal situation by 2035. The gaps that emerge through this analysis are the challenges that must be tackled. Using its experience and knowledge of the industry, the bank speaks with clients and agrees on what to achieve by 2050, then calculates how to fill the gaps.

An industry speaker commented that it is important to differentiate between the transition plans of banks and clients. As a bank, it is necessary to manage the portfolio and the way that a client is supported. Their bank's transition plan starts from science, which clearly shows the sectors that need to move to low-carbon energy. The plan is also based on the importance of incentivising an increase in society's sobriety level. There are three pillars. First, the bank invests massively in renewable energy and energy efficiency. Secondly, it supports clients in the social and economic transition. Thirdly, it organises a phase-out from fossil fuel energy. Supporting change in society is the most complex point. Net transition is the way to quantify the transition and the support of the bank. Last year, the bank (published its climate guide, covering five sectors. A further five sectors were published last December. Net zero is useful in setting the direction of change.

A regulator observed that transitional plans are about firms, banks and financial companies working out how to implement transitions, policy sets and objectives. Some policy objectives have been clearly set in many countries. Objectives do not need to be immediately transmitted to all agents in society; agents must adjust to the policy objectives. All financial institutions should have a good idea about where they are now, where they want to be within the policy objective, and where they think they will be in 50 years. Institutions began putting together statements about where they want to be. Given the many interlinkages, these statements are always dependent on other actors in society.

2.4 Internal buy-in of transition plans and their operationalisation are essential

An industry speaker highlighted that the last part of their bank's report is about implementation. It describes the rewiring of the bank through tools and processes such as transition plan assessments. Transparency matters when describing how business is being adjusted, where there are emissions, and how the bank is addressing them. Transition is not achieved in a vacuum; it requires many other actors to move. The biggest challenge in designing the transition plan was that hundreds of people were working on it. Although there were no new commitments, it took a long time for the organisation to be comfortable with the pieces being put together in one place. However, it was time well spent. From the board down, there is a commitment. Colleagues are understanding how everything fits together.

An industry speaker explained that their bank has used a bottom-up approach, starting from the field entities. This takes time, but it has changed people's mindsets. Milestones, an action plan and emission reductions have been defined. Three key lessons have been learned. Firstly, although the approach is sectorial, the management of the transition is local, taking into account the strengths and weaknesses of local territories. Secondly, the net zero approach is workable if the local ecosystem is considered. Lastly, the transition has huge commercial potential for the bank. This way of thinking based on local strengths has encouraged people to see the transition not only in terms of regulations, but also in terms of creating new, green business.

3. In the EU, transition plans are expected to explain how banks manage the many risk factors and clarify whether the overall financial system is resilient and capable of supporting the transition policies with a timeframe of 2030

A regulator stated that transition plans need to properly reflect on operationalisation in order to measure and manage the risks involved. Institutions need to manage physical and transitional risks and the risk of clients not complying with the transition plans.

In 2022, the Single Supervisory Mechanism (SSM) concluded that the status of transition planning among European institutions was weak. It is good that institutions are working on transition planning. At the micro level, prudential supervisors will continue to assess risks. The EBA has guidelines and a consultation on how to assess environmental, sustainability and governance (ESG) risks under the Pillar II framework.

The EBA is also concerned about the resilience and capability of the overall financial system. The EBA is currently doing a stress test with other European supervisory authorities to determine the robustness of the financial system in terms of achieving the Fit for 55 strategy. The assessment is not about the micro level and the preparedness of every financial institution; rather, transition planning is about the potential risks to the system.

4. Financial market supervisors pay particular attention to transition plans in order to avoid the risks of greenwashing

A regulator stated that market regulators ensure transparency for investors by laying foundations in terms of regulation and supervision. The International Sustainability Standards Board (ISSB) disclosure standards are being promoted. As several jurisdictions are already implementing those standards, the regulator is assisting them with capacity-building. In Europe, there is a binding regime that serves as a forerunner. It is important that this framework is in place as a first step. The second pillar of regulation is

about audit. Trusted information is needed in the disclosures. Audit standards are being prepared and will be ready internationally by the end of 2024.

The second foundation is supervision, where it is necessary to focus on greenwashing risks across the ecosystem and value chain. Forward-looking information and transition plans are riskier, as projections are more difficult. Regulators are paying attention to this and will provide guidance. In the last four weeks, there have been publications by the French Autorité des marchés financiers (AMF) and the Dutch Autoriteit Financiële Markten (DAFM). The UK has already provided guidance. As this is a gradual process, greenwashing is sometimes involuntary. Preparers need to gain experience and recruit staff. It is not only about monitoring and supervising, but also giving guidance to help preparers.

5. Necessary public sector contributions to transition planning

5.1 Financial sectors' agility and their maximised contribution requires public decision-makers clarifying the transition

An official highlighted the importance of remaining agile in the process of producing transition plans. Public authorities try to help the private sector by providing macro milestones. European legislators have consistently chosen not to constrain private players too much in terms of methodology, as institutions must adapt to different local realities. The French Treasury created the Secrétariat général à la Planification écologique, which is working directly with the prime minister and oversees the national decarbonisation strategy. The French Treasury is also producing sectoral strategies, with the aim of providing milestones for private players when they are designing their own transition plans.

An industry speaker observed that tackling transition activity in Asia is a challenge. 70% of coal-fired power plants are in Asia. The industry is still developing, so energy demand is growing. Within Asia, each country has different pathways, so it is difficult to design an appropriate transition plan for every region. Industrial policies drive transition pathways. To understand the industry dynamic, it is important to focus on communication with policymakers. Those eliminating CO2 should be economically rewarded. Carbon credit is one of the frameworks that must be established so that the cost of decarbonisation is shared on an equal basis globally.

The Chair noted that transition plans should improve as updated versions are produced. However, they will only improve with clear ideas about where to focus attention. NGFS is concerned that multinational firms tend to initially consider the transition from the perspective of the places where they are headquartered. It is important to consider the diversity of the global economy.

An industry speaker stated that it is important to ensure that policies or regulations give the private finance sector the flexibility to back transition. There is a concern that regulations in one part of the world could create barriers in another. It makes sense to manage financed emissions globally. This battle will be won or lost in emerging Asia and the Middle East petrostates. It is necessary to consider how to engineer a transition that makes sense for the parts of the world that matter. Anything that prevents international banks playing a role in those parts of the world will be damaging.

There is no one-size-fits-all pathway. It is challenging to create consistency of expectation. Companies and banks should consider the right set of measures without being prescriptive about how to solve the problem, as approaches will look different in various parts of the world.

5.2 By promoting the availability of transition plans in the economy, the public sector increases the ability of financial players to define their transition path

An official commented that the transition of the real economy is important. Even after the full implementation of the Corporate Sustainability Reporting Directive (CSRD), not all European firms will have sophisticated transition plans. The role of public authorities is to incentivise transition planning.

The French Treasury has changed its ESG label to environmental, social and responsibility (ESR). One condition will be for fund managers to make sure that transition planning tools are available for firms. 15% of firms in the portfolio of labelled funds for high-impact sectors will need to be aligned with the Paris Agreement target as of 2026. This threshold will be increased. Banque de France is developing a sustainability indicator to cover firms without their own ESG ratings. Firms without the means to conduct full transition planning exercises should not be pushed out of the market.

5.3 Sector transition plans should be reflected in the taxonomy in order to capture the transition dynamics involved

An industry speaker stated that the challenge is to change the economy and achieve progress in a short period of time. Transition and the cost of energy is a real concern. Regulation and supervision are important, but the cornerstone of regulation is the taxonomy. The transition timeframe has not been clearly defined and should be a political project. There is a lack of confidence between regulatory bodies, banks and the financial sector. They all know that they must change the way they do business. Taxonomy is a cornerstone of regulation, but transition should be the second cornerstone. The transition needs to be defined in a sectorial way.

It is important to acknowledge what is being done for the green economy. The green asset ratio does not reflect the efforts that have been made. The reduction of financed emissions should be acknowledged by the indicator; otherwise, finance will not flow to the green economy.

5.4 Transition plans' iterative improvements, supervisors' engagement, and the implementation of existing EU sustainability legislation are the key priorities

A regulator emphasised that the process of producing transition plans is complex and multidimensional. The

current transition plans are initial versions that will be improved. The problem with the development of regulation is that it tends to have a certain sense of direction and stability in the framework that is put forward. Supervision is the right tool to push forward dynamic solutions. Regulators cannot write regulations and then wait to see whether they have written them correctly; instead, the expectation needs to be that regulations will be systematically revised and improved. There should be more reliance on supervision rather than regulation as the initial approach.

An official observed that much has been achieved under this Commission. There has been a great deal of activity on the sustainable finance agenda. It is now about ensuring that this regulatory architecture enters the everyday life of firms. For financial players, CSRD will be in full implementation by 2028, providing the raw data to work with clients. For transition planning itself, there is a big question mark as to whether the Corporate Sustainability Due Diligence Directive (CS3D) will enter into force. That might change the scope of the transition planning requirements. Finally, the European Financial Reporting Advisory Group (EFRAG) is doing an important job with the sectoral European sustainability reporting standards (ESRSs).

An industry speaker stated that transition planning is not a one-off. There will be challenging years ahead, as regulation is not yet in place. The CSDR will enable more data analysis to be conducted. Banks and regulators need to be able to compare data and share the same definitions. The transition plans of banks, clients and nations need to be aligned, so cooperation is important.

5.5 Mitigating the credibility risk of transition plans is an essential challenge

A regulator stated that transition plans have been voluntary so far. With the future CSDDD-directive, transition plans will become mandatory. For banks, there is another framework. It is important to note that transition plans might lead to credibility risks. Plans might not be backed by sufficient resources, there may be premature commitments, or the use of carbon credits may not be sufficiently explained. There are also problems with corporates, which have a cascade effect on non-financial firms that rely on them.

Secondly, gathering appropriate data for Scope 3 is a challenge. Regulators will try to help with guidance. Another dimension is international coordination. At COP28, IOSCO committed to monitoring the landscape within its remit of investor protection. Others are doing the same in their remits. Further guidance might help to bring more convergence to the system.

An industry speaker stated that client transition plans are being assessed to determine whether clients are investing real capital in meeting these challenges.

5.6 The success of carbon transition policies requires the simultaneous deployment of broader economic and social policies on a global scale

An industry speaker stated that the amount of climate transition pressure that can be applied in other parts of the world is limited. 75% of emissions derive from energy. The priorities of many countries are broader than just climate, so they will not stop producing a certain type of energy if asked to do so. Pressure from rich countries will not automatically translate into climate-aligned activities in poorer parts of the world. If the private sector is afforded the flexibility to find solutions, it will be able to play an important role.

The Chair concluded that the focus should be on the end goal of limiting climate change well below 2 degrees. Secondly, global and local perspectives should be managed simultaneously. Thirdly, everything is conditioned upon climate policies. Finally, it is important to continue being ambitious and pragmatic, relying on supervisors to challenge institutions.

EU Sustainability framework implementation: remaining data challenges

Introduction by the Chair

The Chair welcomed everyone to the panel dedicated to the EU sustainability reporting framework implementation. This is an important topic given that the available data does not meet the criteria of quality corporate information and the landscape remains fragmented despite the efforts made by many. The risks posed by this situation include an inability to make decisions, communicate properly and greenwashing. The transition towards the different sustainability reporting regimes requires determination and patience.

The EU Corporate Sustainability Reporting Directive (CSRD) establishes a clear and comprehensive path forward. The European Sustainability Reporting Standards (ESRS) were adopted last July. EFRAG is working on implementation guidance, a digital taxonomy, the involvement of small and medium sized enterprises (SMEs) and the sectorial layer of reporting. From a jurisdictional standpoint it is better for global players to be coordinated. EFRAG has made every effort to ensure interoperability is achieved when elaborating the Sustainability Reporting Standards, and the ESRS disclosures embed the International Sustainability Standards Board (ISSB) disclosures, correspond to the Global Reporting Initiative (GRI) and are consistent with the Taskforce on Nature-related Financial Disclosures (TNFD) framework.

1. An unsatisfactory situation but progress is possible and will be helped by the interoperability between ISSB and ESRS

An industry representative stated that a successful transition by 2050 will require that the funding gap is filled, amounting to an investment of €4-6 trillion a year. Good, transparent data is required to enable sensible decisions around financing, investment allocation and risk management. Implementing the regulatory reporting disclosure frameworks will require a collaborative effort by industry players to provide better guidance and an improvement in data quality.

The more that global reporting standards can achieve interoperability the better, because the allocation of capital and impacts of climate change play out on a global level. There is an opportunity to create a broader sense of alignment across fundamental concepts that underpin the framework of EU sustainability regulation and achieve interoperability. Tools can help with digital tagging, classifications and technical mapping, bringing a good opportunity to solve these challenges.

In terms of the current EU landscape, an official agreed that global interoperability is important. The ISSB is working closely with EFRAG to ensure there is interoperability between ESRS and the ISSB standards, which is an important step forward. The ISSB and EFRAG work on digital reporting taxonomies is important to identify common disclosures and disclosures that are EU ESRS specific.

The Chair stated that in establishing a second pillar of standardised corporate reporting this needs to be in a format that is readable to humans, able to be consumed digitally, and interoperable with other frameworks. Every effort is being made to ensure that by complying with the mandatory regime in the EU companies will be reporting in accordance with the ISSB.

A regulator commented that there is a need for high quality, reliable data in relation to sustainability investments, greenwashing risks and climate risks in order to allow the proper supervision of the markets. ESMA has been experimenting with three data sets: ESG controversies, greenwashing-related complaints within the EU and AI technology. There are difficulties in terms of consumers understanding where there are greenwashing risks and no common definition of greenwashing.

This work will be impossible without the development of machine-readable information in regulated documents to extract information and to create greater accessibility. The European Single Access Point (ESAP) will bring all those documents together. ESG disclosures are an EU strategic supervisory priority and there will be a number of common supervisory actions to come.

A regulator commented that it is a huge leap forward that the ISSB and EFRAG are talking positively together, as it is important to ensure interoperability between EU and international standards to help support companies in their reporting. We are currently seeing a challenge around whether there is enough capacity for work on assurance but the International Organization of Securities Commissions (IOSCO) workstream is working hard on this with the help of 97 audit firms.

It is also important to start thinking about how data will be used and how it will be compared. The UK Transition Plan Taskforce (TPT) has published its disclosure framework, which is internationally focused and has credibility globally. It is important to try to use the language and metrics that are already there.

ESG data and ratings providers should be trusted sources of delivering sustainability data and

assessments. It is therefore key for these providers to be transparent on the methodology, data sources and objectives of their products – as set out in the IOSCO's recommendations.

A regulator noted that much has been done in a short timeframe and this is promising, but the deadlines are urgent. Sustainability data reporting standards are evolving rapidly and firms are aware that it is relevant in busin ess operations decision-making which leads to increasing interest. The new reporting standards are bringing an enhanced equality, comparability and credibility of the sustainability data. The standardisation of ESG practices will allow easier comparison of sustainability performance across companies and assessing relative strengths and weaknesses, which enables the management of ESG risk more effectively.

The EU has been at the forefront of shaping new corporate sustainability practices and the Centre for Sustainable Delivery (CFSD) and the new ESRS are important steps to enhance the quality, comparability and credibility of sustainability data. The work on assurance and capacity building should proceed in parallel.

2. Challenges posed by the sustainable reporting standards

An industry representative commented that it is pleasing that EFRAG and the ISSB are coming closer together. A comprehensive framework for Europe is welcome, but it is not just ESRS that is being monitored with teams working across different jurisdictions.

First, the key issue is the interoperability and consistency of standards even within the EU. An energy performance certificate (EPC) is required to do loans, but not every country has the same EPC and some do not have a mandatory benchmark, even across the EU.

Second, there is a data gap where smaller companies often do not have comprehensive sustainability reporting available. The data does not exist on Scope 1, 2 and 3 greenhouse gases and so an estimate is prepared, but the method is not consistent across the board.

Third, there is a difference in approach to double materiality between the EU and other jurisdictions, which adds complexity. The Commission can assist by providing practical guidance on how to deal with this from the perspective of several jurisdictions.

It is the case that sometimes the private sector can bridge this data gap by bringing transparency and data comparability into the marketplace. The Net-Zero Data Public Utility has shown encouraging signs in providing a trusted and publicly available centre for company-level climate transition from a data perspective. It is necessary to be pragmatic, minimise the burden on reporting entities and bridge the perceived gap between the different ways of approaching this topic across jurisdictions.

A regulator stated that the new framework has been expanded, strengthened and digitised, which is a move in the right direction. There will be implementation challenges for smaller companies and for regulators. There will be a need for capacity building and infrastructure to properly regulate the market, but the new framework is a step in the right direction in terms of the quality of data.

A regulator stated that two things are needed for endeavours to be successful; first, stewardship is important to ensure people are using data in the right way. The UK does a great deal of work with the stewardship code, supervising asset managers and looking at what they are doing compared to what they are saying, which is important. Second, the FCA's SDR applies later this year. Clear, simple and accessible sustainability data will be key in ensuring the credibility of sustainability-labelled finance instruments and products. Products and stewardship are two areas that will make the transition a success, but a great deal more work is required.

A regulator highlighted several challenges as sustainability becomes more standardised and comprehensive. First, the standards are complex and require a number of indicators and metrics across different areas. Second, there are challenges with collecting, aggregating and verifying data around environmental impacts or social practices, which might undermine the credibility and usefulness of reports.

Third, any gaps in governance or a lack of clear accountability or broad oversight will pose a risk. Finally, competence gaps are linked to data availability. This can be addressed by strong commitment from top management, investment in employee training and collaboration and sharing best practice. There will need to be extra care and attention for SMEs as this is an impossible task for them.

3. What progress can we expect?

The Chair asked the panel when a steady state in terms of sustainability reporting will be achieved. An industry representative stated that all the right steps are being taken to make sense of climate data on a global basis. A more consistent effort is required around guidance and support to issuers and reporters because there are significant disclosure gaps and a lack of capacity and skills in SMEs. Scope 3 in particular is very complex and very volatile and there is a need for participants to lean into the set of recommendations issued by LSEG. It is important to be clear in all discussions that this is reporting with a very clear purpose.

The big hurdle remains with the corporates. In preparing its CSRD report, LSEG is looking at up to 1,100 different data points. This is a prompt that organisations will need a stronger handle on the data around transitioning and building more sustainable businesses.

An official stated that the first challenge is good quality standards and the second challenge is to ensure that those standards are consistently mandated and applied globally. IOSCO's endorsement of the standards last year was a huge step forward and it is important now to engage closely with regulators around the world to

understand how those standards will be mandated. Guidance is being developed to assist jurisdictions to understand how to move the standards into a mandatory environment and this is an important step forward.

There will be a further iteration of a jurisdictional adoption guide published this week, with dozens of jurisdictions currently consulting. Moving to a consistent environment will not be perfect from day one, but it will come through pragmatic working across standard-setters, regulatory partners and other stakeholders.

The Chair commented that the EU is in a frontrunning position with the first reports being prepared for publication at the start of next year. It is a very good sign of convergence that the EU is embedding the ISSB disclosures on climate and S1, and that S1 mentions ESRS as a source for other disclosures.

4. Priorities for Progressing

An industry representative stated that pragmatism from the private sector and guidance from the public sector are the way forward.

An industry representative shared that a recent launch for a code of conduct for ESG ratings had almost 1,000 registered participants, a level of interest never before seen, demonstrating that the work across ESRS, disclosures, and labelling regimes is important to broader market participants.

An official emphasised that continued work is still needed. A regulator added that it is a continuous process that requires persistence in order to build capacity in terms of infrastructure and know-how.

A regulator stated that guidance from regulators will be key. We recognise that disclosures might not be complete first time round and companies are on a journey –and we know that learning will be part of the process.

A regulator stated that the key priority is to support companies to adapt to the new framework and embed positive changes within the organisation.

5. Conclusion by the Chair

The Chair summarised the comments made by the panel. First, regulations and reporting requirements are being established for certain parts of the economy while other parts are not submitted to the same rigour. There is now a reasonable basis from which to address the quality of sustainability-related data with the interoperability between the ESRS, ISSB and GRI. In the chain of production data it is necessary to start with the right standards, implement them using management and governance processes, after which comes assurance, the enforcers and market participants.

There remains an element of scepticism in the EU, but implementation has started with the quality of data. This is a test phase and the standards will be refined over time. It is unclear how long it will take to digest this and make it a success. There was scepticism when IFRS was adopted in the EU, but everybody delivered at the end of the day and there is reason for optimism that this delivery will happen in the EU.

One element of the economy that is not taken on board is the world of SMEs. There is a draft voluntary standard for SMEs, providing basic information for their management purposes, but there are 20 million or more SMEs. It is hoped that the data platform will be considered the right one, but if more data is required it should be one or two extra sets. It should not be expanded because the better is the enemy of the good. It is time for those involved to make it happen and the general public to adjust. This pragmatism can bridge the perceived gap between the different ways of approaching this topic across jurisdictions.

Finance and nature: additional complexity or urgent necessity?

1. The importance of biodiversity for the economy and the financial sector

The Chair emphasised that nature was something to care about because of the alerts from science. It is important for society to stick to a vision of life in which science and rationality matter. There are limited resources in the world. Ecosystems are fragile and limited. A study from June 2023 by the European Central Bank (ECB) stated that 72% of the loans distributed to companies within the euro area are given to those dependent or highly dependent on ecosystem services.

A Central Bank official remarked that De Nederlandsche Bank (DNB) has been trying to identify links between the loss of biodiversity and the financial sector. It recently published a technical paper aimed at linking the ramifications of biodiversity loss scenarios with the solvency of financial institutions and financial stability.

Four transition scenarios and one physical risk scenario were considered for the Dutch financial sector. Biodiversity is more localised than climate, so what is important for the Dutch financial sector might not be important, at least in the short term, for a Brazilian financial institution, for example. Tipping points and second round effects were excluded.

An industry representative stated that society depends on healthy ecosystems, and no businesses, resilient economies or long-term growth are possible without nature conservation. CDC Biodiversity aims to measure its biodiversity footprint and that of other companies, so it launched the global biodiversity score (GBS). The idea is to assess biodiversity impact in all areas of companies' activities across the whole value chain and express that as a single metric. Speaking a common measurement language is key.

2. The implementation of the Taskforce on Nature-related Financial Disclosures (TNFD) Recommendations

An official detailed that the TNFD is a taskforce founded by the UN, and funded by several governments, including several from Europe. The TNFD includes40 Taskforce Members, all large corporations, and financial institutions from around the world, including one on the panel. It has developed a set of disclosure recommendations and guidance that encourage and enable business and finance to understand how nature Interacts with their businesses, and the relationship between their business models and nature. The TNFD aim is to support a shift in global financial flows away from nature-negative outcomes and toward nature-positive outcomes.

The methodology proposed is meant to help decipher how a business model depends on ecosystem services and which ones and understand what the company's impact on nature are through its operations and through its value chain. The TNFD guidance provides a framework for companies to approach this issue in the same way, and then report consistent, comparable, and decision-useful information. About a company's impact on nature, that might be through CO2, but it is only the third-ranked problem. The first is land use change, the second is overuse of resources and the third is pollution, at equal level with CO2 emissions. This is about the facts, the science, and the physical reality of nature.

The framework has 14 recommendations, which are built on those of the Task Force on Climate-related Financial Disclosures (TCFD), to help make them more familiar.

An industry representative reported that on 16 January the TNFD announced the number of companies that had volunteered to become early adopters. Of the roughly 320 companies, 80 were from Japan, making it the country with the largest number of volunteers. The UK was next with 46 companies and then France with 19.

Japan does not have the same kind of political divide that there is in the US. European companies are prioritising the European Sustainability Reporting Standards (ESRS) overuse of TNFD. Japanese companies were advised to utilise TNFD while it was not compulsory, as they could make mistakes and gain useful experience before it becomes compulsory. The goal is not saving nature. Nature will survive one way or the other. The question is whether human beings will be able to survive.

3. The legal and political background in the EU

A public representative remarked that there is currently a debate in European politics on what to do with nature. The Green Deal always assumed that it was not just about climate change; it was also about preserving and restoring nature. However, in the Parliament there have been more debates, mainly on the nature restoration law and pesticides. Some groups do not want to head in that direction. The upcoming elections could shift the balance on the issue.

There is a delegated act on the taxonomy, the environment and climate, which addresses biodiversity. For example, it takes the position that biodiversity offsetting can provide a substantial contribution, which is odd because biodiversity offsetting is a zero-sum game. There is

pressure on the legislator and the Commission to not go too far, and that pushback has existed for some time.

It is positive that the TNFD, DNB and the ECB are taking the time to further develop the understanding of the impact on the ecosystem, and ecosystems' impacts on businesses, in order to produce workable methodologies.

There is a growing consensus that transition planning is essential for sustainable finance to work. It is not self-evident that there is a long-term horizon among corporates and financial institutions, so transitional planning is important. This is a necessary vehicle, because the tipping points may be not five or 10 years away; they may be 10 or 20 years away. It must be ensured, in the current mandate, that the understanding of biodiversity and what corporates and financial institutions can do about it, are better understood, and for the resulting recommendations to have a place in investment decision processes.

An official agreed that many financial institutions and companies in Europe want to concentrate on the Corporate Sustainability Reporting Directive (CSRD) and think about TNFD later. However, adopting the TNFD Recommendations helps in answering the ask from the European Financial Reporting Advisory Group (EFRAG) on ESRS. A methodology called Locate, Evaluate, Assess, and Prepare (LEAP) has been provided by TNFD, which can be used by companies doing ESRS disclosures. They should work together because they are, purposefully, highly interoperable.

The Chair asked whether the backlash regarding there being too many norms and about excessive complexity could disappear after the election. A public representative suggested that for sustainable finance in general, and biodiversity in particular, the benefits for corporates and financial institutions are sometimes elusive. It is unclear what they will bring, so it is sometimes difficult to have this discussion within the corporates or financial institutions. Long-term planning should therefore be emphasised because that will at least make the importance clear.

On the other hand, the costs are clear and sometime high. CSRD is a major effort. That means there is a need to also think about the ecosystem of financial services and whether it is available to make sure that the framework is ready to be implemented relatively cheaply and at a large scale. A public/private partnership to take this into account might be needed.

In the EU, there is money devoted to biodiversity and there is a biodiversity strategy. The problem is with what is done at the national level. In the EU, there is a somewhat coherent approach. However, there is not a particularly consistent approach at the national level.

4. The risks and opportunities for the financial sector

An industry representative stated that, for holistic investment management, portfolio managers need to understand all the risks and opportunities available to a company. Though the situation has improved on climate it is still lagging where it should be, but the situation lags even behind for nature in terms of pricing in the externalities. The conversation is about understanding where the exposures, impacts and dependencies are. The opportunity is that there are plenty of sustainable projects and investments to direct capital to.

However, that new investment alone will not solve the problem. It is about funding the transition and having discussions and engagement with the corporates. The stewardship activity will help push the needle in the right direction. There are many ways that the financial sector can play a role. The goal is to incentivise companies to start thinking about that.

However, the financial sector alone cannot solve the problem. It needs to work together with governments and the private sector generally. Everyone has a role to play. The incentives and creating that enabling environment are very important, and all parties must create space for the corporates to move in the right direction.

The Chair suggested that entities are focused on what they are obliged to do first. The current stage is early in the process, and there will not be a perfect methodology immediately.

A Central Bank official remarked that there are many avenues that central banks could take, depending on their mandates. Supervision also plays a role. From a prudential perspective, the focus will be more on the risk management side. A great deal of analytical work is being carried out. Entities should be prepared for what is going to happen and manage their risks from a financial stability point of view. Then the link can be made, which is needed for price stability. This is not about a harvest that might go bad in one year; there are structural problems. The numbers will then be worked on, as was done with climate. After several years, nobody doubts the importance of climate from a financial stability or prudential standpoint.

The hope is that, with what is being done in terms of risk management and regulation, nature-related risks will be on par with climate-related risks. With regards to disclosures and measurement, as far as possible a framework that institutions already know is being adopted. If CSRD is taken seriously, it will not be a very large step to also take nature-related risks into account.

An industry representative stated that CDC's role is to invest. It invested €3 billion in the last three years in the framework of the recovery plan for biodiversity-friendly projects. However, its main role in this area, as in other general interest areas, is to channel public financing. Public financing is becoming rarer, and there is a challenge to blend financing in order to have public European or national finance, and to optimise the leverage with the investments and private investments. It can be useful, when financing biodiversity projects, to have promotional financing from the EU and the European Investment Bank (EIB), together with CDC'S financing.

An industry representative emphasised that such blending of public and private finance is beneficial. The public sector's role is predominantly one of stewardship, engaging

the companies adopting the TNFD framework and starting to disclose. On the private side as well as on the blended finance side, project finance can be considered.

The 80 Japanese companies that decided to proceed with TNFD are a mixture of financial and non-financial. There are many financial institutions partly because of their rivalry, and partly because of their role to play. The institutions were told that other institutions would be using TNFD. There are also many corporates, predominantly in the manufacturing, food, and telecommunications. Heavy emitting industries like steel or coal are not present yet. Financial institutions should be involved because this is a global issue that everyone must deal with, and many of the entities have global activities. Financial institutions are a channel that governments can work through.

This is an externality, and the question is how to internalise it. In terms of economics, the simple answer is to tax it. But the question is how to come up with a tax rate and how to measure it. If there is this externality, it will not be solved by the private sector alone. Either the activities are made pricier, or the risks are removed so that there can be investment. Blended finance is the typical example of the latter approach.

5. The situation in Asia

The Chair referred to countries like Malaysia and Indonesia and highlighted that some of the key issues worldwide include whether the great rainforests are protected for the biodiversity they contain and for their role as a carbon sink. There are sometimes trade-offs between climate mitigation and protecting ecosystems, such as with the production of lithium for mining for rare earth materials.

An industry representative detailed that TNFD will help improve the level of awareness of these issues. The Japanese economy is dependent on imports for raw materials, including from Southeast Asia. Japan therefore has many transactions with the Southeast Asian countries. There are issues with, for example, palm oil, human rights, and scope three matters.

Companies need to be aware of how their supply chains or value chains are created, and they need to work hard at ensuring the value chains' relationships with ESG issues are dealt with properly. When companies are working through their value chains, they should not work on these items one by one, for example by sending out questionnaires on scope three, then on human rights and then on nature. They should instead deal with all these issues at the same time, which will probably lead to a better set up of the value chains. This could lead to economic security improvements. There are many benefits to trying to understand and improve the resilience of the supply chains and value chains.

This is also an opportunity for all the companies, and through this kind of activity the awareness of the people on the receiving end of these requests should improve. They will have a better understanding of what they need to do and why they are receiving the requests.

An industry representative remarked that many companies in Asia have proactively reached out regarding climate and nature. They see it as an opportunity to attract European investment. They should be thinking about it from a risk management and opportunity perspective, but it is also a way of attracting investment from this side of the world as well.

An official suggested that most of the financial flows being considered are financial flows to corporations, and they are much larger than flows to just a few projects. It is in those flows that there is a need to channel to the right companies that are taking the right transition paths and are planning their transition towards something that makes sense with regard to nature. Part of TNFD's work is to help companies understand what makes sense. There are attempts to develop transition pathways for each sector in turn, so that people see more clearly where they are investing and whether they are investing in the right entities.

The Chair summarised that the risks are real and irreversible. Tipping points can be close, both for humanity and businesses. For example, in the agri-food sector, it is very serious and very quickly there might not be coffee or chocolate. The question is about externalities. Economists usually know how to deal with externalities, but the truth is that there is political force against that, in terms of putting in prices, and there are also very difficult moral and scientific questions around putting a price on nature. However, it is not actually about putting a price on nature; it is about looking at the costs of destroying nature.

Everything is local for nature and biodiversity. It is about channelling money to the right projects worldwide. Given the issues are local, the recommendations will not be one size fits all; a set of different solutions are needed for different ecosystems.

Data and good measurements are needed. Methodologies are already being worked on. For example, there is the LEAP approach, which helps organisations identify and assess nature-related issues, and the global biodiversity score. These tools are a good start. The work is at an early stage, and this should also include issues about transition.

In education, people learn that a company needs capital and a workforce, but what is also needed is access to resources, such as water, materials, and energy. To that extent, everything is global.

It is positive that TNFD has worked well. The International Advisory Panel on Biodiversity Credits will do its best. The hope is that the legislators of the future, the central banks and the private sector will help deliver what is needed to ensure people can continue living on this planet.

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CMU: is there a need for a new approach?

1. Progress made on the CMU

Several panellists highlighted the importance of capital market financing and the capital markets union (CMU) initiative for the EU and its economy.

A policy-maker stated that Europe's financial structure must be enhanced to address the challenges of the 21st century. More investment is needed in smaller, more innovative and riskier projects than previously. It is becoming increasingly clear that such projects need more direct financing via the capital markets. Work has been ongoing in the EU since 2000 to develop and further integrate the capital markets. There is a tendency to downplay the progress that has been made on CMU, but a great deal has been achieved. Most actions proposed by the Commission since 2015 have been agreed by the co-legislators. However, this legislative progress has not yet translated into significant growth in the market, which remains below its potential.

An industry speaker emphasized that capital markets are an essential component of economic growth in a context where the potential of monetary policy has been exhausted and fiscal policy is running at its limits. Demand for financing is increasing in Europe with the twin transition, the deterioration of economic indicators in key EU countries, and increasing geopolitical tensions.

A second industry speaker agreed that much has been done in terms of reviewing existing legislation, adopting new legislation and strengthening market infrastructures, but no significant change has yet been observed on the ground in terms of market development. Market finance in Europe has not picked up and its share of the global capital markets has in fact decreased over the last 15 years[1].

The first industry speaker confirmed that EU capital markets have eroded over the last few years despite the efforts made on CMU. This is particularly the case for equity markets. The market capitalisation of listed companies as a % of GDP remains limited in the EU, amounting to about 50%, compared to 190% for the US. Some US bigtechs have a larger capitalisation than all EU equity markets combined. The EU also has a share of less than 8% of total trading activities globally. Companies are delisting in the EU, causing the loss of growth, innovation, jobs and tax money, and leading to a vicious cycle in relation to fiscal and monetary policy. This leads to growth forecasts being reviewed in several EU countries.

A regulator stated that much has been done to consolidate the capital markets framework. Some key actions are still to be implemented, such as consolidated tapes and the European single access point (ESAP). Despite these efforts, capital markets in Europe remain underdeveloped. Currently, European capital markets are unable to respond to increasing financing needs. This must be urgently addressed. The effectiveness and attractiveness of European capital markets should be improved.

A third industry speaker agreed that CMU is not where it needs to be. There have been some positive developments in new areas and significant steps forward towards harmonisation in the listing, the clearing and settlement spaces in particular, but more needs to be done.

A fourth industry speaker echoed the positive developments on CMU, such as the decision to implement consolidated tapes, the ESAP and the Listing Act. The Faster and Safer Relief of Excess Withholding Taxes (FASTER) proposal, which proposes new rules to make withholding tax procedures in the EU more efficient and secure, is also progressing quickly. However, as AFME concluded in its latest edition of the CMU Key Performance Indicators, there is no visible medium-term progress in terms of the development of EU capital markets at this stage.

2. Key challenges

A policy-maker attributed the slow progress on CMU mainly to the insufficient political backing behind the project so far. Convincing politicians of the need for CMU has been difficult. A wide range of interconnected actions, some quite technical, are needed to develop the capital market, so it is difficult to create a motivating political narrative around CMU. Many of the actions required are also outside the scope of finance ministries and other ministries may have different views. Corporate insolvency frameworks, for example, are in the scope of justice ministries and aim more to deliver social justice and to mitigate losses rather than to build a capital market.

CMU has also been hindered by strong vested interests at industry and member state levels, the policy maker added. The potential benefits of removing barriers to cross-border capital markets are felt by everyone in small amounts, whereas the cost of removing the barriers is felt very strongly by certain players who make rents from these barriers and tend to be more vocal than the majority. There is also significant competition among member states, some of which still believe that building their own capital market is more important than sharing a larger EU market. However, there is no point building 27 small markets that cannot compete globally.

1. Between 2006 and 2022, the EU's share of global capital market activity has decreased by more than 40% (10% down from 18%) while the APAC's share rose significantly (to 31%) and the US's share decreased but remained high (47%) – source New Financial – EU capital markets : a new call for action – September 2023.

An official noted that, despite the general commitment to the project, there is currently some 'CMU fatigue' within the Council and even scepticism about the possibility to relaunch the project. The political will is critical to meaningfully relaunch the CMU.

An industry speaker stated that persistent regulatory and supervisory fragmentation is hampering the creation of CMU. Consolidation efforts in the trading space for example face different national interpretations of common EU legislation due to local gold-plating. Despite the existence of a common technical trading platform covering several EU member states, it is difficult to operate on a fully consolidated basis because of fragmentation in the regulatory landscape. The situation is similar at the settlement level. TARGET2-Securities (T2S) is a great step forward but does not yet deliver all possible efficiencies, as only a limited amount of cross-border transactions are settled in T2S.

Another industry speaker noted that, while there is a shared understanding in Europe that a single market would facilitate capital flows between countries, capital bases and liquidity pools remain fragmented hindering the flow of capital. Market participants are confronted with differing measures and procedures across Europe in many areas, such as authorisations or taxation and this is true both for equity and debt.

3. Key priorities for the future steps of the CMU

The panellists suggested a number of issues and areas of action that should be considered in priority in the future steps of the CMU.

3.1 Mobilising long-term investment capacity across the EU to match capital needs

An industry speaker observed that there is a structural mismatch in Europe between the offer and the demand for long-term capital. Savings that are abundant in Europe are not appropriately invested with 80% of them left in bank deposits or invested in short term and debt financial products. Equity markets are insufficiently developed, and there is an excessive debt bias in the funding of firms. Tackling these issues should be the priority. The regulatory framework should encourage more long-term investment, notably in equity markets, in order to create more congruence between the abundant savings and the forthcoming capital needs. Products connected to workplace saving plans and private pension schemes with additional contribution from the employer should also play a greater role in directing household savings toward more long-term investment.

A second industry speaker suggested that the CMU requires bold new ideas to stimulate investment, such as establishing an EU equity fund covering major indexes from all 27 member states, weighted by the respective market capitalisation. This could allow all European citizens to invest in the European economy and should be paired with a common approach to capital gains tax in Europe and targeted tax incentives. A mandatory holding period could defer the impact of tax reductions on public finances, while allowing for new jobs and growth to be created. Additional ideas could be to create a European version of the 401(k) scheme that exists in the United States, and to ensure that all European member states provide individual savings and investment accounts such as the one that is available in Sweden. Pan-European employee participation schemes could also be developed to favour more equity investment. Such instruments could inject a huge amount of fresh capital into the real economy, while encouraging citizens to invest in the capital markets for the longer term and improving the viability of pension systems.

An official noted that the experience of the Pan-European Pension Product (PEPP) shows that it is difficult to establish a new investment product at EU-27 level. A more realistic solution in the short term could be to design a common savings product with a limited group of countries willing to cooperate. This is one of the concrete proposals on which the working group set up by the French Ministry of Finance to make proposals to relaunch the CMU has been working.

A regulator stated that ESMA also created a taskforce to consider how to develop effective capital markets in Europe. Three main areas of improvement were identified. Firstly, savings in Europe that are substantial, are not being deployed in the right way. Insufficient investments are made in the capital market and there is a need for larger institutional investors, pensions reform and tax incentives. Secondly, companies in Europe need to be able to find sufficient funding for innovative projects. Finally, there is continued fragmentation of European capital market regulation and supervision.

3.2 Enhancing the capital market ecosystem

An industry speaker emphasised that the ecosystem to support the CMU has not been sufficiently considered. Too many oligopolies and duopolies have crystallised in the EU capital market in areas such as rating agencies, benchmarks, asset management, which limits competition, diversity and hinders the achievement of an effective single market.

One idea to support equity markets in Europe would be to create a dedicated segment of the regulated markets devoted to small and mid-caps, with proportionate listing requirements, which would help these companies enter the market before progressively moving to the main segment. A joint venture could be set up between key EU exchanges, pooling together their small and mid-sized segments, to create a single access for IPOs in the EU under the supervision of ESMA.

A public representative agreed that changes are needed in the EU market ecosystem to encourage SMEs to seek funding on the capital markets. A good approach would be to create a European ecosystem in which smaller SMEs can choose whether or not to be subject to European rules until they grow bigger.

3.3 Enhancing supervision at EU level

An official stated that to build a European market, the endpoint should be for more powers to be delegated to

ESMA. The question is how to get there, given the present oppositions to a single supervision model. One solution could be to implement an opt-in mechanism by which players that operate on a cross-border scale, could choose to be supervised at EU level. This would allow to test the appetite for further integration. In parallel efforts should continue to enhance coordination among domestic supervisors at the European level.

An industry speaker stated that moving towards single supervision should be the objective. This is necessary to foster more market integration and the emergence of pan-European players and is possible to implement, but requires political will and a compelling narrative. An opt-in system will not create the desired level playing field and integration at EU level.

A second industry speaker considered that moving towards more EU level supervision is a logical next step to foster integration and agreed that opt-in is not the right solution. With opt-in, there is a clear conflict of interest, as supervised entities should not be allowed to choose who supervises them. Secondly, opt-in will not allow a sufficient level of harmonisation in the market. The Securities and Exchange Commission (SEC) model proposed by C. Lagarde at the end of 2023 could have a more meaningful impact, moving away from the polarisation between having powers at EU level or at national level. The supervisory system must foster further integration and harmonisation, while allowing the national competent authorities (NCAs) to continue to play a role.

A third industry speaker observed that member states are currently competing on supervisory intensity, which implies a lack of trust. A pragmatic solution could be to review the supervisory set-up each time a legislation is revisited, defining the level at which supervision can be conducted most effectively, based on an evaluation by the Commission and co-legislators of the degree of integration in the markets concerned. If the market is highly integrated with standardised products and few actors, then supervision at the supranational level is the most efficient approach; if not, domestic supervision with EU level coordination is fine. An opt-in system could also be part of the solution in this context.

A regulator agreed that there is still too much fragmentation at the regulatory and supervisory level in Europe. Effective supervision can take place at the European level for genuinely cross-border activities or systemic market infrastructures, but the right balance must be found. There should be clear criteria for conducting supervision at the European level. There should also be a single entry point for third-country players into the EU, which is not the case at present. The regulatory and supervisory framework must also become more agile to allow quicker adjustments to market evolutions.

3.4 Developing securitisation

An official emphasised that strengthening the securitisation market is a key success factor of the CMU agenda. There are many hurdles to clear, including the prudential treatment of different products and insolvency laws, that we should aim to lower during the next European mandate. A public guarantee for such products at the European level could also kickstart the market and lead to an examination of the other obstacles that are hindering the development of these products.

An industry speaker agreed that a renewed focus on securitisation would be welcome. Securitisation partly explains why two-thirds of the financing of US companies comes from capital markets, compared to one-third in Europe.

3.5 Achieving a more harmonised regulatory framework

An industry speaker stated that bold moves are needed in the future steps of the CMU to achieve a truly harmonised regulatory framework and to avoid local gold-plating. Reaching the endpoint of full integration will take time and require significant political will, but this is no reason to delay ambitious harmonisation actions that can support a progressive integration of EU capital markets.

A second industry speaker agreed, noting that work should continue on longstanding barriers to further integration such as insolvency law or withholding tax. A third industry speaker suggested that implementing a depository passport should also be a key objective on the future CMU to-do list. The lack of a depositary passport is particularly a hurdle for smaller countries. Restrictions on the location and provision of collateral are a further issue to tackle.

A policy-maker emphasised the importance in the future steps of CMU of distinguishing between actions that must be taken anyway, such as reviews of existing capital market legislations, and more fundamental reforms needed to build a single market in the areas of taxation, accounting, corporate law and supervision, on which more work is clearly needed.

4. Approach going forward

Suggestions were made by the panellists on new ways to approach the CMU in the next political cycle.

4.1. The need for a strong narrative around the financing of the EU economy

A policy-maker stated that CMU does not need a fundamentally new approach. It is necessary to increase political buy-in and ambition around the project and to effectively implement the actions that have been adopted. Developing a convincing political narrative around CMU is essential. Without it, the necessary political commitment will not be achieved. There should be more focus on the ultimate objective of CMU, which is to increase the direct financing of innovation in the EU and to support economic growth, rather on the CMU itself. The Eurogroup initiative and the upcoming Letta and Draghi reports provide a unique political opportunity to seize the attention of the European Council on CMU.

While it would be helpful to evaluate the potential impact of CMU on economic growth with more detailed

economic analysis, such an evaluation would be difficult and time-consuming, the policy-maker felt. Gathering factual evidence by talking to issuers or investors who operate in the US market for example seems preferable to additional academic research. It is important to show that issuers are listing in the US because they get a higher valuation and can access a readymade ecosystem. This may help to convince political decision-makers in Europe that there is a slow-burning crisis underway. The EU capital market is falling behind other parts of the world and its share of global markets is shrinking. These are the arguments that need to be put forward to develop a proper narrative.

A public representative agreed that no significant progress can be made on CMU unless it becomes a priority for the Council and member states. This requires a more ambitious and convincing narrative around CMU so that politicians understand its importance and the implications for citizens, firms and the single market. The new Commission and Parliament will need to build this new narrative and it is hoped that the upcoming reports from E. Letta and M. Draghi will be helpful in this regard. The CMU project must not be viewed as a set of technical measures, but as a fundamental initiative aimed at enhancing financing options for European SMEs. These businesses should be able to access adequate capital through equity markets, reducing their reliance on traditional bank loans. Furthermore, the broader implications of CMU for EU citizens, particularly how it influences long-term investment opportunities and the linkage between pensions and CMU, deserve thorough consideration. This holistic approach will ensure that CMU's benefits are fully realized, fostering a more robust and integrated financial landscape across Europe.

An industry speaker agreed on the need for an aspirational objective to mobilise people around the CMU. The original single market project created a strong mobilisation. Businesses adapted their planning based on the expectation of future success of the single market, thereby creating additional momentum. So far, the CMU project has not managed to create such an effect. In order to make significant progress on the CMU, there must be a theme that can act as a flag around which people and businesses can rally.

Another industry speaker suggested that the CMU is essential for bolstering the evolving ambitions of the single market. Initially, the single market's primary aim was to foster a more integrated internal market by lifting barriers. There are now new dimensions to the single market, such as supporting the sustainable and digital transition of the EU economy and the open strategic autonomy agenda aiming to reduce dependencies. These new dimensions require the single market to facilitate three core transitions: sustainability, digitalization, and increased self-reliance. The CMU, together with the Banking Union, should aim to provide the financing tools needed to achieve these goals and adapt the ambitions of the single market in an evolving global landscape.

An official noted that political will is important but not sufficient. The Banking Union benefited from a major political drive at its outset and has still not been achieved. Developing a narrative for CMU and adopting an effective method of implementation is key. Much progress has been made in many areas of the capital markets framework in the last few years, but what we are trying to achieve with CMU and what CMU precisely implies is still unclear. There should be more focus on a set of priorities and transformative initiatives that are likely to support the financing of the economy.

4.2 Mobilising the different components of the ecosystem towards a common CMU objective

A regulator emphasised the importance of action at different levels and moving in a common direction to progress on CMU. Key political decisions must be made at the European level, but member states must also look at relevant aspects at the domestic level. The market, including citizens and firms, must also be further mobilised around the objectives of CMU and provided with the tools to take advantage of the single capital market. There are significant savings in Europe, but they are currently not employed in a productive way. Households need better opportunities to grow their money. Private pension and workplace schemes need further development to provide the long-term capital needed to fund the economy, while also offering more attractive long-term investment opportunities. This is a key societal objective. Market fragmentation must also be reduced so that companies can find capital across Europe more easily. Europe must also remain open, attractive and competitive as a capital market.

A policy-maker stated that a change of approach is needed in both the private and public sectors. Vested interests must stand aside. An integrated market cannot be regulated into existence. EU legislation removes obstacles to integration, taking away differences in national legislation and replacing them with a single law. It is then up to the industry to take advantage of that single law to further consolidate and integrate. There will be relative winners and losers in the CMU process. If players in the market are unwilling to accept that competition may increase as a result of further market integration and that business models may need to adapt to these evolutions, then CMU will fail, regardless of policy actions taken at EU or domestic level. One option for mobilising the different components of the ecosystem is to combine the top-down EU-level legislative approach with bottom-up action at member state level in areas such as taxation and pensions, where they have competence. However, action at member state level should be conducted in a way that does not prejudice the outcome of a single market and lead to more fragmentation, requiring coordination at EU level.

An industry speaker agreed that CMU cannot only be about top-down initiatives. Strong local capital markets are also needed and there is a role for the national authorities and the private sector in developing them, such as by setting out concrete initiatives that are relevant to a given market. This was done in Italy for example by the local ecosystem and can be replicated in other EU countries, alongside the implementation of a unified top-down EU framework.

A public representative emphasised that connecting the different parts of the ecosystem also requires a connection between CMU and the Banking Union and achieving the Banking Union. To do that, progress is needed on the European Deposit Insurance Scheme (EDIS). Providing tax incentives is also important to encourage the participation of actors in the capital markets, but no lasting and significant progress will be made on CMU without moving towards single supervision, facilitating an effective dialogue between national and European supervision, and creating a market environment that fosters the participation of retail investors and SMEs and a strong connection with the Banking Union. All those elements are needed for making the CMU a political priority that can deliver real progress.

Another industry speaker stated that the question is not whether a top-down or bottom-up approach is needed, but rather whether it is possible to create a system that companies, issuers, investors and citizens truly endorse. Capital markets do not only exist to finance the economy, completing bank and public financing and monetary policy actions, but also to allow citizens to participate in value creation and in the wider economy, ultimately strengthening democracy.

Enhancing the competitiveness of EU capital markets

1. The concept of competitiveness for EU capital markets

The Chair stated that the topic of competitiveness has been at the forefront of many recent discussions and declarations in Europe. In September 2023 the German and French finance ministers published a paper emphasising the importance of considering competitiveness in the capital markets framework in order to ensure that European businesses can find adequate financing in the EU and strengthen the EU's position in the global financial market. What competitiveness means for services markets and for financial markets in particular can be challenging to define however.

A regulator stated that competitive markets are markets that operate effectively, which makes them attractive to firms and investors. Effective competition is also important as it may foster the growth of players that can compete on a global basis, but competitiveness and competition are different notions.

Answering a question from the Chair about the importance of competition for the competitiveness of EU capital markets, an industry representative stated that there is a cause and effect relationship between the two. Effective competition delivers competitiveness by making the market ecosystem more competitive, and the competition within that market also means that globally competitive players can develop. Competition also contributes to bringing down costs, raising service levels, and increasing choice for people using the market, which makes the market more attractive, both internally and externally. Trading is a good example of an area where competition has flourished in the EU. There is also quite an effective competition at the clearing level in the EU despite the number of central counterparties clearing houses (CCPs) operating in the EU.

A second industry representative argued that competitiveness and competition are different notions. Competitiveness is a focus on the EU's own attractiveness towards investors and issuers, whereas competition is a focus on the outside i.e. competition with financial players from other jurisdictions. The two are however related because attractiveness is relative. For example, T+2 settlement currently works well for the EU, but the fact that the US is moving to T+1 challenges the EU's competitiveness and leads the EU to reconsider its standards, because it is effectively competing with other jurisdictions. Competition creates an edge in terms of competitiveness that the EU can compare itself to and benchmark against, and acts as a stimulus because issuers and investors compare different regions. Competition is a trigger to the EU's own competitiveness.

It is also important to have a holistic approach to the competitiveness of capital markets, considering the different trading, clearing and settlement layers and interactions with market participants.

Answering a question from the Chair about the compatibility of the objective of attracting more capital to the EU and the open strategic autonomy ambition of the EU, the industry speaker noted that it is important to identify where autonomy is needed and where openness is needed. Autonomy is needed in areas such as the energy market, payments and vaccines, but for funding growth and innovation it is necessary to attract sufficient money from outside the EU, which requires the EU to be open in order to facilitate the circulation of capital. An 'open' strategic autonomy is therefore needed for ensuring competitiveness.

A third industry representative agreed that clarity is needed on what competitiveness means in practical terms. For a market to be competitive it needs to be deep, liquid, and to facilitate efficient risk transfer. A healthy and diverse ecosystem of market participants is also important. In terms of market structure, a balance is needed between allowing sufficient competition and consolidation in order to achieve a critical mass of activity in the market that is able to draw in capital flows from the outside. This remains a challenge in Europe.

A fourth industry representative emphasized that competitive capital markets are essential for financing growth and innovation. Solely relying on bank financing and family savings, as is often the case in the EU for SMEs, could inhibit that. If the EU lacks a strong capital market at the regional or local level then companies requiring that type of flexible and long term financing will look elsewhere.

2. Current level of competitiveness of EU capital markets

An industry representative noted that capital markets remain under-developed in Europe, with companies typically borrowing 75% of their debt from banks and 25% through the debt capital markets. In the US it is the reverse. One issue with the general reliance of EU firms on banks is that it absorbs funding capacity that could be going into SMEs.

One area where Europe has a clear strength, the industry speaker stressed, is its leading position regarding ESG products. The European ESG capital market represents roughly 41% of global issuance, which is much higher than the overall EU share of global capital markets. The main weakness of the European capital market is its fragmentation, as seen in

the number of listing exchanges, CCPs and central securities depositories (CSDs) that the EU has compared to the US: 31 listing exchanges compared to 3 in the US, 17 CCPs compared to 1 and 22 CSDs compared to 1. This structural fragmentation compounded by legal and fiscal fragmentation and the lack of a common supervision, is a barrier to the development of EU capital markets.

A second industry representative highlighted that what must be avoided is redundant fragmentation. Effective competition can lead to more complexity and more players operating in the market, but it delivers benefits, as seen in the trading space and the central clearing area where new pan-European offers have developed. In some cases however there is fragmentation without benefits from competition, which leads to additional costs. This is the case for CSDs. Trading across Europe requires accessing a large number of CSDs, creating extra costs and no competitive benefit. Liquidity is also fragmented in the exchange traded fund (ETF) market because of local practices and the settlement of trades in different local CSDs which makes these products non-fungible across Europe, although they are effectively the same instrument.

A third industry representative noted that the comparison between the EU and the US can be misleading. It is true that the US has only one CSD, but the US is one country and has a market that is structured to serve one country, whereas the EU is comprised of 27 countries. The EU can improve its competitiveness and integration but will never be one country. That is acceptable, because investors and issuers are not looking for the same opportunities as the US. The EU needs to build its differentiation in the market and sell it better to outside investors and issuers.

A fourth industry representative observed that there has been some improvement in the EU market since 2010, but liquidity volumes have effectively stagnated, particularly in the equity and index options markets. In the same time period other jurisdictions have grown twofold, fourfold or even sixfold in these markets. There is a real cost to fragmentation in Europe, which results in shallower liquidity and fragmented liquidity pools leading to less efficient risk transfer for end users. It is necessary to overcome that fragmentation and reduce the cost of fragmentation baked into the pricing that a liquidity provider is able to offer to the market, which impacts end users and investors and reduces the attractiveness of the EU market.

This fragmentation also increases complexity for institutional investors, with effectively the same ETFs being listed on 25 different venues with different post trade setups. Fragmentation also impacts issuer choice, because they are looking for a vibrant secondary market that supports a primary listing market. For retail investors the issue is more a lack of equity culture and awareness about the need to save for retirement using capital market instruments.

The Chair noted that further consolidation and critical mass would be beneficial in certain areas of the financial system, but not necessarily in all parts. For example competition in the trading area is healthy and has benefitted investors.

3. Expected impact of the CMU reforms underway

Several panellists emphasised the expected impacts of the Capital Markets Union (CMU) actions underway.

A regulator noted that MiFID has fostered greater competition across Europe in the provision of services to investors and in the interaction between trading venues. In the fund management area the UCITS and AIFMD directives have become globally recognised brands and have made Europe competitive in that area. The measures proposed in the latest CMU action plan and MiFIR review will likely contribute to enhancing the competitiveness of EU capital markets further. Consolidated Tapes (CT) and the European Single Access Point (ESAP) will provide information about EU companies and securities transactions in a central location, which will facilitate access and the comparison between instruments and issuers. The Listing Act that has been agreed may also help to enhance competitiveness, making European markets more attractive for innovative and growing SMEs.

An official agreed that the MiFIR review should allow significant progress. CTs will increase transparency and make EU bond and equity markets more competitive and transparent. ESMA has the responsibility of getting the calibration right and selecting the right candidates to set up the service. ESAP is also important, and a balanced result has been achieved on the EMIR 3 proposal. There is also a strong political momentum behind the CMU initiative more generally. Support has been expressed for the CMU by the German and French Ministers and a statement of the Eurogroup on the future of CMU will be published in March 2024 outlining priority areas for action.

An industry representative agreed that significant work has been done on the CMU, which should contribute to enhancing the competitiveness of EU capital markets. In the last 10 years there has been reform of trading, clearing, settlement and market conduct, and a harmonisation of capital market rules. The CT should also help mitigate and tackle the fragmentation of European markets. Much has been done to make progress on the CMU, and this accomplishment must now be sold to foreign issuers and investors.

Another industry representative concurred that CT, ESAP and the EU Listing Act are great developments that should be celebrated. ESAP has the potential to become a proper single access point for information, improving transparency to potential investors and enhancing the attractiveness of EU capital markets. However, more needs to be done in terms of market integration to achieve the CMU because the market infrastructure will remain significantly fragmented despite these actions, which ultimately has a cost and impact on the attractiveness of EU capital markets.

4. Further measures needed to enhance the competitiveness of EU capital markets

4.1 Reducing fragmentation in the EU capital market

A regulator stated that more needs to be done in a number of areas of the regulatory framework to enhance the competitiveness of EU capital markets. A strong regulatory framework and well-designed rules are essential for the competitiveness of the market, including having clear unified rules that are applied in a consistent way. There is still too much fragmentation in the rules and too much national discretion in terms of implementing those rules in national law, despite the efforts made to achieve a single rulebook.

The regulator also emphasised the importance of having more regulations rather than directives in the European framework in order to move towards a single rulebook. However, a single rulebook will be difficult to achieve so long as supervisory implementation and application differ across member states. Financial regulation is also influenced by aspects that are outside the field of financial regulation and EU competencies such as taxation and pensions. The Chair agreed that moving all directives into regulations would be a good start to reduce fragmentation.

An industry representative concurred that the lack of a common regulatory platform and common supervision in Europe is an obstacle to CMU. While the ECB has become the single supervisor for the largest European banks, this is not the case for ESMA. An evolution of the mandate would be needed.

A second industry representative agreed that while the EU currently has a single rulebook in name in many areas, it is not applying it as such. The single rulebook must be enforced by a single supervisor or a single system of supervision under the auspices of ESMA. Reacting to a remark from the Chair that harmonisation has progressed in certain areas of the rulebook such as pre-trade waivers or IFRS supervision, the industry speaker acknowledged that consistency in the application of the single rulebook differs across measures and sectors. Product intervention is the area with the biggest divergence between member states, with differences in the way suitability for retail investors is assessed. This is detrimental for retail participation. For example, there is no common view on the suitability of listed products compared to bilateral ones, which has led to transparent listed products being banned alongside non-centrally cleared and opaque bilateral products in some cases.

Another area of divergence is the application of MiFID, the industry speaker emphasized. The conduct of business rules are the same, but the national competent authorities (NCAs) apply the rules in slightly different ways and with slightly different requirements, which raises the costs and complexity of cross border activity. A single application of these common rules is needed. A further issue is that the EU does not need 27 separate ecosystems that all provide the full value chain of capital markets. Domestic markets are needed but not all member states need to have a fully developed financial centre.

An official added that it is also important to give market participants the possibility to consolidate and increase their competitiveness. That should be driven by market forces and not regulation.

4.2 Competitiveness checks and mandates

The Chair noted that proposals have been made to introduce competitiveness checks of new regulations before they are implemented or a competitiveness mandate for EU supervisors and regulators. How that may be structured and made operational considering the peculiarities of the different sectors and the different mandates of supervisors and regulators needs further considering. The Chair asked the panellists if there is sufficient emphasis on competitiveness in the rule-making and implementation process in Europe, and what further measures may be needed.

A regulator agreed that taking care of competitiveness in the rule-making and implementation process is extremely important. Regulators need to examine what the impacts of regulations are on the competitiveness of Europe in the wider global market. There is already a recital in the ESMA regulation that says it has to consider the impact of its activities on the EU's global competitiveness. However, the primary focus at the supervisory level should be on the core objectives of financial stability, orderly markets and investor protection. If competitiveness is added at the same level alongside those objectives, that may create potential conflicts and confusion. Where competitiveness is most important to consider is at Level 1, because there is less flexibility to adapt rules at Levels 2 and 3.

An official concurred that financial stability is the cornerstone of the financial supervisors' mandate, which is also true for financial regulators. However it is also important to ensure that the ecosystem remains competitive, while guaranteeing financial stability. Both objectives are important.

An industry representative observed that legislators and regulators always struggle with how to enshrine competitiveness in the legislative process and the resulting regulation. ESMA and the NCAs can be given a competitiveness mandate, but the question then becomes how to measure it. Outcomes need to be periodically examined. What needs evaluating is whether the CMU is able to deliver capital to EU firms for growth and innovation, and whether it can provide savers with adequate returns, rather than evaluating impacts on the market microstructure. This evaluation should take place every 6 months and have an EU-level perspective to avoid 27 different perceptions. Another aspect is whether regulation is able to enhance the EU capital market ecosystem, increase bridges between member state markets and reduce market fragmentation. Retail is the area where it is hardest to have an impact from top-down EU level measures, because so many aspects of the retail market are enshrined in national legislation and taxation.

Another industry representative noted that regular reviews of existing regulations are performed, where

time is taken to reassess whether they are still fit for purpose, which is an opportunity to reassess the impacts of regulations in terms of competitiveness.

4.3 Improving regulatory and supervisory agility

A regulator stated that a more agile rulemaking process is needed to support market competitiveness. Changing Level 1 requirements currently takes four or five years, which can be detrimental for the EU's competitiveness, if rules need to be adjusted to new market developments. An ability to deal with unexpected market circumstances through the use of no action letters for example could contribute to improving the agility of the rulebook. An industry representative agreed that the ability to issue no action letters is important.

An official concurred that improving the agility of rule-making is important. Currently, changing rules and evaluating the feasibility of doing so takes too long. It is necessary to find ways to provide supervisors with more flexibility in this regard, particularly the European authorities.

4.4 Increasing incentives for market participants

An industry representative emphasized the importance of proper incentives to encourage market participants to engage in the capital markets, rather than mandating their participation. That will drive volume and innovation in the market, supporting the growth of domestic and non-domestic businesses and allowing them to compete globally.

Another industry representative observed that policies should create the proper incentives for market participants to join the market and support an effective ecosystem aligned with these incentives and policy choices. The Chair remarked that the success of the development of the Swedish market was driven more by actions to improve investor awareness and equity culture, develop pension funds and strengthen the ecosystem, than by financial regulation.

The industry representative agreed that different aspects are important for ensuring the competitiveness of the EU capital market, beyond a strong capital market regulation, which is a necessary but not a sufficient condition. Besides incentives to attract market participants, pension regimes and a strong ecosystem, non-financial tax and corporate rules including withholding taxes for dividends, insolvency law harmonisation and takeover law are also important.

An official noted that incentivising investors to buy sustainable ESG products and exporting that asset class to other jurisdictions is essential and requires reducing the complexity in the EU sustainability framework. It is difficult for retail investors or institutional investors to understand what Article 8 and Article 9 funds represent, so the Sustainable Finance Disclosure Regulation (SFDR) review in the next legislative cycle should be used to reduce the complexity of the sustainable finance framework.

4.5 Developing private pensions

An industry representative stated that reforming Europe's pension systems is a priority for developing EU capital markets. There is a dearth of long-term capital, and most pension savings in Europe are in pay-as-you-go systems that do not accumulate capital. 34% of household assets sit in cash deposits with banks, which could be channelled into the capital markets though private pension contributions or pension funds. 62% of funded European pension assets are concentrated in Sweden, the Netherlands and Denmark. There should also be a greater role for private pensions with auto-enrolment mechanisms in the EU.

The Chair agreed that the role of pensions must not be overlooked. The difference in the amount of investable assets is one of the main differences between the US and EU capital markets.

An official highlighted the importance of establishing and incentivising larger pools of long-term capital, as it is one of the key triggers to enhance the CMU. That requires strengthening pension schemes that work on an asset accumulation basis. Germany is going to establish an equity based pool for its pension system, as well as strengthen its second pension pillar and attempt to reform its third pillar for private pensions.

An industry representative noted that it is important to also be honest with European citizens about pension gaps. Greater awareness about this should create incentives to participate earlier in the capital markets than is the case at present.

Increasing equity financing: trends and main priorities

1. Current trends in the EU equity market

The Chair noted that developing equity financing is essential for funding innovative and fast-growing companies and for strengthening the resilience of the European corporate sector. EU corporates and particularly SMEs, rely predominantly on debt for their external financing, resulting in a significant equity gap in Europe. Statistics from AFME show that IPOs (initial offers to the public of shares) have decreased by 50% and equity trading has also decreased over the last year.

An industry representative stated that there has been a rebound on global equity markets since the start of the year, with a 3 to 5% performance prolonging the growth of 2023. This is primarily US-driven, although European markets saw a 14% increase during 2023, with volatility below the long-term average of 21% at around 14%.

EU equity markets are however facing different issues. A first is in terms of an estimated $60 billion equity outflow from Europe going into the US. The US market is well priced with the real earnings of companies well below consensus. In Europe it is the reverse and a better performance of companies can be expected than the market is anticipating. The valuation gap between EU and US companies is widening, with US companies trading above average at a 20 times price-to-earning (P/E) multiple and European companies trading below average at 13-13.5 times P/E, which means that EU companies are relatively cheap at present.

A second issue are the diminishing expectations of interest rate cuts, which might not be sufficient to ensure a soft landing of the economy. In the US, the market is pricing in a 70% chance of a first cut in June followed by four successive cuts totalling 100 basis points, whereas previously it was pricing in an 80% chance of a first cut in March and successive cuts totalling 150 basis points. The question is when demand for equity will pick up. 2022-23 was a very dry market in terms of equity issuances, which decreased by more than half compared to 2021 in Europe (around €100 billion compared to €269 billion in 2021). The decrease was even higher at the global level ($500 billion compared to $1.4 trillion of issuance in 2021). Investors have also been staying away from equities. They are now looking for growing companies that are also profitable, which is not the case for many IPO candidates.

The macroeconomic and geopolitical context is a third aspect to consider, the industry representative noted. There are many events happening or on the horizon including interest rate increases, inflation, volatility, the Ukraine conflict, Gaza, the US and European elections and China/Taiwan. These are progressively integrated by investors and normalised by the market with a 'house of cards' effect. There is pent-up demand in both the public and the private market with $3 trillion of capital to deploy and portfolios needing to be put to work in the market. This combination of pent-up demand and offer could have an exponential effect on the market. There have been some timid developments in the European market at the beginning of 2024, with a few IPOs and a desire to move more constructively in the equity market, but there is some hesitation due to the uncertain geopolitical and macroeconomic environment.

An official agreed that EU equity markets have been hurt by geopolitical turmoil, macroeconomic uncertainties and rising interest rates. Investments by equity funds in the EU dropped 11% in 2022 and equity exits dipped 27%. This negative trend continued in the first half of 2023. Unprecedented amounts of uninvested cash were also reached by private equity funds in 2022 after record funding, however funding significantly decreased in 2023. There are grounds to expect a rebound in the European equity market and reasons to be optimistic on a longer-term perspective. There is dry powder in funds which can be put to the benefit of innovative companies. The decline in the market is more moderate than that witnessed after the dotcom bubble and the great financial crisis. The progress made on the regulatory side and in the development of the market ecosystem is also a good basis to further develop capital markets in Europe. However, innovative SMEs with intangible assets and limited collateral remain constrained in their access to finance, as the European financial system remains very bank-centric.

Another industry representative agreed that the macroeconomic conditions have been difficult but concerns about inflation are subsiding. There has been a steady return to business and an ability to help SME financing, particularly in the Nordic and Baltic region. The European IPO pipeline is looking attractive with SME and main market spaces showing signs of picking up.

An official noted that equity markets in the EU are much smaller than in the US and Japan in terms of total market capitalisation relative to GDP, but there are also major differences within Europe. In a handful of countries, including Luxembourg, Ireland, Sweden, Denmark and the Netherlands, the total market capitalisation is much higher than in other European countries. The range of market depths between member states is also significant and is one of the reasons why harmonising capital markets is necessary, but challenging.

A regulator stated that figures from a report by New Financial show that the ratio between the least and the most developed capital market within Europe is 35:1. The average stock market cap over GDP in the EU is roughly 70% and in the most developed market it is 140%, which shows that there is significant potential for progress of market-based finance within the current EU framework.

Another regulator emphasised that equity markets are the most important part of capital markets for economic growth in Europe. The market has continued to decrease over the past 20 years, despite many new regulatory measures, leading to an equity gap with insufficient long-term investment and incentives for companies to go public. While consolidating the European capital markets regulatory framework is beneficial, this will take time. Stronger political impetus is needed at the political level to develop equity markets, as well as effective incentives and a greater capacity to mobilise capital.

2. Main issues and challenges to overcome for the further development of EU equity markets

The Chair asked the panellists for their views on the reasons for the limited development of equity markets in the EU from both an investor and an issuer perspective.

2.1 Investor perspective

An investor representative noted that the geopolitical context is worrying for investors. In addition, the lack of understanding and trust among investors about equity investment, notably in SMEs may limit the development of EU equity markets. The latest Eurobarometer shows that 45% of EU citizens do not feel confident about investing in the capital markets due to both cultural aspects and a lack of knowledge and transparency.

A regulator emphasised that the low level of investable long-term assets in Europe compared to the US is a major challenge. The amounts in the US market that can feed liquidity are incomparable. For example, the California Public Employees' Retirement System (CalPERS) fund, which covers two million public employees, has assets under management of $462 billion. This is nearly 4 times more than what the nine million Spaniards hold in pension funds, which amounts to $120 billion.

2.2 Issuer perspective

A regulator emphasised the importance of improving the incentives for companies to go public and increase their equity financing. This would have much more impact than shortening prospectuses. Europe has failed so far to address the asymmetry for companies of tax treatment between debt and equity financing. The Commission's debt-equity bias reduction allowance (DEBRA) proposal, which could have made a significant difference in the way companies approach the funding market was filed, which is a collective failure.

An industry representative stated that healthy secondary market liquidity is also crucial for the functioning of equity and bond markets, as it allows SMEs to come back to the market and raise additional capital during difficult times. In the Nordic and Baltic ecosystem there is good liquidity. SMEs have raised 26 times more capital than when they first IPO'd with the result that 130 of the SMEs listed in the region have moved from the growth market to the main market. There is increasing demand in the private market to help such companies come to market and reach a wider set of investors.

An official noted that, while it is vital to fund start-ups in order to foster growth in Europe, more must be done to fund larger companies that reach the scale-up level. There is often not enough funding available to ensure that these companies continue to develop in Europe, which explains some of the investment flows out to the US. Actions are being conducted to facilitate investment in the European champions of tomorrow and encourage them to stay in Europe. The European Tech Champions Initiative (ETCI) created under the aegis of a group of European governments, is a €3.75 billion fund of funds, which supports large-scale venture capital funds and provides growth financing to European high-tech companies in the late-stage growth phase.

Another official noted that there are common issues in the EU but also specificities related to immature markets. Latvia, despite a strong regulatory framework and an integrated market infrastructure at the regional level, still lacks a liquid market with good exit strategies and a dynamic M&A market. Progress in the development of private equity and venture capital sectors is nonetheless observed in the Baltic region.

3. Possible solutions for developing equity markets

The Chair asked the panellists whether these objectives and challenges are being appropriately addressed in the Capital Markets Union (CMU) initiative and what further actions may be needed.

3.1 Expected impacts of CMU on EU equity markets

An industry representative welcomed the initiatives adopted in the context of the first CMU action plans to facilitate the financing of European companies through external equity including: a single access point for information on EU enterprises (ESAP), improved investment products with the ELTIF framework, the review of Solvency II prudential requirements, further integration of the post-trading landscape with the adoption of the Central Securities Depositories Regulation (CSDR) review and improved listing rules for companies. The MiFIR review is also expected to have positive effects on the competitiveness of primary and secondary equity markets, enhance the level-playing field between execution venues and provide investors with improved transparency and market data availability.

Much remains to be done to develop equity markets, but there is a window of opportunity with the current funding needs in Europe related e.g. to the twin transition, which require a further development of capital markets. Rules need to be further harmonised in areas such as securities and company law including a common definition of securities and shareholders, voting rights, share classes, takeover and threshold rules. This would reduce complexity for issuers and investors and enhance the

level playing field. There could also be more tangible efforts to increase the efficiency of withholding tax processes and harmonise the settlement finality rules. It is moreover essential to provide issuers and investors with appropriate incentives.

An official stressed that actions to further integrate EU financial markets may also foster the limited EU cross-border investment. Reforms that support information sharing and a level playing field are essential in particular to achieve this.

3.2 The role of regional initiatives and public institutions in the development of equity markets

A regulator acknowledged the potential benefits from the improvement of the capital market framework with the CMU and further EU supervisory convergence. However, initiatives at domestic level can also be effective for developing local capital markets, provided they do not hinder further integration and consolidation at EU level. The Nordic region shows that vibrant equity markets can be developed within the current framework. If the functioning of the Nordic market was extended to the rest of Europe the size of the European stock market could double.

An official supported the work on the CMU and emphasised the importance of a common effort at EU and also at regional and national levels to demonstrate that capital markets can work in practice for companies and citizens. Venture capital and private equity programmes supported by institutions such as the EIB, EIF and EBRD such as the Baltic investment Fund, as well as domestic instruments like the SME IPO state-supported accelerator fund in Latvia and Lithuania are playing an essential role in kickstarting the equity market in the region. A number of joint initiatives aimed at building a pan-Baltic capital market have also been undertaken since 2017, including the integration of market infrastructure and the creation of a MSCI index representing the whole Baltic region aiming to make the region more attractive for investors.

An industry representative commented that the equity markets in the Nordics and Baltics have developed due to a mini-CMU-type ecosystem at regional level with an integrated market infrastructure and harmonized trading systems and rules, which provides a consistent and seamless experience for participants across the region.

An official agreed that best practices from the Nordic region, where a successful ecosystem has been built, should be extended to other EU Member States. The official also confirmed that public-private institutions such as the EIF are playing a key role in the financing of growing companies. These institutions act counter-cyclically to support venture capital and private equity funds in periods of slowdown and also help to crowd in private investors. National development banks and the EIB also act as direct buyers and guarantors in the equity market. It is however challenging to attract resources from the insurance or pension funds sector to fund the activities of the EIF because of tax and regulatory obstacles.

A regulator noted that an appropriate balance is needed between the EU and the domestic levels in terms of supervision. European level supervision is relevant for truly systemic and cross-border entities. However, central supervision is not a silver bullet for integration, as shown by the single supervision in the banking sector, which has not fostered cross-border funding in Europe so far, and is two to three times more expensive than national supervision. Giving ESMA more scope to fine-tune parameters in the law and adapt them to changes in the market - e.g. using no-action letters - also makes sense.

3.3 Increasing retail investment

An investor representative stated that academic research indicates that retail investors require more confidence to engage in capital markets. They must have a say and be more engaged in the companies they are investing in and must be adequately protected. There is somewhat of a balancing act when encouraging retail investors to invest in equity, particularly in SMEs. The measures taken to facilitate the issuance of SME stocks should not be to the detriment of retail investor protection with lower standards. There is also a need for more regulatory and supervisory convergence in the EU. In addition, a level playing field should be created throughout the EU in terms of class actions or mass damage actions. The directive on this requires more work, as the impacts have so far been quite limited.

An official agreed that there are cultural and literacy issues to tackle to develop retail participation. Employees who participate in pension funds for example do not have a good understanding of the returns that can be gained through investing in equity rather than in bonds.

An industry representative emphasised that retail participation in equity markets has been a fundamental part of the success of the Nordic and Baltic markets. Direct participation or indirect participation through investment funds and pension funds is essential to the health of SME equity markets. Having a stake in companies also gets households more involved in their country's economy and more committed to financing its growth. This skin in the game will unlock more investment and market capitalisation will grow over time.

The industry representative acknowledged that SME financing is risky and so investor education around risk is necessary. Regulation is important but it is also essential to empower households to understand the European landscape and local economies. The Nordic countries lead in Europe in terms of financial literacy with the inclusion of financial education in the school curricula aiming to nurture a financial culture and the ability to engage on one's private financial situation from a young age. Retail investment is also encouraged in Sweden with the provision of a simple to manage Investment Savings Accounts (ISK) and tax incentives. There is also a sense of getting excited about successful domestic SMEs with an effective marketing of small companies towards retail investors.

A regulator noted that, while enhancing investor protection and regulatory convergence is important, ultimately what drives investors is the prospect of return. An economic environment must be created where the underlying assets in which savers invest are

capable of delivering a better return than putting savings in a bank. The experience of pension funds in the Netherlands also shows that a significant proportion of the capital accumulated is invested abroad to obtain higher return. The objective should be to provide an environment where the prospect of a better return makes it attractive for European investors and foreign investors to invest their capital in European equity markets. A further digitalisation and integration of the EU economy would enhance EU competitiveness and also help the capital markets to grow.

3.4 Improving the IPO process

An industry representative observed that the perception of entrepreneurs planning an IPO in volatile markets and in the current geopolitical context needs considering. The IPO process can take up to seven months during which investors might change their minds and entrepreneurs have no visibility on the outcome of the process, which is quite complex requiring high legal fees. The framework needs to be simplified to speed up the IPO process and allow issuers to address investor demand in a more agile way. The Listing Act will enable parties to reduce the offer period for an IPO to three days. That is feasible with private placement, but there are obstacles, such as the obligation for a compulsory retail tranche in France. Other measures could be proposed to attract retail investors to the market and protect them, that do not compromise the agility of the IPO process.

A regulator agreed that the IPO process and market practices related to this need to be rethought in Europe. In addition, it is necessary to keep European markets open, because outside partners are needed to provide international capital. This must be taken into account in the debate about open strategic autonomy. Further consolidation is also needed at the EU market infrastructure level, which requires having a sensible approach to competition policy at European level.

Another regulator agreed that the European capital market must remain open. In Portugal the largest companies are those that have significant international activities, which requires access to external markets and funding.

Clearing: EMIR 3 implementation and issues ahead

1. Key measures agreed in the EMIR 3 package

A public representative explained that a political agreement has been reached on the EMIR 3 proposal, although it is yet to be voted on and finally approved. There are three main aspects of the agreement. First, a large number of European counterparties will be required to have an active account at an EU central counterparty (CCP) and to clear a minimum number of trades with that account. Activity will be measured both in qualitative and quantitative terms, with a threshold of up to 900 trades per year depending on the size of the counterparty. In the European Parliament's view this agreement represents a good balance between the need to reduce reliance on third-country CCPs, which was the initial political objective, and maintaining the competitiveness of European counterparties. An obligation for European CCPs and counterparties to share with ESMA information about their clearing activities was also introduced. There is also a review clause for further adjustments if necessary.

Second, the agreed text increases the role of ESMA in the day-to-day supervision of European CCPs, which is a basis for further changes in the longer term. A more decisive shift towards European supervision of CCPs was resisted strongly by the majority of Member States, although ESMA is already directly supervising Tier 2 third-country CCPs. Incremental improvements to the current framework include a greater role for ESMA in the oversight at European level and a greater say in the day-to-day supervision of European CCPs.

Third, supply side measures have been agreed to increase the attractiveness of the clearing framework in Europe, aiming to make clearing in Europe more sustainable and more attractive for outside players. This includes measures to incentivise the use of post-trade risk reduction services and to incentivise central clearing by UCITS and money market funds. There are also measures that give more certainty to market players about the treatment of equity options, measures on the acceptance of collateral for non-financial counterparties (NFCs) and measures that clarify the rules for public entities clearing.

An official concurred that the agreed EMIR 3 text is a major step forward given the importance of clearing activities for the whole ecosystem of European markets. The Chair noted that this agreement will provide the necessary framework to strengthen the ecosystem for clearing in the EU, making it more attractive and resilient. EMIR 3 constitutes a significant shift and will contribute to enhancing the consistency of CCP supervision in the EU. Its implementation will require a major mobilisation on the part of ESMA in particular, with more than 20 Level 2 measures to draft in the coming months. When EMIR3 is implemented, ESMA also will have to run a central database for CCPs, co-manage 14 CCP colleges, and set up and chair a joint monitoring mechanism for financial stability.

2. Measures to reduce dependency on third-country CCPs

2.1 Expected impact of the EMIR 3 active account requirements and related issues

The panellists commented on the active account (AA) measures, which captured a great deal of the attention during the negotiations at Parliament and Council levels. An official welcomed the agreement on AA measures, as it can contribute to kickstarting a positive cycle for European CCPs. The discussions began with the idea that thresholds for forcing the migration of clearing volumes to EU-based CCPs could be imposed by ESMA, but there was no common wisdom on how to determine such thresholds and limited data makes it difficult to assess potential effects of such thresholds in terms of cost and competitiveness. The impact of measures to attract more clearing volume in Europe on the whole clearing chain should also be considered, notably in terms of international competitiveness.

Another official emphasised that the reflexion on active accounts comes from a financial stability perspective. European regulators are concerned that activities based outside the EU may have systemic implications for the Union and be difficult to control. This reasoning is not specific to the EU. Regulators in all jurisdictions want to make sure they are at the forefront of discussions should a loss distribution mechanism be triggered for a CCP defaulting in their jurisdiction. AA measures should allow some progress in terms of financial stability by providing a plan B if something goes wrong for a third-country CCP. The lessons learned from the implementation of AA requirements and measures to enhance data quality will help to identify whether further measures are needed.

An industry representative stated that the intention to reduce the dependency on third country CCPs is relevant. The implications for financial stability of this dependency were demonstrated in 2011. In response to the sovereign debt crisis, LCH applied haircuts to a number of government bonds that were bought for repo. Academic research suggests that these haircuts contributed as much as they reacted to the crisis, which led to the desire of EU policy-makers to reduce the dependency on third-country CCPs. This took place at a time when the UK was still part of the EU, which stresses the importance of supervision not only of third-country CCPs but also within the EU.

The industry representative considered that the measures agreed on AA are well balanced. Given that 75% of transactions on euro swaps do not involve any EU counterparty, a quantitative measure to rapidly relocate clearing in the EU would not only fail to reach its objective, but would also increase the dependency on third country entities for trading, as it would be detrimental for EU market makers, which would ultimately further increase reliance on third country CCPs. Time will tell what the impact of the AA measures will be in terms of the relocation of clearing, but it should initiate momentum around the enhancement of liquidity in EU CCPs.

A second industry representative agreed that a workable compromise has been achieved concerning the AA measures. This will likely kickstart a dynamic, the effects of which will need to be evaluated with the 18-month review clause, but it is hard to predict what the effect of this measure will be. In December 2020, figures published by the Commission showed that only 60% of counterparties that fall under the EMIR clearing obligation had an account at an EU CCP. The onboarding activity into EU CCPs has been quite muted since and market participants have not prepared sufficiently for changes to their current setup, despite ongoing discussions about reducing dependency on third-country CCPs. This status quo is not tolerable in the long run and action needs to be initiated.

The industry speaker emphasized that according to the AA agreement, counterparties need to have a minimum level of activity at EU CCPs. It is hoped that by the time the review is performed in 18 months' time that changes will have been initiated by market participants. The evaluation needs to consider costs and also the advantages of transferring business to the EU, for example in terms of portfolio margining that are not available in the UK.

A third industry representative concurred that the political agreement on AA is an important step forward, although potential shortcomings need consideration. AA requirements will likely increase the cost of clearing for EU firms and reduce efficiency by creating constraints that may hinder the optimisation of clearing flows in the global markets. This may negatively impact the competitiveness of the larger EU players compared to their international counterparts that do not have the same constraints. It may also reduce the access of the smaller counterparts to the larger pools of liquidity if they cannot afford to have more than one operational account. This may also have implications in terms of financial stability, because in periods of intense market stress and particularly in the extreme case of the failure of a CCP, everyone needs to have access to liquidity, and with the AA measures there is the risk that access will be limited to the biggest firms.

The industry speaker added that AA should remain a fallback option and not become a tool of industrial policy aiming to structure the market. Users must remain free to choose their CCP and retain access to third-country CCPs in markets that will remain global. The capital markets union (CMU) will not be achieved by erecting barriers. The solution for mitigating financial stability risks is around an effective supervision of these CCPs.

2.2 Market-led evolutions

Some panellists highlighted market-led shifts of clearing activity to the EU that have taken place over the last few years, demonstrating that part of the changes can be made without regulatory action.

An industry representative observed that since the EU sovereign debt crisis the clearing of euro repos has been relocated fully within the EU, which has solved dependency issues for this part of the market without regulatory intervention. The Chair noted that there has also been market-driven developments in the credit default swaps (CDS) market with a split in the product range between the US and the EU, showing that liquidity pools and supervisory actions are not always the main underlying drivers.

Another industry representative added that changes have also been made through market-led solutions in the interest rate swap (IRS) area, where about 20% of volumes in risk-based metrics – corresponding to €33 trillion in notional outstanding - and 10% of trading volumes have been moved from the UK to the EU. It is important to consider market shares in terms of notional outstanding value rather than trading volumes, as a risk-based approach is more relevant for the issue at stake. For example, a Dutch pension fund might not trade all that much but will have large directional positions. Statistics in notional outstanding value show that quite a significant proportion of business has moved voluntarily to the EU. This is not sufficiently considered in the current evaluations by the EU institutions.

A Central Bank official was in favour of market-led solutions as a complement to regulatory action. In addition EU CCPs need to make their clearing services more attractive both for listed and OTC derivatives, which are quite different. This will take time, as EU CCPs need to improve their business models for OTC derivatives.

3. Supervision of EU CCPs

An official noted that the strengthening of the European level supervision of EU CCPs is an important aspect of the agreement. At present ESMA has direct supervisory powers on Tier 2 third-country CCPs, but no direct supervisory powers for the activities of European-based CCPs. This must be adjusted in the perspective of an expected increase of the activity and systemicity of EU-based CCPs. The proposal made by the ECON Committee to move towards an EU level supervision of CCPs met strong resistance but a compromise was eventually found. There is hope that the co-chairing of CCP colleges by ESMA proposed in EMIR 3 will bring more supervisory convergence. The step will remain limited, given the level of systemicity of CCPs, but the lessons learned from this change could be a basis to decide in the future review of EMIR 3 whether a stronger shift of supervision at the EU level would be beneficial, also depending on the volumes relocated to the EU.

An industry representative suggested that there could have been a bigger role for ESMA in the supervision of EU CCPs, in the same way as for Tier 2 third-country CCPs, which would also have been a way for the market to collectively gain experience in terms of tackling clearing risks. The Chair agreed that a full picture inside and outside of the EU of clearing risks is needed to have an appropriate perspective on the supervisory side. There is significant enhancement of access to data and information contained in the EMIR 3 proposal, but to what extent this will shed light on some of the underlying issues on the risk side is yet to be seen.

A Central Bank official stated that the main question to address when considering a move towards a fully centralised supervisory model for EU CCP is: which tax authorities would foot the bill in the event that the financial resources pooled by a CCP that has failed are not sufficient to solve the crisis, and whether the tax authorities concerned would eventually be able to recover their money. The current discussions on fiscal responsibility in this context must be pursued. An official agreed that fiscal responsibilities for CCPs are an important topic that needs to be further assessed in the years to come.

An industry representative emphasised the EMIR 3 also introduces provisions that aim to shorten the cycle for the introduction of new products, which is an important element of EU CCP competitiveness at the international level.

4. Margin procyclicality issues

The Chair sought the panellists' views on margin procyclicality issues, the lessons learned from recent crisis events and how to improve the transparency and predictability of margins.

An official stated that margin issues go beyond the CCP level and relate more to the way that broader financial markets are functioning. The assessments conducted following margin movements usually show that too much credit was being provided to pay variation margins by a given player. This leads to an excessive concentration of risk in an illiquid market which then triggers margin problems. Efforts undertaken at present at the international level to improve transparency should help to ensure that issues can be identified early enough.

An industry speaker highlighted that Europe has taken the lead on many issues in CCP regulation that include pro-cyclicality measures and also CCP recovery and resolution. Some players that consider that the EU measures on pro-cyclicality are too prescriptive or strict, but that is not the case. Global coordination is needed on such issues to ensure that there is no impact on competitiveness from a misalignment with other jurisdictions. The Chair stated that careful steps have been taken to ensure that the technical standards in the EU do not preclude any international developments, taking heed of what is necessary to enhance convergence across EU CCPs.

The Chair asked whether sufficient consideration has been given to the predictability and transparency needed for clearing members.

An industry representative stated that pro-cyclicality is a difficult concept that is not precisely defined in EMIR 3. Under Article 85(8) proposing a precise definition will be one of the first tasks for ESMA. Margin transparency is key for liquidity preparedness of market participants, which is essential to address the pro-cyclical effects of margins. There is a need for strong international cooperation on this topic. One important aspect to consider is that a CCP addressing pro-cyclicality of margins is likely to end up with higher margin requirements in benign times compared to a CCP that has lower margins but is likely to have more potential for pro-cyclicality in times of crisis. Secondly, Article 38 requires CCPs to offer simulation tools under certain scenarios. There will need to be international cooperation and coordination to define the scenarios to ensure that this does not lead to the addition of extra margins for each CCP, since scenarios are due to be specific for each CCP.

A Central Bank official favoured international work on margin practices. A move in the right direction is the January 2024 report on transparency and responsiveness of initial margins in centrally cleared markets by the BCBS, CPMI and IOSCO. The report sets out 10 policy proposals which aim to increase the resilience of the centrally cleared market ecosystem in times of market stress. The proposals are designed to improve market participants' understanding of centrally cleared initial margin calculations and potential future margin requirements. They cover aspects of CCP transparency, governance and review of initial margin models, as well as clearing member transparency for clients and CCPs.

It is often feared that margin transparency may fuel pro-cyclicality, potentially making investment choices more unstable in stressful conditions, the official stressed. The right approach is being taken by the international standard-setting authorities in not requiring CCPs to be fully transparent about margins, because this allows CCPs to retain some discretion in changing margins. However, CCPs are asked to be fully transparent about how this discretion is used, so that the investor community can prepare to manage stressful conditions and forecast liquidity needs. It is important to have international coordination in this area because there are major differences in the approach to margin transparency and margin pro-cyclicality across jurisdictions. This may take a toll on the level playing field and ability of EU CCPs to be competitive.

The Chair commented that an adequate balance has been achieved in the EMIR 3 proposals and there should not be compromise on elements that are necessary from a stability perspective.

An industry representative suggested that allowing access to clearing for nonbank financial institutions (NBFIs) can also contribute to address pro-cyclicality issues. Although this is a controversial question, allowing NBFIs into repo clearing can help to improve the functioning of the ecosystem.

5. Expected impacts of technology in the clearing space

An industry representative stated that it is important for CCPs to be able to access best-in-class technology and providers such as cloud service providers (CSPs). The move to the public cloud is driven not by cost but by operational resilience. Rather than impede its usage regulators should equip themselves with the proper tools to mitigate any concerns they may have with the use of cloud. Regulators should focus on outcome, which is sometimes missed in DORA, rather than getting caught up with the nitty-gritty of the functioning of CSPs. The industry needs to spend its energy on preventing operational risks rather than following excessively detailed requirements that can turn into tick-box exercises.

An official observed that there are many interesting discussions around how the blockchain can help to improve the full securities processing chain from issuance to settlement, including clearing. This is more a question for the private sector, but there are also potential regulatory implications. Before FTX collapsed there were pretty advanced discussions with the US CFTC about proposals made by FTX to implement a new clearing model with direct access for retail and institutional participants that would allow derivative risks to be assessed and mitigated in real time with an almost continuous setting of margin levels. This included a 24/7 operating auto-liquidation mechanism enabling client positions to be automatically closed out if margins fell below predetermined threshold levels. One further question to be assessed is the implications in the clearing space of a possible move towards T+1 settlement following the changes underway in the US.

European post-trading roadmap: T+1 and harmonization challenges

1. Improvement of settlement efficiency

The Chair highlighted that other jurisdictions, such as the US, are moving forward with shortening the settlement cycle. It is important to understand whether Europe should also move in that direction, whether this would support the capital markets union (CMU) objectives, and also the roles that regulation, new technologies and automation may play in this context.

1.1 Potential benefits of improved settlement efficiency

A regulator noted that supervisors want settlement activities to be safe and efficient. Settlement efficiency is important for buyers and sellers of securities, as it conditions the fact that assets are purchased and cash received safely, without extra penalties and costs. Settlement efficiency has improved significantly in Europe, particularly for equity transactions, with the implementation of the Central Securities Depositories Regulation (CSDR), which established measures to reduce settlement failures. The CSDR review aims to increase efficiency further. ESMA is also working on measures to improve the penalty mechanism.

The main current question, the regulator stressed, is whether the settlement cycle should be shortened to T+1. ESMA launched a call for evidence a few months ago, the results of which are being analysed. One benefit is that reducing settlement time to T+1 reduces liquidity needs and counterparty risk. In theory, there may also be a reduction in collateral needs and collateral margins, leading to some savings, although they seem fairly limited. It is also important to align with other jurisdictions, given that the US, Canada and Mexico are moving to T+1 in two months and the UK is initiating a debate on this topic.

An industry representative suggested that moving to T+1 could be a catalyst for a further harmonisation of practices and a removal of remaining post-trading barriers. However, from a custodian perspective, the potential savings seem very small compared to the costs. The results of ESMA's cost/benefit analysis should be waited for before any final decision is taken. The figures that have been shared by the European Association of Clearing Houses (EACH) so far demonstrate that the savings in terms of margin calls are equal to 0.5% in the equity market, but the costs will probably be more than that, because such a project requires a huge amount of resources and capacity. The Commission has argued that moving to T+1 will enhance the competitiveness of EU capital markets, but the attractiveness of European markets and the competitiveness of EU players has nothing to do with the settlement cycle.

1.2 Operational implications and challenges of a move to T+1

A regulator emphasised that the EU has a very complex ecosystem. There are more than 20 CSDs and several currencies. If the settlement cycle is reduced, that should not be to the detriment of settlement efficiency. The reduction will also require significant investment in automation and technology.

An industry representative noted that when the discussion about possible migration to T+1 started in Europe, the CSDs decided to take a neutral position, as they are already prepared to settle at T+1, if needed. CSDs will follow the decisions of the public authorities, but there is a need for the whole market to be prepared, which is a challenge in a context where many regulatory changes and ECB projects like the Eurosystem Collateral Management System (ECMS) are already being implemented. The migration to T+1 implies a huge change for all stakeholders, and for custodians even more so than for the CSDs. Significant preparation and testing will be necessary, as well as taking into account the learnings from the US experience, as moving to T+1 is more complex than the previous change from T+3 to T+2. In terms of timing, a possible migration should occur in the second half of the year to avoid the season of corporate events, which is very important for CSDs and the markets, and if possible at the same time in the EU, the UK, and Switzerland.

A second industry representative agreed that the whole ecosystem end-to-end must prepare for a transition to T+1. One of objectives of CMU is to make European markets more attractive, which includes attracting investors from different time zones, but T+1 will create further challenges for certain products and activities, such as FX and exchange-traded funds (ETFs). Lending desks in a T+1 environment are also going to have higher risks of settlement fail and of being in breach of the regulatory framework.

A third industry representative noted that a move to T+0, which is sometimes mentioned, would be even more challenging and is not a desirable objective for the industry in the short to medium term. There are two types of T+0: end of the day and instant atomic settlement. The latter form of T+0 would require a huge change in terms of legacy infrastructure, and is not necessarily in the common interest of all participants, because it would require a pre-funding of each trade, which would increase the costs of transactions and have liquidity consequences.

1.3 Next steps for preparing to move to T+1

A regulator suggested that moving to T+1 seems inevitable, given that the US, Canada and several other jurisdictions are currently doing so. The question is therefore not if the EU should move, but how and when, as recently stated by Commissioner McGuinness. Being

aligned in the process with the UK and Switzerland is important, as is having a joint purpose and strong co-ordination among all market stakeholders.

An industry representative emphasised that the need to move to T+1 must be quickly and carefully assessed, because having different settlement cycles in the various jurisdictions is suboptimal. The decision of the US and Canada to move to T+1 has more implications than India or Mexico, which do not have the same levels of cross-border transaction volumes. A pragmatic approach should be taken and the consequences should be assessed product by product. Products that have a strong non-EU component, such as exchange-traded funds (ETFs) with US underlying, FX or depository receipts, are most important to consider. Nonetheless, the EU will not be moving to T+1 in two months, so there will be different settlement cycles for a period of time.

A second industry representative stated that collaboration across all sectors of the industry and with regulators is critical to successfully implement T+1, according to the experience in the US. SIFMA, ICI, DTCC and the SEC worked collaboratively over a number of years to produce a roadmap for the US industry's transition to T+1 including a playbook, a set of testing plans and documentation for firms. The UK's Accelerated Settlement Taskforce is looking to bring a similar collaboration into play. In the initial phase, it is looking at publishing best practices and defining how to increase standardisation and harmonisation in the market, and then it will endeavour to build out the transition plan. The question for Europe is how to mobilise its own market. A sensible approach would be to set up a task force in charge of driving that implementation, and defining a transition plan in close collaboration with the UK and Switzerland.

A third industry representative agreed that creating an industry working group to prepare the implementation of T+1 with an end-to-end perspective is very important. The group needs to include the buy side, the sell side and the market infrastructures and also consider the possible unintended consequences of that change.

1.4 Interplay with the digitalisation and automation of settlement processes

The Chair asked how the objective of shortening the settlement cycle interacts with the increasing digitalisation of securities processes and the ongoing implementation of new technologies such as distributed ledger technology (DLT).

An industry representative suggested that a successful transition to a T+1 settlement cycle in the EU will require an increase in the current levels of post-trade automation. T+1 provides an opportunity to enhance operational efficiencies by encouraging an automation of manual processes, and an adoption of industry standards and best practices.

The industry representative emphasised that there has been a lack of investment in the automation of post-trading processes in the EU and progress is needed independently from the objective of moving to T+1. Automation is particularly needed in two main areas: trade matching and standing settlement instructions (SSIs). Trade matching is a critical part of the post-trade lifecycle and serves as the first safety check after execution has taken place and the buyer and seller have agreed on the details of the transaction and before the settlement process begins. Trade matching allows counterparties to identify and address exceptions that might cause the transaction to fail. The quicker this can be done, the higher the chances are of meeting an accelerated settlement timeline. Trade confirmation, allocation and matching should take place on the trade date, to allow for T+1 settlement. SSIs which relate to information that remains the same from one transaction to another are another critical component of the post-trade lifecycle that requires further standardisation and automation to avoid trade fails and facilitate accelerated settlement. Manual SSIs and the current absence of storing, and sharing of SSI data in a standard and automated fashion across the industry lead to inaccuracies and incompleteness. This introduces risks and inefficiencies in the post-trade process and is often the primary reason for trade failures.

To address both areas - trade matching and SSIs - firms should evaluate best practice solutions that allow for automation and improvement of these post-trade processes, and then make the necessary investments. Automated central matching platforms, enriched with golden source SSI data and workflows that facilitate accelerated settlement already exist, and are key to achieving greater settlement efficiency. Moving towards further automation requires collective work throughout the industry on how to drive more efficient workflows from an end-to-end perspective and how to interoperate.

A Central Bank official noted that the policy discussions on T+1 have a shorter-term horizon than the perspective of using at large scale new technologies, such as DLT, in settlement processes. The challenges of moving to T+1 for cash securities transactions do not stem from the limitations of existing infrastructures, but from the lack of automation and straight-through processing.

DLT and other technologies such as robotic process automation or AI are not a panacea for tackling automation issues, the official stressed, however, they can definitely support process improvements. Use cases should be developed and the assessment of how DLT can add value in the post-trading space should continue. The EU DLT pilot regime will support this, and the ECB, together with several national central banks, is very active in this area, for example by conducting work on how wholesale financial transactions recorded on DLT platforms could be settled in central bank money.

2. Further improvements needed in the post-trading space

2.1 Enhancing harmonisation, standardisation and integration

A Central Bank official presented the main initiatives that are being conducted by the Eurosystem in the securities settlement space. The Eurosystem is continuing to develop the TARGET Services, which aim to ensure the

free flow of cash, securities and collateral across Europe and settlement in central bank money. These include TARGET2 (T2) for settling payments, TARGET2 Securities (T2S) for settling securities, TARGET Instant Payment Settlement (TIPS), and ECMS for collateral management. Moreover, in the previous year, 5 new markets onboarded to T2S while ECMS is scheduled to go live later this year. Finally, separately from the TARGET services, the EU issuance service which has been developed also with the support of the ECB / Eurosystem, was launched in January 2024.

Going forward, the focus should be on harmonisation and standardisation in order to reduce fragmentation and increase efficiency in the European market. Work on standardisation has already made significant progress in the context of the Eurosystem's Advisory Group on Market Infrastructures for Securities and Collateral (AMI-SeCo)[1], which has agreed on standards for European markets and committed to their implementation. One area where AMI-SeCo has played a key role in terms of harmonisation is corporate events processing, which includes corporate actions, shareholder identification and general meetings. AMI-SeCo published the 2023 Corporate Events Compliance report which provides an assessment of the current levels of compliance with European corporate events standards[2]. The monitoring exercise shows improvements in compliance, but the level of compliance remains insufficient. Non-compliant entities are being contacted to encourage them to make progress at a faster rate. A second area is collateral management. The 7th AMI-SeCo SCoREBOARD reporting the progress in implementing the Single Collateral Management Rulebook for Europe (SCoRE) was published in December 2023[3]. Although significant progress has been achieved overall by the monitored actors, several markets reported delays. The rescheduling of the SCoRE Standards implementation date to November 2024, in line with the go-live date of ECMS, gives markets more time to prepare.

Further areas of harmonisation concern withholding tax procedures and the ISO 20022 messaging standard, the official noted. The European Commission published the Faster and Safer Relief of Excess Withholding Taxes (FASTER) proposal in June 2023, which sets out new rules to make these procedures more efficient and secure, and to prevent tax abuse in the single market. The adoption of the ISO 20022 messaging and data dictionary will also help to drive simplification and convergence, foster further improvements, while reducing manual interventions and risk of operational errors. Beyond these standardisation efforts, AMI-SeCo is working on the identification of any remaining barriers to integration in the post-trading space and based on this fact-finding may discuss further harmonisation areas.

An industry representative remarked that there is currently no uniform identification reference added to transactions that persists throughout a transaction's lifecycle. This could also support standardization. Securities markets should look to how derivatives markets solved this problem with the introduction of Unique Transaction Identifiers (UTIs) for trade reporting purposes. UTIs allow transaction identification to happen near instantaneously and create greater visibility across the transaction chain. This enables quicker identification and resolution of bottlenecks or settlement lifecycle issues, while reducing operational risks and costs arising from potential settlement fails. Many elements, such as UTIs that may support further standardisation are already available, but they are not all fully implemented, and also need to be considered from a cross-market perspective. The focus should be on implementing existing rules rather than issuing new ones, and on ways to leverage the technology already in place in traditional markets to its maximum.

A second industry representative highlighted that although there is still fragmentation in European post-trade, a great deal has already been done to improve the situation. When making comparisons between the US and EU infrastructure, it is important to consider that achieving the same level of integration will not be possible, because the US is a single jurisdiction with one currency and one language, which is not the case in Europe. Further progress can nevertheless be made to reduce fragmentation. One of the key drivers for this is T2S, which was initiated in July 2006 and implemented from September 2015. However, T2S is not being utilised for cross-CSD transactions at present. Only 1.5% of cross-CSD transactions are settled in T2S and traditional approaches with the International Central Securities Depositories (ICSDs) and global custodians acting as intermediaries are still predominantly being used instead. An increased use of 'highways' like T2S is needed to achieve an integrated settlement system in Europe. A first step for this is to identify the remaining barriers that need to be overcome, which AMI-SeCo is currently doing. Withholding tax procedures is one of the most important barriers.

A third industry representative noted that the European jurisdiction is complex with 27 member states, many CSDs, many CCPs, many trading venues, many competent authorities, different tax regimes and 14 currencies. The first Giovannini report on post-trading barriers was published 23 years ago, but the lifting of these barriers is still not achieved.

2.2 Evolutions needed to support the CMU objectives

A regulator remarked that the broader issue going forward is defining a relevant European post-trading roadmap to support the CMU objectives. EU markets and infrastructures need to operate in an efficient way, in order to support investments in the capital markets and the funding of companies. EU markets should also be competitive internationally in terms of cost, and be safe

1. AMI-SeCo is a market stakeholder forum sponsored by the Eurosystem (i.e. the ECB and the national Central Banks of the countries that have adopted the euro), bringing together central securities depositories, central counterparties, banks, central banks, issuers and industry associations. It covers the European Economic Area, UK and Swiss markets.
2. i.e. Market Standards for Corporate Actions Processing, Shareholder Identification and T2S Corporate Actions Standards.
3. SCoRE Standards cover Triparty Collateral Management, Corporate Actions and Billing Processes (while AMI-SeCo aims to define further SCoRE Standards).

in order to bolster investor confidence and contribute to financial stability. Prioritisation is needed, as resources are limited at the policy-maker and supervisory levels. It is important to keep in mind the final objective of CMU in order to allocate resources appropriately and make sure that the right incentives are provided. The market will do the rest.

An industry representative suggested that T+1 could trigger a reshaping of the competitive post-trading landscape. This may lead to re-examine the issues raised by the current fragmentation of central counterparty clearing houses (CCPs) and central securities depositories (CSDs) in Europe, in terms of costs and complexity of clearing and settlement activities and evaluate the benefits of further consolidation.

Another industry representative noted that it is often suggested that further consolidation in the post-trade environment would make European markets more attractive, but in reality post-trading is already efficient and working well in Europe. The top five CSDs in Europe already represent 83% of the European capital market. The main challenge ahead is to attract more investment flows into European corporates, notably from the larger US and Asian asset managers. That requires a better understanding of the needs and behaviour of these players, and implementing adequate incentives to drive more investment. Fast action is needed, because Europe is losing ground to the US and Asia in terms of investments. Improving the plumbing will not contribute significantly to that objective. It is not certain either that further consolidation of CSDs would contribute to driving more investments into Europe, and whether member states would be ready to give up part of their current role in this space. On the retail side, the Markets in Financial Instruments Directive (MiFID) rules are also an obstacle. That needs to be tackled in order to increase retail investment in European capital markets, as well as providing appropriate fiscal incentives.

Conclusion

The Chair summarised that, with regard to shortening the settlement cycle, there are mixed views about the benefits. There is a general agreement that securities settlement works well at present in the EU, and this achievement should not be compromised. In addition, the European post-trade landscape is more complex than in the other main jurisdictions. However, the political pressure appears to be quite high for there to be a move to T+1. That evolution should be prepared for and conducted in a pragmatic and collaborative way. Dialogue is needed at market level, for example in a cross-sector industry working group, to formulate a clear transition plan. ESMA's assessment of the costs and benefits of moving to T+1 is needed, but reflecting on the topic should be initiated at industry level in the meantime.

Regarding additional improvements and policy priorities in the post-trading space, there are ongoing initiatives on harmonisation and standardisation at the Eurosystem level, and significant achievements related to the TARGET systems, including ECMS going live at the end of the year. The settlement systems in Europe are generally working well, following a number of improvements in recent years. Automation should be improved across the market. DLT will not solve all of the issues at stake, but it should be part of the solution. The key questions are how to attract more investment into Europe, and what further incentives are needed to that end.

Retail investment strategy: key pending questions and way forward

1. Objectives of the RIS proposal

The Chair explained that the Retail Investment Strategy (RIS) proposal made by the Commission addresses the nexus of investor protection and Capital Markets Union (CMU). Retail investment must increase to develop capital markets in Europe, but more retail investors will not enter the market without adequate rules notably in terms of investor protection. This balance needs to be found to develop retail investment.

A public representative agreed that the right balance must be found in the CMU between developing and increasing the attractiveness of European capital markets and ensuring investor protection. The RIS is a strategy, not a mere technical exercise. It should address the short, medium and longerterm drivers for developing retail investment. The proposal is a good starting point, but it could be more ambitious in areas such as financial literacy and there are some drawbacks to tackle. The current uncertain environment must be taken into account, as well as the objective to reinforce Europe's strategic autonomy[1].

2. Proposal for a partial ban on inducements

The Chair explained that the Commission has proposed a partial ban on inducements which covers unadvised investments. If there is no advice, there should be no need for inducements. Given that the ban is only partial, there is a *caveat venditor*[2] dimension to the RIS proposal.

An industry speaker noted that, while the proposed ban is partial, the Commission has clearly indicated that it is a first step towards a full ban on inducements. A partial ban will be difficult to enforce. Customers usually have successive discussions with advisors on a range of topics before making an investment, which means it will be difficult to demonstrate a direct link between an investment and a clearly identifiable piece of advice.

Moreover, a ban on inducements would not be in the interest of European citizens or the wider European economy and it would distort competition by favouring feebased models, the industry speaker stated. First, the Commission's impact assessment did not clearly demonstrate the existence of conflicts of interest linked to inducements. Banning inducements on the basis of a theoretical risk does not seem appropriate. European retail banks serve a wide range of customers over the long term and have no advantage in deceiving them. On the contrary, it is in the banks' interest to retain their customers over the long term. In addition any potential ban should not target services where there is no possibility of a conflict of interest, such as portfolio management. A ban would kill this type of service since managers would no longer be able to remunerate distributors for their products. Secondly, a ban on inducements would prevent many retail investors from having appropriate access to financial services because it will no longer be possible to finance large scale distribution and advisor networks. A ban would only benefit the wealthier investors who can afford independent advisors and who only represent a small proportion of the population. In Europe, 10% of customers own two-thirds of the total financial wealth. Since the median European financial portfolio is around €10,000, and most retail investors have mostly savings accounts generating no inducement, most commissions come from the richest 10% of retail investors.

Finally, this ban would strengthen the flow of investment outside the EU by promoting the simplest and cheapest products, such as exchange-traded funds (ETFs), which are mainly based on thirdcountry assets. US securities represent a higher proportion of global market capitalisation and have higher longterm returns than EU securities and are therefore over-represented in ETFs compared to European securities. The ban would also weaken the distribution of ESG assets, which require significant support from advisors and are not the most costefficient products. The ban would moreover negatively impact the selling of actively managed funds. This has been observed in countries that have already banned inducements.

A public representative considered that a middle ground must be found between a full ban and no ban. There is a need to tackle conflicts of interest, but it is also important to preserve access to advice. After a ban was introduced in the Netherlands, the % of customers using advice fell from 21% in 2013 to 5% in 2021. In the same period, the number of bank branches fell by 70% compared to an average of 39% in the eurozone. The potential impacts of a full ban need reconsidering in the proposals made. In addition, these proposals must properly take into account new market developments related to digitalisation, such as the development of neo-brokers and the evolution of investment practices with an increasing use of digital channels.

1. This roundtable took place in February 2024, before the vote on the RIS proposal in the ECON Committee.
2. *Caveat venditor* implies that service providers and product manufacturers will be accountable for the products or services which they sell. The value for money (VFM) approach proposed in the RIS contributes to this objective.

An investor representative welcomed the partial ban proposed by the Commission, as it will likely contribute to improving investor outcomes and increasing retail participation in the capital markets. Many studies show that the use of inducements steers consumers into highly packaged and complex products, which are underperforming. In addition, the argument that many retail investors will not be able to afford the cost of advice is not valid because many of them already pay high costs for biased advice in the current system, albeit indirectly. Investors would be in a better position with the same amounts paid for independent advice.

The investor representative noted some potential drawbacks from the partial ban proposed that need tackling. In its current form, the ban might negatively affect platforms that distribute simple and costefficient products such as ETFs and ETF saving plans, which are adequate investment solutions for retail consumers. Additionally, the proposed rule will allow member states to opt-out by choosing to make advice mandatory for investment products such as insurance-based investment products (IBIPs). Any exceptions to the ban should however include safeguards to ensure that retail investors are not encouraged to invest in complex and underperforming products.

3. Value for Money measures proposed

The Chair asked the panellists for their reactions to the VFM measures in the RIS, which would require product manufacturers and distributors to assess the overall cost of a product and its expected return and only manufacture and distribute products likely to provide sufficient value for money for retail investors. This would be quantified with regularly updated benchmarks on cost and performance created by ESMA and EIOPA. Products which do not meet the VFM benchmarks would not be allowed to be marketed to retail investors unless further testing could demonstrate the contrary.

3.1 The relevance of the VFM approach

A regulator stated that it is important to consider the impacts of product costs and cost structures for retail investors. In MiFID, there is already a duty on investment firms to ensure that the cost structure of their products does not jeopardise investor returns. However, this requirement is difficult to enforce for regulators. It can be difficult to demonstrate that the claims made in marketing material about potential returns are mathematically inconsistent with the structure of the product. The VFM requirements could be useful in this respect if their purpose is clearly defined. The objective is not for regulators to set product costs or impose fee structures but to eliminate outlier products that do not serve clients' best interests.

An industry representative stressed that despite its good intentions, the current VFM proposal has several flaws. First, there is an excessive focus on cost, which may be counterproductive. While cost optimisation is an important factor in the management of investment portfolios, it does not necessarily lead to high return. Many other factors come into play, such as the quality of portfolio management and the type of advice, service, reporting and risk management that investors are provided with. A highly cost-based approach would also be particularly counterproductive for ESG investing. An effective ESG strategy is costly because it requires asset managers to engage with investee companies actively, set benchmarks and help them move towards net zero. This requires numerous meetings and costly tracking and measurement. Secondly, performance is tied to risk and requires portfolio diversification. The current VFM approach favours passive allocations via ETFs, but these strategies are not adapted to all market segments, particularly higheryielding assets in the long term. To invest in the SME market, for example, the key issue is to avoid default. The work of the asset manager is to manage default risk on behalf of investors, which cannot be done passively.

A public representative agreed that there are many other factors besides costs that are important factors in fostering greater retail participation, such as access to advice, trust and quality of advice.

An investor representative considered that the VFM measures proposed in the RIS are not excessively focused on cost and may provide better outcomes for consumers. Cost is extremely important for investors. While low costs do not guarantee high performance, high cost does limit performance. A study conducted by Better Finance on the correlation between cost and performance demonstrates clearly that customers who pay higher product costs often obtain smaller returns. As Prof. John Kay suggested, the simplest strategy to improve investor returns is for them to pay smaller fees to financial providers. Risk should not be overlooked either, as it is as important as performance and cost for investor outcomes and should be considered both in terms of magnitude and probability.

3.2 Implementation challenges

A regulator was favourable in principle to a quantitative approach based on benchmarks, as it may help to identify outliers in a more objective way, but highlighted some challenges that need tackling for this approach to be workable. First, it will be necessary to conduct an appropriate sampling for every category of product. If the sampling is not sufficiently relevant, there will be many false positives and false negatives and this could be a timeconsuming and costintensive exercise with a disappointing result. As a direct corollary, the peer groups for most investment products should be established at a national rather than European level because most products are not currently distributed at a panEuropean level. Secondly, these product peer groups will have to be defined in an adequate way. They will need to be defined on the basis of the asset management strategy, in order to be sufficiently homogeneous, rather than performance, which can only be measured in terms of realised performance and may lead to false positives as it fluctuates.

A further condition, the regulator stressed, is that quantitative benchmarks must take account of all costs, including distribution costs, which might be quite

significant for certain product categories such as IBIPs. This requires establishing a quantitative approach at the stage of distribution and not production, which is more challenging, because the data is not readily available; it will require additional reporting. These technical challenges are not a reason to abandon the quantitative approach, but it will take time to find the right solutions in collaboration with the industry.

An industry speaker agreed that the implementation of VFM will be very difficult, although it is an interesting concept. First, the benchmarking of comparable products requires adequate product clusters to be defined, which will be very complicated. Secondly, the distribution strategy must be taken into account. It is not possible to compare a financial product sold online with limited services with a financial product sold by a physical retail network. Thirdly, the features of many financial products depend on domestic specificities, which make European comparisons difficult. Fourthly, it is important to consider the qualitative aspects of performance and how it is achieved. Finally, VFM benchmarks might lead to excessively bureaucratic and cumbersome procedures.

A public representative concurred that enforcement is a major challenge for achieving wellfunctioning VFM requirements, despite the merits of this innovative proposal. Without precise guidance at Level 1 on the concrete implementation of VFM, there will continue to be questions about enforceability. Consistency in the implementation of these measures across the EU is also very important. This is why, on one side, companies should have more responsibility for establishing the VFM of their products, and on the other side, supervisors must be given additional tools to act through the use of benchmarks.

An industry representative observed that an alternative would be to rely on the industry to carry out the VFM assessments in a comparable way and provide the data with transparency obligations. This could achieve the objective of progressively weeding out the overpriced and wrongly structured products with a simpler process. The large asset managers already provide peer assessments of VFM. Creating product benchmarks in a centralised way at EU level, as is currently proposed, will be very difficult. In addition, the evaluation of VFM should take account of the full value chain, including the production and distribution of products, which is not foreseen in the current proposal.

4. Financial literacy and measures on finfluencers

4.1 Improving financial literacy

The Chair noted that the RIS also seeks to boost financial literacy. Financial literacy is sometimes considered to be the solution to all problems concerning retail investment. Although this is not necessarily true, it is still an important component of the RIS.

A public representative considered that the proposals made by the Commission in this area could be more ambitious. The EU has limited competency concerning financial education, but it can help member states enhance their national initiatives. One solution could be to create a European platform, with all the relevant public and private stakeholders, to share best practice at EU level. At present, member states work in silos with no consideration of what other member states are doing or have already tested. These efforts need to be pooled at EU level and the lessons learned must be shared. The experience of the OECD in this area is also relevant. The importance of digitalisation was recently highlighted by an OECD report on the French retail investment landscape showing that 70% of new French investors are using digital channels to invest. This shows that digitalisation can play a key role in mobilising retail investors, notably the younger ones, and that retail investor information and protection need adapting to this changing environment. The OECD is planning to develop more specific financial education measures on the back of this report.

An industry speaker noted that there are frequent references to the active engagement of retail investors in the capital markets in the US. Formal training in financial literacy is not part of the US school curriculum, but making money and investing is a part of American culture. In addition, several events have created incentives for US citizens to increase investments in the capital markets. In the 1980s, political debates about the sustainability of the social security system triggered the creation of the 401(k) scheme, which provides tax advantages for investing in a retirement account. This was an inflection point in the US. There is now an additional tax advantage if people save for their children's education. At the end of the 1990s, the dot-com bubble also taught Americans not to put all their stocks in one sector, which led to further improvements in the way they invest money. This shows that in addition to financial literacy programmes on how to better manage money, it is also necessary to explain to European citizens the background and reasons for doing so, in order to create stronger incentives to invest in the capital markets. There should also be an honest conversation about whether the current pension systems in the EU will be sufficient to pay retirement benefits in the future or whether they need to be supplemented by private schemes.

4.2 Finfluencers and product information

A public representative noted that digitalisation is bringing new channels for informing retail investors, including so-called finfluencers. It is important to ensure that retail investors are provided with adequate information about investment products also through these new channels, which implies making sure that new players such as finfluencers are sufficiently knowledgeable about the products they promote.

A regulator underlined the importance of including proposals about finfluencers and product information in the RIS. Addressing these developments at an early stage is essential, because investors are increasingly exposed to finfluencers remunerated or incentivised by firms to promote products. It is necessary to ensure that the same rules apply to all marketing communications,

including these new channels and that information is relevant. The RIS proposals define marketing communications and practices, including in situations where the marketing is done via somebody paid or incentivised by a firm. The RIS clarifies the responsibilities of manufacturers and distributors and reminds firms that they are also responsible for marketing done via third parties such as finfluencers. The RIS also introduces new rules on marketing communication and practices and on the involvement of the management in these activities, as well as recordkeeping requirements to ensure that these measures are enforceable. Finally, supervisors need to have greater enforcement powers, including the possibility to suspend marketing communications and, in particularly complex or difficult situations, to restrict or remove access to online content.

The RIS also seeks to improve the framework for product disclosures, the regulator observed, with the objective of further streamlining information, making sure it is relevant for investors and making the information more fit for digital use. Ensuring that there is more accurate information about cost and performance will be particularly important. The RIS proposes to create an EU template for disclosures on costs, associated charges and third-party payments. This disclosure should be made on an ex ante and ex post basis via an annual statement. However, it will be important to ensure that these new disclosure requirements do not lead to an overload of information.

An investor representative welcomed the measures proposed on finfluencers. As for disclosures, there have been longstanding problems with key information documents (KIDs). Some of the information provided in KIDs does not bring much value to consumers, such as the pseudoscientific future projection scenarios. It would be preferable to base the benchmark in the KID on past performance information.

An industry speaker observed that all advertisements about investing in the US include a warning about the possibly of losing some or all of the investment. This is the type of message that needs to be conveyed in marketing communication in order to ensure that investors are aware of the opportunities and risks of investing.

5. Cross-border supervision

A regulator stated that the single market for investment products and services does not function in an optimal way. Many cases of misselling are related to products sold directly to consumers on a cross-border basis with no local branch. In France, more than 80% of the complaints received by the AMF come from French investors who have invested in products this way. In this situation, the sole responsibility for supervision lies with the home authority, but in some cases the home authority has no incentive to supervise the firm, because the firm has no domestic customers in its home member state. This is a structural issue in the single market, which could jeopardise its benefits. Tighter cooperation between supervisors will allow them to be more agile and efficient when dealing with these problems. The Commission has made several useful proposals in this regard, such as the review of article 86 of MiFID. The draft amendments that have been put forward within the Parliament are also welcome because they address the issue of regulatory forum shopping.

An industry speaker considered that the supervision of cross-border financial firms in the EU works well generally. The speaker's company, a global insurance firm with one subsidiary and several branches across the EU, is supervised by a college consisting of a home regulator and 11 host supervisors which meet twice a year. This structure facilitates effective communication among the supervisors and with the company. The home regulator also conducts branch visits to which the host regulator is also invited.

Conclusion

The Chair emphasised that the primary purpose of the RIS is to increase retail participation in the capital markets. If the current set-up in terms of advice and investment products offered was performing well, there would not be a shortage of retail investors in Europe. This is often blamed on Europe's inherently riskaverse culture, but this is not true. European citizens and countries are capable of risk-taking as proved by the example of Ireland which has become an entrepreneurial country in a relatively short period of time. This is not a question of culture; it is about incentives. These incentives can be created through the tax system, by honest communication from the public authorities about the sustainability and adequacy of pensions or by regulatory requirements applying to products and their distribution.

While measures on financial literacy, product disclosure and finfluencers are important, they will not be sufficient to eliminate the current information asymmetry in the financial sector, which is a major obstacle to retail investment. Many individuals know nothing about finance or investment products. This is why further measures are needed to alleviate potential conflicts of interest and to clarify the value for money of products, which is the main logic behind the Commission's RIS proposal.

Asset management: trends, challenges and priorities for the next legislature

1. Main trends in the European asset management market

1.1 Product trends

The Chair stated that there has been constant growth in the European asset management sector since the financial crisis, despite outflows in 2022 due to the adverse economic situation. The strong EU fund framework, including the UCITS and AIFMD directives, has supported this growth, as it allows a huge variety of products to be developed and sold domestically and also cross-border thanks to the passport. UCITS has also become a global brand. Funds are the easiest way for retail savers to invest in the capital market and to participate in the real economy. Product categories with specific rules have also been created at EU level, such as the European Long-Term Investment Fund (ELTIF), and at domestic level, such as real estate funds.

An industry representative confirmed that trends are positive in the EU asset management market, with stock markets at an all-time high. There is also a strong upside potential ahead. Investment funds only represent 25% of the overall EU investment market, which is relatively low compared to other advanced markets such as the United States, where they account for 60% to 70%. There is strong demand, with investors who are better informed and are looking for investment opportunities that will help them to tackle the changing macro environment. A regulator noted that in recent months there has been more investment into fixed income strategies and, on the equity side, higher investments in the technology sector.

A second industry representative highlighted the growing trends in the areas of sustainability, exchange-traded funds (ETFs) and private assets. Although the focus on sustainability reduced last year, partly due to investors allocating more money to cash and fixed income in response to market events, it is expected to return and remain an important trend going forward. An increasing number of investors also see the benefits of ETFs. This includes synthetic products, which are considered to be more complicated and risky. Measures have been taken to alleviate the risks, such as using multiple counterparties, but adequate controls are necessary. Another trend which started in the US and is now gaining traction in the EU is the launch of active ETFs. These enable investment managers to wrap their active management capabilities in a different instrument and make it available to different client segments. ETF share classes can also be launched within existing mutual funds, which gives investors access to ETFs without having to launch a separate ETF. A third important trend is the democratisation of private markets. Asset managers and regulators are considering how retail investors might access that part of the market, while acknowledging the illiquidity and increased complexity of these products. This would offer multiple benefits, including the fact that these assets are part of the real economy.

A regulator remarked that providing investors with access to new asset classes, such as private assets, real estate or long-term assets, is an important objective that is consistent with the macroeconomic goal of financing the transition.

1.2 Wealth management and distribution trends

An industry representative observed that the asset management industry is also impacted by the ongoing transition in the wealth management sector from a product-centric value proposition to a client centric proposition, with a move from selling products to providing portfolios. This changes completely the way clients are approached. Wealth propositions are also being brought to investors in innovative ways with new online players entering the market.

Three trends in the wealth management industry illustrate this client-centric evolution, the industry speaker explained. The first is a shift towards fee-based advisory solutions that integrate the entire value chain, from the advisor interacting with the client to a central portfolio building team. This approach, which leverages centralised investment strategies that can be either discretionary or non-discretionary, has demonstrated efficacy, yielding lower risk and enhanced performance and a capacity to build scale. It is anticipated that this model will dominate the market in the coming years, regardless of regulatory changes, with many players currently testing new approaches and business models in this area. Some banks are already proposing discretionary portfolio management services from €3,000 in some parts of Europe, which was unheard of 12 months ago. The second trend is the growth of independent wealth managers in Europe. This is a big market in the UK and US, but still only represents 10% to 15% of the EU market. Growth in this market is driven by experienced advisors who previously worked for traditional banks and are now proposing to their customers a more client-centric approach around financial planning and whole-portfolio management. The third trend is accelerating digital distribution. Retail and private banks are investigating how to re-engineer their processes and improve their client front ends to compete with retail neo-brokers that are starting to capture a significant market share. These brokers control 5% of the market and their share is expected to increase to 15% in the coming years.

A second industry representative observed that in the US there has been a growth in managed accounts for higher net worth individuals, with the minimum eligibility decreasing at a very high speed. This suggests the type of disruption that could be experienced in the EU over a five to 10 year horizon. Technological innovation, such as artificial intelligence (AI), will accelerate the pace of those innovations.

1.3 Digitalisation and technology trends

An industry representative noted that digital transformation and the use of technology are important trends in the asset management sector. An increasing proportion of tech savvy investors buying products online want to do the research themselves and expect further transparency around products and charges. Serving these clients adequately is important for the growth of the sector.

A regulator highlighted that the ongoing digital transformation in the asset management sector also aims to increase the efficiency and safety of operations and reduce costs. Much progress is being made on digitalisation in the industry. For example, distributed ledger technology (DLT) is being tested to enhance fund distribution. The use of AI for portfolio management and trading is increasing and AI can also help to create new products. The topic of tokenisation of investment fund shares, and securities more broadly, is also emerging. This should contribute to reduce costs and facilitate product distribution.

Existing legal frameworks such as the Digital Operational Resilience Act (DORA) will help to mitigate the risks related with these changes such cyber-risk, the regulator considered. Traditionally, asset management companies may not have been subject to rules as stringent as banks on cyber and digital operational resilience, but this will change. This will also be a new area of work for the supervisory authorities.

2. Competitiveness challenges facing the European asset management sector

2.1 Main aspects to consider for the fund sector

A regulator noted that the competitiveness of the EU fund sector must be considered at different levels. First there is the competitiveness of the EU market vis-à-vis other jurisdictions, which requires conducting regulatory changes with a global perspective. The second level is the competitiveness of fund products compared to other types of investments, which needs taking into account in regulatory discussions. Many assessments focus on the investment fund sector, but the investment universe is much wider. A third level of competitiveness is at the asset manager level in terms of yield provided for investors and profits generated for the asset management company. Technology can play an important role in reducing the costs of the launch of new products and supporting distribution, which may bolster the competitiveness of individual management firms, but investor interests need considering first, as this will eventually drive the competitiveness of the sector.

Another regulator emphasised that the European fund market has many competitive strengths including strong product frameworks, a global brand with UCITS and access to a large savings pool. In addition, technological developments in the market can contribute to improving the management and distribution of investment products and support investment decisions.

2.2 Market fragmentation and divergence issues in the implementation of regulations

An industry representative emphasized that the European fund market is still very fragmented. Despite a slight increase in cross-border funds, 80% to 90% of funds bought by retail investors in the three main fund markets of France, Italy and Germany are domestic funds. There are more funds and share classes in the EU than in the US and the average size of EU funds is smaller. There is moreover a shortage of European asset managers able to compete at a global level with only one European asset manager in the global top 10. Over the past 10 years, the share of European asset managers in the top 30 players of the EU market has decreased from 70% to less than 60% in 2023. In contrast, European players have only a 2% market share in the US, showing an unbalance among jurisdictions in terms of openness to foreign products.

In Europe, this fragmentation is notably due to different national transpositions and divergent interpretations of product rules such as UCITS across the EU, the industry speaker stated. There is also sometimes gold plating by national competent authorities (NCAs). As a result, when passporting a fund to another EU country, it can be necessary to create a dedicated share class, increasing cost and the number of products in the market.

A regulator considered that, overall, Europe has been very successful in cross-border distribution. Products with a critical mass have been launched in a number of jurisdictions and the quality of European products is recognised internationally. Harmonisation efforts however need pursuing.

2.3 Lack of clarity of regulation

An industry representative noted that the lack of clarity of some Level 1 regulation hinders the competitiveness of EU asset managers. For example, the industry is still struggling to define sustainable investment in relation to the Sustainable Finance Disclosure Regulation (SFDR), as this has not been clarified in the Level 1 text. Clarity is also still lacking on some aspects of the ELTIF Level 1 regulation, for example evergreen ELTIFs and article 18.2, on which views differ.

A regulator agreed that a lack of clarity of some rules makes it difficult for market players to comply and for supervisors to verify compliance.

3. ELTIF Level 2 regulatory technical standards

A regulator noted that ELTIF is an opportunity to establish a strong new brand in the fund market. These vehicles should be promoted to retail investors but with a prudent approach, given the lack of liquidity of the underlying assets, including real estate and private assets, and their exposure to the macroeconomic climate. ELTIFs have to meet in full their liquidity promise made to retail investors. This requires an appropriate balance between the liquidity offered and

the holding of liquid assets. The higher the redemption frequency offered to investors, the higher the liquid assets ELTIF should hold. This is the basic principle of fund structuring that i) will ensure that retail will receive their proceeds as promised; and ii) reduces the chances that ELTIFs will have to sell assets at a substantial discount in times of stress or only meet redemptions partially.

Another regulator considered that ELTIF has potential in terms of retailisation of alternative products. However, getting the Level 2 regulatory technical standards (RTS) right is essential, as ELTIF 1 did not work as intended. Discussions around the RTS are ongoing, creating some uncertainty in the meantime. These discussions must end soon to avoid jeopardising the product's chances of success. Cross-border distribution will also be an important factor in the success of ELTIFs.

An industry representative suggested that investors need access to a broad range of investment vehicles and opportunities, including private market assets such as corporate credit and real estate, to get a better return in the longer term. This access should be provided in a way that ensures an appropriate level of protection. The EU's recent legislative review of the ELTIF Regulation is an improvement in this regard. However, a pragmatic approach to the regulatory framework and technical standards is needed to seize the opportunities of these funds. This includes solving some regulatory implementation issues in relation to fund strategy and distribution. These products are complex to launch and expensive to seed. They are also long-term oriented investment vehicles, so a stable regulatory approach is also essential.

4. Further actions needed to enhance the competitiveness of the EU fund sector

4.1 Implementing a competitiveness check of new regulations

An industry representative stated that strong and competitive European players, notably in the asset management sector, are needed to build a real capital markets union (CMU). One way of fostering this could be to carry out a competitiveness check of new regulations based on solid impact assessments of the European Commission's proposals but also of the amendments made by co-legislators, to ensure that the measures do not have negative unintended effects in terms of competitiveness for the European financial industry. For example, the shortening of the securities transaction settlement cycle to T+1 that is currently being assessed creates new challenges for European financial players, including for the buy-side. The way this rule is transposed in the EU should take account of the fragmentation of the European post-trading market and notably the presence of multiple CSDs. The review of the benchmark regulation is another example where impacts on EU industry players need considering. Buy-side players are using an increasing amount of data and indexes and that has a cost. A further idea could be to provide the European Supervisory Authorities (ESAs) with a clear mandate to integrate competitiveness implications in their regulatory work.

4.2 Encouraging retail engagement in the capital markets and retirement planning

An industry representative noted that, while household savings and investment rates in the Euro area are trending slightly above pre-pandemic levels, they have remained lower in recent years than in many other developed economies. With the EU's green and digital transition plans estimated to cost around €645 billion per year through the next political cycle and beyond and as public spending remains under pressure, it is clear that more needs to be done to mobilise private capital in Europe. As policymakers start to consider the next steps for progressing the CMU, attention must be given to policies that are likely to engage and empower a more diverse investor base in Europe and foster a more proactive culture around long-term investment and retirement planning. The Retail Investment Strategy (RIS) proposal which can contribute to this objective must be finalised. The measures proposed to improve citizens' financial literacy, and to develop financial competence frameworks for citizens jointly with the OECD are particularly important. One way of putting them into practice could be through the institution at Member State level of financial health checks, encouraging citizens to assess the robustness of their financial planning at key stages in their life and to adjust it if needed.

Helping EU citizens to prepare for their retirement is also essential, the industry speaker stressed. Addressing the tax aspects that hinder the establishment of pan-European private pension products, revitalising the PEPP (pan-European personal pension product) and developing auto-enrolment schemes should all be part of the next CMU agenda. The financial industry should also change the way it approaches retirement issues. At present retirement is considered as a moment of change in people's lives rather than a part of an overall journey. Product innovations to better support customers throughout the phase of asset accumulation and after they have retired need to be further explored.

A second industry representative noted that ETFs can play an important part in achieving the objectives of the RIS and increasing the participation of retail investors in the capital markets. Low-cost investment models via digital channels involving ETFs should be taken advantage of in particular. These developing trends should be appropriately considered in future legislation including in the RIS proposals. More generally, future legislations should leverage the potential of the asset management sector to drive the CMU forward and to ensure a steady inflow of long-term capital into capital markets. This requires maintaining a high degree of investor confidence in the sector. The strong EU fund frameworks should contribute to this. Much has also been done in recent years to increase investor protection and also enhance the resiliency of the sector and reduce spill-over risks. Going forward, a balanced message

must be delivered about the risks posed by the asset management sector, taking into account these measures, in order to preserve investor confidence.

A third industry representative suggested that the wealth management sector also has an important role to play in attracting more retail investment. This requires adapting the advisory process to focus it more on long term financial planning and on building an appropriate investment portfolio, than on the sale of products. It also requires empowering advisors further to have financial planning discussions with their customers and regulations that foster such approaches. This will help to better answer investor needs and also facilitate investment in ELTIF products that are better suited as a component of a portfolio than as standalone products.

4.3 Fostering more consistency and stability in the European regulatory framework

An industry representative stated that more convergence is needed in the interpretation of rules for legal and marketing documentation across Member States. ESMA has a key role to play in this area. Regulatory stability should also be an objective. Care should be taken before changing any rules on UCITS at Level 1, as this is a gold standard that must be preserved. However, supervisors should have the ability to adapt rules to changes in the market in an agile way if needed. The possibility for ESMA to issue real no action letters should be considered in this perspective.

A regulator agreed that there must be a degree of regulatory stability in the EU. Its is expected that new regulation will be introduced in a more staggered way during the next political cycle, after relatively intensive legislative work during the current legislature. However, new policy or the review of existing policy will also be needed to improve the regulatory framework and adapt it to market evolutions. For example, reviewing SFDR is a priority as it has produced completely unexpected results. That would also contribute to resolving the issues around the heterogeneity of rules applying to marketing material. There is also a structural weakness of the single market in the way that supervision is conducted. The various supervisors across the EU all act in good faith but have different traditions and national views, which leads to a fragmented approach. Supervisory convergence and coordination between supervisors must be enhanced, as has been suggested in the RIS proposal.

Another regulator noted that effective mechanisms are in place that allow NCAs and supervisory authorities to exchange views, notably in crisis situations. There are sometimes divergences in views, but these are discussed and collaboration has been successful in many instances. There are however some areas where a more harmonised approach is needed to make the single market work from an asset management perspective that need to be further explored, based on feedback from the industry.

4.4 A more consolidated approach to asset management groups at EU level

An industry representative suggested that group structures should be better recognised and taken into account in the regulatory and supervisory framework in order to allow a streamlining of processes and foster more industry consolidation at European level. When a function is delegated from one entity to another, the fact that this takes place within a European group with a parent company supervised by an NCA based in an EU Member State is not taken into account at present. The subsidiaries of asset management groups are considered to be completely different management companies and entities.

A regulator noted that, as a side effect of the single market, the structure of asset management groups has changed significantly. Firms typically have teams in various European countries and funds located in other countries. Insufficient coordination between the relevant NCAs in this context might create inefficiencies and complexity for market participants. A more consolidated approach to supervise the business of large pan-European asset managers should be introduced, although this will require finding an appropriate balance between national and European-level responsibilities for supervision.

Pension and long-term savings gaps

1. Main challenges and obstacles to overcome

1.1 Main challenges facing pensions in the EU

A policy-maker stated that Pillar I regimes, which remain the main source of income at retirement for a majority of European households, are facing considerable challenges. Due to an ageing society it will be increasingly difficult to finance Pillar I pay-as-you-go (PAYG) systems in the coming years. Many Member States have already conducted pension reforms, but Pillar I systems will struggle to ensure a sustainable future income for European citizens and will need to be completed by Pillar II and III occupational and personal private pension schemes.

A regulator confirmed that the ageing population is the main challenge. The old-age dependency ratio[1] of 34.4% is due to increase to 59% by 2100, meaning that there will be significantly fewer working-age people to pay for the state PAYG pensions of older people. Three working people are currently contributing to the state pension of one pensioner, but in the next 40 years that will drop to between 1.5 and 1.7. State pensions are expected to fall as a percentage of retirement income from 46.2% in 2019 to around 37.5% in 2070. Only 23% of the European population currently participates in an occupational pension scheme, and 19% own a personal pension product. Much is being done however to improve Pillar I systems, which are the basis of the pension system. Pillar I systems are important to preserve, as they provide mutualisation in society and prevent poverty.

The regulator added that 18.5% of senior citizens are at risk of living in poverty in Europe, which may cause major problems as it comes with other costs to society. In addition, there is a significant gender gap, with a 35% higher risk of poverty in old age for women than for men. Women also have pensions that are, on average, 30% lower than men.

1.2 Obstacles to overcome for addressing pension challenges

A regulator noted that increasing the uptake of Pillar II and III private pension schemes is not easy. Young people are not interested in saving for their pensions, and by the time they are aware of the importance of doing so it is often too late to build up a sufficient pension.

An industry representative highlighted three main issues that need to be addressed in order to stimulate savings for retirement and reduce the pension gap. The first aspect is that the level of financial education is heterogeneous across Europe. Building awareness about the need to save for retirement is more difficult for people who have limited understanding of financial concepts. The second aspect is the over-reliance of many citizens on the Pillar I state pension system. The third element concerns the access that people have to adequate information on their future pension, which is still limited in many cases.

A second industry representative observed that financial literacy must be distinguished from awareness. Most US citizens are not more financially literate than Europeans, but they live in a country where the State is not considered as a solution to individual problems such as retirement, which creates awareness for the need to prepare one's own pension.

A consumer representative highlighted that if current pension gaps are not tackled then Europe might be facing a major pension crisis at some point that may be much more challenging to handle. Pillar I pensions are still important for many people, particularly those who have limited saving capacity, but will be insufficient in the future, so private pension products need to be developed in parallel. However this requires improving product quality and the functioning of pension product markets. In some countries there are adverse selection problems due to poor market design. Bad products are being sold by financial intermediaries because of incentives such as inducements and tax reductions. If the product offering in Europe is not attractive and does not correspond to customer needs, then consumers will start looking for alternative products such as exchange traded funds (ETFs), many of which are managed outside the EU and invest in non-European assets. The consumer representative added that a consequence of the insufficient financial literacy and awareness about long term financial planning needs of many Europeans is that saving rates are high in Europe, but investment rates in the capital markets are extremely low.

2. Importance of pension savings for the EU economy

A policy-maker noted that well functioning occupational and private pension systems (Pillars II and III) are essential for increasing the scale and the competitiveness of EU capital markets and achieving the objectives of the capital markets union (CMU). They are an important potential source of capital for financing the green and digital transitions in particular. State pension systems are a key source of revenue after retirement for many households, but they function mostly on a PAYG basis and do not accumulate assets.

1. The old-age dependency ratio is the ratio of the number of elderly people at an age when they are generally economically inactive (i.e. aged 65 and over), compared to the number of people of working age (i.e. 15-64 years old).

A regulator agreed that private pension systems can have significant economic impacts beyond improving revenue at retirement for future pensioners and contribute to the transition of the economy, which explains why the pension topic is gaining traction in the CMU context. For this to happen, it is however necessary to retain the capital in the EU in addition to providing savers with appropriate return, which is an issue that remains to be addressed. A further aspect worth considering is that countries with well-developed Pillar II and III systems also tend to have a large contribution of the 50+ generation to the economy in terms of contribution to GDP. Academic work shows the prospects of the silver economy, which is needed in a region with an ageing population.

Another regulator confirmed that Europe needs a funded pension system to foster the CMU. Pre funded pensions are significant in the Netherlands, with Pillar II savings representing around 150% of annual GDP. Pension adequacy issues for the older generation are also limited, but it is an exception in the EU. The regulator agreed that the impact of pre-funded pensions on EU capital markets and the funding of EU enterprises is less obvious. The capital accumulated in the pension system does not necessarily flow to European enterprises and SMEs, because a large part of it is invested abroad. About half of the capital accumulated in Dutch Pillar II pension schemes is invested in the US and Asia. In addition, it is not certain that European capital markets have the capacity at present to absorb a significant increase in the amount of pension savings.

3. Possible measures to address pension and long term savings gaps

A policy-maker expected that the Commission will attach more importance to the topic of pensions in the next European political cycle. This issue will need to be addressed jointly by all relevant services, notably the employment and social affairs side of the Commission and DG FISMA. Pensions require both a citizen-centric and an employee centric approach.

3.1 Implementing mandatory or automatic enrolment private pension systems

The Chair asked the panellists whether Pillar II and III pension systems need to be mandatory for their success.

A regulator noted that the current system in the Netherlands is mandatory for employees, who represent 90 to 95% of the population. However, it is different for the self-employed, resulting in a pension gap in that area. Policy measures related to pensions go far beyond financial market regulation and also concern social, fiscal and labour market policies.

A consumer representative observed that mandatory systems have proven to be effective in some countries such as Sweden, and that this is something that should be further explored across member states. In addition, any market-led solution must take customer interest into account particularly in terms of product performance and quality.

An industry representative was not certain that making Pillar II and III mandatory for all citizens is the right approach, as it may depend on the specificities of different countries. Creating appropriate incentives to encourage more long-term savings is more important. A mandatory system or a system based on auto-enrolment can be helpful to nudge people to start saving for their pension, but efforts must also be made to build awareness around the need to save for retirement, otherwise contributions will end up being lower than expected. In Italy there is an auto-enrolment system with opt-out applying to severance payments whereby the sums due to employees by their employers are automatically transferred to Pillar II pension funds with certain fiscal benefits, unless employees explicitly opt-out[2]. It worked well, because it forced people to reflect on the different available options before making a decision on the payment modalities, which contributed to building awareness around pension related decisions.

A second industry representative stated that there are pros and cons associated with mandatory pension systems. A mandatory Pillar II provides a long-term saving capacity for all customers, but it reduces their investment options and does not contribute to increasing awareness about the need to save for pensions. The US does not have a mandatory Pillar II system and has similar distribution systems to the EU, but has much better results than the EU in terms of pension savings. Pillar III, which is also well developed in the US with the individual retirement accounts (IRAs) market, can help to create that awareness and provide customers with more investment options. In the EU the preferable solution could be to develop Pillar III products, leveraging existing distribution networks and products.

A second regulator suggested that the automatic enrolment of employees (auto-enrolment) with the possibility to opt-out could be considered as an alternative to mandatory enrolment. Such a scheme should also apply to the self-employed. People do not tend to opt out very quickly from schemes with auto-enrolment due to a certain degree of inertia. Decades of dialogue between different stakeholders have been necessary to build mandatory systems such as those that exist in Sweden and the NL.

A policy-maker noted that the Commission has opted for encouraging the development of auto-enrolment and conducted preparatory work on such mechanisms with input from EIOPA.

2. Historically, in Italy employers accrue every month the equivalent of a severance payment (TFR, "trattamento di fine rapporto") for each of their employees. When a contract is terminated (layoff, retirement, etc.), the employer pays a lump sum, equal to the accrued amount, to the employee ("liquidazione"). Since 2007, upon signing a new contract, employees have 6 months to decide if they want the TFR to be paid as a lump sum upon termination of their contract, as was done previously, or if they prefer the TFR payments to be transferred monthly to a Pillar II pension fund (with certain fiscal benefits). In the absence of an explicit decision by employees during the first 6 months of their contract on the modalities of the payment, the default option is that all the payments are automatically transferred to the pension fund (hence the "auto enrolment"). Employers must propose the two options to their new employees and this remains an employee decision.

The first regulator stated that the most effective solution is mandatory enrolment, but agreed that there are political challenges around that. The next best solution would be auto-enrolment with opt-out, which is likely to stimulate more interest in pensions. The main objective is getting people to save more for the long term.

Reacting to a comment by the Chair that the existence of safeguards and adequate supervision are critical aspects for a mandatory system, the regulator observed that such safeguards exist in the Dutch Pillar II system. The system is run by the labour unions and the employers, as they are closer to the interests of employees than the government may be. The whole system is also closely supervised by both the central bank and the conduct regulator. There are also tax incentives for savers. This shows that Pillar II systems are not just a matter of financial regulation, but also concern social, labour market and fiscal policies.

3.2 Implementing pension dashboards and personal pension tracking systems

A regulator suggested that a key first step should be to produce a comprehensive dashboard per country of all existing pension schemes, including Pillars I, II and III. This could be done jointly by DG FISMA and DG Employment, Social Affairs and Inclusion. It is essential to have a clear picture of the present situation of pension systems at national level to decide what additional measures are needed. Such dashboards already exist in certain Member States such as Sweden and the NL.

The regulator added that a personal tracking system is also needed. Every European should be able to go online and get an overview of what they have saved for their retirement and of their potential pension. This can also encourage people to save more. Only seven Member States currently have that system in place. Tracking systems are mostly created by the industry in countries where they are available. EIOPA has provided advice on how to implement dashboard and pension tracking systems. All three pension pillars have to be considered when these systems are established to evaluate ongoing changes and improvements in an adequate way, as in some Member States incentives have been shifted from one pillar to the other.

A policy-maker noted that the Commission has performed preparatory work on pension dashboards and tracking systems on the basis of the input provided by EIOPA. The Commission is also looking into the development of a tool that will strengthen the monitoring of pension developments across Europe.

A consumer representative agreed that systems such as dashboards and pension tracking systems can be useful, as they can help to create awareness and give an outlook to people of what their situation will be. An industry representative added that pension tracking systems and individual simulation tools are useful to make the pension situation more tangible for people.

A second regulator acknowledged that pension trackers are useful, but stated that they are not sufficient because young people do not look at these projections. Good-quality, low-cost, simple pension products are also needed to encourage more long-term investment, supported by independent advice in the interest of the client. An additional approach that is being discussed in the Netherlands is to set up a system of periodic financial health checks, where people are presented with their financial position at certain intervals or at certain stages of their life. That can help to clarify pension saving needs, support more adequate financial planning and nudge people early on into investing with a long-term perspective. Such an approach seems more effective than actions to enhance financial literacy, because many people who are fully trained do not sufficiently take care of their pensions.

3.3 Reviewing the Pan-European Pension Product (PEPP)

A regulator stated that the PEPP needs to be relaunched, as it can be an appropriate solution not only for people working cross-border in the EU to save for their pensions, but also for people changing jobs within a member state. Many of the features of PEPP, like low cost, simple, digital, are helpful for many. Taxation must also be considered, as different tax treatments across Europe have been a major barrier to the uptake of PEPP so far. The 1% fee cap imposed on the basic PEPP must also be reconsidered. To be successful, the relaunch of the PEPP must also be combined with measures aiming to create urgency around the need to save for the long term. Citizens in some member states have indicated in a survey that they would be more likely to save in a European pension product because they would trust it more.

An industry representative observed that PEPP makes sense from a European integration point of view, as it provides access to additional Pillar III products for all European citizens. The issue is tax treatment, which differs across European countries.

A consumer representative considered that a PEPP with a 1% fee cap will not get distributed, but simply increasing this cap is not an appropriate solution. Europe first needs to fix market failures in the retail investment product distribution market in order to foster the development of products offering adequate investor outcomes and a viable option for producers and distributors.

A policy-maker stated that the Commission is committed to make the necessary changes to PEPP for it to work. This includes considering the effects of the fee cap. The Institutions for Occupational Retirement Provisions II (IORP II) framework is also currently up for review. Input has been received from EIOPA on how to improve the IORP II framework and a decision has to be made on the way forward.

3.4 Increasing retail participation in the capital markets

A consumer representative stated that the right incentives need to be in place for people to save in private pension products. If they start investing, their investment culture will progressively improve. The Retail Investment Strategy (RIS) proposal of the Commission, which includes measures aiming to enhance the value-for-money of investment products

and reduce conflicts of interest by limiting inducements, is a step in the right direction. With more expert and independent advice, citizens would also have a more open access to the better-performing products. Conduct must also be improved, which requires that the European Supervisory Authorities (ESAs) and the national competent authorities (NCAs) have the right powers and adequate resources. Finally, tax incentives must be reviewed to ensure that they do not steer retail customers towards low-performing products.

Answering a question from the Chair about the role that technology may have in facilitating access to independent advice, the consumer representative agreed that technology could play a role in reducing the cost of independent advice, for example with robo-advice platforms, provided they are designed in an unbiased way. Most people investing online however do so on an execution-only basis at present, so the impact may be limited and part of the market also prefers in person advice for products in which there is a long term engagement, such as insurance-based investment products (IBIPs).

A regulator considered that inducements tend to favour expensive products. In the Netherlands the decision was taken in 2013 to ban inducements completely, because some extremely bad products had been on the market. A policy-maker emphasized the importance of improving the value-for-money of investment products to ensure that the products on the market are worth investing in. To a certain extent that is more important than making investment in pension products mandatory or based on an opt-out.

An industry representative agreed that the measures of the RIS may encourage more retail investment. The value for money requirements and the measures aiming to avoid conflicts of interest in distribution networks can contribute to improving investor outcomes. The proposed reviews of the Insurance Distribution Directive (IDD) and the Markets in Financial Instruments Directive (MiFID) are also relevant in this perspective.

A regulator emphasised the importance of adequate supervision in connection with the RIS measures for developing retail investment. Supervisors can check whether products that are sold to consumers provide sufficient value-for-money and are understandable. Supervisors should also be able to intervene if this is not the case. In the context of IDD, a European mechanism is needed involving EIOPA to allow the removal of a cross-border product from the market that is detrimental for consumers, if the issue cannot be solved by the NCAs on a home-host basis.

3.5 Role of the financial sector

An industry representative stressed that the private sector also has a key role to play in encouraging more retail investment in private pension products, by providing adequate products and supporting customers in their choice at the point of sale. Distributors, agents and brokers can indeed play a significant role in improving the awareness of citizens about the need to save for their pension and can provide advice about adequate products for achieving pension objectives.

Another industry representative agreed that private companies can play an important role in drawing people into the pension system and compensating for the lack of financial literacy. The operating model of different companies and the types of distribution networks differ, but in many cases there is a capacity to reach individuals and engage with them on these topics, including some who are not naturally interested in saving for their retirement. Insurance-based investment products can also contribute to reducing the long-term saving and pension gap due to their flexibility and their capacity to support the evolving needs of customers throughout their lifetime.

Securitization: regulatory priorities and impact on private risk sharing and transfer

1. There is a need to make progress on securitisation in the EU

The Chair opened the panel on private risk sharing and the role of securitisation. There is a need to make progress on securitisation. There is a huge need for investment in Europe from both the public sector and the private sector to meet new challenges such as increased defence expenditure and the green transition. Securitisation helps by transferring risk and ensuring that private risk is shared. Over time, Parliament and the Commission have adopted policies on synthetic and green securitisation. The legislators are ready to move forward, but it is not clear what to do next.

An industry speaker emphasised that there is still a substantial challenge in Europe. In the EU, one third of finance comes from capital markets and two thirds from banks. In the US, one third comes from banks and two thirds from the capital markets. Recent statistics published by the Association for Financial Markets in Europe (AFME) indicate that in 2023 billion 200 of securitised products were issued in Europe. In the US, it was 1.5 trillion. Much of the risk continues to be retained by issuers. This trend has increased in recent quarters. 50% to 60% of European issuance continues to be retained by issuers. Significant risk transfer (SRT) securitisation has been a success, however. This market continues to grow. It will help by providing funding tools to banks, enabling capital and balance sheet relief, and allowing non bank institutions to increase their funding activity and foster long term investment in the EU.

2. Europe's misunderstandings about securitisation are obscuring huge investment opportunities and benefits to the financing of the economy

2.1 Securitisation has not reached its potential in the EU

An industry representative opined that securitisation is widely misunderstood. It is often suggested that agency securitisation drives the US market, but this is not correct. US agency securitisation is between 1 trillion to 1.5 trillion per annum, but non agency securitisation is around 1 trillion. The number provided by AFME for Europe is 200 billion, but only 100 billion is placed with investors. Therefore, private sector securitisation is 1 trillion in the US, while in Europe it is only 100 billion. Converted into GDP, this is about 0.3% to 0.5% of European GDP over the last five or six years. For the UK, it is 0.7%. For the US, it is 2%. For Australia, it is 2.5%. Australia has a fraction of Europe's GDP, but it generates more securitisation per annum.

2.2 Securitisation's poor reputation in Europe needs to be fixed

An industry speaker noted that securitisation was very popular in Europe before the subprime crisis, but it has unfairly gained a bad reputation. Without securitisation, it will not be possible to finance the green transition, digitalisation, and the wider economy. There must be securitised products on the balance sheets of European banks to enable them to compete with US banks. Securitisation should be a priority for capital markets union (CMU). It would be better to act at European rather than national level. The creation of a safe asset held by the European Investment Bank (EIB) is a good idea, but it will take some time. Securitisation should be one of the priorities of the next Commission.

2.3 The benefits of securitisation: funding, liquidity, risk management, investment opportunities, higher stock valuations

An industry representative emphasised that securitisation is more than a funding and risk transfer tool. Securitisation creates liquidity from illiquid assets. These assets can be converted into bonds and placed with European investors. Every year, between 60 billion and 70 billion flows out of Europe and into other markets. Europe could have its own investable instruments, which could feed European pension funds and in turn fund the economy.

Securitisation has many other benefits and uses. First, there have been discussions about how to manage the output floor. Going forward, banks will have to apply a portfolio approach and manage around the output floor to use capital optimally. This cannot be achieved without risk transfer, securitisation, and insurance mechanisms. Secondly, securitisation will be very useful for greening balance sheets, for example. It is possible to go to the market without securitisation, but this requires banks to have more capital and more debt. At present, the cost of capital is extremely high. Finally, EU banks' price to book ratio is 0.5. For US banks, this ratio is 1.5 to 2. If this does not change, Europe will not be able to get the funding it needs.

An industry speaker emphasised that securitisation is an important funding tool for banks and non banks which can channel more investment into the real economy. It is also important for pension funds and insurers because it creates another source of long term and low risk investment assets.

3. The UK is consulting on some adjustments to its securitisation regulation

A regulator stated that the UK remains committed to a well functioning and sound securitisation market. In the euro area, two thirds of funding is provided by banks and one third by non banks. In the US, it is the opposite and the UK lands somewhere in the middle that there is a 50:50 split between bank and non bank finance.

The securitisation market is very important. It supports bank lending by allowing banks to shift assets into the non bank system and enables them to hold risk in different forms, which helps to diversify the flow of finance to the real economy. It is crucial to have a diversified mix of funding tools and securitisation is one of the tools for providing finance to the real economy, alongside the covered bond market and traditional forms of bank lending and non bank finance. There is some complexity in securitisation structures compared to other forms of finance, so it is important to ensure that these products are properly regulated. In the UK, we have published a consultation to transfer regulatory requirements to the FCA rulebook, as well as to consider how to tweak or simplify inherited EU regulation to remove unnecessary barriers to issuance in the securitisation market.

4. Securitisation should be expanded to counter the currently unfavourable cost benefit ratio of securitisation in the EU

A regulator agreed that there is a need to finance the green and digital transitions. Securitisation is a valuable risk management and capital management tool. In this context, it is important to mention insurance linked notes (ILNs) and the insurance sector. ILNs are a form of reinsurance which can be used to manage risk and reduce risk-based capital requirements. The idea of pooling risk and assets makes complete sense. There have been problems in the past, but the risks have been addressed by regulation. However, there has not been widespread uptake of securitisation over the past few years. There are some positive signs in the SRT and simple, transparent, and standardised (STS) categories.

Ultimately, this is a question of supply and demand. Looking at supply, the question for financial institutions is whether securitised products are sufficiently attractive. In Germany, there is a strong mortgage covered bond market. It is not a surprise that securitisation is not popular in real estate because covered bonds are working well. During quantitative easing, it was important to have collateral on balance sheets, but currently quantitative tightening is being undertaken. 60% of bank securitisation was retained. There is a directly link to monetary policy here. The current process of quantitative tightening is certainly not driving the supply side of securitisation. On the demand side, there are many other alternative products to invest in. The outlook on real estate is not currently very positive. It is not reasonable to expect that originate to distribute (OTD) models will have positive results.

This raises the question of whether any changes to regulation are decisive to change market dynamics. The poor development of the securitisation market can partly be explained by looking at the alternatives in some markets. Securitisation has potential as a risk management tool and it should be part of CMU to make progress, even if securitisation markets will not change completely over the short term.

4.1 Not everyone agrees on the merit of adjusting securitisation regulation in the insurance sector

A regulator observed that there is little appetite for securitisation from the insurance sector. Insurance companies indicate that the alternatives are easier to manage. The complexity of investing in securitisation is an issue. Firms must match assets with liabilities and there are also better alternatives in terms of the risk return profile. However, securitisation does have potential. European Insurance and Occupational Pensions Authority (EIOPA) and the Commission are working on securitisation. After analysing a large amount of data, it was determined that the volatility in the market did not justify recalibrating the capital requirements related to securitisation. In the insurance industry, many institutions use internal models rather than the standard formula. The big players justify their lack of appetite by citing the risk return profile and the difficulties of managing asset liability consistency. EIOPA believes that the specific needs of the insurance industry need to be understood before uptake will increase. There has been a constantly low level of investment since the advent of Solvency II. Even when the capital requirements for other classes of investment were eased, the level of investment did not increase. There does not seem to be a correlation between capital requirements and investment appetite.

The manufacturers of securitised products need to have greater engagement with the European insurance sector. At present, there is little appetite for securitisation. Firms do not discuss the regulatory framework as an important factor. EIOPA runs public consultations and is in constant dialogue with firms. When the EIOPA board discussed the Commission's recent advice about recalibration, regulation was not highlighted as an issue. EIOPA will continue to look at securitisation with an open mind, however. It has no bias or stigma against securitisation. EIOPA will continue to look at evidence from the market. It is for insurance companies to invest if they consider securitisation to be convenient.

An industry representative asserted that it is vital to bring insurers back into the market. Between 10% and 30% of all US securitisation is sold to insurers; in Europe, the figure is 2%. In 2010, securitisation made up 10% of insurers' assets under management; today, it makes up 3%. The largest insurers made this change to their balance sheets two years before the introduction of Solvency II. Clearly, regulation does have an impact. When the regulatory capital requirements for senior

tranches of SRT were reduced, synthetic securitisation increased rapidly.

A regulator stated that regulation is not holding back investment in securitised products. There are simply better alternatives in terms of risk return profile, liability matching and complexity.

4.2 Key actions to expand securitisation: increasing transparency, developing common standards, fostering innovation, and raising awareness

An industry speaker considered that it is important to consider how to expand securitisation. The regulatory framework is sufficiently robust and transparent. There is a need for bolder actions and a broader strategy. The public and private sectors need to work jointly on increasing transparency and raising awareness. Securitisation is still perceived as opaque and risky, although there is considerable transparency and robust risk management. The public and private sectors also need to develop and support the adoption of common standards. There have been some great successes in the US. In particular, the government sponsored agencies such as Fannie Mae and Freddie Mac have had a positive impact on mortgage financing.

The private sector needs to continue to innovate. There has been innovation in asset classes. Traditionally, there has been asset backed security (ABS) issuance in auto and car loans, but more recently there has been innovation around equipment, aviation, renewable energy, data centres and music royalties. This will grow the market, diversify the issuer base, and create opportunities for investors. Most of that innovation has been in the US. Europe should seek to innovate in ESG related asset classes. ESG asset related securitisation levels are only 1.5% in Europe. In the US, the figure is 30%.

4.3 Adjustments to regulation could focus on increasing market efficiency and simplifying the reporting and due diligence requirements

A regulator emphasised that the UK's Financial Conduct Authority (FCA) continues to support the regulation that was put in place after the global financial crisis. however, now is an appropriate time to look again at whether regulation could be improved and help ensure securitisation markets work effectively – recognising that regulation is not the only factor influencing market activity. The aim of the FCA's initial consultation on securitisation was to start a conversation about change and see whether the regulation could be tweaked allow the market to work more efficiently. For example, questions were asked about reporting template, how they apply to private versus public securitisations and whether the obligations for private securitisations could be reduced. There was a discussion about making due-diligence requirements more principles based, including when investors are buying overseas securitisations. The consultation also made proposals for adjusting the securitisation market for non performing loans (NPLs) The FCA has received a considerable amount of feedback on issues that fell outside of the initial consultation which will be picked up in a second consultation in 2024.

An industry representative noted that, while regulatory capital has a major impact, it is not the only issue. The other requirements are also important. The European Central Bank (ECB) recently published a paper showing that the reporting requirements for securitisation contain 8,400 lines of text. No other asset class in Europe has this level of reporting. There are six different reporting requirements in Europe within the prudential requirements. This level of complexity must be reduced.

4.4 The regulatory burden should be consistent across asset classes

An industry representative highlighted the importance of realigning the regulatory framework across asset classes and introducing greater transparency to the market. At present, the due diligence requirements are excessively onerous. As an example, 5 billion of asset backed securities were sold within two and a half weeks during the UK pension fund crisis. Almost 90% of these assets were purchased by US asset managers. The European banks could not react to the market dislocation in a timely manner due to the due diligence requirements. They bought the appreciated asset backed securities, which were sold at a profit by the American asset managers.

A regulator agreed that there is a need to reduce complexity and drive down the cost of securitisation as a tool. Indeed, it might not be necessary to recalibrate the capital requirements as the current framework functions well. It might be possible to move to a system of state guarantees, similar to what exists in the US, but this is a decision to be made at the political level. The next step should be to reduce the level of complexity in the sector.

The Chair emphasised that securitisation is important because private risk sharing will be an absolute necessity in the years to come.

Sessions

VII

FINANCIAL STABILITY AND CLIMATE RISKS

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Financial stability in Europe: what are the main emerging risks?

1. Navigating an uncertain and challenging environment

1.1 High public indebtedness remains a key vulnerability in the EMU

A Central Bank official stated that the large fiscal support during the pandemic and the recent energy crisis resulted in higher public indebtedness in more euro-area countries. It has also directly translated into higher interest rate costs of sovereigns, although its pass-through to the average cost of outstanding debt has been relatively slow due to the earlier lengthening of public debt maturity.

Debt service-to-income ratios are being pushed upward, and pressure could mount if downside risks to GDP materialise. Treasuries have been working on extending the average maturities of their debt. Public debt levels are projected to remain above the pre pandemic level in the medium term. But there are many challenges for debt sustainability on pensions, healthcare, defence spending and climate change mitigation. It is vital to start fiscal consolidation without any delay. A key aspect is the right balance around flexibility on fiscal discipline.

Debt sustainability is at the centre of the political discussion. Calibration of country specific issues is vital, because the new rules take public investment and structural reforms into consideration. The intermediate target is under the control of the authorities and can have countercyclical features. Realistic programmes to adjust public debt are needed.

1.2 The corporate sector remains resilient

1.2.1 The corporate sector has been able to absorb the deterioration of its interest coverage ratio

The Chair highlighted the clear message around less fiscal space. Corporate credit quality has slightly been obscured by the fiscal impulses that were given through Covid and the energy crisis.

A Central Bank official stated that UK corporates have generally entered this period of higher rates and weak growth in good shape; net debt to earnings is at the lowest level since 2003. Greater finance has been provided through markets, typically at fixed rates rather than floating rates, which gives companies time to adjust. Insolvencies are at a decade high in the UK but are still well below the levels seen in previous recessions. Companies with low interest coverage ratios are expected to stay below previous peaks, but small and medium-sized enterprises (SMEs) are an area of particular concern.

Leveraged loan defaults have increased from 2% to 6% in one year. Although that is below the levels seen in the global financial crisis (GFC), it is high. Despite some pickup in the second half of last year, headline default rates in high-yield bond markets remain low. Market based finance requires refinancing. A great deal of refinancing is due in 2024 and 2025, and economic stress could be seen if that refinancing is not available. Commercial real estate is also an area of concern.

1.2.2 Corporate bankruptcies rose in 2023 but remained below pre-pandemic average

A Central Bank official explained that default rates in the corporate sector have increased, although it is still below the pre-pandemic level. There has been a decline in the interest coverage ratio, but the cash buffer was also large. Corporate debt is about 78% of GDP in France but corporate cash is about 32% of GDP. The interest coverage ratio takes time to decrease due to the loans' long maturity. The increasing interest rate initially benefitted the corporate sector because their assets were more liquid than the liabilities.

1.3 Residential real estate and commercial real estate markets are vulnerable to higher interest rates

1.3.1 Worrying signs in the global real estate markets

An industry representative highlighted worrying signs in the global real estate markets. Europe is in a much better state than Japan was in the 1990s, as its banks have more capital, more liquidity, transparency, and adequate safety nets. A potential risk is the time lag between what is happening in the markets and becoming aware of the scale of the problem and acting to remedy the situation. Europe needs to reexamine its safety nets and closely monitor the real estate markets to prepare for what may be coming.

The Chair noted that many jurisdictions have tried to implement a proactive macroprudential policy. Macroprudential buffers are now in place in most European jurisdictions, which have built resilience in the system. Inaction bias has to be fought on a daily basis. There is a public sector with less fiscal space, corporates with increasing risks, and an increase in insolvencies off historic lows and problematic real estate markets.

1.3.2 Firms operating in the commercial real estate sector face financing and income challenges

The Chair emphasized that the commercial real estate markets are correctly at the top of the priority list. The more private the markets, the longer it takes for valuations to flow through the system. Banks will have a much tougher 2024 than 2023, when the interest rate margin had been maximised and the credit costs had not been flowing through to a major extent.

A Central Bank official observed that the focus is the commercial real estate sector. Non performing loans (NPLs) are being examined, which is vital in a situation with high interest rates. NPL levels are stable, but there is

an increase in the consumer credit and commercial real estate areas at the same time as bankruptcies in the corporate sector are increasing. All in all it's probable that the asset quality in bank portfolios will deteriorate in 2024.

Commercial real estate borrowers have faced declining profitability, with higher interest rates reducing the income of specialised firms operating in this market and the value of their properties. The market is also adjusting to lower demand due to structural changes reinforced by the pandemic, such as shifts towards online shopping and working from home.

Commercial real estate accounted for 9% of the loan books of significant banks in Q2 2023, and less than 4% of those loans were classified as NPL. A very negative shock will cause spillover effects to other sectors. Portfolios in the commercial real estate market segment have a higher likelihood of facing debt servicing challenges than those in other market segments.

Work has been ongoing in leveraged finance. Increased risk has been seen as a result of the increased interest rate. Refinancing risk is increasing, and a number of banks have had to do significant write-downs. A few years ago the ECB introduced a leveraged capital add on, and in 2023 there was an increase in the number of banks who had a capital add-on on leveraged finance.

The Chair observed that some banks are much more exposed than others on commercial real estate and noted that that uneven exposure could potentially cause problems in a stress scenario.

1.3.3 The residential real estate market in many parts of Europe is heavily dependent on the economic trajectory

A regulator stated that real estate markets are the most complex ones, as they are driven by behavioural aspects of society, migration and macroeconomic perspectives. There has not been pressure on residential real estate prices in the regulator's country. The commercial real estate market is more rational because interest rates have a direct impact on prices and occupancy rates. Price drops have not been seen in the residential space. Continued pressure on prices in the commercial real estate segment might lead to substantial losses, so the banking system should be well capitalised to absorb them.

In residential real estate the interest rate environment is increasing pressure on debt capacity servicing, especially on passing interest rate risk from banks to clients, as many clients have used flexible mortgage rates. What is good for the banking system in terms of interest rate in the banking book is bad on the credit side, because the default rates might increase with falling prices and pressure on households. In some areas there is fear of spillover risks coming from other markets, in particular from the non bank financial institution (NBFI) sector.

The Chair observed that the residential real estate market in many parts of Europe is heavily dependent on the economic trajectory. Avoiding deep recessions will avoid unusual amounts of default. A deep recessionary scenario is when the volume effect of the residential real estate markets can play an important role. Inflation is impacting households, but they are still benefitting from wage rises.

2. Addressing macroeconomic environment impact on banks and non-bank financial intermediation

2.1 The resilience of the EU banking sector

An industry representative highlighted that interest rates in the euro area have gone from -0.5% to 4%. Banks are well capitalised, liquid and able to lend. The origination spread for banks has never been tighter. The margin of banks is tight, which means there is competition, capacity to lend and liquidity to lend. The lending growth of eurozone banks had trended at 3-4% until 2022, but it has flatlined or declined. Certain sectors are continuing to increase but other sectors are facing challenges. The area where banks are very concerned is commercial real estate and the fact that they require refinancing.

A Central Bank official stated that supervisors have to be vigilant even if. Europe has resilient banks that are well capitalised, the liquidity buffers are at good levels, and the quality of the assets are good. Banks have also been through a number of external shocks in recent years and have been resilient.

A Central Bank official explained that French banks have been very resilient due to limited exposure of the sectors that are most vulnerable to an interest rate increase. French banks are diversified and have large capital and liquidity buffers that were accumulated prior to the interest rate shock. France has a sectoral systemic risk buffer for exposures to highly leveraged large companies. Borrower based measures are in place for house credit, which keep French default rates extremely low. If credit is extended it is based on the income of the borrower and on fixed rates, not on a loan-to-value (LTV) ratio. Net interest margins are quite small, and in France they have not yet benefitted from higher interest rates. There has also been a reallocation of deposits towards interest-bearing deposits.

The Chair observed that the message is 'so far, so good', but that relies on valuations which are going to be under pressure in certain sectors. The impression is that market valuation corrections are done quickly in the US but not so quickly in Europe.

2.2 It is challenging to mitigate financial stability risks in this deleveraging context

A Central Bank official pointed out that risks are difficult to translate into concrete actions. Indebtedness ratios in the Spanish private sector are at their lowest for more than 20 years. The private sector, households and corporates are deleveraging, but it is hard to understand what will follow that. Work is needed to understand the underlying revenue streams that will repay the loan. It is vital to be mindful of the situation of each country. Real salaries have increased and recovered in the eurozone. The profits of corporates are buoyant, so it is hard to see a significant accumulation of NPLs in the short term. It is important to strengthen the collaboration between the micro supervision and the macro authorities, and to cooperate with bankers, because they need to continue lending to the economy. Good underwriting standards need to be maintained.

The Chair agreed that the current resilience in banks is going to be tested.

2.3 Supervisor and regulator concern around NBFI

A Central Bank official stated that supervisors and regulators are concerned about NBFI because the combination of leverage, liquidity and interconnectedness is toxic. The Banque de France has conducted risk mapping for the banking sector from NBFI. Direct risk is currently quite limited; NBFI in France is smaller than in other countries, but due to data gaps the cross border exposure is not precisely known. NBFI is about 10% of French bank assets and about 17% of their liabilities. Fire sales would have an impact on market valuations and is the trigger for derivative markets, margin calls and risks through the real economy.

So far there has mostly been microprudential regulation in terms of liquidity buffers or liquidity management tools. The system wide stress test that is carried out in the UK is a useful innovation. There could be examination of macroprudential entitlement to activate liquidity management tools and to fill data gaps, but those gaps will not be filled if there is no pressure of regulation.

The Chair agreed that there are unknowns in that space, and some underestimated 'knowns'.

A Central Bank official agreed that the combination of leverage, liquidity and correlations leads to stress. When looking at data on individual entities there is no sense of how there might be a market wide stress. The UK is conducting a system-wide exploratory exercise, which is designed to stress test in the good times to see the potential for where resilience needs to be built in advance of the bad times. Market based finance is half of the financial system and has led to the extra financing that the corporate sector has seen since the global financial crisis (GFC).

The Chair observed that in the credit crunch there had been a lack of availability of market finance, which is going to turn on and off quicker than relationship lending out of the banking sector.

An industry representative stated that NBFIs play an important part in the financing of the economy. The industry needs to obtain more data around NBFIs. It is important to recognise the benefits such as diversification and business opportunities that NBFIs could bring to the financial ecosystem; any regulatory efforts need to strike the right balance between those potential benefits and risks. It would be appropriate to adopt an activities-based approach to non-bank risks, rather than an entities-based approach.

If regulators and policymakers are to take steps to address the risks, they should not surprise the markets. Predictability is needed. For example, a number of decisions have been unpredictable, such as taxing banks on an ad-hoc basis and reducing their ability to generate capital.

2.4 Addressing deficiencies in the frameworks that banks have in place for internal governance, managing credit risk and for operational resilience

A Central Bank official observed that work needs to commence with the macroprudential authorities, because 60% of the commercial real estate sector is financed by investment funds. More data and more cooperation is needed. The ECB published its priorities at the end of December. The near perspective is very important, in order to ensure that banks identify issues early and measure their risk and provision. Banks need to be able to manage the present economic downturn and the uncertainty around geopolitical risks. There is a focus on credit risk, liquidity, funding and interest rates in the banking book.

The ECB's second priority is governance. Risk aggregation has been a Basel core principle for 10 years but banks are still not fulfilling it. The ECB is also focusing on climate and environmental risk. If banks are not fulfilling supervisory expectations the ECB will use its escalation ladder and potentially proceed to enforcement. The ECB's third priority is operational resilience. Third country providers are important, in order to ensure that banks understand the risk. Most banks are digitally transforming their business models, which will lead to sustainable business models in the future.

The Chair noted that there is an increasing stability risk in the IT environment.

A regulator stated that capital is at the centre of the stress test and the Pillar 2 requirements, but there are areas of activity on a microprudential level, especially with regards to internal ratings based (IRB) banks. The regulator's organisation wants to look at what capital levels they produce, add multipliers to those Pillar 2 requirements, and correct the outcomes of the models, if needed. Much can also be done in the governance area by monitoring exceptions to policies and challenging banks on deviation from those policies.

A consistent implementation of Basel III is needed. The regulator's organisation appreciates the more stringent guidance on loan-to-values and debt service capacities requirements. When Basel III is introduced there will be more risk sensitivity in the system.

The Chair agreed that a consistent and stringent implementation of Basel III is needed.

An industry representative disagreed with the Chair's assertion that too much has been distributed out of the banking industry in good times, as the market will adjust as long as the frameworks are clear. The cost of equity for banks remains extremely high due to the predictability of regulations.

An industry representative noted that there is a problem with indirect exposure. The world is so interconnected that there are bound to be blind spots such as derivatives or structured products. Preventing regulatory arbitrage is vital, particularly in benign times. Housing loans made by NBFIs or any other type of finance are innovative, but previously, regulatory arbitrage has always produced gaps and blind spots.

Thought is needed about how to replenish liquidity before it is too late. It is vital that central bank liquidity is available for solvent banks with sufficient qualified collateral. The other task is to replenish capital; Japan has coped with public funds, but other things can be done to facilitate it. Additional Tier 1 (AT1) instruments could be used, with a caution around investor suitability.

NBFI risks: are further measures needed?

Introduction

Non-bank financial intermediation (NBFI) comprises investment funds, insurance companies, pension funds and other financial intermediaries. The NBFI sector has grown to almost half of global financial assets, worth around $218 trillion in 2023, and has become more diverse. As a result, the importance of NBFI for the financing of the real economy has increased.

Within the eurozone, the growth of NBFI sector accelerated after the global financial crisis, doubling from €15 trillion in 2008 to €31 trillion. The share of credit granted by NBFIs to euro area non-financial corporates increased from 15% in 2008 to 26% at the end of 2022. While they are differently regulated than banks, the EU is advancing the process of enhancing their prudential requirements (AIFMD, UCITS, IORPS, Solvency II). Nevertheless, also in the EU, NBFI intermediaries can continue being a source of or an amplifier to risks to financial stability, as the sector often combines liquidity, maturity mismatches and leverage.

The Chair remarked that the aim is to build up and support markets, and to ensure there is resilience and sustainability. Markets should develop, but there should not be reliance only on banks in the European Union and Europe as a whole.

The first part of the panel discussed the importance and the main challenges raised by non-bank financing. The second part was dedicated to the main risks stemming from non-bank financial intermediation and the ways to address them.

1. The features and challenges of NBFI

1.1 The rapid growth of NBFI

An official emphasised that there is a large amount of heterogeneity within the NBFI bucket. The NBFI sector is mainly composed of the other financial intermediaries, including hedge funds, money market funds, other investment funds, among others. According to FSB, these other financial intermediaries constitute 64% of the NBFI sector, pension funds are 19% and the insurance sector is 16% at year-end 2022.

An industry representative noted that Europe is behind the US in terms of where NBFIs are. Harmonisation and more unification around language, culture and legal aspects are needed for capital markets to develop. Capital goes where there is a bigger chance of returns and clarity of gain. The more complex the regulatory structure is, there is more opportunity for arbitrage, which is credit negative for the system. There is also less capital provisioning, because less capital will flow there. What is needed is clarity in terms of regulation, the intentions of the players and their role in the economy.

Provisioning into non-financial corporates by banks is only 20% in the US. In the 1980s, it was 60%. Finance companies, the collateralised loan obligation (CLO) market, business development companies (BDCs) and other private credit funds fill the space between those percentages. Meanwhile, Europe is at a roughly 52% bank market as provisioning capital. It is more onerous for banks when they have to retain that capital rather than distribute it. There is less capacity on the bank side to provision capital on a regular basis. However, it could be a demand issue rather than a supply issue. Diversification of supply and capital for different purposes is good, to avoid having the same type of risk on banks' balance sheets.

Moody's is focused on private credit[1]. Private credit is almost the same as NBFIs. NBFIs can include pension funds, insurance companies, securities firms and funds of any kind. The focus is on provision of capital by non-banks to non-financial corporates. The private credit market is deemed to be around $ 1.7 trillion, up from 500 billion a few years previously.

1.2 The benefits of NBFIs

A Central Bank official highlighted that there are some areas where bank lending is not the right tool. There are some areas where non-bank lending is a substitute for bank lending. There is a stabilising nature to non-bank lending, so participants can come into markets in stress. Much of non-bank financing is fixed rate than floating, which has helped to smooth the impact.

A Central Bank official suggested that direct landing was an important area to develop. NBFIs could create viable alternative financing options for small and medium-sized enterprises (SMEs). Another viable option for the non-bank financial sector is financing the transition to a zero-carbon economy and the digital transformation.

A Central Bank official remarked that the non-bank sector in Europe is an enormously significant and potentially hugely beneficial asset. NBFI brings many

1. Private credit is non-bank lending to mostly private-equity-owned, middle-market companies that are not publicly traded or issued. European private credit has been growing fast over the past several years. Some market participants define private credit differently, classifying it as a ~$40-trillion market comprised of private, largely investment grade assets spanning a range of asset classes.

benefits. Enhancing capital markets broadens financing channels, reduces reliance on traditional banks to fund businesses, creates jobs and enables investors to access financial products that meet their savings and investment needs while also diversifying their portfolios.

1.3 The challenge of quality data

A Central Bank official emphasised the need for data. The non-bank sector is global, interconnected, and diffuse, which necessitates international approaches. There have to be definitions, metrics and modalities for sharing data. Within Europe there is a single set of requirements, and the data situation is relatively good, but there is still more to do, particularly on the differences between regulatory reporting and statistical reporting.

A Central Bank official remarked that there is too much to monitor, not enough of the right data, and the data cannot be added up across borders. It is very difficult to know whether multiple banks are exposed to the same types of NBFIs, which is true even for the banks themselves. It is also difficult to get data on, or to be able to understand how risks will evolve under stress in the non-bank sector. The fastest growing area is private equity and private credit, which is where the least data is available.

An official noted that the BIS has identified some non-bank financial intermediaries and is focusing on open-ended funds (OEFs) because there is information there. However, there is a large area with very little information. The capacity to process the data is being built up. The European Systemic Risk Board (ESRB) has invested a great deal.

An industry representative noted that their firm, which is principally in credit and insurance, wants to provide data, but it is difficult to know who to provide it to and in what format. NBFI is a relatively new category, and it is not well defined across sectors. The infrastructure is set up with different terminology, different companies and different types of risk.

1.4 Potential systemic risk implications

A Central Bank official commented that the risks in the non-bank sector are different from those in the banking and insurance sectors. In investment funds and the asset management area, the risks are specifically around liquidity mismatch, leverage and hidden leverage, and the interconnection with the broader financial sector.

An industry representative remarked that the development of private credit has been very helpful recently, particularly as capital markets shut down in the leveraged finance space in the US. However, as asset managers continue to grow their private credit portfolios, their investment, risk management and funding decisions could reverberate more strongly throughout the financial system and the broader economy. Asset managers are typically subject to lighter prudential regulatory oversight than the banking sector, and there is a lack of transparency about the growing importance of the financing they provide to the real economy. As a result, it may be difficult to see where bubbles of risk are forming. Although liquidity risks are modest, considering the absence of overnight liquidity demands for these funds relative to the liquidity difficulties of risky structures formed in previous cycles, banks are still the largest lenders to private credit funds, and therefore the linkage with the banking system should not be ignored.

2. There is still much progress to be made in tackling the risks associated with NBFIs

2.1 Getting appropriate information for understanding of the whole underlying chain in NBFIs and identifying where the risk lie

2.1.1 Identifying where risks reside

An industry representative noted that the first consideration, in terms of where risk resides in the financial market, is structural risk, which means asset and liability management (ALM). Policymakers are thoughtful in identifying the acute risk of liquidity runs in vehicles that were not historically prudentially regulated, such as funds.

For leverage, there is significant focus on how much leverage is in the system, but there also needs to be focus on the quality of leverage. Is it term funded? What is the optionality? Is there collateral? Is it daily margin? Things that are good for the borrower are bad for the lender; things that are good for the lender are bad for the borrower. It is a zero-sum game. Therefore, there has to be diligence in the market. The commercial activity from NBFI, inclusive of insurance, provides a level of diversification and resilience, but it needs to be better understood.

A Central Bank official stated that the question is about who to worry most about at the current juncture. One approach is to ask which participants on the non-bank side have not fully adjusted to the new interest rate environment and what is still to come through in terms of higher interest rate transmission. That means the corporate bond market, private credit, private equity and real estate. The second approach is to ask, in a world with much more risk of volatility and liquidity risks crystallising, which participants are most exposed. In the UK, work is being carried out on system-wide stress testing, involving 50 participants from across the market, and looking at how stresses evolve in the sterling rates market. Many participants are quite well buffered currently in response to past stresses. One question is how to lock in some of that protection.

2.1.2 The links between banks and non-banks

A Central Bank official highlighted that there is extensive literature on the cases that shook the financial markets in recent years: such as the collapse of Archegos in 2021, and the fire sale of UK gilts by investment funds using liability-driven investments (LDIs). Three underlying problems can be identified:

poorly managed and excessive leverage, defects in the governance structures and a lack of transparency.

It is vital to have an understanding of the magnitude and exact nature of the interlinkages between the NBFI sector and the traditional banking sector. The Capital Requirements Regulation 3 (CRR3) is a major step forward. However, further enhancements are needed.

A Central Bank official remarked that non-banks are playing a bigger role in markets intermediation and core markets compared to before the global financial crisis. Banks' footprints have not grown as markets have grown. Non-banks also play a great role in direct lending to non-financial organisations. In the UK, it is about 50/50 non-bank financing versus bank financing. Since 2008, all of the net increase in corporate financing has come from the non-bank sector. There can be an amplifying effect as well. Leveraged participants will go the other way in stress. They will have to step out of markets, and some non-bank participants are quite leveraged.

An industry representative stated that the regulation proposed by the International Organization of Securities Commissions (IOSCO) has been very helpful in terms of thinking about the underlying illiquidity of an asset and the kind of funding it matches. Liquidity risk and mismatches can apply to any asset class or any financial institution. Around 450 to 500 billion of the private credit market (estimated at 1,7 trillion) is in Europe. Having good transparency and regular evaluations is very important. When a bank's line of reporting says exposure to non-bank financials, having an exposure to a mortgage lender that lends traditional mortgages to Fannie and Freddie is very different from commercial real estate that is leveraged six times.

It would be very beneficial for the system to understand matters from the bank's perspective, break down the NBFI line and understand how much is private equity, how much is hedge funds or CLO securitisation of vanilla assets.

2.2 Mitigating the risks

2.2.1 The potential systemic risk posed by investment funds

Thie Chair stated that the Alternative Investment Fund Managers Directive (AIFMD) was recently finalised. A Central Bank official remarked that the objective, in dealing with the risks, is the collective outcomes of activities. How funds act together in a crisis, or a stressed situation, is a collective problem. The risks are very flow-type, so it is very dynamic. They are also heterogenous and include leverage, liquidity mismatch, and excessive risk taking at an aggregate level across the financial system. Concentrated and over-lapping market positions can lead to spillover effects to other parts of the financial system and real economy, but they have also been instances where a single entity has caused a systemic event.

In February/March 2020, the first mover dynamic very clearly emerged in high-yield funds. If matters had not stabilised, that dynamic would have led to a spiralling effect in those asset classes. Stress would not be expected in gilt markets and liability-driven investments, but it was seen because of the high levels of leverage.

The issue with liquidity risk is the mismatch between assets and liabilities. The specific nature of that concerns the first mover dynamic. In the funds context, when there is daily dealing around less liquid assets, there is first mover advantage to get out, and that creates the dynamic of systemic risk.

The FSB and IOSCO have spoken of the importance of liquidity management tools that work, and about requiring a degree of matching between the liquidity of the assets and the redemption requirements. If liquidity management tools can work better, and swing pricing can be well calibrated, not only to individual funds but also in the collective context, then the situation would be better to address some of those, somewhat crude, measures.

2.2.2 Liquidity risks in open-end funds (OEFs)

A Central Bank official stated that the OEF space should have the benefits of investing collectively with the experience of investing individually. What should be avoided is a situation where, if other investors leave a fund in stress first, they get a better deal than those after them and are not paying the price of the liquidity that they should be. The risk in the fund sector is greater where the mismatch is greater, where the assets are less likely to be liquid, particularly in stress. The risk is also greater where there are fewer tools to ensure that investors pay the right price for the liquidity.

The FSB has done well by focusing on two elements. One is making sure funds categorise where the risk is likely to be bigger, and the other is making sure that funds have a set of tools to price the liquidity. However, some jurisdictions do not have all of the tools, and some funds do not have all of the tools in place. Where they do have the tools, they might not be using them to the best possible standards; there is divergence across the sector in terms of best practice.

An industry representative agreed that significant structural risk exists in open-end funds. Funds have $10s, sometimes $100s, of billions in longer duration assets while offering daily investor liquidity. Even the best risk overlays may be outmatched when faced with a structural liquidity mismatch such as this. Policymakers are understandably reviewing regulatory measures, including enhancements to risk management, swing pricing and fund reporting.

2.2.3 Enhancing the resilience of OEFs and money market funds

An official stated that there has been significant progress in terms of the two very deep reports on the risks that OEFs and money market funds are exposed to and the policy options to address those risks. One major step that lies ahead, and something that was learned from the banking regulations, is that after agreeing on what good policy options would be, there should be a peer review to take stock of which of the options have been implemented. The money market fund reform assessment is currently ongoing, and for the open-

ended funds one will have to be completed in 2026, and then in 2028 there will be an assessment.

It is very important to ensure that entities manage their liquidity risk, but they cannot be asked to manage systemic liquidity risk. Something that has been seen in the liquidity assessment of investment funds is that each individual fund manager takes a very prudent look at the liquidity of the portfolio, but it is not known what the others are doing, and they cannot anticipate what everyone else will be selling at that particular point in time. This is where the systemic dimension needs to come in, and that is where there will need to be much more progress on the policy side, in order to develop clear expectations about what can be done, and to come up with tangible results.

The recommendations at the international level will always only be minimum standards. There is a clear expectation that, at the jurisdiction level, they are topped up to fully address the risks that are specific to the relevant industry.

The Chair suggested that money market funds are the most important issue to address. Europe has to do better with them. A Central Bank official replied that, in their jurisdiction, few matters cause as many headaches for the population and policymakers as real estate investments. A considerable portion of the population still believes that real estate is the safest possible investment. Something has to be done about that. Effective and usable liquidity management tools are needed for the real estate investment funds.

A Central Bank official added that the Commission's macro-prudential review has three key items: the implementation of the FSB recommendations mentioned, money market funds and buffer usability.

A Central Bank official stated that policy development has occurred twice with money market funds and OEFs. There is a need to move forward and show that can be implemented nationally.

2.3 Addressing insurance risks in a changing world

2.3.1 The IAIS's Global Monitoring Exercise (GME)

An official detailed that insurance is well-regulated and has a large amount of data available. In many jurisdictions, there are public disclosure requirements. There is the IAIS' global monitoring exercise, as part of its systemic risk framework, which is data driven. Data is collected from 60 of the largest internationally active insurance groups, as well as from IAIS member supervisors. Interconnectedness is a key component of the global monitoring exercise.

Areas for improvement were identified in the IAIS' Global Insurance Market Report (GIMAR) report. There are two specific structural shifts for which monitoring will be strengthened going forward. The first is the increased shift to alternative placements such as private placement and structured products, and the second is the increased use of asset-intensive reinsurance, which will mean a change to the liquidity profile of insurer balance sheets. For both, the monitoring will be enhanced, to support global supervisory discussions.

2.3.2 Insurance sector resilience

An official remarked that the IAIS has assessed, in its global monitoring exercise and GIMAR report, that the insurance sector has proven to be resilient in recent years. There are solid levels of capital adequacy and solid liquidity ratios. However, in the previous year's GME, there were slight declines in liquidity positions and solvency positions. The sector is still very resilient, but it is not immune to movements in financial markets. Key risks are interest rate and inflation risks, credit and liquidity risks, cyber and climate risks, and geopolitical tensions.

2.3.3 Higher credit and liquidity risk for insurers

An industry representative noted, regarding the concept of illiquid assets and where they are best housed, one of the benefits of the private credit funds, particularly the largest and most established ones, is that they are funded with permanent capital, and, if there is leverage, it is well-distributed. If there is bank leverage, it is not single bank reliance. An investment grade rating cannot be achieved for a debt fund that, by nature, has illiquid SME-leveraged assets, unless it has characteristics of this kind. Permanent capital is critical. Regulation should match those characteristics.

Insurers gain incremental returns by moving into higher-yielding private investments that, while largely structured as investment grade assets, include more speculative investments. However, the increased yield also brings higher credit and liquidity risk. The insurance capital charges that were introduced after 2022, to increase the capital charge and assume a 40% run of policies, was a particularly positive step. Permanent capital, particularly for insurance companies that have more long-term liabilities, might be a good match for these assets. However, it has to be well-structured.

There was a firm in Italy, that experienced, a run-on policy withdrawal (Eurovita). There was low capital, high investment risk and a bad distribution channel. Insurance companies can indeed run. In particular, in a higher rates environment, there is greater competition for competing products. That risk is well managed in Europe.

An industry representative remarked that it is rare for an insurance company to have a run, but it is nonetheless possible. His firm spends a great deal of time on product features, surrender charges, market value adjustments and taking into account tax disincentives, because it has long-term guaranteed products. It has highly stable products relative to some policies. It also has non-surrenderable policies, which account for about 25% of its portfolio. It does not use private credit in its liquidity stress assumptions, which is an advisable approach. Products are tailored to target assets to the extent possible. However, that type of thinking has to occur both at a company level and a supervisory level, to ensure there is a rational insurance company that is taking good risks for policyholders.

Although not all players do that, it is a micro-prudential issue on the liability side for supervisors to

understand exactly what is going on in each individual company. At the macro level, the European Insurance and Occupational Pensions Authority (EIOPA), national regulators and the National Association of Insurance Commissioners (NAIC) in the US have had a significant focus on this in the last year, as a result of mass lapse assumptions. A mass lapse is the equivalent of a run on an insurer.

On the asset side, the markets are not necessarily what they used to be. There have been treasuries and gilts with low liquidity. Dealer bond inventories are at an all-time low. Corporate bond issuers are concentrated in massive companies with fewer issuers than is assumed. Liquidity is a relative term, though private credit is less liquid than treasuries. There has to be particular focus on the liquidity of the assets paired with liquidity of the liabilities.

In other words, product design and ALM are not the end of the story. The investments for funding liquidity demands are also subject to a range of factors impacting liquidity risk. Certain asset types may no longer be as liquid, and therefore as reliable, for stress situations as they once were. As seen in the UK LDI situation, market illiquidity can occur with assets that are considered the safest and most liquid.

2.3.4 Measuring liquidity risk

An official agreed that a run on insurers is a key liquidity risk to monitor and manage, both on the insurance company side but also on the supervisory side. For insurers, it is very important to establish robust governance of liquidity risk, to monitor and stress lapse risk, and to also develop effective contingency funding plans. It is equally important for supervisors to ensure that they have the necessary tools in place, for instance, to be able to step in if a mass lapse risk occurs, so that they can temporarily pause that event and allow the insurance company time to come up with the liquidity sources to meet the liquidity needs.

A second liquidity risk to which additional attention has been paid is the risk of margin calls. Derivatives exposures are quite heterogeneous across insurers. Some have almost none; others have more significant exposures. If an entity has more derivatives exposures, it makes sense to make sure that, in its liquidity risk framework, it takes into account potential liquidity outflows from margin calls in the form of additional cash or collateral postings.

The IAIS has been focusing extensively on liquidity risk over the past years. In 2022, it developed liquidity metrics, which consist of an insurance liquidity ratio (ILR), where the liquidity sources are compared to the liquidity needs, including under stress, and it has taken an asset/liability perspective, with asset/liability matching and management. Secondly, the IAIS liquidity metrics consist of a cash flow approach, whereby the cash inflows versus the cash outflows under stress are mapped. As an integral part of its standard setting work, in the insurance core principles there are also specific standards that address liquidity risk, with a focus on governance and liquidity risk management, for example.

An official highlighted the importance of asset liability management and stress testing for all of the NBFI sectors. An industry representative stated that there should be clarity around private credit concerns from policymakers. An industry representative (Ana Arsov) added that there should be more clarity around banks' exposures to NBFIs.

Sustainability risks in the banking sector

Introduction

The Chair stated that climate is a global issue that demands global solutions and international cooperation. The financial industry is at the centre of this challenge. Both industry and supervisors are trying to find concrete solutions to improve the assessment and management of climate-related risks that could fuel major global financial crises.

1. Banks' journey to address sustainability risk is far from finished

1.1 Banks started embedding sustainability risk in disclosures, decision-making processes and customer interaction. Further improvements are necessary, however, on data, risk coverage, measurement, and transition planning, while operationalising sustainability risk approaches in day-to-day as well as strategic decisions across organisations raises unprecedented challenges

A regulator emphasised that this is a process in which European society can provide a strong push. There is a perception that Europe is arriving too late to this problem, and that there is a need to do more and to act more quickly.

There have been improvements in the banking sector over the last three years. Sustainability concerns have been considered at all governance levels within institutions. Many institutions already have sustainability committees and are addressing sustainability issues. They also consider ESG risks when they address customers. Institutions are enhancing disclosures. In early 2023, some Pillar 3 requirements were put forward. A substantial amount of regulatory work on disclosures is being put forward and will need to be implemented. The International Sustainability Standards Board (ISSB) is working on international disclosures.

However, all these areas require enhancement. It is necessary to enhance modelling techniques and risk measurement methods, with appropriate integration into the day-to-day management of institutions. The ability to obtain relevant data from counterparties must be enhanced across the whole of society. The Pillar 3 disclosures contain a green asset ratio that addresses only a very small part of the banks' activities. For other activities, there is currently no methodology available to assess banks in terms of willingness. Risk modelling is very important. The European Banking Authority (EBA) is working on guidelines for stress testing on climate risk and sustainability. As this is further built into the regulatory framework, it will be important to use forward-looking data methodologies.

A Central Bank official observed that it is now clear that the current global path on climate is not sustainable. The ECB's main concern is to operationalise the consciousness of problems that banks already have. In banks, operationalising is about money and real-life decisions. The ECB is trying to push banks forward on the assessment of materiality, risk frameworks and strategy.

There is currently no requirement to have a transition plan. Transition planning serves a wider economic purpose. The ECB's minimum requirement is for risks inherent in the transition to be measured. In the ECB's recent appraisal, published this year, it was observed that many banks are not yet trying to construct proxies of their portfolios to see how they evolve. Progress is needed here, independent of legal obligations to conduct transition planning.

1.2 Learning by doing and disseminating good practices are the best approaches promoted by the ECB to progress

A Central Bank official stated that the ECB is trying to lead by example. It has published an example of methodology. The purpose of this is not to be prescriptive; rather, it is to be transparent about a possible approach that has been identified. This is a frontier that the banking system will need to cross soon. Dialogue is the ECB's first approach. If dialogue does not result in delivery, then pressure will be exerted.

1.3 However, global standards are necessary

An industry representative stated that further work on operationalisation is needed. Climate risk cannot be addressed through local solutions, so the EU needs to help drive global standards.

2. Climate risk and a net-zero transition plan are becoming core management features

2.1 Climate risk and a net-zero transition plan clarify key dependencies and external factors essential for banks cooperating with both customers and policymakers

An industry representative commented that banks are now trying to understand the financial implications of climate risk. This analysis will feed into strategic decision-making processes. In working on climate risk and the net-zero transition plan, several key

dependencies and external factors have been encountered. Future emission reductions will not be linear. There may be an increase in financed emissions in certain sectors. Supporting customers through cooperation, financing and dialogue is key. Collaboration and engagement with public actors will also be vital in ensuring a successful transition.

An industry representative observed that transition plans and climate risk are becoming core concepts for all managers of banks.

2.2 The challenge for banks is to combine the mitigation of sustainability risk with an appropriate contribution to the net zero transition of the real economy. Supervisors should better understand related constraints

An industry representative stated that the risk management function should enable transition risks to be identified and quantified. New measurement tools will allow risk appetites to be appropriately set, preserving financial stability. The objective of transition planning and climate risk management should not be conflated with the work on transitioning the real economy. Climate risk should be approached similarly to other drivers of traditional financial risk.

Financed emissions or scope 3 are important data points to consider, but this is to understand a bank's focus on transition planning and to understand where the key climate risks are. Financed emissions should not be used as a proxy for climate risk. Transition finance is needed hard-to-abate sectors decarbonize, which might mean financed emissions increase temporarily. This can be done with confidence if the risks are well understood, and the risk profile is appropriately set.

Banks have a unique role to play, as they are in direct dialogue with clients and understand the challenges faced by clients in different jurisdictions. Banks need ongoing dialogue with their clients to understand whether transition plans are ambitious enough and whether transition risks are being managed. Transition planning is an important risk framework; on the other hand, the important activity that banks need to undertake is around supporting clients through transition in a safe manner.

Given the significance of the problem, all actors need to come together. Banks have a responsibility to navigate the process safely, working with regulators and supervisors. Banks have an important role to play as enablers of this process, mobilising private and public capital. Banks need to have well operationalised, well developed risk frameworks.

2.3 Banks are improving transition planning by doing; however, a more global and consistent approach is necessary, which should factor in that the road to net zero is not linear, and that flexibility and realism in banks' transition planning is important since transition plans have to feed into banks' day-to-day lives

An industry representative stated that MUFG will publish its first global transition plan in April. This is a continuous process, based on intense dialogue with clients. The more the standards and methodologies are applied globally, the more effective banks can be in ensuring that transition plans provide all necessary information. The transition plan needs to be further hardwired into the core risk management mechanism.

An industry representative commented that DNB's transition plan was launched in October 2023. This is an important strategic tool in understanding the business implications of the net-zero transition. In the transition plan, DNB has set science-based targets covering around 70% of financed emissions in its lending portfolios. Targets have been set for asset management activities. There are several relevant external factors. A balance must be struck between a fast and a just transition by considering the impacts on nature and human rights. The impact of climate change will vary across the world, as exposure to high-emitting sectors differs substantially between countries and regions. Energy security must be considered throughout the transition. The road to net zero is not linear, so flexibility in banks' transition planning is important.

A Central Bank official stated that the transition plans of listed companies should be strategic and cohere with ambitions. The transition plans of banks should be risk-oriented and acknowledge that greening the economy means working with sectors that are not yet green.

A consumer representative commented that transition plans are important strategic and risk management tools, giving information about a bank's portfolio and potential transition risks. They can also provide important supervisory information. For transition plans to work, they should focus on mitigating the transition risks inherent in client business models. Client engagement should be credible, following up on stated ambitions. Speaking about transition plans as one disclosure and risk management tool is important to contextualise emission metrics. A baseline is needed for how transition plans should be built and which scenarios to use, so that banks' performance can be credibly compared.

A regulator emphasised that transition plans are operational tools.

A Central Bank official stated that plans need to be consistent and operational in day-to-day life.

3. Defining realistic and useful stress scenarios is challenging

The Chair noted that several stress tests have been implemented. Progress has been made in the definition of scenarios and the refinement of approaches. Such tools are essential to enhance the forward-looking elements of the prudential toolset.

A Central Bank official stated that stress testing should be about the real economy. It must be recognised that the materialisation, measure, and timing of the impact is subject to substantial uncertainty. Some modesty is

necessary. The purpose of scenarios is to get as close as possible to reality. Even though stress testing is forward-looking, it is often based on historical data. Trying to imagine scenarios and get as close as possible to the what-ifs is often more thought-provoking than conducting an administrative exercise.

3.1 Various stress scenario shortcomings need fixing: data availability, interconnectedness, the consequences of protection gaps, while preserving workability and banks' agility

A Central Bank official observed that there are still shortcomings relating to scenario exercises. Data availability is still an issue, although this is improving. It is questionable whether second-order effects and interconnectedness across the financial sector are truly being integrated. In countries where the protection gap in insurance is large, banks might be confronted with the results of the absence of enough insurance in another part of the financial sector. These elements may not be sufficiently integrated in scenarios.

There is another flaw that organisations like the Network for Greening the Financial System (NGFS) are working on. These exercises usually have a long-term focus. They work by considering static balance sheets, assuming that banks are not going to react and that all incidents will occur instantaneously. In reality, balance sheets are likely to adapt. Combining a long-term scenario with short-term assessments might significantly improve these scenarios.

An industry representative stated that opportunities will emerge as banks get better at measuring risk and advancing the available toolkit. The current formats are not perfect, as nobody has yet lived through the climate transition. To play a role in enabling the real economy to transition, banks need to be good at measuring and managing risks. Agility is needed to respond to new insights. MUFG has produced two Japan-focused white papers, leading to many insights about transition pathways, the challenges faced by clients, the technology needed to resolve issues, and the associated risks. The stronger the risk toolkit is, the more confident banks can be about helping the real economy to transition.

3.2 At present, some consider that existing stress scenarios give an inappropriate sense that climate related risk is benign. Yet climate related stress scenarios should address various challenges: banks' dependence on transition policies, an uneven assessment of these risks which lacks comparability, the short-term focus of bank management

A consumer representative stated that a radical rethink of the approach to climate scenarios and stress testing is needed. It is important to continue working on these scenarios, while also recognising that climate and economic systems are highly complex. It is not easy to build a model that incorporates everything, given the problems with collecting data and reflecting complex interactions between the environment, economy, and the financial system. The scenarios conducted to date clearly concluded that timely actions are needed to address climate-related risks as the cost of inaction clearly outweighs the cost of timely action. The actions that would facilitate a timely transition would be better for financial stability than delayed or no action. However, the predicted losses to the financial system from those scenarios are benign. This has led to a false sense of security.

Fundamental flaws in the scenarios have been identified. The scenarios used by the NGFS are based on the economic models put in place to analyse traditional financial risks, which are, however, not suitable to analyse economic effects of climate change. These models usually assume general equilibrium in the economy, which will not be the case if the world is disrupted by climate change.

One example is the damages assumed in the economy because of climate change. Most models use the quadratic damage function, so losses are assumed to be quadratically dependent on the rise in temperatures. This leads to the conclusion that, by the year 2100, a rise of 3.5 degrees Celsius will lead only to a GDP loss of 7% to 14%. This is clearly at odds with what climate scientists are saying. Most scenario analyses exclude the gravest impacts of climate change such as sear level rise, extreme weather events and mass migrations. If the estimation of the cost of action versus inaction is not rethought, there will always be a tendency towards inaction or milder measures.

A lot depends on governments. Leaving institutions to navigate uncertainty and provide measurements is not sufficient. Many meaningful climate-related risk management principles with meaningful frameworks. These principles stipulate that risks must be identified and then either be mitigated, or there must be adequate capital to bear the risk that cannot be mitigated. This is the basic framework for banks. However, in the case of climate-related risks individual institutions lack the capability to apply this basic framework. Climate-related risks will also be systemic so it is important to turn to the tools that can address this issue, and address short-termism, which prevents the incorporation of climate-related risks into today's decisions. If all banks continue to delay acting, the risks in the system will remain.

There are macroprudential tools that are designed to address these challenges. In the banking sector, these tools are well defined and able to prevent the build-up of future risks, although there are still many questions regarding how these tools should be calibrated. It is clear in which sectors there will be concentrations of exposures that will be subject to high transition risk. Metrics on alignment are also very important. Work should continue evolving the macroprudential framework to account for the need to use forward-looking information and to establish robust methodologies for transition risk metrics. In case of credit risk, probabilities of default (PDs) and loss given defaults (LGDs) are the relevant indicators, widely recognised and used by all industry participants. In case of climate risk, the indicators are not yet widely established. It is necessary to continue this work, while also turning to macroprudential tools and starting to mitigate the risk proactively.

3.3 Existing climate related EU policy, namely Fit for 55, and the ability of the economy to implement it, are key features of the stress test scenarios in the EU

A regulator highlighted that the EBA is currently running a joint stress test assessment on the financial sector with the European Securities and Markets Authority (ESMA) and the European Insurance and Occupational Pensions Authority (EIOPA), with support from the ECB. The scenario is about a climate risk policy, namely the Fit for 55 strategy. It is important to consider not only the banks and the financial sector, but the economic policy towards climate and how this impacts the financial sector.

With the introduction of ESG risks in the current Basel III CRR III/CRD VI package reform, one key component is that banks consider climate-related sectoral policies when assessing risk. This joint assessment considers the European financial system's ability to achieve the Fit for 55 strategy, and the potential risks that may apply. There are two scenarios: one in which the transition is smooth, and another in which it is not. The approach is bottom-up rather than top-down. This is not about asking individual institutions to provide information; the aggregate concern is more important. Finally, the approach is about trying to assess cross-sectoral linkages.

Banks need to properly assess risk, including climate risks and policy-related risks. It is necessary to ensure that these two elements are intertwined. The third aspect is to ensure that the regulatory framework is adjusted to properly address risks when considering the prudential framework.

3.4 An essential added value of climate-related stress tests is to trigger strategic and operational adaptations within EU banking groups

A Central Bank official stated that the main issue is to operationalise the effect on the day-to-day lives of banks. In 2022, only 40% of banks had developed internal stress tests integrating climate, and only 20% were accounting for stress test results in their loan granting processes. The goal is for everybody to take these risks into account in their day-to-day lives. In 2024, the situation is better, as the results of this exercise are being followed up on. In 2022, even the 40% of banks that had internal stress tests did not include reputational risk. Policy was almost entirely lacking. Supervisors have more freedom to devise scenarios.

3.5 The many ways in which a bank can incorporate climate-related risks, which only materialise in the long term, into its strategy in the short or medium term raise issues and feed the sense of risk benignity

A Central Bank official noted that bankers might have a portfolio of credits in a risky sector for the next four or five years. If it is explained to these bankers that they will be in trouble in 10- or 20-years' time, they will not worry, as they have time to adapt their strategies. It is important to identify the long-term challenges that are societal and common to all. Not taking the long term into account can perhaps be a temporary business strategy, but it can't be a societal one.

A Central Bank official emphasised that the ECB stress test had a three-year horizon. This is why the results were found to be so benign by some observers. While the risk is lower within the three-year horizon, there is an expectation to take immediate action.

4. Forthcoming regulatory evolutions foreseen in a vibrant EU climate-related regulatory landscape

A regulator stated that, regarding the prudential banking regulatory framework, the disclosure requirements are now applicable on Pillar 3. As banks consider Pillar 2, they should incorporate ESG in all relevant risk aspects. The guidelines on ESG governance are being adjusted. Guidelines are also being adjusted to ensure that ESG issues are assessed when loans are originated, and that ESG risks are introduced when remuneration is considered. The internal capital adequacy assessment processes (ICAAPs) and supervisory review and evaluation process (SREP) guidelines are important.

The EBA confirmed its views on Pillar 1 requirements in its autumn 2023 report. Pillar 1 is a regulatory framework, so it is important to be sure about what to put into it when it is embedded. To make that step, it is first necessary to assess additional risk and how it is materialised concretely into banks. The report contained some short-term ideas that can be implemented, but the medium and long term require further analysis. Another aspect to consider is the way in which this is built into the regulatory framework. It cannot be based on the use of historical evidence. Scenario stress testing must be used to properly assess risks and to include them in the Pillar 1 framework.

AML: key success factors to boost EU effectiveness

1. It will take three years to implement the single directly applicable legal basis for anti money laundering (AML) and establish Anti Money Laundering Authority (AMLA)

The Chair explained that the aim of the European Commission's 2022 AML package was to create a new basis for Europe's AML regime. The package standardises the legal requirements for obliged entities, which are mainly in the private sector. In the future, there will be a single directly applicable legal basis in the form of a regulation. This will be supplemented by the establishment of AMLA, which will be a European standard setter, a supervisor, and a platform for information exchange between financial intelligence units (FIUs).

In the financial sector, AMLA will directly supervise high risk companies, instruct AML colleges, and even have the power to assume national supervision. In the non financial sector, AMLA will primarily conduct oversight via peer reviews. The trilogue negotiations on the AML package were successfully concluded in January 2024. In view of the upcoming Parliament elections, any delay could have caused considerable damage to the fight against money laundering.

There will be a transition period of three years for the regulation to be applied and the directive to be implemented. Until that point, AMLA must be established and strengthened. The level 2 and level 3 texts must be developed to ensure that the provisions are sufficiently detailed to be directly applicable in practice. One of the key challenges will be to bring together AML and data protection. This is another success in the substantive law. There will now be a clear legal basis for information exchange, which creates certainty for the private sector.

2. Key success factors for creating an effective AMLA: cross-border cooperation, including data analysis; matching supervision with risk; human and technical resources; and ever increasing agility

A regulator commented that there is an opportunity for AMLA to learn from the establishment of the European Banking Authority (EBA), European Securities and Markets Authority (ESMA) and European Insurance and Occupational Pensions Authority (EIOPA).

There are four key factors that will ensure AMLA is successful. The first is international cooperation and convergence. Effective AML is only possible through cross border cooperation. The European supervisory authorities (ESAs) have considerable experience of international supervisory cooperation, from which AMLA can learn. Secondly, AMLA must practise high quality risk based supervision. Currently, the data required to undertake risk based supervision is not collected effectively. Consolidating the data sent to the ESAs will eliminate redundancy and duplication, reducing the burden on the financial sector. Thirdly, AMLA's procedures will need both resources and interconnectivity. The final key factor is education. AML is evolving constantly as entities find new ways to avoid the rules. AMLA must try to continuously learn and adapt to these challenges. It must be able to develop new tools quickly in response to new threats.

The Chair observed that the AML legal text shows that the legislators have already learned some lessons from the establishment of the other ESAs.

3. National authorities are preparing for the new AML framework and AMLA

3.1 Under the umbrella of the EBA, national authorities are adapting their processes, systems, governance arrangements, staff and cultures

A regulator explained that the preparation for AMLA is already underway. Initially, AMLA will have a large amount of work to do with few staff. At national level, preparatory work is being done by national supervisory authorities and FIUs. Many national authorities, including the Austrian Financial Market Authority (FMA), have set up project like structures to manage the transition to AMLA. This is a critical process. All national authorities need to study their processes, systems, governance arrangements, staff, and culture. At European level, there is a need for coordination and collaboration. The efforts to prepare supervisors and FIUs will be a critical factor in the success of AMLA. The EBA has created a forum to allow European supervisors to discuss the practical implications of AMLA. This forum has determined some common priorities to ensure that the preparatory work is efficient and coordinated. The new model will be about common risk based supervision. The analysis of risk will play an important role in determining which institutions fall under AMLA's direct supervision. Supervisors will have to decide how to collaborate in terms of data management and the exchange of information. Ultimately, AMLA will only be as good as the national supervisors joining forces under the new supervisory model.

A regulator emphasised that cooperation between national competent authorities (NCAs) will be the most crucial success factor. In the past few months, Malta's Financial Intelligence Analysis Unit (FIAU) and the Malta Financial Services Authority (MFSA) have created independent structures to assess AMLA's impact on processes such as licensing, risk assessments, supervision, and enforcement. As commented above, AMLA's effectiveness is also dependent on the procedural and operational maturity of the EU Member State's competent authorities on AML/CFT. From what is already observable at present, it will be necessary for some NCAs to gather more data/information which they are not currently gathering from both their respective industries and other supervisory authorities. Still, the developments required will not be limited to this, NCAs will need to assess their overall risk assessment, supervisory, and enforcement processes to facilitate European consistency. Preparatory work is currently being undertaken by both the European Banking Authority in collaboration with NCAs to facilitate Europe's transition to AMLA as a dedicated supervisor.

An industry representative highlighted the importance of having agile systems. Obliged entities will need to have easily modifiable systems for transaction monitoring, case management and Know Your Customer (KYC) and the ability to implement new requirements. It is not practical for an obliged entity to develop new systems and protocols in response to each new regulatory obligation.

3.2 After regulatory adaptation and clarification, which is the immediate priority for member states, there should be a period of regulatory stability

A regulator stated that regulatory adaptation is the most urgent priority. AMLA will have to deliver around 70 mandates in the next two years. It will be very difficult for AMLA to achieve this task if it is forced to rely on national supervisors. National supervisors will need to coordinate and deliver the preparatory work, which AMLA will pick up and transform into a single rulebook.

A regulator noted that both the Maltese FIAU as the single regulator for AML/CFT and the MFSA have started to engage with stakeholders and other European and local authorities facilitate the transition to AMLA. Particularly, the MFSA, as the Maltese financial services regulator, houses a dedicated committee intended to centralise the consideration of AML/CFT, including the very major changes that will be required because of the implementation of AMLA. At European level, the EBA, through its Standing Committee on AML/CFT (AMLSC), is conducting a significant amount of preparatory work alongside NCAs, such as by taking stock of risk assessment and supervisory practices across all the Member States. The AMLSC significantly facilitates the ESAs and NCAs discussions on the implementation of the AML package.

An industry speaker considered that there should be a period of institutional stability once the framework is implemented. Over the last 30 years, the EU's preventive AML regulatory framework has been frequently adjusted. Institutional stability will get the best out of the system. The main challenge for AMLA will be to complete the single rulebook. A significant number of implementing technical standards (ITS) and regulatory technical standards (RTS) will have to be drafted in a very short timeframe. The challenge will be to communicate this to obliged entities in a clear and timely way to ensure they understand the rules are, how the rules should be interpreted, what the supervisory expectations are and what the supervisory cycle will be. Obliged entities can then prepare themselves ahead of the deadline. AMLA will try to instil a common supervisory culture by engaging with domestic AML authorities and learning from them. By supporting and assisting the domestic authorities AMLA will come to be regarded as a trustful and reliable partner.

An industry representative emphasised that the introduction of standardised rules across Europe is good news for banks. It is shocking how many countries in Europe have implemented directives in very different ways. Although these are new regulatory requirements, this consistency should be very helpful. The priority of banks is to comply with current regulatory requirements. The banks do not want to be caught off guard by the new requirements. They are trying to conclude their remediation programmes to ensure their 'house is clean'.

3.3 The use of the tools developed for the Single Supervisory Mechanism (SSM) and the Single Resolution Mechanism (SRM) could benefit AMLA and contribute to the global credibility of the EU AML model

An industry speaker noted that AMLA bears some similarities with the SSM and the SRM. Many of the tools developed at SSM level could enrich AMLA's toolbox. However, there are also sizable differences. First, AMLA's scope will be sectorally broader and geographically more fragmented. Secondly, the risk profiles allocated to obliged entities will be dissimilar to those in the prudential domain. The risk is not specifically proportional to size and is more complex to define. Thirdly, AMLA will need to ensure that FIUs work together, exchange information and investigate cross border cases. AMLA will need to use the full range of tools available, including a new version of FIU.net. FIUs should also provide feedback to obliged entities about the effectiveness of their transaction monitoring systems. AMLA will enhance the credibility of the EU model globally. For AMLA to be regarded as a trusted and influential partner in the definition of further standards and requirements at Financial Action Task Force (FATF) level, the European model will have to be regarded as a global point of reference.

An industry representative commented that banks will need to have access to data. When an institution comes under SSM supervision, the ECB asks for many different types of data. For AMLA to be successful, it will have to do the same. Banks and other entities want to be able to send supervisors the correct data immediately. Ultimately, the governance framework for any new regulatory requirement should be useful; it should not be a bureaucratic nightmare. The creation of a streamlined and effective governance framework will ensure that entities know what to do and who to work with.

4. For AMLA to be able to analyse bulk data effectively, it will require technology, trained individuals, Joint Investigation Teams (JITs), an outcome based approach and agility

A regulator stated that effective AML/CFT is dependent on collaboration, cooperation, and the exchange of information. For AML/CFT efforts to be effective, supervisors need to be able to collect and analyse bulk data. Given the difficulty of processing such a large volume of data, technology and IT systems will play a key role in achieving an effective AMLA, exacerbating the importance of utilising AI/Machine Learning technologies. Secondly, there is also a need for appropriately trained individuals who can intelligently analyse said data and. Thirdly, the key to identifying issues and taking action is the processing and analysis of data. NCAs will be able to help AMLA by using task forces and Joint Supervisory Teams (JITs), in which officers are able to access data and exchange and analyse information in bulk. Fourthly, AMLA will need to take an outcome based approach towards its supervision to facilitate its supervisory effectiveness as a new European agency. A great deal of time and effort will need to be invested in the creation of a risk based approach to supervision, intelligence sharing, decision-making and cooperation with law enforcement.

An industry representative highlighted the importance of focusing on how to fight financial crime legislatively. Banks are filing thousands of alerts with FIUs every day. Currently, the regulatory framework obliges banks to file alerts when they detect anything suspicious. A bank is not a law enforcement entity, however. It does not know whether someone is conducting a criminal activity or not. Consequently, banks are filing a very large quantity of useless alerts. The potential of being subjected to a detailed regulatory investigation induces the banks to file these so called defensive alerts. Fighting financial crime effectively means only filing relevant alerts with the FIU. Banks have spent billions of euros trying to build something effective, but the current system does not work.

An industry speaker agreed that effective transaction monitoring is one of the main challenges faced by obliged entities. There are limitations on transaction monitoring, such as limits to the capabilities of rule based transaction monitoring systems, the siloed approach in which obliged entities only see particular customer transactions and the lack of feedback from FIUs. These limitations can in part be overcome by using technology. AI and machine learning can be very useful tools for AML. These technologies can identify links between data points and identify patterns in transactions. These tools need (to process) massive amounts of data, however, which raises some data privacy concerns.

5. Balancing effective AML with privacy and data protection

The Chair commented that it is also very important to discuss balancing effective AML exchange with privacy and data protection. It is very important to cooperate on this topic with colleagues who work in data protection.

5.1 Privacy and data protection are fundamental rights

A regulator explained that privacy and data protection are fundamental rights enshrined in articles 7 and 8 of the EU Charter of Fundamental Rights, but they are not absolute. They must be considered alongside other policy objectives and legitimate interests in EU law. Finding a balance can sometimes be complicated, but the Court of Justice of the European Union is clear that these fundamental rights prevail. The ruling on the register of beneficial ownership should serve as a reminder of the need to strike the right balance. The Chair observed that the uncertainty of the rules is a significant problem, but it is very positive to see that European legislators have tried to strike a balance and create a clear basis for the rules.

5.2 Network analysis and transaction monitoring

An industry representative stated that society recoups around 1% of the $800 billion to $2 trillion laundered globally every year. The current system does not work. It does not recover what should be recovered. For this reason, it is important to consider what works and what does not work. Network analysis and transaction monitoring is very important. These systems enable society to 'follow the money'. The goal of the regulatory requirements is to fight financial crime. There have been discussions about how the new regulatory requirements will classify the mayors of small towns in Europe as politically exposed persons (PEPs). This will have no added value in the fight against financial crime.

What does work is data sharing. Transaction Monitoring Netherlands (TMNL) is a data-sharing initiative. In July 2020, five Dutch banks agreed to share transaction data anonymously. Although the data is anonymised, many people are surprised to hear that this data is being shared. Their personal records are not shared, however. The key responsibility of a bank is to manage data. There is nothing new about banks having access to data. The question is how to share this data in an anonymised way to identify the bad actors trying to launder dirty money through the financial system.

TMNL is already anonymously sharing data on small businesses. The system works. Banks in TMNL have been filing alerts to the FIU that would not otherwise have been detected. These bad actors are professional money launderers working for criminal organisations. They open accounts with every single bank and launder money via small businesses. Usually, they do not wave a red flag and say, 'Look at me, I am high risk'. Often, they take over small businesses which were previously legitimate. It is very difficult to identify that any change has happened. The smart criminals always act under the thresholds, which makes them hard to detect. TMNL allows the banks to see whether a client has accounts with many different banks or whether there is evidence of suspicious withdrawals or deposits.

An industry speaker noted that obliged entities need to work together and cooperate on KYC and Know Your

Transaction (KYT) frameworks, which raises some privacy concerns. Obliged entities will have to cooperate more intensively with FIUs to avoid overwhelming them with an extremely high volume of suspicious transactions reports. A failure to report could be a criminal offence, but there are no sanctions for over reporting. This demonstrates why there is a need for obliged entities and competent authorities (incl. FIUs) to work together on intelligence led monitoring, exchanging information and receiving feedback. This also raises some privacy concerns.

An industry representative considered that the concerns around data privacy are understandable. Ultimately, society will have to make this decision. If banks are only allowed to see their own transactions, it will never be possible to compete with the bad actors. It is extremely important for banks and other institutions to be able to share data in an anonymous way.

5.3 Data protection rules can contribute to cost efficient and effective data collection

A regulator emphasised that the application of privacy rules can make the AML framework more efficient. There are synergies between the different sets of rules. The General Data Protection Regulation (GDPR) contains rules on data accuracy, which is crucial to the efforts of supervisors and obliged entities in detecting financial crime. Data minimisation is another key principle of GDPR. Supervisors should only collect the minimum level of data that is needed to monitor and carry out checks. This can also lower the administrative burden for obliged entities. In the last months, CNIL and the European Data Protection Board (EDPB) have expressed various public positions on the AML package. Data protection rules can be used to prevent obliged entities from de risking by submitting false positives to FIUs without regard to the efficiency and effectiveness of their submissions.

5.4 Technology can foster privacy and assist in the monitoring and analysis of bulk data

An industry speaker highlighted the role of privacy enhancing technologies (PETs), such as data obfuscation tools, federated or distributed analytics, data accountability tools and encrypted data processing tools. These technologies allow for the processing, monitoring, and analysis of massive amounts of data without publishing the underlying private data or allowing the data processor to access any private data. However, these technologies will need more time to develop. Some of them are still in their infancy, others lack scalability or compatibility with other applications, and many require a massive amount of computational power and regular cleaning of data. Obliged entities will have to design these tools and technologies into their transaction monitoring systems. These entities will have to adapt their procedures and processes, test them regularly, train their staff to understand them and perform privacy assessments.

The AML regulatory framework and the data protection regulatory environment are two different worlds with two different philosophies, concepts, and languages. Specialists in one domain are not always versed in the other. There must be a reconciliation between these worlds. Both domains need to work with each other on a common literacy that would bridge concepts to close this gap or at least move closer together.

5.5 Balancing effective AML and data protection in the digital euro

A regulator stated that the digital euro is an interesting example of the interplay between privacy and anti money laundering/countering the financing of terrorism (AML/CFT). The digital euro is an emerging technology with a social dimension. The Commission's text on the digital euro is now being discussed by the co legislators. In parallel, the ECB has launched a project to design the digital euro. There are two modalities for the digital euro: the offline modality with transactions on wallets and the online modality with transactions via account.

Privacy is the key condition for the success of the digital euro. In the ECB consultation in 2021, 43% of respondents highlighted confidentiality as the most important feature. In a very competitive payment landscape, in which private payments work well, the EDPB believes that the value added of the digital euro is confidentiality and privacy. To generate public trust in the project, there will need to be a parallel with physical cash. Privacy by design will be crucial to the success of the digital euro.

The offline modality, which was introduced by the recent Commission text, is a point of satisfaction for data protection authorities. It does not allow AML transaction monitoring for small value and proximity transactions. This is equivalent to cash. CNIL believes that this monitoring is not needed. Offline transactions do not need to be subject to transaction monitoring because they are low risk. The EDPB is in favour of applying this approach to online transactions on account, as well, which the Commission proposal does not do. The AML risk can be mitigated in the design phase to ensure that this a low risk activity or that low value online transactions have the same level of AML risk as those conducted with physical cash. A proper assessment of the interplay between both sets of policy objectives during the design phase of the digital euro will lead to greater technological possibilities and increased social acceptability.

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Strengthening the EMU: way forward for the next 5 years

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Pierre Gramegna

Good evening. It is a pleasure to have so many of you listening to us. It is a honour for me to moderate this panel dedicated to the strengthening of the European economic and monetary union and the way forward in the next five years. I would say there is a way forward for a longer period. The Stability and Growth Pact (SGP), which is in place now, was established in 1997. It has already quite some history. Four years ago, ministers of finance started to discuss how to modernise and revamp the SGP and called the discussion the Economic Governance Review.

Let us jump very quickly to the decision made by the finance ministers in December 2023. The trilogue was successful. We now have a provisional agreement, which needs to be finalised. I think we are on the right track to finish this on time. You might say this is the obvious. I can tell you, having attended these discussions over many years, it was not obvious at all and there were many – probably not only in the room here, but also outside – who thought that Europe would never make it to amend those rules.

It has happened and the new rules will reduce debt and deficit, while at the same time ensuring that there is sufficient room for manoeuvre for public investments in the dual transition, be it the green one or the digital one. I think that is one of the major lessons learned from the existing SGP, which was penalising public investment too much. There are many topics to be discussed, so I will just say that I think that the new fiscal rules are ambitious. I am going to ask the panellists to react to that. Do they find them ambitious enough?

The second key point, I think, which needs to be underlined is that the new rules are intended to be implemented in a better way than the old ones. This is thanks to the fact that they will be catered more to the specificities of every country, to ensure ownership of the reduction of debt. The third point is that this new SGP should make Europe ready for future challenges, including not only the double transition that I mentioned, but also make Europe more competitive. Also, it makes sure that these SGP rules will work in the future when another crisis strikes. It means having sufficient room for manoeuvre.

Last but not least, as the European Stability Mechanism (ESM), we have followed this very closely, and in fact reduction of debt is one aspect that the ESM considered carefully. The SGP triggers the use of certain instruments of the ESM. For us, the whole discussion was totally meaningful. I am glad to be here with you today. I will start by asking you, Gintarė, how you see this new SGP.

Gintarė Skaistė

You were talking about whether these new rules are ambitious or not. From my perspective, the discussions started not because the old rules were not ambitious. The discussions started from one side because they became not realistic and some of the countries were not implementing them with all the necessary strictness. For another part of Europe, the key issue was that investment was not sufficiently supported under the old rules. I think everybody wanted to change the rules, but to match different desires into one point was pretty difficult, just because the

intentions as to why we are changing the rules were quite different from the beginning.

From my perspective, I am from the country that has low debt. For us, the old rules were not the problem. However, the problem was that in some cases at EU level the old rules were not realistic anymore. When we were discussing about the debt reduction rule, you may imagine that some countries from the southern part of Europe understood that they cannot implement it with the normal functioning of the economy, not to speak about the investment side. Everybody understood that we have to adopt a more country-specific approach to ensure realistic debt reductions paths and, at the same time, still have room for growth enhancing investment.

The discussions were not really easy among the ministers of finance but, as everybody wanted the new rules, they are there. Are they better than the old ones? I do not know for sure. Maybe yes because there are more built-in incentives to follow the rules. For example, countries should have more ownership when constructing individual fiscal structural plans and there should be more realistic and achievable fiscal goals. Also, an important element of the new rules, especially for countries with less fiscal space, is the flexibility to accommodate necessary investment that enhances growth. The possibility to extend the fiscal adjustment period for up to three years will give countries more incentives as implementation of structural reforms will allow for a longer adjustment period.

However, from my perspective, investment related flexibility might also be the Achilles heel, because everything will depend on the implementation. The key issue going forward will be how to evaluate structural reforms - whether they are truly growth enhancing or not? In this case, transparency and equal treatment of the countries is something that I would desire, but I am not necessarily sure that this will be the case. The devil is not in the details this time. The devil is in the enforcement of the rules and we will see how it will go.

From our perspective as a low debt country, we are happy that we were not left behind the eye of the European Commission. We will also have guidance about our fiscal trajectory. It is really important to have this suggested fiscal trajectory for the domestic policy debate, because if you know politicians, they want to spend all the money but they don't like to talk about taxes and revenue. To have some guidance from Brussels, not just a 3% benchmark from the Treaty, is something that I, as a minister of Finance, am really happy about as it will be useful tool in the upcoming budget drafting process.

Finally, something that is really important in the current geopolitical situation is some flexibility of the new rules related to defence spending. Without this flexibility, for a country like Lithuania, there would be a trade-off between being strict and fiscally prudent – which we tend to be – and having necessary investment into our security. In this case, I have no alternative but to make the investments, because we are dealing with existential risks. Therefore, having the flexibility plays in favour of national ownership.

Pierre Gramegna

Thank you, Gintarė. In fact, you are happy with the whole idea of ownership. You mentioned flexibility for investments and the longer duration of adjustment – four to seven years. You also touched upon the specific issue of security and defence, which, for an understandable reason, is very close to your heart and your geography but, I can tell you, even if you are further away, it is in many people's hearts and minds now. You said – and I find this quite interesting – that it all depends on the enforcement and the guidance. I will come back to that.

Riccardo Barbieri, how do you see the picture?

Riccardo Barbieri

The picture is complex, as always, but I think this has been a good compromise. I think you alluded just now to the challenges we have. We took more than a year to discuss the reform of EU fiscal rules, while we have much bigger problems looming on the horizon. Being convinced that the solution is always European, I am hoping that this is just one step and that we will accelerate in the process of trying to find European solutions to the big challenges of our time.

Having said that, I think it was a good compromise because, in actual fact, in its implementation, the existing SGP saw a complete focus on the short term. The long-term projections about ageing costs, pension systems lived in a different sphere, which was the sphere of the Ageing report, and only indirectly had an impact on fiscal plans because the medium-term objective of a country –to be precise, the so-called minimum medium-term objective (MTO) – depended on projected ageing costs. Here, we now have a framework that is based on the debt sustainability analysis (DSA), which covers a 10-year horizon, and you have between four to seven years to achieve a sustainable path for your public debt.

When you start your first fiscal structural plan, your horizon – if it is, say, a five-year plan – is effectively 15 years. There is a focus on expenditure, even though you can achieve a given adjustment in net expenditure on the revenue side. Governments that like to tax and spend can do so, that is, carry out fiscal consolidation on the revenue side, but your starting point is expenditure net of interest, excluding one-offs and costs for cyclical unemployment benefits. I think the approach is more promising than the existing rules.

I can tell you that before 2020 I went through lengthy negotiations with the European Commission over whether the adjustment in Italy was one or two tenths of a point less than it should have been. I am hoping that, with the new approach, we will talk about more fundamental issues, even though enforcement, admittedly, will be a problem in the sense that there will always be a temptation, if things go better than expected, to look for exceptions. Here, we must be prepared for that eventuality, not just for downside scenarios, but also for upside ones, because another advantage of the new system is that it is less procyclical.

In order for it to be anticyclical, as I said, if, say, you follow a certain trajectory of this net expenditure

aggregate and it turns out that your deficit falls more than expected – because, say, bond yields fall more than expected and your interest expenditure is lower – then you should not spend this windfall. You should stay the course or whatever is the path that is on the expenditure target that you negotiated with the European Commission.

What I am hoping is that perhaps this more forward-looking mechanism will lead governments to also focus more on the key economic challenges we are facing. I can tell you that there has been a lot of criticism about the agreement on the governance reform in Italy, but what encourages me is that the way I think our government read it was that we now have to focus more on the medium and long-term challenges for the public finances, not only on the next year. We will see if that really happens, but this is what I am wishing for us and for all the European countries.

Pierre Gramegna

Thank you, Riccardo. I will now turn to you, Tuomas. Just to structure our discussion, we have had now two interventions focussing on the specificities and innovations of the new SGP. Maybe you can tell us a little bit about the timing, the schedule, or the transition period. How do you see it? Because you were at the heart of the negotiations and I know it is a difficult question, so I dare to ask it to you. You have the floor.

Tuomas Saarenheimo

Thanks for the question and let me now proceed to answer a different question. I actually planned to tackle the question that you asked first. The transition, the implementation timelines for this year, are still very much a work in progress. It is a challenging timetable, to squeeze them into the remaining part of this year, once the legislation is actually formally in force. It is doable, but the exact timetables you will have to wait for later.

Let me start from the question of whether these rules are likely to be implemented. I like the word 'implementation'. It is much preferable to 'enforcement', which is something that comes from outside. It is enforced upon you. That is not the way it works with fiscal policies. I think a good place to start answering the question is to ask why the old rules failed, and I think it is fair to say that they failed. The reason was that we discovered something that was kind of obvious: budgetary policies are key to sovereignty and the political life of member states. The EU just blindly enforcing rule that did not feel just in member states was always politically too heavy-handed.

Rules are enforced in the political context and, if the political price of literal enforcement is too high, then the rules will not be enforced. This was the case. They were not enforced. When this happened, the victim was not only fiscal consolidation. The other victim was the honesty of our framework because, in search of some awkward compromises that were needed to create pathways to circumvent the rules and avoid escalation, we ended up giving approval to budgetary policies that did not deserve it.

From that viewpoint, are the revised rules ambitious enough? I think the failure of the old rules was false ambition. It was ambition that was not backed up by true ability to implement. I would say, yes, the new rules are ambitious enough. If they are implemented, they will definitely be enough to put debt levels on a downward trend. My hope is that the new rules and the new framework will help us to take a different approach, to implement better and to create an implementation culture where the member states take both ownership – and by ownership I do not just mean ownership by a narrow political class and a handful of civil servants, but also ownership by wider society – and responsibility over national budgetary policies. It will create a situation where the implementation of the framework is not an antagonistic but a cooperative effort.

Not to be naïve, there will be difficult situations. Fiscal consolidation sucks. It is really unpleasant. You do not want to do it, but my hope is that better ownership, the broader debate and the better design operational target for the framework helps in implementation, so that these rules will be implemented better than the old ones.

Pierre Gramegna

Thanks, Tuomas, for the interesting and thought-provoking answer. It is doable, the timeframe, to do it this year. That is good news. Thank you for elaborating on the word implementation. Let me turn to you, Markus. What is your assessment? You followed this from the perspective of the European Parliament.

Markus Ferber

Thank you very much, Pierre. I watched this from the beginning. I was even in the Parliament when we voted in 1998 on the first 11 participants joining the euro, so I remember all these developments during the last 25 years. We said it was a success story and even what we achieve now is a next step which can create a success if we understand what was 25 years ago the common understanding: whatever you do in your national budget has an impact on the others. This is a question of trust and confidence. I have responsibility not only for my own budget, but I have responsibility for the fiscal situation all over the Eurozone. That is a key element we should not lose over time and that is why, from time to time, we have to adjust the rules, to bring that back.

Of course, we had to adjust the rules. That was described more than once. The old ones were not workable anymore, especially after Covid, and therefore a new proposal was needed, and a new decision had to be taken. I am very happy that the negotiations were concluded before 15 February, because Esther de Lange, one of the two rapporteurs left us at this date. I am now the lucky winner, as I will take over the role from her without having the need to sit in these long trilogues. That is only the personal story.

What is key? Number one, equal things have to be treated equally. Sorry I have to come to this horrible phrase from Jean-Claude Juncker, 'Because it is France.' No. Equal things have to be treated equally in the Eurozone. Someone has to take care of individual agreements. I share the view that the

word 'enforcement' is not a nice one, but we need a referee. The referee must have the right to take out of his jacket the yellow or red card. That is what we have missed for the last 25 years, because we have had more than 200 violations of the agreements, and we never had any meaningful sanction. The yellow or the red card were never used by the referee.

That is the question. Even in a football match, all 22 on the field know the rules, but you need referees – a central referee and two a side – and the fourth one observing the others. There is an observer of all referees and we have now this TV (video refereeing), which follows as well. It is a crucial thing to establish that the rules are obeyed and we need the same. Whether you call it enforcement or not, I prefer the referee picture. It is needed, especially when we start now with individual arrangements with the various member states.

The last point I want to mention is that whatever we agree is nice, but in the end, the market has to accept our rules. It is the market that decides whether a member state is able to ask for more debts or not. It is the markets that will ask then for higher interest rates, if the market thinks it is required. Therefore, we have to be aware of that. The market will not look whether we fulfil the criteria of our fiscal rules. The market will decide whether member states can bear the burden. That has to be in all responsible officials' minds, to be taken into account. You cannot bet against the market, whatever rules we do. Having that in mind, I think the rules are very close to what is demanded by the market and therefore can create trust and confidence, not only between the member states but with market participants as well. I think we did a good job.

Pierre Gramegna

Thank you. It is nice to hear that the European Parliament has a similar view as the Council. That is why we have an agreement. Turning to you, Jacques de Larosière, how do you see the new SGP? What are the strengths? What are the eventual weaknesses that you see?

Jacques de Larosière

Thank you very much. Before answering your question, I would like to say that this is a very fundamental matter. If you read, for instance the macroeconomic scoreboard of this financial organisation, Eurofi, you see that the countries that have the highest public debt are also the countries that have the least growth, the least productive investment and more unemployment. This is not a gentle fantasy that we are speaking about, a mania, to reduce our budget deficits. It is something absolutely fundamental because, if we continue on the path of super indebtedness that we have been taking over the last years, we will go to much less growth and to much more heterogeneous problems within the Eurozone.

Having said that, I am answering your question, Mr Gramegna. After first reading of this new pact, I was favourably impressed because of the method. It consists of a dialogue between the individual countries and the Commission, and a dialogue that is based on the observation of facts and economic facts is something better than obeying a more or less artificial figure that has no real ownership within the member countries. You struck two birds with one stone. On the one side, you had a better, in-depth examination of the problem of each country, which is always a singular problem, and on the other side you could act correspondingly; not with artificial measures, but with individually discussed gauges.

After second reading of the compromise, I was less favourably impressed because a text like this one, which is fundamental – it is part of the Treaty – has to be right in its incentives. This is a rule of economy. If you have the right incentives, you are okay. If you have the wrong incentives, you are not going to be okay – at least, not always okay. The wrong incentive, the disincentive, which is buried – you have to read very precisely the text to understand it – is that, if a country continues to run a budgetary deficit bigger than 3%, then it is exempt from the 1% annual reduction in public debt, which was something that seduced me when I read it the first time.

This is an anti-incentive. It means, if you still have a very negative budget with a deficit bigger than 3%, you are okay. We will not bother you with the reduction of an average of 1% a year of your public debt. That is, for me, incomprehensible, because it means that the country that has achieved at least a little less than 3% is going to be sanctioned by this rule requiring them to reduce their public debt by an average of 1% a year. This is the best way to encourage the worst performers not to reduce their debt to GDP ratio! It is as if the worst performers in a class were exempt from extra effort and sanctions as long as their results remain mediocre.

It would have made more sense, in my view, to examine the capability of a country to produce primary surplus, even a very small primary surplus, because that leads to the mastering of your public debt. There is nothing in the text that forces anybody to be consistent with the primary surplus notion, which is the key to reducing the future public debt.

I would add one point: For the transitory period in 2025, 2026 and 2027, the Commission may exclude the expected rise in the debt service costs when calculating the adjustment effort, despite the fact that it could become the largest item of budget expenditure in some over indebted countries, such as France. This measure raises questions insofar as it reduces the effectiveness of this EU mechanism and weakens efforts to consolidate the public finances of over-indebted Member States. You are going to have a length in the adjustment process that is extremely long.

Furthermore, I am not so sure that this transitional measure is legitimate because during the 15 years of zero real interest rate, were there provisions made to pile up these benefits, which were extraordinary, and which could be used today? No. Nothing was done in some over-indebted countries to reduce their primary deficit. I do not buy this argument of excluding completely the rise in the debt service costs when calculating the adjustment fiscal effort and I buy even less the argument saying that, if you have a very high

budget deficit of more than 3%, you are okay. If it is less than 3%, you are not okay. That is something that is, for me, incompréhensible.

Pierre Gramegna

Thank you, Jacques, for highlighting one of these European texts that seems paradoxical. I am being nice by saying paradoxical, but I think that describes it well. That would then lead to the second part of the debate, where I would as Tuomas eventually to elaborate a little bit on how this came about and what the rationale is, noting that the excessive deficit procedure was a very important theme during the whole negotiation. Quite quickly, it emerged that this procedure should remain basically untouched as far as possible, because it is linked with implementation and enforcement. It is a key point and I think, Tuomas, you are probably in the best position to clarify the paradox.

Tuomas Saarenheimo

I do recognise, Jacques, what you said. The first reading was positive, the second reading not so positive and, once you get to the fifteenth reading, then you just find acceptance of the fact that this is what it is going to be. Out of that acceptance grows an appreciation of its beauty. That is where I am right now. Your question is why does the debt safeguard not apply to countries in the excessive debt procedure (EDP) – I asked the same question when this was posed to me. There is a political story to it and then there is an economic story. I will tell you the economic story.

There were two motivations. First, for countries with high initial deficits, the debt safeguard would lead to very high – and, one could say, unrealistically high – adjustment efforts, just because of the pure deficit/debt mechanistic dynamics. The second point is that both the debt and deficit safeguards are meant to create guardrails around the DSA methodology, to ensure that the DSA does not lead to anomalous outcomes. In the context of the EDP, there is already inherently such a guardrail, in the form of the 0.5% structural adjustment requirement. Adding another safeguard did not seem really necessary or consistent with the broader approach.

Do you want me to stop here? I was prepared to address whether the adjustment horizon is credible. In the questions we received, there was a question as to whether 50 years is too long for some countries to reach 60%. I think the question is whether any shorter adjustment period would be credible. Look at what happened over the last 50 years, from the oil crisis to today. In 1974, during the oil crisis, debt levels in the Maastricht 12 EU countries was about 30% of GDP. 25 years later, by the time the SGP came into existence or took effect, that 30% had grown into 60%. Then, the next 25 years, we had the SGP. Did that hold the increase? Of course not. You know that.

During the existence of the SGP, our rate of debt went up from 60% to 100% of GDP. If, in the next 50 years, we manage to get the debt levels back down to 60%, I would define that as a magnificent success, compared to the previous 50 years.

Pierre Gramegna

Thank you, Tuomas. Let me just rebound on what you said. Let us face it. In a period like Covid, you add 10 to 20 percentage points to the debt to GDP ratio in one or two years, and then it takes many years to go back to the position you were in earlier. That is why I think having buffers and not using the 3% deficit as a target, which some countries underlined a lot, is key. 3% is the maximum. On a transitory basis, you can have countries – if we do a photograph today – that are above the 3%, but this must be avoided by all means. I think this focus on the 3%, independently from the paradox you described, Jacques, is maybe something that is a focus for every year. It is only if you respect that target that you will be in a position to slowly but surely reduce your debt.

Let me ask Gintarė and then Riccardo how they would like to rebound on this discussion or highlight other aspects. I will leave to you to decide which ones you intend to elaborate on further.

Gintarė Skaistė

I would like to tell you a story. During the Covid period, countries increased their debt level by 10%, 20% and to decrease that would take a lot of years. I will give you an example. My country, Lithuania, during the Covid years increased its debt level by 12%. Guess what? We are at the pre-Covid level today. I think everything is in defence of the national implementation. As everybody mentioned, you have implementation and you have enforcement. I think these two forces must work together: national implementation but, at the same time, somebody has to be the referee. Without a referee, we see that some national authorities are not implementing rules as they should be.

I think everything is achievable if you are really dedicated and focused and know what you are doing but, at the same time, you really have ambition to implement the rules, and not only follow some loose guidelines by somebody else. You are implementing, at the national level, everything that you can. At the same time, you expect some results.

For example, we in Lithuania are now reviewing the expenditure that we have, because we have increased needs for defence expenditure. We are reviewing all of the other expenditure to maybe have some spare money to fund defence. At the same time, we are also implementing the mid-term budget project, so maybe some money will also be spent more prudently than it was previously, because at the end of the year everybody was spending a lot just to have all the funds that were dedicated to the same institution. Everything depends on the national implementation, but also the enforcement, the referee role is really important. Without a referee, without red cards, we see that implementation is lagging a bit.

Pierre Gramegna

Thank you, Gintarė. Riccardo.

Riccardo Barbieri

I think, first of all, we need to clarify a little bit the apparent laxity of these fiscal rules. The agreement –

saying that as long as a country is in EDP in the early years of implementation of these rules is not subject to the debt safeguard – was a compromise. We favoured a transitional period. We favoured not basing that exemption on the fact that you are in EDP, but simply that, in the first four years of implementation of these rules, we knew that some countries had some issues with stock-flow adjustments. In other words, there is a difference between what you would expect based on the trend in the budget deficit and what happens because of the evolution of the cash borrowing requirement, which may be different. That is, for example, true in Italy's case.

Aside from that, what is important to understand is that this is the combination of the original proposal – which, as I said, is based on DSA and an expenditure rule – and the safeguards that were required by some member states. We know that in Europe we have a wide diversity of budget deficits, debt debt-to-GDP ratios, of views about fiscal policy, of the desirability of having a very low debt to GDP ratio. Some countries believe that, if you look around the world and you see the debt ratios of the United States, Japan, it is not that we have to imitate them – we should not follow the excessive debt of some of these countries – but, at the same time, we have to be in the real world.

Other countries are actively using subsidies for renewables, for chips, for EV batteries, and we might end up with a wonderful budget balance but being dead industrially. I am not favouring fiscal laxity, but what I am saying is that you have to find the right balance between these two views. In the end, for Germany to sign off the agreement, there were to be some safeguards. We have, first of all, a debt reduction safeguard, at least one percentage point of GDP per annum. It does not say, 'This is the rule.' It is the minimum you have to do. It is the guardrail, as Tuomas said.

Then, there is, in the medium term, an equivalent of the existing medium-term objective. Your structural balance should not be worse than 1.5% of GDP. In addition, there are rules about the speed at which you converge towards these balances: in the corrective arm, at least 0.5% per annum, with an exception (if an increase in interest payments is recorded) in the early years, and, in the preventive arm, there are different rules, depending on the level of your debt to GDP ratio, to converge to that 1.5%. When you simulate the effects of these rules, you have to take into account that you have the overlay of these two mechanisms: the DSA, which would take you towards debt reduction – but not as much as under the existing rules – and the safeguards.

We have run several simulations. If all goes well – meaning that the rules are applied and we do not die in the meantime – by the end of the next decade, to give you the example of Italy, the debt to GDP ratio will be at levels that today would be viewed as high but in line with the European average or the average of countries like France and Spain. My key message is that when they tell you, 'The rules have been simplified', you should assume the opposite. In order to reach a compromise, bringing together two different philosophies, it was necessary to make the mechanisms quite complicated.

The only thing that worries me is whether public opinion, and the body politic, will understand what the rules are about. In terms of the rules being too lax, I would say that they are less stringent than the existing ones, because you are not supposed to go down to the MTO of a balanced budget – or even a surplus, in the case of Italy – but you do have to achieve a structural balance of no worse than minus 1.5% of GDP in the medium term.

Pierre Gramegna

Thank you, Riccardo. Now the whole room understands the rules much better, I am sure. We need to keep some sense of humour despite all these numbers. The safeguards in the last part of the new negotiations are quite important. They also brought in a more reasoned position, which we really needed, and I am glad that a compromise could be found. Riccardo, you described this dynamic very well about the objectives and the safeguards.

Markus, what last comment would you like to make?

Markus Ferber

I will make only a short remark. Firstly, I have similar calculations as you have, Jacques. That is really one of the concerning issues, establishing whether we are on the right track. If I take the member state I know best, we do not have a problem on the income side. €1,000 billion income from taxation in Germany is quite a huge amount. We have a problem on the spending side, which is not attracting investments. It is not bringing more people to the labour market. These are the challenges and we do not have a problem on the demand side. We have a problem on the supply side and even that has to be addressed.

I refer to what Executive Vice-President Dombrovskis said before our meeting: one of the headlines for the next five years is competitiveness. We have to get back onto the road of growth. That is the main problem in the member state I know best, because we calculate everything in relation to GDP. If the GDP goes down, automatically the ratio goes up, even if you do not make new debts. If you create growth all over Europe – and I think there are possibilities, with a great deal of things to be done in the years to come to achieve that – even that is a helpful tool, without taking into account what you have mentioned is needed as well.

Therefore, I think we should concentrate on this agenda. We have to deliver on the supply side. It is very important not to leave this. We have to deliver on the path back to growth in the European Union. We have some tools. We have discussed these at a lot of panels, and we will do that in the next and tomorrow. Then, we are on the right track, and that even helps to reduce the debt burden.

Pierre Gramegna

Thank you, Markus, for that last point. I am going to conclude now. We are a little bit over time already. It is difficult to conclude. I would like to thank the

panellists for their insightful comments. I will start with the last one that Markus just made. These rules will function if we have sustainable growth in Europe. By definition, they will. If we have no growth, I think whatever rules we would have come up with, we would have difficulties to comply with.

The second point is that high deficits do not ensure growth. High deficits, as Jacques de Larosière rightly pointed out, just ensure the contrary. Let me underline that the five countries that the ESM supported financially had to do structural reforms because it was part of the conditionality framework. These countries have, today, higher growth in the euro area than other countries, because they did some reforms. My third point – and we mentioned this at the ESM all the time – is about two things we really need in the new set up of the new SGP.

The first is credibility. Credibility was mentioned by a few of you. That is credibility for ourselves, for each country, which is public opinion, and you do not want to be alone there. Commission do not let the ministers of finance be there alone. They need your guidance. The second point is on equal treatment. They need you to ensure equal treatment and it is extremely important. You need credibility towards the markets and you need credibility because we are all on the same boat. If one country has major problems, it has a domino effect on others, both in the economy and also in public finances.

Last, but not least, is implementation or enforcement. In this context, the Commission has a huge responsibility and tasks to accomplish. I would like to say that it is not only about ensuring equal treatment and serious analysis, because I trust they will do that. It will be how the Commission itself will communicate this to the larger public. If we have to communicate to the larger public the structural balance – as we used to have it – safeguards or complicated ratios, we will lose the interest of the public. I think that part is in the making or needs to be reinvented, in terms of commenting on it so that member countries, when they get the grading and the comments, they can use it in a way so that they can explain it.

The simplification task is still out there to be achieved, but communication is very often a large part of simplification. If the math behind the calculation is complicated, let that be for specialists. Yet the result needs to be understandable for all. I hope you understand much more now than an hour ago. I enjoyed the debate very much. Thanks to all of you and I wish you all a good evening. Thank you.

EU priorities for the 5 next years in the banking and financial services area

Axel Weber - President, Center for Financial Studies
Markus Ferber -MEP, Committee on Economic and Monetary Affairs, European Parliament
Jacques de Larosière - Honorary President, EUROFI
David Wright - President, EUROFI

Axel Weber

Let me welcome you to this wrap-up session. It is an honour and a privilege to have Jacques de Larosière with us again. Jacques has been a continuous source of wisdom for me in my career for as long as I can remember being in finance.

I thought it was a fascinating speech that Enrico Letta just gave. I was particularly moved by three points. The first one is that he teed up the four areas that we have ongoing debates about, energy, banking, defence and telecom, as the ones that were excluded from the discussion of EU integration at the start. It is obvious that, having been excluded, we did not make as much progress, but if you look at where Europe is now, it is exactly these areas where we need the biggest progress. Having delayed action for some time, we probably need to move faster on them than in most of the other areas. That is a very important message that he started with.

I am also very impressed how he framed the lessons learned from the financial crisis and the European debt crisis. He made a double reference to 2008 and 2011 as events that have dominated our thinking about how Europe should move forward. Maybe we should look at it more as a legacy rather than a modus operandi. That legacy might have prevented us from doing certain things over time that, with all the changes in geopolitics, we need to embark on now. The need has never been more obvious than it is now, so moving bold and moving fast is an important lesson.

Last but not least, what was music to my ears as a former banker is the word 'scale'. For 10 years, I chaired a large Swiss bank, which is now even larger, and I can tell you that the worst way to gain scale in banking is through accidents of others, because that means you are taking big decisions on scale in a very short period of time, often over weekends. We have had that experience before in the financial crisis. Sometimes crises happen, but it cannot be that the only way that US or European banks can gain scale is through emergency meetings over weekends, which have all their own dynamics and lead to idiosyncratic risks.

It is worthwhile to think about scale by recognizing that only profitable banks are good banks. Profitable banks need to have a recurring revenue base which covers all of their costs of operation, in particular their fixed costs, which is easier for larger, as opposed to smaller banks. We have a very fragmented market, and gaining scale has to be part of the process of making banks more profitable and safer.

I thought that was a perfect setup for our discussion on the stage now. Let me make the usual joke which I make when I come to Eurofi meetings, to which Didier has invited me for the last two years. I moved to Switzerland 10 years ago. I come back to Europe 10 years later, and nothing has changed. That is usually the joke that I make in the context of European banking union, because it is more than nine years ago that we started to discuss the concept of banking union. We are also still talking about capital markets union, which is also badly needed.

Markus, I want to start with you. The progress we have made could be better. Of course, Mr Letta also gave you some coverage in terms of where some of the resistance comes from. It basically comes from member states, not excluding the one where I hold a passport from, Germany. I do not want you to talk about Germany and some of its resistance on elements of the banking union, but where do you see the main reasons why in general, we have not progressed that much over the last 10 years?

Markus Ferber

Thank you very much. I can share your analysis and even say that you said it already. If we look at how we regulate and organise Europe, we speak about a single market, but honestly, we have 27 markets in all areas, on the real economy side as well as on the banking side. When you speak about banking union, we have been able to have progress after a huge crisis. The good old phrase in Europe is, 'Never miss a good crisis,' but now the next steps need to be taken without a crisis.

Then, of course, we have to answer what I call the chicken-egg issue. What is more needed as a frontrunner: a more united real economy or a more united banking sector? Ultimately, we need both. If I take the four areas Mr Letta has described, there is clearly a need for more European cooperation.

Telecommunications is the most integrated market although we are still a big step away from a fully integrated market. There are 27 different markets with 27 rules, and there are about 100 telecom providers, all of which are too large to die but too small to survive and compete globally.

Regarding the defence sector, everyone knows that action is needed. If you look at the figures, together the EU spends more money and has more soldiers than the United States, but with less capabilities. This is a misspending of European taxpayers' money. We are spending more money than the United States, yet we are not able to deepen cooperation.

This shows very clearly that more Europe is needed. If the headline for the next five years will be "competitiveness", it is necessary to Europeanise many aspects. Although there are already some well-integrated markets, the EU is unable to make the last step and fully integrate them. To Europeanise, the Commission must rethink its competition rules. Competition inside a single market would create an environment that encourages the creation of a banking union, which is needed because larger entities in the real economy need larger entities to finance them and to organise financial products and services. Without taking this next step, Europe will be diminished by developments around the globe.

Axel Weber

David, one thing I learned is that, when you talk in front of European audiences, the best equivalent you can make is to refer to soccer, because in soccer we are world leading. The US has no soccer to offer. They have some teams, but it is often retired European players. How do we get to that stage when it comes to banking? At the moment in banking, it is the other way around.

I have two questions for you more specifically. The first is that, in soccer, you need to have a good defence and you need people who score the goals. We have built a single supervisory mechanism. We have really upped our defence, but who is going to score the goals for European banks? How do we get to scale? Would that require a mindset change with the supervisors?

Secondly, do you see any gamechangers that would lead us to think about scale differently? That is what Mr Letta asked for. That might be the view that he voices in his report for European industry, but how do we get that view to gain traction among European regulators, supervisors and policymakers?

David Wright

It is very difficult, but let me just go back a bit here, Axel, if I may. What we need in Europe is to create the excitement of the European dimension.

The feeling that Europe is a capital market, or a banking market is lacking. Europe is fragmented and costly. The emergence of a European dimension must be encouraged. The articulation between the European and local levels is extremely important. This model does not need to be threatening.

Secondly, progress cannot be made without the right politics. To create this European dimension and European excitement, there must be an agreement between the incoming Parliament, the European Council and the Commission. The top people in all the key positions should have the single-minded objective of delivering this. The scale will come from markets deepening and widening, not from trying to close off or protect markets. Thirdly, the argument has not yet been won that this will be hugely beneficial for all member states.

The treaty should be used. The treaty has enhanced cooperation mechanisms, so these mechanisms should be utilised. Given the competitiveness situation, Europe cannot afford for this to drag on for years in technocracy with a pan-European dimension not emerging. Governance is very important. Key objectives, although not too many should be set with the European Parliament and the Council, including some bold technology targets. Governor Villeroy de Galhau mentioned a European Union digital ledger. This is an exciting combination of capital markets and banking union. It should be possible to reach agreements and create this excitement, as Jacques Delors did, although it requires a huge effort.

Finally, when Michel Barnier was working on the Brexit negotiations, he took a totally inclusive approach. He worked with all the member states. He worked very closely with the European Parliament. This was the right thing to do. Crucially, he formed a superb team of people in his cabinet to drive forward the negotiations, and he delivered a very good result.

Axel Weber

Thank you. Jacques, you have been a long-time observer of the European road to capital markets union. Also, in your previous capacities both as governor of the Banque de France and an outstanding IMF managing director, you have given advice to countries on how to get their acts together when they ran into trouble. What would be your advice to the current leadership in Europe?

Jacques de Larosière

I have spent a great part of my life giving advice to governments, and I must say the results have been rather poor, but if you ask me my impressions, I have

been in many of these Eurofi meetings over the last decades, and I would say this: Europe has delved into three orientations that we should be careful not to follow too closely.

The first orientation is that we speak of regulation. Over the last 25 or 30 years, I have been hearing about regulations to prevent the 27 countries from hurting each other. That attitude was mistaken. We should be opening our windows. We should be competing in the world and not competing against each other. That is the first point. Let us open the windows. Let us participate in the world of competitiveness.

Secondly, the excessive role of the public sector. We have been moving, over the last 20 years, from a reasonably situated public sector at around 20% or 30% of public debt to GDP, which is manageable, to now skirting with 100% or 110%. This does not apply to all countries. I know that Germany is much more sedate in that field, but the tendency has been to increase the role of the public sector. When looking at the efficiency of the system, as Markus Ferber has just said, the results are not there. We have a very large public sector without the desired efficiency that we should be asking for. That is my second regret.

The challenges are exactly the opposite of what we have been doing. The challenge is to participate in the world more actively and more with a common view of things, instead of looking in a narcissistic way to our own regulatory systems. That is the first thing I would like us to do.

The second issue is to shrink the public sector. Why? Because the big challenges, which are the energy revolution and the geopolitical presence that we all desire, need us to have a private sector that is willing and able to move. The energy revolution that we are craving will only come through the private sector, not the public sector. It will come through the private sector, so let the private sector live. Do not overtax the private sector. Do not think that you can reduce, by automatic and administrative ways, the remuneration of private sector savings. This is crazy, and this is what we have been doing for years. Let the private sector live. Do not overtax it, but if you do not want to overtax it, you have to have a smaller public sector.

These are the things we should be doing. Of course, it is very important to have a capital market. It is very important to have banks that can really exchange in an efficient way. I take on board all the remarks by David Wright on that, but I would say that we have too much regulation and not enough strategy.

Axel Weber

Thank you, Jacques. John Berrigan was on a previous preparatory call, and he also made this distinction. As we do not have the honor of his presence, I just want to briefly portray this. He made the distinction between changing the system or building and running the system. For a long time, it was viewed by the Commission that their job was running or maintaining the system. Take the example of the four areas Mr Letta has talked about, where we have not acted because we have largely maintained them as they were when we entered into the European Union, and they have not changed a lot. If you want to now create momentum in these four areas, there are two ways of doing it.

One is that we take action in these areas at the European level. Then you and Mr Letta asked the right question: how do we engage and create a euphoria, or at least a positive mood for Europe? If we try to do it by command and control, it will not happen. Is there a way to engage on this that is more driven by the markets and market players themselves?

This reminds me of something I have talked about at Eurofi conferences in the past. The US-wide banking market was not created by ordering all US banks to be operating across the US as federal banks. It was achieved in 1860 by offering a choice to US banks to be state-chartered or federally chartered. The Federal Deposit Insurance Corporation (FDIC) was invented as a deposit insurance scheme across all US states, and the Office of the Comptroller of the Currency (OCC) was created as a supervisor for state-chartered banks. Maybe Europe is at the point where it should look at what the US did 160 years ago as a more viable option, giving banks a choice to be truly European as opposed to ordering all of them to become more European.

One of the biggest hurdles for banks is the way in which banking union and EU supervision are constructed. The single supervisor is now 10 years old. 50% of every country's banking market was to be supervised centrally, instead of the top 50% of the banks within the European union. The single supervisor faces a complete continuum of entities, from purely domestic banks in small countries to major global players. A better way of creating the European dimension could be to move towards a banking union that creates more momentum for those that want to have a European licence, giving them a single license with a single supervisor, a single resolution regime and a single European passport. This is a better way to create some euphoria and momentum towards Europe, rather than allowing the momentum towards banking union and capital markets union at the European level to depend on the lowest speed in the most opposing member states, which is what currently determines the speed at which Europe moves.

Given that the system is under pressure, maybe it is time not to maintain the system, but rather to change the system and to move to the next level. This can only happen with changes in how we organise ourselves. Schengen was not ordered by member states; it was a voluntary contractual arrangement for those member states that wanted to be part of it, without being held back by the speed of those that did not want to move ahead within the EU. On banking union within the euro area, those member states wanting more global, more dynamic and more competitive European banks should sign up for a special agreement and a special passporting system that allows for pan-European banks but does not impact the choice of the smaller local banks to stay local or some member countries' preference to maintain a more grassroots banking systems.

Markus Ferber

That could fit, but could lead to other problems with some member states being covered more than others. The SSM thresholds came about in order to have a balanced approach that covers almost all member states and types of banks. While it is always possible to identify problems and solutions, there is no political power and willingness to achieve these objectives.

Many things that have been clear for decades are no longer clear. Rules-based trade is being challenged, meaning that the single market must be strengthened. Instead of member states competing within the European Union, Europe must compete against other markets in the world, as Jacques said.

Ideas are needed. Schengen was never an idea during a treaty change; it started with a decision by 10 sovereign states and was ultimately incorporated into the treaties. The European Parliament is wrong to always ask for a new convention. Frontrunners with ideas for deeper integration are needed; the others will then join in. At the end of the process, new ideas will be incorporated into the treaty. Integration was never the result of the treaties; the treaties consolidated the integration that had already been achieved. Schengen is the best example of what is possible.

A French-German initiative could be the cornerstone; others will join in immediately. Without such initiatives by a few member states, there can only be failure. The issue will not be solved through treaty changes or the next working programme of the European Commission. We need a few member states that go forward, and the others will follow.

Axel Weber

David, there is a light at the end of the tunnel. Do not say it is a headlight of a train coming towards us. Add to the positivism that Markus has just talked about.

David Wright

Just on your points here, we are going to need more flexibilities in the system in the future. We are 27 member states now. How many are we going to be in the future? 35 or something like that, and maybe even more. It seems to me that whether we are talking about some 28th regime now, that is one method of flexibility. Enhanced cooperation under the treaty rules could be another, but we are going to have to use that to move forward, as Markus was saying.

Now, I am referring here to the report I had the honour to work on with Jacques de Larosière. When the European supervisory authorities were set up, there was significant resistance from Germany. The Sparkassen were worried about the articulation of a new European supervisory authority, and the Landesbank feared competitive disadvantage. Time was spent trying to reassure them that this was in their own interests.

It is always important to engage and to demonstrate that these ideas are in the best interests of everybody. It must be shown that there is a level playing field for everybody. There cannot be a biased system in Europe that favours one area of the market. Not enough has been done to reassure people that this is beneficial to everyone, as Delors did with the Cecchini studies. Without ensuring a fair and level playing field, Europe will experience major headwinds.

Axel Weber

Yes, and I think you said the right thing. As we are adding more countries that are even more diverse than the existing European average, any change in governance will be slowed down. We need to find a way for those countries that started Montanunion, or the original founders, to move to the next level of integration without really waiting for the speed of everyone to convert to the average first. Jacques, you talked about the fiscal dimension.

Jacques de Larosière

I am very interested in what you said. I would like to come back to something that David said, which is very important. He said that we have to use the intergovernmental reinforced systems. if people are asked about concrete outputs of the European Union, they might point to Airbus. Airbus is not a European construction; it is an intergovernmental European construction. There has been too much regulation and too little action. More Airbuses are needed in the new digital systems. There is no European equivalent of Google (Alphabet), Apple, Facebook (Meta), Amazon, and Microsoft (GAFAM). Would it not be adequate to try to make something or do something concretely? This is what I would like.

Energy-wise, we will always be a dwarf in the geopolitical system if we do not have energy. It is important to concentrate on clean energy, which is now the object of a proliferation. The clean energy revolution is happening, and it is emanating from the private sector. Nuclear energy, which the Germans have abandoned for political reasons, is important for the future. France has understood that the recent reductions in electricity of nuclear origin were a mistake. There must be negotiations between states within the cooperation of Europe.

In other words, Europe is a framework for intelligent cooperation of nations rather than an entity in itself that must be serviced.

It is often said that union is the source of force. In fact, it is the forces that make the union more so than the reverse. There has been so much focus on the importance of having a strong union that it has been forgotten that the union does not exist without the nations.

Axel Weber

Thank you, Jacques. You raised one important issue that I would like to ask the other two gentlemen to also comment on. You mentioned the green transition, which is an important project for Europe. My question to both of you would be: if you also add the digital transformation, which is a similar project in a different dimension, does that not require more and faster progress on banking union and capital markets union? How can we go about that? My question is: since it has to be driven by the private sector, who will finance that?

We do not have the deep capital markets the US has, and so capital market progress is probably slower than banking union, and the banks do not operate European-wide. How do we finance those needed transitions, and is that not, in itself, requiring a gamechanger?

David Wright

Absolutely. No, it cannot be done unless we have deeper, more efficient and linked capital markets. This is not a European capital market to the exclusion of local capital markets. We have to find an articulation between that, as I said. I fully agree.

I just want to make one point on what Jacques said. The Commission sometimes forgets that it works on behalf of the member states to determine the European public interest. It is important to engage with member states and to work in a cooperative way with the European Parliament. However, there are some dimensions where there is a need for the European Union as a whole. For example, under the treaty, the European Union has a responsibility to negotiate trade on behalf of member states. In my time, when I was in the cabinet of Sir Leon Brittan, we did a deal on the Uruguay Round. Who negotiated that? The European Union on behalf of the member states, and most people would say we did pretty well. In fact, we did very well, in my view.

On the other hand, when we turn up at Basel, what happens? This is competence of the European Union under the treaty. My view is it should be the European Commission that negotiates on behalf of the member states. All the member states turn up in Basel and we get perhaps a less than optimal outcome from the point of view of European banks.

In the future, the EU will need to move further into areas such as defence and digital. In the areas where the treaty defines responsibilities for Europe, it is important to have a unified European Union, with the Commission always working closely with the member states to define the common interest.

Markus Ferber

I have only two remarks. Firstly, as Jacques said, where are the European GAFAMs? Where are we? For 10 years I have been asking, ‘Where is the European cloud?’ Microsoft, one of the GAFAMs, is now investing €3.5 billion in Germany to create a European cloud to fulfil our data protection requirements, but it is a US company investing US money in Europe, and the benefits will go back to the US. Where is Europe?

Digitalisation will not work if Asia is producing the hardware, America is producing the software, and Europe is organising data protection. That does not create enough value for money for our economies. While the public sector can take some risks, it is the private sector that must finance digitalisation.

When people throughout Europe and political groups in the European Parliament use the phrase ‘capital markets union’, they are often speaking about completely different things. The Commission could help by describing what is needed. Capital markets union is not only about transferring money throughout the European Union; it is about having a financial sector that is delivering all financial services inside Europe to meet all the demands of the real economy.

Currently, Europe is not able to deliver that. In Germany, there is not a single bank that is able to finance large investments; consortiums must be organised to manage this. This shows that the real economy is already ahead of the banking sector in a member state. At the European level, huge developments are needed over the next five years. Otherwise, only outside investors will benefit, as is happening currently.

Axel Weber

Thank you, Markus. This being the last panel, let me close with two remarks. First, Jacques, I want to give you the floor,

The ministers have sent me a short message that, if Jacques de Larosière has a single request, they will decide about it today and do it today, so what would your request be? What is the one thing you want the ministers to do to move us on the right track to capital and banking market union?

Jacques de Larosière

Stop easy fiscal policies.

Axel Weber

Very good. I knew that he would bring it down to less big government. Thank you all for listening to this final panel.

Conversation with Mark Jopling

Mark Jopling - Head of Global Financial Services, EMEA and APJ, Amazon Web Services
David Wright - President, EUROFI

David Wright

Ladies and gentlemen, my fourth guest this afternoon is Mark Jopling, who is the head of global financial services, EMEA and Asia Pacific Japan (APJ), for Amazon Web Services. He joined AWS in January 2020 as director for global financial services customers. Before that, he has been at Lloyds Bank, and also in the ExxonMobil and Mars. He has a PhD from the University of Warwick and is based in London. How do you see all these innovations we have been talking about, such as the cloud and AI, changing the structure of the financial industry and the way financial services are provided and consumed?

Mark Jopling

Thank you, David. Thank you for another successful event. New technologies have always been adopted by the EU financial sector, but I think we would all agree that the pace of change in recent developments, such as cloud and artificial intelligence, have reinvented the relationship between financial institutions and their customers. I will not do a show of hands, but if you think about the things that we now take for granted, like the personalised services we use, the way we interact with our bank through a mobile phone or a tablet, or trading equities and crypto on a mobile application, it is very straightforward and very common. In the insurance sector, if one of your children comes home from university, it is two or three flicks on an app to put them on your family car insurance. If you have a claim on your insurance, you may even manage a claim entirely through an app interface, without those long processes where you are taking a long time to process a customer journey. I think things have already changed quite a lot.

I can give a couple of examples of cloud-enabled innovation, which is innovation that would not be possible without the cloud. When we saw the pandemic, we saw some industries, or some parts of some industries had to scale down super quickly. Others had to scale up. A number of customers had to take their contact centre staff and their branch staff, close them down and ask them to work from home. That scalability of the cloud made those changes possible.

If I can give a recent example, which ultimately impacted end customers and how they consumed a service, I can name the bank on this one because it was a public reference at our re:Invent training conference in 2023. That was the Santander fixed income team. They wanted to modernise their trading platform. They chose to do that with us. The business outcomes were a lower cost base, but because of the nature of the solution we built with Santander, more of the engineers that were previously tied up with running that platform were freed up to focus on innovation and change on that platform. The agility of the cloud enabled that platform to basically increase the frequency with which that platform could be adapted. In the legacy world, that platform was changed maybe twice a year. In the modern, cloud-native infrastructure it could be changed much more frequently.

We have talked a lot about artificial intelligence, machine learning and generative AI. It has been a theme of the week. We recently released a study. We discovered that there has been a 32% growth rate in AI adoption since 2022 within European businesses. That is across all sectors. The report estimates that maintaining this rate of AI uptake, this sort of growth would contribute an additional $600 billion in gross value-add for Europe by 2030. This is a really significant technology. Cloud plays a key role in that process, because making AI accessible to businesses of all sizes and running the technology required to run large language models, which is the clever bit behind generative AI, and this requires the storage capacity and computing power that you can only have with cloud infrastructure.

If I can say one more thing to answer the question on how things have changed, I would also say that sustainability is now a big factor, driving both the choice and behaviour of businesses and also consumers. We recognise a big gain or realise a big gain when we move from legacy data centres to cloud infrastructure, which are anything between three and a half and five times more efficient. That is the start of the road to optimisation for power and sustainability. We continue to innovate with our chips that drive those cloud servers to further reduces the carbon footprint.

David Wright

It is impressive, continuous and rapid change here. What do you think this means for industry, and particularly for regulators? Are they up to speed? Where is this going from the regulatory point of view?

Mark Jopling

Let me answer that one. I am going to use a word that you will expect. The Digital Operational Resilience Act (DORA) has already been mentioned. Before I get to DORA, I will start with the third priority of the single supervisory mechanism (SSM), which I quote is, 'Further progress in digital transformation and building robust operational resilience frameworks.' There are two key phrases in that third priority. Obviously, the other two priorities are based around financial stability. It is a top three priority in the medium term for the European Central Bank (ECB) SSM. Based on the experience we have had so far with digital transformation, we believe that digital transformation is most successful when it is driven by a true conviction from the top, from the boardroom, with a clear vision for change. Then the boardroom is committed to unblocking barriers to change. This is a really significant moment.

In terms of regulation specifically, we have DORA coming in January 2025. That is top of mind for customers and top of mind for us. It is no surprise that it has been a very common topic with the customers and regulators we have been meeting this week. We are at a point in an implementation process where it is important the framework remains flexible enough to handle this dynamic complexity in finance and technology, and the changes that are coming, and that will continue to come. This will ensure that the EU can leverage the technological change that we are in the middle of now and in future.

David Wright

Do you think it is flexible enough? Are you worried?

Mark Jopling

No, I do not think we are worried. We are still in a consultation phase, and we are an active participant in that consultation.

David Wright

How do you respond to the issues of stability, risk and so forth? Do you think these are perfectly well covered by the regulations?

Mark Jopling

Yes, I want to be really clear about DORA. We do not know who the nominated critical third parties are yet. At the stage we are at now, as an organisation which provides services to an increasing number of financial services institutions in the EU, we are committed to working with the community, regulators and customers on the implementation of DORA. Given some of the examples I have already given, we believe our cloud technology can enable the digital transformation as the priority that the SSM mentioned and improve security and operational resilience. It is not just about innovation. There are multiple benefits. We believe a harmonised, clear and proportionate regulatory framework will be a good thing. It will drive the innovation, security and resilience, and help the long-term competitiveness of EU financial services institutions. DORA is important in that regard.

David Wright

Looking forward, Mark, here we are. The focus of this Eurofi is looking forward to the next political cycle in Europe. What do you think should be the priorities of the new European Commission in the area of digital finance? Do we need to tweak, change or fundamentally review certain things, from your perspective?

Mark Jopling

From our perspective, the first priority is finishing the consultation and then implementing DORA in January 2025, in the proportionate way that I described. That will help the industry to leverage more cloud services, this interest in artificial intelligence, machine learning and gen AI that we have heard so much about. That is how DORA will fit. We expect it to fit with other regimes. Obviously, we have a similar regime in the UK with critical third parties. There is ongoing work with the Financial Stability Board (FSB) and other international forums on operational resilience and third-party risk management. That is important because it is a global industry. We would encourage a consistent approach where possible, and when I say consistent, I mean internationally consistent. DORA is an early mover in that sense for the EU to set those expectations.

We think the level of technology innovation is going to continue to be rapid. The potential of generative AI is one example. Other speakers have talked about the cyber security landscape and how these technologies can help threat management. There will continue to be innovation.

Then the other request I would have, to answer your question around the next cycle, is that we are at an important moment in regulation in its widest sense. We are talking about DORA, because that is specific to myself representing a potential critical third party in this industry. There are a lot of cross-sectorial regulations that also impact this space. What springs to mind is the Network & Information Systems directive, cyber security, corporate sustainability reporting, where I touched on our potential role, the Data Act; and the AI Act, to name but a few. How these all play out and how they overlap will be really important to create the right regulatory environment for our joint industry.

David Wright

Do you get concerned sometimes about a lot of talk about open strategic autonomy and all this sort of language? Is this something that you worry about as a firm, or do you take it and move on?

Mark Jopling

No.

David Wright

Just tell me, are you seeing or is the financial industry seeing less fraud and less money laundering? Are these new cloud technologies helpful in the sense of reducing financial crime?

Mark Jopling

Yes, they are. Yes, I am not in a position to give an absolute measure of which types of fraud are up and which types of fraud are down. What I would say is we work deeply with customers, particularly to use machine learning technologies to improve fraud detection and analyse data at the scale and in real time in a way that was not possible before cloud technology. The threat landscape is continually changing. The people that would seek to steal are often seeking new ways to try and defraud. Those of us tasked with preventing that fraud also have to be innovative. The technologies that we are using are innovative and provide the ability to do things that were not possible before.

David Wright

I was on the board of a stock exchange in India. I saw the number of cyber-attacks per day. I am sure that is true of every firm here. It is just astonishing. All the policies are defensive policies. We do not have any offensive policies. This is something that you think is able to be better managed through your technology.

Mark Jopling

I am not a law enforcement person, so I will not comment on offensive strategy against the criminal mind. What I would say is there are many tools available in this complex cybersecurity landscape that we live in in the financial services sector. It is a continuing innovative cycle to create preventative measures to be one step ahead of the proliferation of threats.

David Wright

Thank you so much for being with us, Mark. It has been really interesting listening to your perspectives. Please, join us in Budapest. Thank you again for your support.

Mark Jopling

No, thank you. I have been to several Eurofis now. I consider myself a fully paid-up member of Hotel California. I look forward to going to Budapest.

David Wright

You have a permanent room in the Hotel California.

Conversation with Paul Donofrio

Paul Donofrio - Vice Chairman, Bank of America
David Wright - President, EUROFI

David Wright

My next guest, ladies and gentlemen, is Paul Donofrio, who is the Vice Chair of the Bank of America. He is a member of the Executive Management Team and co-chairs the Responsible Growth committee. I think he has been at the bank since 1999. He was the Chief Financial Officer of the Bank of America between 2015 and 2021. He has an immense CV, so I am not going to go through it all, because we want to hear from you most importantly, Paul. Thank you very much for Bank of America's support of Eurofi. Tell us how you have become involved in sustainability.

Paul Donofrio

First of all, thank you, David. It is great to be here. I think a CFO makes a great leader of sustainability for any company. Sustainability cannot be built in a silo. Particularly with respect to banks, sustainability has to be built into the existing processes of a bank. It has to be built not only into how you deliver your products and services, but also how you deliver your support functions through HR, finance, and especially risk. If you build it in a silo in the centre, then nobody who runs anything at the company owns it. It is somebody else's job. I think it was a wise choice for Brian Moynihan, our CEO, to pick a CFO to continue to lead our sustainability efforts and help us play our role in the energy transition.

When you are the CFO, you get to know every part of the company. More importantly, you get to build relationships and hopefully credibility with all the other people who run the other departments. That is incredibly important as we all work together to build everything that we are going to need to get to a clean energy future. I think it is natural for a CFO in terms of a second act. When you have been CFO of a large bank for six years, you are looking for something else to do. It is a very rewarding role.

David Wright

In this role in your very large bank, how does the Bank of America advance progress? Tell us how you do the job here.

Paul Donofrio

At the end of the day here, I think what banks need to do is just do their job. They need to help their customers achieve their financial objectives and grow. With respect to this, the job is to help our corporate customers - large and small - understand the risks and opportunity the energy transition presents, so they can develop and execute a credible transition plan.

Then banks have to help those companies execute and finance those plans. That is the short answer.

Let us take a step back. I think banks need to start with their own operations by achieving carbon neutrality and making progress on the emission targets that they have set for themselves. Bank of America achieved carbon neutrality in 2019. Some of the things we did to get there were to buy all our electricity from renewable sources; to green our buildings by upgrading heating, ventilation, and air conditioning (HVAC), water, electricity and data centres; to install wind and solar, production on site. I think banks also have to make sure that their supply chain has credible transition plans. At Bank of America, we have already ensured that suppliers representing 70% of ourspend have climate targets. By 2030, we will be increasing that percentage and adding requirements.

Focusing on a bank's operations and suppliers does not really move the needle, because they only represent a fraction of a bank's emissions. For Bank of America, for example, they represent approximately 5% of our

emissions. Why is that? This is because the vast majority of our emissions, frankly, are not our emissions. They are the emissions of our corporate customers that we are counting as our emissions, based upon the level of business we do with them. The flip side of that is a tremendous opportunity for our corporate customers, given the scale of the transition already underway. I think everybody in this room probably knows this, but just attempting to get to net zero in less than 27 years, is going to have more impact on the world economy than the industrial revolution. Companies that do this well are going to see their businesses grow.

Experts vary, but everybody agrees we are going to need at least twice the amount of normal investment each year to achieve net zero. Most estimates I see put that number in aggregate well in excess of $200 trillion. You have to think about all of the jobs, the innovation and the socioeconomic progress that will surround an investment of $200 trillion. You have to remember that, when the government invests, when one company invests, that is just another company's revenue. The incentives for companies are huge here. If $200 trillion of potential revenue growth is not incentive enough if you are a company, then there is the opportunity or risk to gain or lose market share as more and more companies choose suppliers with credible transition plans. At Bank of America, we call this the business imperative for companies to develop and execute credible transition plans.

What is the role of a bank? In addition to addressing your carbon neutrality and your supply chain, the most important thing a bank can do is to respond to their customers at scale, by engaging on the business imperative and then helping them develop or helping them finance the plans and goals that will naturally develop from that business imperative. The key phrase here is 'at scale'. At scale means all your bankers and all your corporate customers, large and small across every industry. I think if the banking industry does this well, if they do it at scale, then we will play our role in a more sustainable future and achieve the targets that we have set for ourselves.

David Wright

In Europe, one senses a certain pushback against climate change demands. Are you seeing that in the US or are you seeing big opportunities? It is quite interesting whether there is this change of dynamic on different sides of the Atlantic.

Paul Donofrio

We are a large bank. We have targets to reduce our emissions in line with 1.5 in the science by 2030. There are people in the United States who do not want us to make any lending in any way to oil and gas companies. Then there are people who are worried that we are using our balance sheet and lending capability to coerce them. Neither of those is true. We are responding to our clients' needs. At Bank of America, and I think at most large banks, customers are driving how we approach this. If you look at our large customers, they all have transition plans in one way or another. Midsize companies are on their way to understanding the business imperative, the risks and opportunities, and are developing plans. Smaller companies may be just getting started.

For a lot of us, we have dedicated teams that are focused on helping these clients. If you are going to actually put it into practice, the way this has to work is you cannot rely on those small teams to go out and meet with your clients, because there are only so many meetings they can go to in a day. For us to reach our 40,000 corporate clients globally, we needed to create scale. That is what banks do well, create scale. We spent two years, all of 2022 and 2023, developing the capabilities and tools so that our thousands of bankers could go out to engage credibly and skilfully with our corporate customers, respond to them and engage with them on the business imperative.

That may sound easy but doing that well across thousands of bankers takes a lot of time, effort and devotion. Our bankers have to learn about the transition pathway for every company, the risks and opportunities for every company, because it is all different. How to benchmark their progress is what CEOs and boards love to hear. If you want to get a meeting with a CEO or board, just offer to benchmark their progress on sustainability relative to competitors, how to measure and report their progress and certainly how a bank like us can help. Doing it well, by the way, can have a giant impact. On any given day, we at Bank of America are having 1,000 to 2,000 meetings with owners, boards of directors, CEOs or treasurers. When our bankers skilfully engage on the subject, we improve and deepen our relationship and that drives business for us. It is not only helping us achieve our goals around sustainability, but it is growing our business.

David Wright

You see this demand from your customers growing very strongly. They are seeing the opportunities. You do not have to tell them. They are seeing the business opportunities of appropriate investments to reduce their carbon footprint, or whatever it is.

Paul Donofrio

The short answer is yes. Of course, there are companies that may be resisting for one reason or another, but the business imperative is real. You just have to work with them to make sure they understand the risk they are taking and the opportunity they are missing by not engaging on sustainability. As I said before, the business opportunity, the opportunity to grow your revenue and to gain market share is huge. Every company is in the supply chain of some other company.

David Wright

You see different attitudes in your US clients compared to your European clients. Do you see a different type of approach here?

Paul Donofrio

Not really. I think the fundamental difference is that in Europe there is more agreement amongst voters that we need a cohesive, multi-decade sustainability green agenda. I think if you ask people in the United States, they will say, 'Of course, I want to live in a cleaner

environment. Of course, I want things to be green,' but there is still a lot of political debate right now. As a bank, we do not decide for others. We are just a transmission mechanism for the global economy. We have to balance all that.

David Wright

Do you worry or do your clients worry about the different types of approaches on both sides of the Atlantic? Europe tends to go for a regulatory approach, adopting the International Accounting Standards Board (IASB) standards. The US does not. Is that a problem? Is there a competitiveness issue?

Paul Donofrio

We are a large global bank. We are very proud of our operations all around the world, and especially Europe. We are committed to the EU and to Europe. We are going to operate within the laws and regulations of the EU. I do not have any criticism of the government. I will say that we should all spend as much time thinking about and developing market forces to accelerate the transition as we spend on rules and regulation.

David Wright

It is very interesting listening to you, because one gets the sense sometimes that the dial is getting pushed backwards. You are not saying that at all. You are saying, 'We think it is a huge opportunity for us as a bank, but also for clients who take forward long term investments, or whatever it is.'

Paul Donofrio

Yes, I am also saying that we can see the activity in our corporate clients. It is real. It is every day. Again, our bankers are out there meeting with them. The receptivity and the interest from boards and CEOs on how to capture that opportunity and avoid the risks that the transition presents are only increasing.

David Wright

Are some sectors more advanced than others?

Paul Donofrio

Yes, oil and gas, power, auto, cement, steel, marine and all the high emitting industries are. You can go out and people can quibble and argue that they are not going fast enough. Believe me, they are focused on it.

David Wright

That is tremendous. Thank you, Paul, very much for being with us. I find this really fascinating that not only have you built an effective offer here, but your clients seem to be taking it up.

Paul Donofrio

There is a reason to be optimistic. I do not know when or if we are going to get there precisely in the way we all think it is going to play out, but there is clear momentum, and it is building.

David Wright

Thank you so much for being with us and thank you for supporting Eurofi, as you have done for many years.

Conversation with Francesco Vanni d'Archirafi

Francesco Vanni d'Archirafi - Chairman, Euroclear Group

David Wright - President, EUROFI

David Wright

Ladies and gentlemen, my next guest is a very distinguished person: Francesco Vanni d'Archirafi, who has been working in the finance industry for many years. He was the former CEO of Citi Holding and Citi Transaction Services in New York. He had a 38-year career, if I am not wrong, in Citi. He is now the chairman of the Euroclear Group. This is a crucial role, as everybody knows from today's newspapers.

We are going to talk more broadly about how the European markets are working and some technology issues. Francesco, first of all, we greatly welcome you being here. Thank you for your support of Eurofi. First of all, tell us how you see capital markets in Europe today. Are we making the sort of progress that your firm, Euroclear, would like to see?

Francesco Vanni d'Archirafi

Thank you, David. It is a pleasure to be here. I made a big mistake, which was not to ask you who was speaking before me. J. Berrigan said everything, and D. Schwimmer is also very aligned with my views. So there is very little I can add.

What I see is a huge opportunity, but with a very difficult execution like J. Berrigan mentioned. I have spent the last day and a half here and I have never seen so much alignment on the long list of things that need to happen to move forward with ambition. I always say, let a crisis not go to waste. I think we are in one of those moments. I started with Euroclear during Covid in September 2021, then there was the full-scale invasion of Ukraine in 2022 and we now have another terrible war in the Mediterranean. In the US, there is also an election cycle which might create even more momentum for all these discussions.

Europe has always moved forward during difficult times. I am an eternal optimist and after all the presentations, the panels and the discussions that I have heard I keep this optimism. I know J. Berrigan has a lot of scars, but we need political leadership that do not only understand the opportunities and the risks, but also enables the Commission to drive change and executes it.

I will not repeat everything that has been said in the last two days but, for me, an important moment was Christine Lagarde's speech on 17 November. Europe is facing challenges with demographics, deglobalisation and decarbonisation. For demographics, there are going to be fewer workers for every person that is not working, and a tipping point is set to begin in 2025. That is a challenge, but it could also be an opportunity if we can use saving products. We need the equivalent of the 401(k) plans. We need the pillars on the pension that other countries have recently implemented. For example, we know Sweden very well as we own the depository. They have been able to engage the citizens as investors in the capital markets, which allowed small and medium-sized enterprises to benefit from stronger local capital markets. If we were to do that at the European level, we would move forward at scale.

For my benefit, I did a list of all the initiatives that are happening with the Capital Market Union (CMU) as a focus. I just want to read it because I think it is impressive. Obviously, a fellow Italian is going to deliver a report very soon, Enrico Letta. When Enrico speaks, he talks about the single market being like a big dream. I have been personally very close to at least part of that development, and it is a huge success. Nobody would have said that we would be able to move people, goods, and services around the

biggest single market in the world like we do today, although it is not so much a success in the financial services indeed. I am sure the Eurogroup will also present a long list of recommended policy initiatives to the next Commission. In the second quarter, there will be the European Securities and Markets Authority (ESMA) task force on the effectiveness of the EU Capital Markets and the Advisory Group on Market Infrastructures for Securities and Collateral (AMI-SeCo) post-trading recommendations.

Then another Italian leader – Mario Draghi – will come after the elections with a very important report, which is centred on everything we are talking about. Many industry and think tank reports on the CMU are also being drafted as we speak. Then we have the elections, then we have Eurofi in Budapest, then we have the parliamentary review of the next Commission, and there we will start to know if the new commissioners are up to the task. I think D. Schwimmer said that we need the ambition. It is not like we are inventing something new. We know why the capital markets in the US are very strong and deep. This is important as it is not about the intermediaries or the financial market infrastructures. It is all about innovation and economic growth to the benefit of society at large. If we do this right, the benefits will be huge for all European citizens.

David Wright

I very much share your sentiment in this interview so far, that we have a convergence of interests, a convergence of analysis, and a sense of some people calling it a crisis, but that others would say it is urgent to move. In terms of the infrastructure world that you live in here, are there any specific measures that you feel are necessary? What about being ambitious on moving to T+1 or even T+0? Is that not an ambitious aim that, for example, should be in the political package you are referring to for the new Commission?

Francesco Vanni d'Archirafi

I think the train has left the station, in a sense. The US is going to T+1 on 28 May, there is no question about that. Although our European ecosystem is a bit more complex, the question is about when and how this will take place, not if, as has been said in many panels over the last two days. The issue is not the infrastructure providers or the big players of the ecosystem. This is not a technology issue either. It is really about making sure that the entire ecosystem is able to deliver. If you cannot get there, what is going to happen is that all the small intermediaries running their business on a spreadsheet will have to pass that business to the bigger players. That is going to be a huge force for consolidation, which might be good or bad. I am not going to be the judge of that. But we need to make sure that the entire ecosystem is prepared.

Then another point I would make is that our friends from across the channel are also thinking about when moving to T+1, and we have heard the same from the SIX representative for Switzerland. There needs to be alignment between our countries, otherwise it could be a major headache.

David Wright

That is to T+1. Do you think T+0 is a way off? Do we need that?

Francesco Vanni d'Archirafi

I think T+0 is a bit aggressive. Our experts at Euroclear say that we are ready for T+0, but probably the rest of our ecosystem is not. By our ecosystem I mean our clients and our suppliers. If it was so easy, the US would have gone to T+0 directly. When we talk to our Asian clients, they are even worried about T+1. Compared to T+2, T+1 means that you lose 80% of the time to settle. That is a huge change for everybody. The window becomes very small. Then you start talking about cross-border and FX. It really pushes the limit for now. But I think we will eventually go there. There are new technologies, like distributed ledger technologies (DLTs), blockchains, artificial intelligence and quantum computing. When you go down the list, these are all accelerators of change. Here again, I do not think it is a technology issue but an ecosystem issue.

David Wright

How do you look at these new technologies you just referred to in terms of Euroclear? Do you see them as huge opportunities or risks? For example, would you expect some quite bold moves on technology on CMU in the next political cycle, to drive forward the integration of the capital markets in Europe?

Francesco Vanni d'Archirafi

I think technology is a facilitator and an enabler. It creates the urgency that we need because if somebody else uses the technology better than you do, they will have a competitive advantage.

Let me give you an example with DLT. We have put our DLT platform together and we have issued for one of the biggest global issuers under our DLT platform. I remember one or two years ago, blockchain and DLT were going to solve everybody's problems. The reality is that DLT fragments the market, because the tokens issued are usually locked on siloed DLTs with no secondary market liquidity. What we do to avoid that problem is to flip the security token to our legacy infrastructure as soon as the issue is funded and underwritten. This means that, until there is a secondary market liquidity on chain, we will run the two infrastructures at the same time. Liquidity is what attracts issuers and investors. Until you can generate that liquidity on the DLT chain, I think it will be an example of a very powerful technology but that is not necessarily doing what everybody was expecting.

In the last 12 months, DLT has been overshadowed by Gen AI as a topic of discussion. That shows you how quickly technologies come. They find their place where they can be used as a competitive weapon by bringing important opportunities or disruption, like it is the case for AI.

I think D. Schwimmer mentioned that AI works for your labour force, it works for your clients, it works for your suppliers, and we are aligned with that. It is probably

one of those situations where you need to co-create. As a systemic and highly regulated financial market infrastructure, we cannot bet on a new technology. We have to understand it, use it intelligently, and use it responsibly. I think that is the term I like. New technologies should be used responsibly for the benefit of our ecosystem.

David Wright

Francesco, thank you so much for being with us.

Francesco Vanni d'Archirafi

I am delighted to be here.

David Wright

It has been really enlightening to talk to you. Thank you for your support of Eurofi.

Francesco Vanni d'Archirafi

Thank you very much. And next time, I will have a better look at the agenda.

Conversation with David Schwimmer

David Schwimmer - Chief Executive Officer, London Stock Exchange Group
David Wright - President, EUROFI

David Wright

We are very lucky this afternoon that we have a series of conversations with some of the industry leaders in Europe. Our first speaker is David Schwimmer, who is the chief executive officer of LSEG. I am sure he will tell us more. David joined the group in August 2018. Before that, he was with Goldman Sachs as chief of staff to Lloyd Blankfein, who was then the president and CEO of Goldman Sachs. He has just about the most impressive academic record that you could have coming from the US, having degrees from Yale, from Harvard, and from the Fletcher School of Law and Diplomacy. That is fantastic. Let us start.

You are at the coalface. You see things moving every day. How do you see the European capital markets today? Are we making progress and moving in the right direction? You probably heard J. Berrigan saying we have more to do. How do you see the big issues today? What do we need to do to make it more vibrant and dynamic?

David Schwimmer

Thank you, David. It is great to be here. I was just listening to J. Berrigan's remarks. I agree with pretty much everything that he said. I think there is an opportunity to go from making important changes that really have an impact on the margin to really significant political decisions that could have an impact on how attractive and competitive the EU is seen to be. I think we all know what those issues are, so there is no need to recount them. It is a question of emphasis. I am not the first to say that the EU is a leader in regulation. How does the EU become a leader in innovation? I think that would be a fundamental shift and a really important opportunity. We also all know that capital is mobile. When capital gets excited, it moves. We have seen that excitement in the US. We have seen that excitement recently in India. We are even seeing that excitement now in Japan. There are different drivers of this, but it would be great to see some of the political decisions that focus on competitiveness and opportunity and help unleash that in Europe.

David Wright

I am very glad you used the word excitement. My memory goes back to when Jacques Delors was driving forward the single market programme. This was at the beginning of the 1990s, but there was excitement. There was a genuine belief that things were really happening at the European level. I think he deserves enormous credit for building that. How do we generate that excitement again in Europe nowadays? What do we need to do here?

David Schwimmer

Without going into a number of the specific reforms that J. Berrigan and others have talked about, I think there is a mindset issue here, and almost a cultural dynamic. If you look at how the EU tends to approach a lot of issues, in effect, there is an effort to force activity to either happen within the EU or stay within the EU, as opposed to trying to attract activity to happen within the EU. This gets to this discussion around competitiveness. If there were the same focus on competitiveness that we have in the EU on the digital transition or the green transition, which I know people are talking about, that would have a dramatic impact. It is a mindset shift in terms of being focused on attracting capital into what should be a huge, dynamic, attractive, active capital market. That is a significant mindset shift.

We do not have all day here, but there are a number of other aspects in terms of the cultural dynamics. J. Berrigan touched on financial literacy. How do we get more retail involvement and retail excitement? You see that in some countries in Europe, but how do you get that more pan-European interest? How do we have

pension funds taking a more active role - in terms of the pension capital that is available in Europe, I do not mean to overly generalise here ?. Some are fantastic investors, but I think there is more opportunity there.

David Wright

Knowing the US capital market very well, would you argue that the multi-trillion capitalisation and securitisation like the 401(k) plans and these types of instruments provide the bedrock of a deep, liquid capital market in the US? Is that something we have to replicate here in Europe, for example?

David Schwimmer

I think it is an important part of it. I think this is why this issue is so challenging. There is no single silver bullet. This is about having the right regulatory environment. It is about having the right political environment. It is about having the right embrace of risk culture. It is about having the appropriate balance between capital market activity and bank lending activity. That does not change overnight. I think all of these issues come into play. I think this is something that needs cooperation and partnership between the public sector and the private sector. I think you need an acceptance of risk because capital markets are about risk and allocation of risk. There are winners and losers. That often is a concept that fits pretty uncomfortably with a regulatory environment. All of these things play a role.

David Wright

David, one thing I definitely wanted to ask you about is listings, because I think there has been a collective frisson in Europe about losing a lot of listings. First of all, listings are going down. Secondly, there have been a lot of listings drifting across the Atlantic. I think that is partially true in the UK as well. What does one do about that? Are the rules wrong? Is it the depth of the markets? Is this a fragmentation issue? Why is it so sudden?

David Schwimmer

I think it is related to the conversation we have had already, but there are some nuances to it. The first point I should make is that there is a very strong narrative about listings going to the US, whether from continental Europe or from London. The narrative is, frankly, a little bit overplayed if you look at the actual number. I think it is important to keep that in mind. There is also a narrative about a difference in valuations that you can get in the US versus listings in continental Europe or in London. That narrative is also overplayed. There are a number of banks that have done some good analytical work on this. Look at companies on a comparable apples-to-apples basis in terms of growth rates. If you adjust out for the significantly larger number of tech stocks that have a very high multiple in the US market, there is not that kind of meaningful differentiation in valuation. Some of these overly simplistic narratives have gotten a lot of play in the media. You have to look at them a little bit more sceptically.

Having said that, there is an issue. It comes back to some of the topics that we were touching on already, in terms of risk appetite among investors. The US is the largest capital market in the world. That is both positive and negative. This is something that we have seen with a number of companies. It does not make sense for every company to go list in the US. A lot of companies that go list in the US get lost in the capital markets there, given their size. We have looked at the statistics specifically of companies that have gone from the UK. A significant majority of those that are still listed are trading well under their listing valuation, and a number have been delisted. It is not such a wonderful environment to go into. I think the narrative is still out there.

There is an important aspect here, which is that the US is seen somewhat culturally as more receptive to longer-term innovation, longer-term growth opportunity and near-term profits. There is less demand for that. As an investor, you may say, 'I would rather invest in the UK or European markets,' but if you think about the kinds of companies that are driving change, that are driving innovation, a lot of them take that longer-term perspective. From an investor perspective, do we have that kind of support for those companies here in the EU? Do we have that kind of support for those companies in Europe broadly?

David Wright

Looking at the smaller companies, do you think Europe is doing a rather poor job? We are not getting many fast-growing, small companies to list in Europe. That is the future economy, is it not? That is where huge numbers of jobs and growth will come from. What I am asking here is, is there a particular problem regarding small companies?

David Schwimmer

Here is where I want to be a little bit careful about the narrative becoming too negative. First of all, the Initial Public Offer (IPO) environment around the world has been pretty grim for the past couple of years, including in the US. The other aspect of this is that, because we have had low interest rates for so long, people often lose sight of the fact that we are basically at the tail end of a 20-year cycle, when it has been very easy for companies not to go public. They have had plenty of access to private capital. I do not want to make interest rate predictions, but if we are at the end of a 20-year cycle, and if we are in a position where capital actually has a cost again, then you will see companies thinking very differently about access to capital. We are already seeing significant changes in terms of how the private equity sector is working.

I think that is a long way of saying it is a little bit early to call the death of small and medium-sized IPOs in this market and in other markets, because I think this change in the interest rate paradigm is going to have an impact on how access to public equity capital is seen as relatively more attractive.

David Wright

Finally, David, myself and others have been reading about some very interesting technology projects underway at the LSEG. How are you adapting to all the AI, distributed ledger technology (DLT), desktop

management interface (DMI) and tokenisation? This is a big question. Maybe you could steer us and give us a flavour of where the LSEG thinks it should move.

David Schwimmer

There is a lot going on at LSEG in terms of what we are doing with both DLT and with AI in different parts of the business. I will just touch briefly on an initiative. We have to build digital market infrastructure. We are basically building what we refer to as asset class agnostic digital infrastructure, so that you can have the custody of the tokenisation, the actual execution and settlement in an existing digital infrastructure. Our focus initially will be on asset classes. I will call them new asset classes, but they are basically asset classes where the current market infrastructure does not work so well. You should not expect us to go after public equities. That is actually working pretty well. For example, private assets tend to face much more friction in terms of how the execution takes place.

On the AI front, we are using AI in a number of different areas. In our operations, we are using it to answer customer queries. In terms of our data ingestion, we have thousands of people doing data ingestion, given the scale of our business. You can just imagine the greater efficiencies we are getting out of those people by arming them with AI technology to help ingest the data that we use in our global data business. We are embedding it in some products that we are building, in particular with products that we are building as part of our partnership with Microsoft. We expect to be rolling that out. Some of the pilots are actually coming over the course of the next few months. They will be generally available over the course of this year. There is a lot of excitement internally about that. There is a lot of excitement in terms of the customers that we are designing these products with. I think they are going to have a big impact in terms of the workflow, how the financial sector really interacts and is able to work with each other.

David Wright

Finally, I have a curveball question, as I think you call it in the US. Think forward 10 years, David. Is it an instantaneous trading, clearing, settlement, tokenised world we are going to be living in, in terms of trading and so forth?

David Schwimmer

There are many different ways to speculate on that question. Maybe I will pick up on one of the comments that J. Berrigan was making earlier. Today, there is still this emphasis on the geographic location of where trading supposedly takes place. Capital is global. Companies tend to be at least international, if not global. I think with the benefits of technology, 10 years from now, we are in an environment where the trading does not necessarily take place in a specific location. In this case, we are talking about equity trading, but the trading does not take place in a jurisdiction. It is taking place in the cloud.

There is an important question there. What happens from a regulatory perspective? Some asset classes do not require regulation. The way we like to work, and given the institution we are, we work with regulators. We are having these conversations already. I think there is a real opportunity here for regulators to also have this mindset and think, 'How do we apply our regulatory medallion in a less geographically focused but more functionally focused environment that this digital, cloud-based, et cetera?'

David Wright

Thank you, David. It is great pleasure to have you with us. Thank you for your support of Eurofi. We look forward to seeing you in the next edition in Hungary in September time.

David Schwimmer

Thank you for having me.

Conversation with Philipp Lotter

Philipp Lotter - Managing Director, Head of Global Ratings & Research, Moody's Investors Service
David Wright - President, EUROFI

David Wright

I am very pleased to welcome Philipp Lotter, who is the managing director and head of global ratings and research at Moody's Investors Service. Philipp, first of all, thank you for the support of Moody's of our work over many years. It is greatly appreciated. You have been at Moody's since 2003. You have had an immense amount of experience in the Far East, in Singapore and in Dubai, heading up various departments and offices in these regions. Now you are responsible for Moody's global ratings and research business, based in London, so you have a really crucial and very important role in European capital markets. Let us start off by asking you, Philipp, if I may, what are the big credit themes that you see today for this year.

Philipp Lotter

Thank you, David, and thank you, Didier and all the organisers, for what looks like another absolutely fantastic conference. As it has been mentioned before, the current environment is complex. Our job at Moody's is really to distil complexity into messages that I would not call simple, but clear. What we have attempted to do for our imminent credit outlook is to look at the four key themes that are going to drive credit and, by extension, the capital markets, not just in Europe but globally over the next year and probably beyond.

The first key theme is clearly the broader rate environment and the growth environment. We call it higher rates/lower growth. It is no surprise to anyone here that we have come off a period of unprecedented cheap money and are now in the midst and, as it looks like, the end phase of a really unprecedented correction and adjustment of financial and, to some extent, fiscal policies. That is going to remain a theme, certainly for most of this year, in that central banks are going to want to make sure that inflation is sustainably heading back towards their target corridors before they start loosening the monetary agenda.

I think that the markets have gotten a little bit ahead of themselves until very recently in talking about March rate cuts. We would be very surprised if we saw rate cuts in March. I think that even May might be a stretch. Ultimately, rates are going to come back down. We think that the Federal Reserve (FED) will go towards 4.25% or 4.5% by the end of this year, and the European Central Bank (ECB) likely towards 3.25% by the end of the year. We have certainly reached a peak, but not to the extent that inflation has returned comfortably back to sustainable levels. As we have seen, inflation is bumping up and down and, accordingly, markets and monetary policy will remain on edge until we have clarity.

I do also want to highlight, though, that one of the biggest fears throughout the decade of easy money was, 'How are we ever going to get back to some form of normality?'. The central banks have done a very good job of leading us through this period of monetary adjustment without, so far, having caused serious recessionary impacts across most of the developed economies. The resiliency of the markets and of economies is quite astounding. I know that some pessimism has been raised in the EU, and the EU is certainly performing below potential at the moment, but, even in the EU, we have had relatively strong economic resilience, as well as consumer and labour market resilience. Particularly in the US, resilience has been quite phenomenal. There will be continued volatility certainly over the course of this year.

Secondly, I want to touch upon the other three key considerations very briefly, because they are all very relevant to the discussions taking place over the next couple of days. The first one is structural shifts. Again, there are a number of challenges posed by climate change, technological advancement, and demographic and social pressures. We can already see the effects of climate change really starting to challenge business models and bringing costs and insurance premiums up. No matter where you stand in the debate, the tangible

impact is already quite noticeable. Then, of course, you have social considerations that are posing risks. Something that, a year ago, no one was even talking about was Generative Artificial Intelligence (GenAI), which is now a popular topic and has already fundamentally changed the way people work and operate.

I want to mention the third key theme, which is reforms and regulations. That is all about how governments and policymakers are responding to some of these shifts. We have already seen tighter regulation in the US on the banking side following some bank failures there. We are seeing increased pressures to disclose sustainability metrics for climate risk. We have a huge transition financing gap, which is affecting all governments, but particularly those in frontier and emerging markets. The big question is, 'Who is going to fund it?'. That will be a question not just for the EU, but globally, for the foreseeable future.

The final key theme is politics – in particular geopolitics, geopolitical realignment and the polarisation that has come with that. Most of us in this room have heard this phenomenal figure that two-thirds of the democratic electorate are going to go to the polls this year. We have the EU parliamentary elections coming up in a couple of months. We have the presidential election in the US. This will likely bring about greater polarisation as well as more complex and more uncertain policymaking. That is something that the world and all of us are going to have to navigate quite carefully over the next couple of years.

David Wright

Thank you very much, Philipp. What about the euro area economy and recent downgrade forecasts by the Commission and the ECB? Could you steer us here?

Philipp Lotter

We heard the gentleman from the International Monetary Fund (IMF) earlier. We are not far off. We think that EU area growth will be 1.1% this year. Then, of course, you have a lot of the economic engines of EU growth – Germany, Italy and France – all performing at 0.8% or 0.7%, i.e. well below their potential.

The good news is that, as we start to see inflationary pressures ease and interest rates come down, that will also provide impetus to the EU economy. NextGenerationEU (NGEU) funds will start to support growth across the EU area. For next year, we are in the 1.7% camp, which is an improvement, but I would certainly argue that is still below potential and still below some of the larger competing economies around the world while being enough to maintain living standards across the EU. Then again, governments still have very limited fiscal space to respond to a lot of social pressures. Going back to my earlier point around polarisation and fiscal space, that is going to be a challenging conflict for some governments to manage.

David Wright

We heard on the previous panel a lot of talk of competitiveness, the single market, and people talking about Europe's economy falling behind the US since 2008. What do you think are the main reasons for this? Do you buy the thesis that Europe is sliding downwards compared to the US and China?

Philipp Lotter

I would not argue that it is sliding downwards, but there is certainly a gap, and that gap is not new. As the previous panel said, we have had that for over two decades. There are a number of reasons for that, and the previous panel was fantastic at spelling some of those reasons out, but I would like to focus on two in particular.

One is the demographic disadvantage of the EU. Our US colleagues all work a lot more. When they take a long weekend, they call it annual leave. That is something that has an impact on productivity. Their population growth is stronger and, generally, the demographic dividend that the US has over the EU is one that, again, is not new. I do not want to be all negative. There have been labour market reforms in the EU – and I want to highlight particular countries like Greece and Portugal, as well as France – which have boosted employment. Overall, however, this is still a structural disadvantage with which the EU will have to operate.

The second point that I want to mention, as mentioned in the previous panel, is capital markets and capital markets infrastructure. There is lower capital formation in the EU. There is a much more risk averse approach to early-stage investments. There is still a mismatch between funds and investments that need to be funded. Research and development (R&D) was mentioned earlier: in 2020, the EU invested 1.5% of GDP in R&D while in the US, it was 2.6%, and that is a big difference.

These are structural issues that are set to remain and not to change anytime soon. Coordination is key, and I am very much looking forward to seeing what Messrs Draghi and Letta come up with in their upcoming reports. A lot of these questions and topics require a fresh impetus and a fresh focus from policymakers.

David Wright

Europe has not sat back and done nothing. We had the NGEU programmes, which M. Nava was just talking about, and €850 billion of expenditure. Only 25% to 30% has been absorbed up to now. How do you look at this? Is this potentially a good medium-to-long-term driver or is it deficient in its structure?

Philipp Lotter

Again, I want to show some qualified optimism here, because the NGEU funding programme is a landmark and unique programme in mobilising funding across the EU, which should not be neglected and forgotten. However, you make exactly the right point. The complexity around NGEU, particularly versus the Inflation Reduction Act (IRA) in the US, makes it more difficult and less flexible. In the US, the IRA is very much targeted at the private sector. Accessing loan grants and guarantees is a relatively straightforward process. The fact that you have this direct access by the private sector makes it a much more easily accessible fund.

Again, we must not forget the breakthrough that was achieved. In fact, we recently upgraded some sovereigns

in the EU, such as Cyprus, Portugal and Greece, which are all countries that we refer to quite explicitly as net beneficiaries of some of these investment funds to the extent that it has already had promising effects on credit profiles and, thus, ratings.

David Wright

As a final question, although we could go on a long time, looking forward and particularly looking at the capital markets and banking markets, what are the key drivers? What could really change the perception of Europe and the supply of capital? What would you do? What are the priorities? Given the theme of this conference, how do we drive this forward and be more successful?

Philipp Lotter

Again, it is simpler to answer than it is to execute, but it is all about new impetus, better integration and better coordination. What we need in the EU is more diversified funding sources, deeper credit markets, deeper fixed income markets, a greater EU fiscal capacity, and matching funding to much greater risk appetite. As mentioned earlier, savings are greater than investments, and that free flow of capital across EU member states is so important in facilitating these developments.

We have been talking about capital market and banking unions for many years, and we have made progress. The Single Supervisory Mechanism (SSM) and the Single Resolution Mechanism (SRM) are already two very important anchors of financial stability that exist today. Again, as mentioned earlier, we need the European deposit insurance scheme, which has made some progress but is still not where it needs to be. In order for it to be successful, you need central pooling of authority and centralisation across member states, although some progress has been made. Again, it goes back to fresh impetus and increased coordination.

The other thing that I just want to highlight around banking union is that, even if we did make progress on the capital markets side, there is still a lot of work that needs to be done on the banking side. There are still big differences in product features, in regulation and in insolvency laws, etc. There is still a mountain to climb and I am sure that we will be hearing a lot more of that over the next couple of days here in Ghent, but it has become very clear that the motivation for greater union, greater integration and greater alignment is just going to increase.

David Wright

I hope that you are right.

Philipp Lotter

Don't we all?

David Wright

Thank you very much for being with us. You are absolutely right that we need new impetus. We will get these very good reports, for sure, from Mario Draghi and Enrico Letta – and others, because there are others who are hardworking. The question then is the politics and the economics. I was going to ask you a left-field question. Do you think that we have won the economic arguments about integration at the European level? I am not so sure.

Philipp Lotter

Most people in this room will probably agree with the economic arguments. We still have to convince a lot of others outside of this room.

David Wright

Philipp, thank you very much, and thank you again for supporting us.

Conversation with Jean Lemierre

Jean Lemierre - Chairman, BNP Paribas
David Wright - President, EUROFI

David Wright

A very warm welcome to Jean Lemierre, chairman of BNP Paribas. Jean, I begin by thanking you and your bank for your continuous support of Eurofi, which is greatly appreciated and, I would say, essential. Jean, we are going to discuss the economic perspectives of Europe, starting with the competitiveness of Europe in particular. Can you give us your view? You see what is going on on a day-by-day basis. How do you see European competitiveness today? Are you concerned or not? What do we do?

Jean Lemierre

I shall make two remarks. First, Europe is beginning to suffer some slowdown, but hopefully for not too long. It is the unavoidable impact of getting rid of inflation, before a rebound. The rebound will be strong if Europe is competitive.

When I speak with clients, many of them have doubts, and this is worrisome. We need to be very much aware that investments are attracted to the United States for three reasons. Investors see the US as an efficient single market. May I remind you here that progress on the single market is absolutely key? It is Europe's main asset, and we should improve it.

The second point is the cost of energy. Energy is roughly three times cheaper in the US than in Europe. We know why and we need to find the solution. I believe energy transition is part of it.

The third element is about subsidisation. Money is on the table in the US. It is easy to get it because it comes in the form of tax incentives.

I stop there and simply say that we have to be very aware of the fact that, today, the debate is not about China or about emerging countries, but about serious transatlantic competition.

David Wright

When you look at the single market as a great asset of Europe, it seems to me that we have had ups and downs over many years from the days of Jacques Delors to where we are today. However, the challenges regarding the single market, as you said, are growing. They are not diminishing:we have energy issues, we have enlargement, and at the same time we have a growing competitiveness gap. We have plenty of savings, but, as you said, too much of it is heading to the United States. What do we do about this? What is your policy?

Jean Lemierre

In very few words, David, you have put many questions on the table. These are serious questions. Strong collective action is needed to succeed. Any kind of fragmentation will be a loss for Europe.

You also raised the question of enlargement. How compatible is enlargement with the single market? How do we make it compatible? Many in the world begin to think the future enlargement would be a threat to the single market. I shall simply share a remark made a few minutes ago by Sylvie Goulard who knows Europe well. We need to speak about non-EU countries' preparation for the future enlargement, but we should also prepare ourselves for it, which we never speak about.

My third point is about the corporate sector. Companies are key. They have to – and they try to – be competitive. There is no competitiveness and efficiency without a sound, efficient and competitive financial sector. That is the point that we have to discuss here. We have proven, over the last months, that the financial sector in Europe is resilient. For instance, we have been able to deal with serious tensions about liquidity coming from across the Atlantic and from Switzerland.

I refer to the financial sector, not only about banks. Competitiveness in the financial sector comes, of course,

from the action of each company, bank and fund, but also from supervision and regulation. We have to make sure that we are safe and efficient. We should never oppose the two.

Of course, you drive me to a point that has always been at the heart of what Eurofi does, which is the efficiency of channelling Europe's savings to the real economy. I mean capital markets union we have spoken a lot about. If I may make a new wish before the elections to the European Parliament for the new Commission, it would be to let us deliver. This is part of Europe's efficiency and competitiveness agenda.

David Wright

Just on the efficiency point, what does that mean for you? Does that mean, for example, old British ideas of simplification, cost-benefit analysis and competitiveness testing? One reads about that, but what does it mean in practical terms, in your view?

Jean Lemierre

Good or bad, Europe is funded mainly through banks. That was the case 15 years ago and still is. We have not changed this.

First, banks must have the capacity to deliver well and efficiently use their capital to fund the economy. The securitisation agenda is part of this effort. It was obvious in the US 40 years ago. It should be obvious, even more so nowadays in Europe.

Then we need to make sure that capital and liquidity can flow efficiently across Europe. That would be excellent for everybody. Capital markets union must be grown step-by-step. There are two different approaches. One is perfect. It means alignment of legal systems, unification of market supervision in Europe and tax harmonisation. It will take years.

Let us adopt a more pragmatic stance by promoting securitization first and finding the resources to grow equity in the corporate sector.

David Wright

Finally, Jean, are you hopeful? We have these various reports coming out from Enrico Letta and Mario Draghi, and from Christian Noyer, who is chairing a group in France, and there are many others. The European supervisory authorities and many industry groups are hard at work. There does seem to be some growing interest in trying to progress. Do you see it like that in your contacts? Do you see people finally realising that Europe cannot achieve its laudable objectives unless these things happen?

Jean Lemierre

I do. They will promote the policies well discussed in Eurofi which is a leader.

David Wright

Thank you so much again, Jean. It is always fascinating to listen to you. I share your cautious optimism. Thank you very much.

Conversation with Jérôme Grivet

Jérôme Grivet - Deputy Chief Executive Officer, Crédit Agricole
David Wright - President, EUROFI

David Wright

My next guest is Jérôme Grivet, who is the deputy CEO of Crédit Agricole. A very warm welcome, Jérôme, and thank you very much for your continued support of Eurofi. You have a most distinguished background, having been advisor for European affairs to Prime Minister Alain Juppé. You worked a great deal after that for Crédit Lyonnais and, at the end of 2010, became the CEO of Crédit Agricole Assurances and deputy general manager of Crédit Agricole in charge of finance in May 2015. You were appointed deputy CEO in charge of steering and control in September 2022. You have come from the École Nationale d'Administration (ENA), as so many great French officials who I have met in my life have.

We are going to talk about the digital euro in particular. How do we make it work? Is this good news for consumers? Is it good news for banks? How do you see things?

Jérôme Grivet

It is a very complex and technical question, but I will try to make it as simple as possible, because it is important to really stick to the main principles. Simplicity is the heart of the matter. If we want to ensure the success of the digital euro, it has to be very simple for the European citizens.

Most European citizens would think that they already have digital euros in their pockets, with all the tools and devices that are provided by their banks. It is perfectly legitimate for the European Central Bank (ECB) to want to provide European citizens with the latest formal step of a currency. There were the coins, then banknotes, and now the digitalised euro, but, if we want to make it a success, it has to be very simple. We must start with the basic functionalities and try as much as possible not to duplicate the existing payment functionalities that are already provided by banks to their consumers.

I will make one final, important point. Every time we question our clients about what they think about this prospect, privacy is also an essential element that they point to.

David Wright

Talking about the needs of users, you mentioned privacy. Are users positive or negative about this? How do you see this?

Jérôme Grivet

They are very attached to privacy. If the idea is that the digital euro is the newest form of the traditional euro under the form banknotes, it has to come with exactly the same privacy elements as cash. This is probably why all European citizens questioned about the digital euro very much emphasize this issue of privacy.

David Wright

Is this account- or wallet-based?

Jérôme Grivet

Every solution comes with its own advantages and drawbacks. If the digital euro is to be a substitute for the physical euro that we already have today, offline wallet is the preferred solution. If we go online – which is perfectly understandable, because, if we want to be present in the digital world, we need to have the capacity to interact with e-commerce – it is another issue. In that case it is much more directed at payments rather than cash deposits considered as a reserve of value.

David Wright

How does the business model work with banks? Is it integrated into banks' websites or apps? What is the right business model, from your perspective?

Jérôme Grivet

If we want to make it as simple, as swift and as efficient as possible, it has to be completely integrated into all the tools that banks already provide to their customers. It has to be seamless. Whatever the form, there must be continuity between what exists already – all of the tools that all of us have in our pockets in order to use our cash and our deposits – and the digital euro. It has to be integrated with banking tools.

We know that this comes with a lot of costs. Banks will have to deal with Know Your Customer (KYC), with anti-money laundering (AML), with the capacity to use ATMs and with the issue of fraud. When it comes with costs, we have to define a business model in which there is a balance between costs and benefits, and between obligations and incentives. In terms of remuneration, which is going to be limited, because the digital euro has to be free for citizens, and the ECB wants to cap the costs of payments for merchants, we must ensure that all the costs that banks will incur are compensated by some type of interchange fees, especially when payments are made with thereverse waterfall process.

David Wright

Are you very worried about the cost side of this? Do you think that it will be just dumped on the various financial institutions, who will be told, 'Good luck. This is it. Take the costs'?

Jérôme Grivet

We know that all these payment systems are costly, because they need to be very secure and to cover all aspects of regulation. I mentioned AML and KYC, and there is always the possibility of fraud, the cost of which also must be covered. We need systems that are efficient, instant and very secure for the consumer, and this comes with a cost which must be adequately covered.

David Wright

Just tell us a bit about how you see the preparation and the debates going on at the ECB and the Commission. Is it inclusive and open enough? Is enough work being done on the costs and benefits, or are you concerned that there are too many shortcuts?

Jérôme Grivet

There is still a lot of work to do, because we have not found the right schemes and the right balance between obligations and incentives and between costs and benefits. From the point of view of a bank that has 35 million individual customers in Europe, we do not think that the right balance has been set.

David Wright

One issue that often comes up is that of financial stability, with tensions in the markets, and people shifting their portfolios from one type of cash to another. Is that a matter of concern to you? Is this one of the primary problems?

Jérôme Grivet

Financial stability is very important for the development of the European economy and is one of the key successes that have been achieved over recent decades. It is important to preserve and further enhance this financial stability going forward. The digital euro has to take that into account. There is the issue of possible bank run because European citizens could easily switch their bank deposits to their digital euro wallet. Studies show that, under certain circumstances, this could represent quite significant amounts of cash flowing out of banks' balance sheets, and this would be detrimental to financial stability by fostering systemic movements. Indeed, would not happen when everything is quiet and calm, so this is an important issue.

Financial stability is also not only a matter of avoiding disintermediation that would be detrimental to the role of banks in financing the economy, but also to avoid disruption in the payment activities, hence the necessity to find the right balance between the costs and benefits and between the obligations and incentives.

David Wright

Would you favour some sort of cap or limit on how many digital euros your 35 million customers could hold?

Jérôme Grivet

If we refer to the cash holdings of European citizens as of today, it is around €100. This can be a reference. Another functionality of the digital euro is to facilitate payments, and so the system of waterfall and reverse waterfall makes it possible to avoid large holdings of digital euros . What is important is to have an equivalent of the cash holdings that European citizens have nowadays, because the digital euro is intended as a means of payment and not as a store of value. This leads to a very limited amount, for sure.

David Wright

It has been most interesting talking to you about this subject. Do you see the digital currency as part of what is called open strategic autonomy? Do you see this as a building block of strengthening the European capital market per se?

Jérôme Grivet

It is clear that there is a strategic dimension in the launching of the digital euro, and it is very important for Europe to watch what is taking place worldwide and what other jurisdictions are doing with their own central bank digital currencies. We see that, in China, for example, it has been launched but is not used very much by Chinese citizens. It is also important to look at what kinds of private initiatives can be taken with stablecoins and private currencies. It is very important that Europe has its own answer, but we must continue to watch what others do in order not to deviate from what is most relevant to securing our strategic goals.

David Wright

Thank you very much, Jérôme, for being with us, and thank you, again, for your support of Eurofi. The debate is not finished, which means that you have an open ticket to Budapest in September. I hope that you will be with us there.

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Deputy Prime Minister and Minister of Finance, Belgium

Opening Remarks

Good morning, ladies and gentlemen. Dear David, dear Didier, dear participants, thank you very much for this invitation and also for the opportunity to open this Eurofi this morning in Ghent. If there is one thing that you can mention on social media, it is that Ghent is the most exciting city in Belgium. I say this, of course, in full and objective transparency.

Every time – and it is the case today – Eurofi manages to assemble top experts and policymakers from the financial sector to discuss the challenges that we collectively face in order to work on finding common solutions. I understood from Mr Wright that this Eurofi in Ghent is breaking records regarding attendance, with over 1,300 people registered to join over the coming days. This is, of course, a success in itself. Only by commonly identifying and understanding our shared obstacles will we pave the way for prosperity, for innovation and for economic growth.

The coming days will be packed with discussions and presentations on our European financial and banking landscape. From digital finance and cyber risks to payment services and monetary policy challenges, all of these topics will be discussed in the light of the challenges ahead of us. In all the challenges that we face, be it in the green and digital transition, in defence, or in our strategic autonomy and competitiveness, financing will be of utmost importance.

As Belgium now assumes its 13th presidency of the EU, we find ourselves at a crucial juncture. Both immediate and long-term challenges are impacting our socioeconomic outlook. Most importantly, the EU is facing a major competitiveness challenge – first of all, externally, how to compete with the rest of the world, but also, internally, how to further strengthen our European internal market.

Tackling this competitiveness challenge is high on the agenda of the Belgian presidency as well as the next European Commission. As ministers of finance, we shall examine how our European financing will be organised in the coming years, as enhancing our competitiveness will require significant investments from both the public and the private sector. When it comes to public funding and financing those challenges and investments, I am very proud to announce that, last week, on 10 February, I managed to reach an agreement on the revision of the European budgetary rules on behalf of the Council, together with the European Parliament. Country-specific and multiannual debt reduction trajectories will be combined with incentives for reforms and investments. Going back to the old rules was not an option. We needed to provide clarity for both governments and financial markets.

Moreover, yesterday we presented a review of the recovery fund, which will start a discussion on a possible follow-up instrument. Over the coming years, we will need to ask ourselves to what extent we need more European financing to tackle our common priorities and challenges. It will not be the only answer, but we should not shy away from the discussion on Eurobonds. Over the past day, the discussion on a common defence bond has already gained attention, which I can only support.

Second, given the amounts at stake, which is where you all come in, a big chunk of financing the competitiveness challenge will come from the private sector. The financial sector can and must play a crucial role. Both the banking sector and financial markets are essential players. Clearly, we will need all of you to tackle the challenges of tomorrow.

First of all, as European companies still rely to a large extent on bank financing, we must also further strengthen our European banking union to ensure stable banks and more integrated financing for businesses at the European level. This is clearly a priority of our presidency, and we will work hard to finalise the crisis management and deposit insurance (CMDI) file. I am, therefore, glad to see that CMDI is also on the agenda of this Eurofi.

At the same time, we must also further strengthen our European capital market, which is still underdeveloped and too fragmented. A better developed European capital market could further leverage the necessary private capital, and not just institutional private capital but also household savings. Only a fully-fledged CMU will be able to mobilise much-needed private capital. Therefore, I am glad that

we have already closed some of the major files of the CMU package over these first weeks of our presidency, such as the Listing Act, the review of the European Market Infrastructure Regulations (EMIR), and the ESG ratings file.

However, this is clearly not enough. Apart from finalising some important legislative CMU files, we also need to start thinking about the Commission's next work programme and what our financial system and banking system and sector should look like in 2030. Ladies and gentlemen, this Eurofi conference, together with an informal ECOFIN on Friday on Saturday, will be a major moment to reflect on the question of what our financial system should look like. During this informal ECOFIN, I will, first of all, organise a debate on the future of the European Investment Bank (EIB), which is the largest multilateral investment bank globally and a major partner in facilitating more risk financing within the EU. For this session, I have invited the new president of EIB, Nadia Calviño, and, together with her, we will evaluate current EIB practices and discuss the strategic direction of the bank.

Moreover, during this informal ECOFIN, we will also look into the European capital markets. In this context, we will particularly discuss retail participation in financial markets and how to improve the overall financial literacy of European citizens. In order to put citizens' savings to work, we should focus on financial literacy. According to an Organisation for Economic Co-operation and Development (OECD) survey, about half of the EU adult population does not have a good understanding of basic financial concepts, and households without a good understanding of financial concepts will not actively invest in financial markets. All of those different elements, such as a better functioning and more risk-taking EIB, as well as a more developed and integrated EU capital market, will help to improve our European competitiveness over the decades.

To finish, on Saturday morning, I have invited Dr Mario Draghi, who is currently preparing a report on the future of European competitiveness. As ministers of finance, we will, during this debate, have the opportunity to feed into the final report by giving our different perspectives on this major topic of competitiveness.

Ladies and gentlemen, financial experts and policymakers, I also want to emphasise a final concern of mine to conclude. During this Belgian presidency, I am putting a particular focus on strengthening trust between citizens and financial institutions. Over the past months and years, we saw cracks emerging in citizens' trust in our financial institutions. In recent months, we have seen various member states resorting to very different measures to restore confidence. In Belgium, for example, we successfully issued a state bond at the end of last year. I am very much convinced that it is time to make a strong stand together – both policymakers and financial experts – to restore trust between citizens and financial institutions, because trust is crucial for the stability of our financial system and, by extension, of our union. For this challenge, I count on each of you collectively.

To finish, I only want to wish you all a very constructive and fruitful conference over the coming days. I want to thank again Mr Wright, Mr Cahen and their team for the excellent organisation of the Eurofi event in Ghent, and I wish you all a very pleasant stay in Belgium's most exciting city. Thank you very much.

Pierre Wunsch

Governor of the National Bank of Belgium

Lessons from the recent episode of high inflation

Introduction

Ladies and Gentlemen,

It is my privilege and honour to address such a distinguished audience, here in the beautiful city of Ghent.

Tonight, I would like to talk to you about the lessons I have drawn from the recent episode of high inflation. I am aware that I stand between you and your dinner, so I promise to be brief.

Central bankers need to look back with humility at their failure to contain inflation over the past two years. Inflation had not been as high for decades, and it stayed above the target rate for much longer than initially thought. While it's true that inflation first began increasing due to rising energy prices, core inflation quickly followed. Central banks were slow to react to these new dynamics. And, yes, headline inflation and core inflation do seem to have reached a turning point, but we might not be completely out of the woods yet.

There are four key lessons I would draw from this experience so far. The first is on forward guidance, the second on model-based forecasts, the third concerns the mechanisms of expectations formation, and the fourth and final one relates to fiscal policy.

Let me elaborate on these.

Lesson one: forward guidance

First, the role of forward guidance will have to be revisited.

Forward guidance proved useful at the effective lower bound. Short-term rates could hardly get any lower, and indications that they were going to stay «low for long» weighed on medium-term rates.

That said, there is scant evidence that forward guidance helped support inflation during the lower bound period. What is clear, is that it took a long time for inflation to get back to 2%, and that it stayed there only briefly before rising to over 10%.

Moreover, forward guidance can tie the hands of policymakers. The policy of continuing PEPP reinvestment is a recent example. With the pandemic essentially over, reinvestment is being continued effectively to honour an old promise. Fortunately, the impact of an additional year of reinvestment is limited. Another example relates to the conditions set by the ECB prior to raising rates during the post-pandemic recovery.[1] These conditions were very much inspired by the strategy review, with the dominant view that inflation would converge smoothly to 2% from below. But with contingency based forward guidance, central banks can get into trouble when things turn out differently than expected. In line with its forward guidance, the ECB started raising rates in July 2022 which, in hindsight, could be considered late.

Lesson two: model-based forecasts

The prevailing idea that inflation would smoothly converge to 2% from below largely emerged from model-based forecasts. This brings me to the second lesson: models are full of shortcomings, and they can sometimes be very wrong about future inflation.

Virtually all the models that underpin inflation forecasts assume a long-term mean that is more or less «hard-coded» around 2%. They are likely to miss regime shifts or the consequences of tail events. And since the last significant inflation surge was in the 1970s, models estimated on the most recent data probably underestimate the persistence of inflation when it starts to climb.

I read that the Bank of England and the Bank of Canada want to revamp their modelling infrastructure. This is a good idea and involves central banks continuously learning and adapting. Central banks thrive when they integrate the latest modelling techniques and data science methods. Aiming to improve forecast accuracy should be a continuous pursuit. In particular, it should be possible to reduce repeated under- or over-estimation of inflation, i.e. the issue that negative (or positive) forecast errors tend to remain negative (or positive).

But let's pause here for a second. What are we really after? Are central banks aiming to perfectly predict the future? Can you imagine a world that is almost entirely predictable? What a strange place that would be! One where whatever we did, whatever shock occurred, the inflation rate would almost certainly end up within a narrow

forecasting range. Plus, if we were able to perfectly predict the future state of the real economy, there would be huge «free-lunch» investments. A world without uncertainty is not within the realm of possibility.

The discussion that we need to have about model-based forecasts in fact goes beyond simply improving their accuracy: it is about weighing them correctly in policymaking. A basic principle to follow could be to grant a lower weight to model-based forecasts when forecast uncertainty is higher. This idea pushed the ECB to adopt a «data-dependent» approach to setting interest rates over the past two years. Conversely, the more accurate the model forecasts, the greater the weight that should be given to them. But model-based forecasts will never be entirely accurate, meaning the weight assigned to them should always remain well below 100%.

Lesson three: mechanisms of expectations formation

One reason economists were misled by model-based forecasts during the post pandemic recovery probably relates to the fact that many models are based on the paradigm of rational expectations. This paradigm most likely under-estimates the complexity with which expectations are formed, which leads me to my third lesson.

In 2021-2022, unexpected rises in inflation probably woke up rationally inattentive households. If households start forming expectations in line with recent inflation prints, inflation becomes more persistent, and a stronger monetary policy response is required.

Presently, monetary policy is not that restrictive, and yet we seem to have reached a turning point in inflation dynamics. This can only happen when agents are forward-looking, at least to some extent, and expect low, stable inflation.

So, further analysis of how and why economic agents shift back and forth from a forward- to a backward-looking approach to form inflation expectations appears to be required. These shifts determine the optimal degree of monetary policy tightening necessary for a timely return of inflation to target, while limiting economic costs.

Lesson four: fiscal policy

The last lesson I would like to mention is that, in some countries, it might be difficult for the fiscal authority to return, after a crisis, to its role of ensuring debt sustainability.

If governments do not make more efforts to reduce public deficits, central banks could come under pressure. In the euro area, we seem to be in a situation of weak fiscal dominance. In many Member States, public deficits are well above 3% and are expected to stay at high levels in several countries. In Belgium, the latest projections of the National Bank indicate that the public deficit will remain at around 5% until 2026.

Better fiscal rules are probably needed to guarantee monetary dominance, which is why I welcome the recent reform of the EU fiscal rules. But the EU needs to make sure that these fiscal rules are properly enforced. At the same time, the reform did not extend to the coordination of fiscal policies across the euro area, which would have facilitated the work of monetary policy.

Conclusion

I would like to conclude with some pragmatic observations about monetary policy.

Substantial uncertainty remains: Ukraine, Gaza, the Red Sea, the fiscal stance, etc. It therefore seems opportune to remain data dependent. That being said, models have been doing better recently: inflation forecast errors are much smaller (and actually turned negative). In fact, it might be time to think about returning to «business as usual», with more weight placed on the inflation outlook rather than on underlying inflation and the strength of monetary policy transmission.

Much will depend on the labour market. Wage growth, corporate profit margins and potential continued labour hoarding will, in particular, need to be closely monitored.

If inflation gets back to 2% by 2025, as forecasts suggest, rate cuts will have to be considered at some point this year. These would help to avoid inflation undershooting its target and weighing too heavily on economic growth.

The Governing Council may well be able to get inflation down while implementing rate cuts this year. In that case, a soft landing for the economy is in sight. This stands in sharp contrast to the 1970s-1980s when inflation also reached 10%, and is a good sign for the ECB's credibility.

With that, I would like to thank you for your attention. Enjoy your meal.

1. The three conditions were: (i) inflation reaching 2% well ahead of the end of the projection horizon; (ii) inflation forecasts being at 2% for the rest of the projection horizon; and (iii) underlying inflation being sufficiently advanced so as to be consistent with inflation stabilising at 2% over the medium term.

Valdis Dombrovskis

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

Securing EU's competitiveness – the role of the EU's financial sector in the years ahead

Ladies and gentlemen: it is a pleasure to return to Eurofi, this time in the beautiful and impressive city of Ghent.

Thank you for inviting me.

We are only a couple of days from the two-year point marking the start of Russia's brutal full-scale assault on Ukraine.

It was on that day - February 24, 2022 - that I spoke to the Eurofi high-level seminar, in Paris.

At the time, I called it a watershed moment, with Russia posing a real threat to the free world. And it still does.

I called it a gross violation of international law. It still is.

But Russia's aggression is much more than that. It is also an attack on democracy and European values.

The European Union will do whatever it takes for Ukraine to win this war. Our support will continue on every level.

It is the only way to ensure long-lasting peace in Europe.

As I said to you two years ago, we cannot be naïve about Russia – or we risk moving from a world of law and order to one where the only rule is 'might is right'.

Ladies and gentlemen

When this European Commission started its mandate in late 2019, nobody could realistically have expected the sheer upheaval that lay ahead – economic, social and geopolitical.

It has been a tough period for everyone, certainly from the economic perspective. And it is not over yet.

As we approach the end of this mandate, there is still a good deal of work to do, and a lot of uncertainty.

Today's challenging macroeconomic and geopolitical landscape has taught us many lessons.

But it poses many significant challenges as well.

To start with: the need to preserve our open market economy and to strengthen the single market.

Then, the importance of safeguarding our economic security and making sure of resilient supply chains.

Lastly: the fundamental requirement of having a strong, integrated financial system, especially in the event of a crisis.

Thanks to the many reforms and policy initiatives taken over the years, the EU financial sector has managed to withstand a good deal of turbulence. And the wider EU economy has held up remarkably well through a series of major shocks.

For the longer term, our focus must be to maintain and strengthen the EU's financial and economic resilience, maintain and boost competitiveness, as well as to create lasting and sustainable growth.

Above all, this starts with our principal strength and asset: the EU single market, where we should remove the remaining barriers to the free movement of goods, services and capital.

The single market plays a key role in building a resilient economic base that will keep the EU competitive for the long term. Our economic and social fabric depends on it.

Another factor is the dramatically altered geopolitical situation. This makes it especially important to maintain financial and macroeconomic stability.

A solid, versatile and well-regulated financial sector has a vital role to play here, particularly in driving forward the green and digital transitions – and our long-term competitiveness too.

To generate the financing that Europe needs for the future, the right conditions must be in place so that we can:

- advance towards sustainable economic growth,
- meet the goals of the twin transitions,
- build strong job-rich economies,
- and promote the EU's competitiveness.

This brings me to the Banking Union and Capital Markets Union.

We need to make more progress on both projects to ensure our long-term growth and competitiveness.

On one hand, to make sure that our banking system is sound and

resilient. On the other hand, to deepen EU capital markets and broaden the possibilities for our companies to access resources so they can innovate and grow.

To start with the Banking Union: at present, we are focusing on our proposal on crisis management and deposit insurance reform. Reaching agreement here would not only make our financial system more resilient.

It would also pave the way for progress on the other outstanding building blocks of the Banking Union.

On the Capital Markets Union: we have come a long way since the first CMU action plan in 2015.

Just recently, we reached agreements on the Listing Act and EMIR Review. They come on top of major prudential reforms.

Last year's endorsement of Basel III and the Solvency II review will make sure that our banks and insurance companies can stay resilient and provide the long-term finance that the EU economy needs.

Most importantly, we have reached agreement on our AML rulebook. After more than 30 years since the first AML Directive, we are finally moving from 27 systems to a single rulebook. It will be overseen by a new EU authority – AMLA. The vote is taking place today.

This reform will give the EU a stronger and safer AML/CFT system, as well as simplifying rules for financial institutions.

In short: we have achieved a lot with the CMU, even though it may take some time to see full positive impact of the recent advances that I just mentioned.

However, there is still work to do in strengthening and integrating, and improving the efficiency of EU capital markets, promoting cross-border investment, and providing more alternatives to bank financing.

In Europe, companies usually obtain most of their financing from banks. And banks should keep playing this important role.

That said, in Europe, young innovative companies still find it difficult to get the financing they need to expand and thrive.

Ideally, they need other sources of capital financing to allow them to scale up – and of course, this is a primary objective of the CMU. For them, equity investments are crucial, such as those made by venture capital investors.

When it comes to venture capital, the EU lags way behind other jurisdictions. Venture capital is a potential area for the next Commission to consider, along with securitisation markets, pension savings, tax incentives and retail investment products.

But we are not just talking about start-ups and smaller companies. These issues concern the financing of more traditional companies as well. The CMU aims to provide better and more diverse financing conditions for all companies – of all sizes – via EU capital markets.

We should remember too that the CMU is a long-term project.

The challenges will only increase due to the major economic transformations that lie ahead and the financing they will need.

In turn, we would need our capital markets to increase in size and liquidity so they become more efficient and competitive.

This reinforces a longstanding aim of the whole CMU project: to build a single developed capital market for the EU as a whole and move away from today's patchwork of national markets.

Ladies and gentlemen

Earlier, I mentioned the vital importance of maintaining stability: financial as well as macroeconomic.

Without stability, we will not be able to secure lasting and sustainable growth. We cannot just be looking over our shoulders to deal with immediate problems and the next crisis.

Our revised fiscal rules will help us to ensure that stability, by underpinning sound and secure public finances across the EU's Member States. They are a key element of a stronger Economic and Monetary Union. They provide the basis for debt sustainability, inclusive economic growth in all Member States through reforms and investment, and our long-term competitiveness.

Just recently, the European Parliament and Council reached a provisional political agreement

on the proposed reform of the EU's economic governance. It is vital that we end this Parliament's mandate with new fiscal rules in place so that we have clarity and predictability for the years ahead.

To achieve this, we will:

- move to a risk-based differentiated approach,
- build in strong incentives for investment and reforms,
- strengthen national ownership.

This will be backed by effective enforcement to make sure that Member States abide by their commitments.

A key element in maintaining the EU's macroeconomic stability is to prevent and address issues that can jeopardise the stability and functioning of our economies.

In practice, this means a stronger focus on the evolution of risks and on the policies to tackle imbalances.

The new system will give Member States greater leeway in designing their medium-term fiscalstructural plans.

These will set out fiscal targets, priority reforms and investments, as well as measures to address potential macroeconomic imbalances.

Ladies and gentlemen: let me now turn to economic security.

Facing greater global risk and uncertainty, and in the wake of a series of supply-side shocks, the EU decided to re-examine its relationship between openness and economic resilience.

We need both elements, of course - but they must be balanced.

The European economic security strategy aims to raise the EU's capacity to identify, manage and assess the security risks that we face, and address them proportionately and precisely.

It maximises the benefits of openness to trade and foreign investment, while addressing risks to economic security.

The strategy has three pillars that are equally important: promote, protect and partner. In essence, they entail:

- building on our strengths
- strengthening partnerships around the world
- staying open to trade and investment
- but defending and protecting ourselves when we need to.

The strategy directly reflects the concept of open strategic autonomy, which has been guiding our work on trade policy for most of this mandate. It means focusing on a free and open economy, working cooperatively with others, and strengthening our internal capacities to deal with emerging challenges.

It is also about protecting the EU, and the single market, by addressing the unintended consequences of excessive vulnerabilities. But staying competitive at the same time.

To conclude, ladies and gentlemen: Europe faces a complex economic and political landscape.

This is likely to remain the case for some time, with both challenges and opportunities for the EU's financial sector.

It has a vital role to play in developing our economy, both now and in the years ahead. I know that we can continue to rely on the support of Eurofi and its members. Thank you.

Pablo Hernández de Cos

Chair, Basel Committee on Banking Supervision
& Governor, Banco de España

Two truths and a myth in banking regulation

Introduction

Good morning, and thank you for inviting me to speak at this Eurofi High Level Seminar. It's a pleasure to be in Ghent with you today.

Throughout the years, there has been no shortage of discussions at these Eurofi events about the work of the Basel Committee, and prudential regulation and supervision more generally. Take a cursory look back at previous conferences, and you will stumble upon sessions with titles such as:

- "Impacts of Basel III on EU financial activities";[1]
- "Implementing Basel III in the EU: remaining challenges and timing";[2]
- "Basel III implementation in the EU: key political stakes";[3] and, as part of this week's event,
- "Basel III implementation: global consistency challenges"[4].

You would be forgiven for wondering whether we are in some sort of Basel III implementation Groundhog Day! In fact, Basel Committee member jurisdictions are making good progress with implementing the outstanding Basel III standards. Around a third of members have implemented all, or the majority of, the standards already, while two thirds plan to implement them by the end of this year. Most of the remaining jurisdictions expect to implement the outstanding standards by next year.[5]

But it is also true that discussions around Basel III – including at these events – are often dominated by somewhat flimsy assertions. Many have been warning about the detrimental impact of Basel III for almost 15 years now. Yet the empirical evidence to date is overwhelmingly clear: the global banking system has become more resilient since the implementation of Basel III, and bank lending has expanded in most jurisdictions during this time period.[6]

So we could all benefit from a reminder about why the Basel III standards are critical to safeguarding the resilience of the global banking system and supporting economic growth and the prosperity of households and businesses. I will therefore take a step back today to underline two recurring truths and to debunk a recurring myth when it comes to bank regulation and supervision.

Truth number 1: banking crises have a profound impact

The history of banking crises is rich and deep. Since 1920, the average share of countries around the world experiencing a systemic banking crisis in any given year is about 7%.[7] There have been over 150 systemic banking crises around the globe since 1970.[8] The Committee itself, which celebrates its 50th anniversary this year, was established in the aftermath of a series of banking crises in 1974.[9]

Systemic banking crises have a profound impact on our economies and social welfare.[10] Banking crises have historically led to a persistent loss in output to the tune of 10% of GDP.[11] Banking crisis-induced recessions permanently depress the level of output, with typically no return to pre-crisis trends.[12]

If this sounds like ancient history, then recall that it was less than a year ago when we witnessed the most significant system-wide banking stress since the Great Financial Crisis in terms of scale and scope.[13] Over the span of a few days and weeks, five banks with total assets exceeding $1.1 trillion were shut down, put into receivership or rescued. The distress of these banks triggered a broader 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. A back-of-the-envelope estimate suggests that roughly $500 billion of direct public support was provided in response to the turmoil.[14] That's a large number!

So what does the history of banking crises tell us about the future? Forecasting is a notoriously imprecise science; the economist Ezra Solomon once quipped that "the only function of economic forecasting is to make astrology look respectable".[15] Notwithstanding that word of caution, we can be fairly confident in saying that crises are a quasi-inevitability of a banking system model premised around the use of leverage and maturity

transformation. But we have a choice to make as to how frequent and severe such crises may be in the future.

The Basel Framework is not designed to produce a "zero failure" banking system, but rather to reduce the likelihood and impact of banking stress, while facilitating financial intermediation and economic growth. Attempts to weaken the framework will only aggravate the impact of future crises.

And yet, despite the painful experiences of the many past banking crises, history suggests that the lessons from such events can sometimes be forgotten as part of a so-called "regulatory cycle".[16] Memories of banking crises fade, whether because of the mere passage of time or due to later events.[17] Vested interests start to gain momentum, and the fallacy of "this time is different" reoccurs. This tests our will to persevere with the implementation of post-crisis reforms. We convince ourselves that some reforms may no longer be needed or warranted, or even that rolling back reforms may be the key to achieving other short-term economic objectives. This is a path that we must collectively resist.

Each banking crisis has its own distinct features and specificities. All healthy banks are alike, while each distressed bank is distressed in its own way, to paraphrase Leo Tolstoy.[18] But there is one recurring theme throughout crises: it is strong and healthy banks that are able to withstand crises and continue to lend. That, in turns, requires having robust regulation and strong supervision as a foundation, and that we draw the lessons from each crisis. This is why, in response to last year's banking turmoil, the Committee is prioritising work to strengthen supervisory effectiveness and identifying issues that could merit additional guidance at a global level.[19]

Truth number 2: finance and banking are always evolving

The banking system has historically always evolved and adapted in response to structural changes.[20] Discussions today about the use of artificial intelligence and machine learning in banking are a far cry from the Babylonian financial system.[21] Indeed, we are witnessing profound transformations – and with them potential risks and vulnerabilities – to the global banking system. Let me mention three such examples.

The first is the ongoing digitalisation of finance. Finance and technology have a long and symbiotic relationship.[22] Yet the most recent technological breakthroughs in payment systems, digital banking services and data analytics stand out for their pace and scale. The very definitions of "banking" and what a "bank" is are being put to the test because of these technological innovations. The use of ever more digitalised banking services – which can in principle be beneficial – presents its own set of risks to banks. Digitalisation may also increase the interconnections across different sectors and nodes of the global financial system. This is why the Committee will publish a report in the coming months on the bank and supervisory implications of the digitalisation of banking.

A second example is the financial risks stemming from climate change. It is now generally accepted that climate change may result in physical and transition risks that could undermine the safety and soundness of individual banks, and have broader financial stability implications. Banks worldwide are potentially exposed to such risks regardless of their size, complexity or business model. Against that backdrop, the Committee is pursuing a holistic approach to mitigate climaterelated financial risks to the banking system, spanning the three Basel pillars of disclosure, supervision and regulation.[23]

Third, non-bank financial intermediation (NBFI) has grown significantly since the Great Financial Crisis, and now encompasses nearly half of total global financial assets. While the Committee focuses on the global banking system, the growth in NBFI is important, given the interconnections between banks and non-bank financial intermediaries. [24] Events over the past three years, including the market turmoil in March 2020, idiosyncratic episodes of NBFI distress and margin dynamics have highlighted how these channels of interconnections can pose risks to banks. Against this backdrop, the Committee will be consulting on updated supervisory guidance with regard to NBFI risk management over the course of this year.

Yet despite these structural developments, we cannot lose sight of the fundamentals of banking supervision. The Committee's Core Principles for Effective Banking Supervision provide a de facto minimum standard for the sound prudential regulation and supervision of banks worldwide. Indeed, they are universally applicable and accommodate a range of banking systems and a broad spectrum of banks. The Core Principles are intended to be a "living" standard that evolves over time in response to global financial developments. This is why the Committee consulted last year on revising the Core Principles to reflect the evolution of risks and vulnerabilities affecting the banking system.[25] I expect that we will finalise these updates over the coming months.

Myth: now is not the "right" time to implement reforms

And now, the persistent myth. Since the Committee launched its Basel III reforms in late 2008, we have repeatedly heard assertions along the lines of "now is not the right time to implement Basel III" due to "unique" and "exceptional" circumstances. The list of arguments provided over the past 15 years has continued to grow and includes economic headwinds – including both the "low-for-long" and "high(er)-for-long" interest rate environment – national elections, the pandemic, geopolitical developments and, perhaps most ironically, concerns about the frailty of banks.

Yet the truth is that waiting for the "ideal" time to implement Basel III is like waiting for Godot. To be

clear, there is of course a need to ensure that authorities and banks have enough time to transpose and implement the standards. This is why the Committee included generous phase-in arrangements for each set of Basel III standards: nine years for the initial set of reforms, and a further 11 for the subsequent ones. And we have been pragmatic as well, for example by deferring the implementation of some of the Basel III standards in response to the Covid-19 pandemic. In total, it will be 20 years since the Great Financial Crisis by the time the last element of the outstanding Basel III standards is expected to be implemented in 2028. Banks have surely had more than enough time to shore up their resilience through retained earnings, building liquidity buffers and making other portfolio and strategic adjustments.

Consider the counterfactual scenario where no aspects of Basel III had been implemented thus far. Banks would have operated with wafer-thin capital, with leverage ratios for some banks teetering at under 1.4%, and acute maturity mismatches. How would the global banking system have fared in response to the various shocks that we witnessed over the years with such high levels of leverage? How many banks would have failed, or would have required further taxpayer support, were it not for the enhanced resilience delivered by Basel III? How severe would the accompanying credit crunch and impact on jobs have been? There are clearly no definitive responses to these questions, but we can be fairly confident in assuming that the global banking system would have been in a much more dire situation.

In fact, the evidence is now increasingly clear that the outstanding Basel III reforms will complement the previous reforms in having a positive net impact on the economy, including in Europe.[26] For example, a recent analysis by the ECB suggests that the GDP costs of implementing these reforms in Europe are modest and temporary, whereas their benefits will help permanently strengthen the resilience of the economy to adverse shocks. [27] The benefits also extend to banks' own private gains. Empirical work suggests that there is a tight link between the profitability, valuation and resilience of banks, with price-to-book ratios positively associated with banks' capital buffers.[28]

I would be remiss if I did not try to counter a related myth about bank capital. Bank capital is not idle money that banks hold or that is is "set aside...or locked away in a vault".[29] It is quite simply a source of funding akin to others that can be used for lending, trading and other activities.[30] And let´s also stress the existing empirical evidence that finds a strong association between higher bank capital and a lower debt financing cost.[31]

But the job is not done. It is critical that member jurisdictions implement the outstanding Basel III standards in full and consistently, and as soon as possible. Many have already done so, and are benefiting from the increased resilience of their banking systems. The fault lines that these reforms seek to address remain as material today as they were seven years ago. This is why the Committee will continue with its Regulatory Consistency Assessment Programme over the coming years to assess the implementation of these standards at a jurisdictional level.

Conclusion

Regulators are often accused of fighting the last war. Yet in the case of implementing Basel III, it is the dragging on of the process – with attempts to reopen past reforms and battles – that will divert important resources from banks and supervisors to deal with current and emerging risks instead. We owe it to our citizens to lock in the financial stability benefits of Basel III and, in parallel, to ensure that we are able to identify and mitigate new risks so that our mandate to safeguard global financial stability is fulfilled at all times.

1. Eurofi (2019).
2. Eurofi (2021).
3. Eurofi (2022).
4. Eurofi (2024).
5. BCBS (2023b) .
6. BCBS (2022).
7. See Reinhart and Rogoff (2009). The cited figure is the simple average of the two-year average share of countries with systemic banking crises.
8. See Laeven and Valencia (2018).
9. Hernández de Cos (2019).
10. See, for example, Claessens et al (2012), Jordà et al (2013), Jordà et al (2015) and Aikman et al (2022).
11. Cerra and Saxena (2008).
12. Cerra and Saxena (2017).
13. BCBS (2023c).
14. Based on a best-efforts calculation, using public data, of the amount of support provided/pledged through: (i) government guarantees; (ii) central bank emergency liquidity provision; (iii) central bank funding schemes; and (iv) central bank FX swap lines.
15. Zeikel (1991)
16. Carstens (2019).
17. See, for example Thorndike (1914) and Underwood (1957).
18. Tolstoy (1878).
19. BCBS (2023b).
20. Grossman (2010).
21. Bromberg (1942).
22. Hernández de Cos (2022b).
23. Hernández de Cos (2022a).
24. Hernández de Cos (2023).
25. BCBS (2023a).
26. BCBS (2010, 2019, 2021).
27. Budnik et al (2021).
28. Caparusso et al (2023).
29. Admati et al (2024).
30. Ibid.
31. Gambacorta and Shin (2018).

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Free trade and financial stability, containing the effects of geopolitical fragmentation

Thank you. It's always a pleasure to be at Eurofi, a great meeting place to exchange views on finance and the economy. And could there be a more fitting place for this than the city of Ghent? When you are in the city centre, and you walk from the magnificent Belfry tower, past the St Nicolas church, to the St Michiels bridge and the Korenlei, you cannot escape the impression that this is a city that not only has a rich history, but also a history of richness. And indeed, in the 13 and 14 centuries Ghent was the Silicon th th Valley of Europe. It was the first real industrialised city, where wool was transformed into very fine cloth, 'laken' in Dutch, which was in high demand in the rest of Europe. This industry was so highly developed that wool was imported from Scotland and England. Thanks to innovation and trade, Ghent was one of the biggest and most prosperous cities in Europe.

Free trade, economic growth, prosperity: they often go together. And that is a fitting illustration of why we should be concerned also today about the growing geopolitical tensions and geo-economic fragmentation, and their impact on cross border trade and investment.

Let's have a look at the history of trade. As the chart shows, free trade has experienced periods of rise and fall throughout history. During much of the 19 century we saw an th increase in trade, as measured by the global-trade-to-GDP ratio. This golden age of industrialisation and international trade came to an abrupt end with the outbreak of World War I. During the first half of the 20 century, world trade collapsed as a result of th the Great Depression, nationalism and war. In the post-war decades, there was a prolonged period of growing world trade. Of course, it was the period of the Cold War, and trade between the eastern and western blocs was very limited. Nonetheless, world trade increased, driven by the post-war recovery and policies of trade liberalisation. After the fall of the Iron Curtain, trade between east and west expanded rapidly. This coincided with a period of hyper-globalisation in the 1990s and 2000s. The ITrevolution, multilateral trade liberalisation and an easing of global politics all worked together to boost global economic and financial integration to levels never seen before. A historic moment was when China joined the WTO in 2001. Closer to home, the introduction of the euro was a huge milestone. Not surprisingly, this was also a period marked by high economic growth.

However, the pace of globalisation has stagnated since 2008, with trade-to-GDP stabilising. Over the past five years, the threats to free trade and investment have increased. Scepticism about globalisation has grown. International cooperation is in retreat. Brexit, ongoing tensions between the US and China, the Russian invasion of Ukraine and the conflict in the Middle East have put further pressure on globalisation. In 2/4 BIS - Central bankers' speeches response to geopolitical developments, countries and blocs more often apply a policy of strategic autonomy.

According to the IMF, around 3,000 trade restricting measures were imposed last yearnearly triple the number imposed in 2019. And many firms around the world are reorganising their supply chains and are considering re-shoring, near-shoring or friendshoring. So while global trade is still resilient, we are already seeing more and more cracks appearing under the surface.

Of course, these policies don't come out of nowhere. Strengthening national security and curbing strategic economic risks are logical policies in a world that has become a more dangerous place. But, if not properly managed, the economic costs of these policies could be very high.

Coming from the Netherlands, I know the benefits of free trade for a small and highly open economy. Our share of imports and exports is almost 180% of GDP, one of the highest in the world. That makes us vulnerable to disruptions in global value chains. While the Netherlands may be a rather strong case of economic openness, the essence also holds for the EU as a whole. The numbers show that even as a bloc, the EU economy is more open than, for example, China and the US. EU trade with other countries is more than 40 percent of EU GDP. Europe has prospered as an open economic region, but is also more heavily exposed to the effects of geo-economic fragmentation.

And let's not forget that today's economies are much more connected than only a few decades ago. Global trade-to-GDP is now

60 percent compared to 24 percent during the Cold War. That tells us that this time the potential costs of fragmentation are much higher.

Let's have a look at the channels through which fragmentation impacts the real economy and financial stability.

From an economic viewpoint, an increase in geo-economic fragmentation can be seen as a negative supply shock. Such a shock has a downward effect on economic growth and an upward effect on inflation through increasing trade costs. Fragmentation in the form of increasing trade restrictions leads to higher import prices, market segmentation and reduced access to technology and knowledge. Cost estimates of trade restrictions vary widely. But we do know that they are particularly high in the case of barriers to technology diffusion and disruptions in global value chains. The IMF estimates that trade fragmentation could reduce global GDP volume by up to 7% over time. And as we know, countries that rely more on international trade are particularly susceptible to trade fragmentation.

Another transmission channel of fragmentation is inflation. International political tensions make inflation dynamics less predictable. An example is the current situation in the Middle East. An escalation of the conflict could trigger a spike in commodity prices that could impact price stability. A quite prominent case is the attacks by Houthis on cargo ships in the Red Sea. Some shipowners have decided to send their ships on the much longer route around the Cape of Good Hope. Obviously, this disrupts global value chains and raises transportation costs. These are the types of events that inflation 3/4 BIS - Central bankers' speeches models do not take into account. This makes inflation less predictable and it makes the job more difficult for central bankers.

Fragmentation does not only impact the real economy and inflation. It also impacts financial stability. First of all, weaker growth and higher inflation make it more likely that banks and other financial institutions will incur credit and market losses. Restrictions on the flow of capital and investments limit the ability of financial institutions to diversify their portfolios. Fragmentation is also associated with a more challenging cyberthreat landscape. State actors have become more active in this area, and geopolitical conflicts have become more hybrid.

Perhaps the most important way in which fragmentation impacts financial stability is when we cannot find each other any more in important cross-border challenges. And there are many such challenges. During the Global Financial Crisis, policymakers around the world were able to respond swiftly and effectively. This was possible thanks to good relations among public-sector financial decision makers and solid institutional structures that had developed over the years. After the crisis, countries around the world, assembled in the G20, took the lead in hammering out a firm package of financial reforms. In a fragmented world, such a swift response is becoming more complicated. This could prove costly. That's because the most important challenges to financial stability that we currently face are precisely the cross-border issues that we can only solve if we work together.

The clearest example is the energy transition. This is an area where geo-economic fragmentation could be particularly damaging. Access to commodities, raw materials and products for energy generation is essential for the energy transition. There is a high concentration of suppliers of these goods. For many countries in Europe, China is the main supplier of energy transition goods, such as solar panels and lithium batteries. The same holds for the supply of critical and strategic raw materials. These are mainly sourced from non-EU countries. Think of Russian nickel, copper and cobalt. Hence, a global approach and multilateral cooperation remain key as we move forward with the energy transition.

We also continue to need a global approach to financial regulation. For example the regulation of non-banks, the so-called NBFIs. This sector has shown tremendous growth and now represents more than 50% of the global financial sector. Its significant cross-border interconnectedness requires that regulators worldwide work together on this issue. Another example is the regulation of crypto assets. A number of incidents over the past years have highlighted the vulnerabilities in the crypto-asset

ecosystem. These vulnerabilities also require a consistent international regulatory approach based on the principle of 'same activity, same risk, same regulation'. If we do not work together, we risk a race-to-the-bottom dynamic where crypto dealers are located in the least regulated regions, but spark problems elsewhere.

So a global approach is key in many of the challenges we face.

But at the same time, we need to be realistic: geo-economic fragmentation is already underway. Policymakers face difficult trade-offs between dealing with geopolitical security concerns and minimising the costs of fragmentation. What we need are pragmatic approaches that preserve the benefits of free trade to the greatest extent 4/4 BIS - Central bankers' speeches possible while also safeguarding international cooperation aimed at solving global challenges.

What does that mean for EU policies?

First of all, a strong Europe is more important than ever. Our internal market can at least partly protect us from adverse developments elsewhere in the world. While Europe is relatively heavily exposed to fragmentation, on the positive side, we also have unique opportunities to deal with it as we are still far from having exhausted the full potential of our internal integration.

Therefore, as an economic antidote to global fragmentation, we should strive to further deepen the European Single Market. By removing the remaining internal barriers, for example, we would boost the mobility of labour and capital, and make it easier to transition to new technologies. Second, by completing the Capital Markets Union, we would help to mobilise much-needed funding for the EU's enormous climate and digital investment needs. To this extent, together with the Dutch Authority for Financial Markets we recently joined an increasingly impatient chorus of authorities having published a position paper containing concrete priorities and recommendations. Finally, by completing the banking union, we would stimulate pan-European banking competition and allow bank capital to be used more efficiently.

We do not only need to strengthen the internal market. We also need to find a balance between autonomy in strategic areas such as defence, healthcare and energy, and we must maintain a multilateral mindset. It is common sense that Europe should protect its strategic interests and cut down on dependencies it doesn't want. But while doing this, policymakers should strive to protect free trade and not undermine the internal market. We should therefore be selective in our policies to increase strategic autonomy. And the EU should make a strong stand for maintaining and supporting the multilateral rulebased system that has brought us stability and growth.

The people of Ghent knew the perils of geopolitics. During the Hundred Years' War between England and France, trade with England suffered greatly. We too live in a time where war has come close to our borders, and geo-economic fragmentation is increasingly a reality. Yet, even in this new geopolitical reality, policymakers can seek pragmatic solutions that minimise the economic costs of fragmentation. We should do our utmost to find these solutions. Because just as we need to protect ourselves, we also have to protect the free flow of goods, services, investment and knowledge. Things that are fundamental to economic growth and the prosperity of billions.

François Villeroy de Galhau

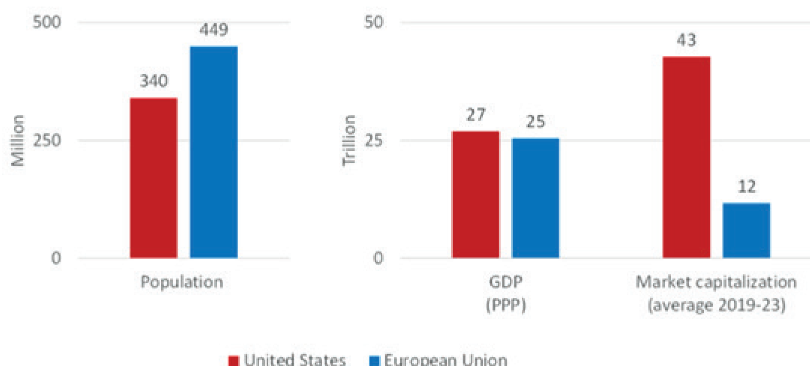
Governor, Banque de France

From a Capital Markets Union to a genuine financing union for transition

Ladies and Gentlemen,

It is a great pleasure to be here today, and I extend my warmest thanks to David Wright, Didier Cahen and Eurofi's team for organising this event in this architectural jewel of the city of Ghent. The focus of my speech today will be on the Capital Markets Union (CMU). Some may think that this theme it is a bit too familiar, with the same tired messages. But this time is different.

The Capital Markets Union has long been seen as the Ugly Duckling,[1] sparking little public interest, and lacking political ownership. The reasons for this are well known: the CMU involves a myriad of technical measures, relating to a wide number of sectors – the financial sphere, as well as corporate legislation and capital taxation. The Commission has nonetheless worked tirelessly on the 2015 and 2020 action plans and accomplished massive progress, albeit underestimated: no less than 33 out of 36 measures have been implemented or are underway. Nevertheless, Europe remains far below its potential in terms of financial power relative to its economic and demographic power (***Slide 1***).



Slide 1

Source: United Nations, IMF, World Federation of Exchanges

In line with this insufficient dynamism, the EU's share in the global volume of financial transactions almost halved between 2006 and 2022.[2] But a window of opportunity has recently opened with Christine Lagarde's push for a "Kantian shift".[3] In France, the Minister for Economic Affairs Bruno Le Maire launched a taskforce led by my predecessor Christian Noyer,[4] to make "tangible recommendations". I don't want to preclude their conclusions and the views I share this morning are mine. But I couldn't agree more with one conviction: we should go beyond the "CMU fatigue" – which is real –, and scale up our "CMU ambition". To change gear, I am calling today for a higher purpose (I) and for broader instruments (II).

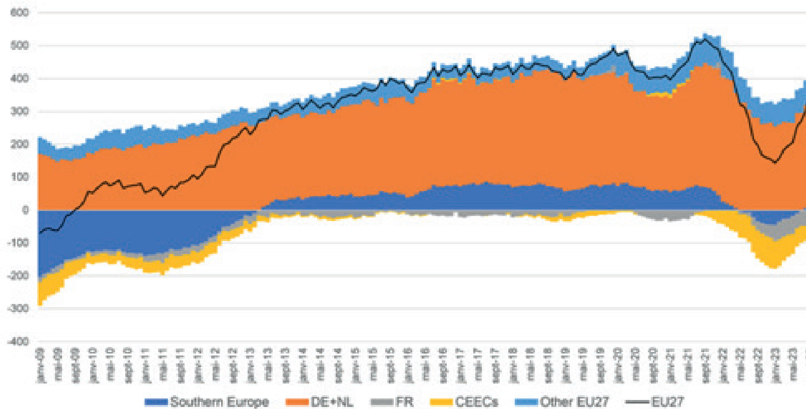
I. Why: unite around a higher purpose

After the Great Financial Crisis, the CMU has been promoted mainly for its "stabilising" effect, which has proved insufficiently galvanising. The 2015 action plan was with the idea of shifting companies' debt financing from banks to markets – a more "US-like" model –: this opposition was simply misleading, while we should pursue complementarity. The CMU was also intended to cushion asymmetric shocks in an Optimal Currency Area perspective[5] – which remains valid, but not very appealing politically. As a result, we put too much emphasis on the "M" of the CMU, i.e. on the development of market financing, and too little on the "C", i.e. on equity financing, as well as on the "U" for cross border flows.

The priority is now to shift to a higher and more unifying purpose. Here, the precedent of the single market can provide valuable insights: Jacques Delors's genius was to bring a collection of 300 technical texts under the banner of the four freedoms of movement. I think that the CMU's banner is quite clear today: we need to unlock

financing for the twin European transformations, ecological and digital. They will require, respectively, up to EUR 620 billion and EUR 125 billion of additional investment per year in the EU up to 2030.[6] In more economic terms, we must shift from a mere stabilising purpose to an allocation purpose, and thus "rebrand" the CMU. I hereby call loudly and clearly for a "Financing Union for Transition".

And we should therefore mobilise the European excess of savings over domestic investment,[7] which should amount to around EUR 370 billion in 2023 (***Slide 2***).



Slide 2: EU current account (in B€)

Note: moving average over the 12 last months
Southern Europe: GR, IT, PT, ES;
CEECs: BG, HR, EE, LV, LT, HU, PL, CZ, SK, SI, RO

Source: ECB SDW

Let me be more specific about what this Financing Union for Transition encompasses. The current – and very welcome – momentum on the CMU must not leave two other fundamental projects behind, – or worse, serve as an excuse for scrapping them. First, the **Banking Union** is a natural complement to the CMU. Together, Pan-European capital markets and banks would be a powerful vector, enabling funds to flow freely across Europe. We have built a successful "Supervision Union" – for 10 years now –, but not yet a Banking Union. On the one hand, we could renounce a fully-fledged European Deposits Insurance Scheme and opt for an alternative set-up, such as liquidity support between national Deposit Guarantee Schemes. On the other hand, we must overcome long-standing deadlock on home/host issues with pragmatism. We should foster the development of genuine pan-European banks – we have almost none – by facilitating cross-border waivers on capital and liquidity, and "branchification".

Second, a Financing Union is inherently linked to the **single market**. Often seen as a grand legacy from the past, the potential of the single market is far from having been fully tapped, especially in the area of services. The IMF's recent call to deepen the single market[8] and the upcoming report on the future of the single market lead by Enrico Letta[9] should be politically aligned with the momentum on the CMU: less national state aids, which distort the optimal allocation of capital; and more European integration in at least three sectors that were left aside in 1993 and require major investment, namely, energy, telecoms and technology, and defence.

II. How: broaden our scope around four more ambitious instruments

Of course, a great deal of work which has already been done on a number of technical issues needs to be continued, such as the harmonisation of insolvency law.[10]

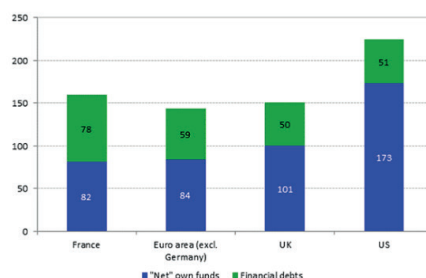
As the first goal of our Financing Union for Transition should be to finance innovation and greening, let me focus accordingly this morning on four more ambitious instruments.

1. Equity financing is the most appropriate tool for innovative projects, given their higher level of risk and the need to finance them over a long-term horizon. There is undeniably a growing momentum here: private equity fundraising has grown by 246% since 2015,[11] and more than 40 funds have been registered each year since 2014 under the EuVECA dedicated label (European venture capital Funds). But we are still lagging dramatically behind the United States: in the third quarter of 2023, equity financing only represented 84% of euro area GDP versus 173% in the United States (***Slide 3***). And the biggest European venture capital fund is still smaller than the 10th US venture capital fund, in terms of the amount raised over 2019-23.

Slide 3

Source: Eurostat, calculations

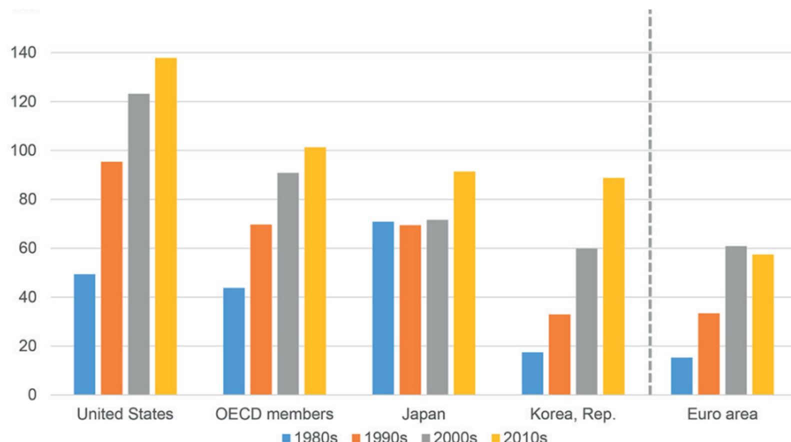
Non financial corportations liabilities: «net» own funds and financial debpts (en GDP pp, 2023Q3)



10 biggest US and European venture capital funds (amount of capital raised over 2019-23)

UNITED STATES			EUROPE		
Venture capital fund	Country	B€	Venture capital fund	Country	B€
US fund 1	US	17,9	European fund 1	SE	2,2
US fund 2	US	12,9	European fund 2	UK	1,7
US fund 3	US	8,9	European fund 3	UK	1,6
US fund 4	US	8,6	European fund 4	FR	1,6
US fund 5	US	4,4	European fund 5	UK	1,4
US fund 6	US	4,6	European fund 6	UK	1,1
US fund 7	US	4,2	European fund 7	SE	1,1
US fund 8	US	3,7	European fund 8	UK	1,1
US fund 9	US	3,5	European fund 9	UK	1,0
US fund 10	US	3,3	European fund 10	DE	1,0

If I had one wish for the European financial sector, it would be to double the size of the EU's market capitalisation to reach 100% of GDP over the next decade in order to boost innovation,[12] as was the case in the United States in the 1990s[13] (***Slide 4***).

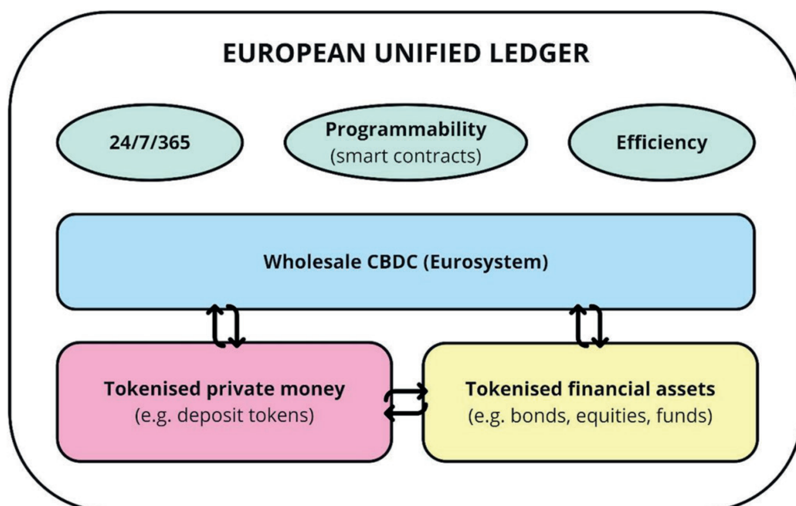


Slide 4: Market capitalisation of domestic listed companies (% of GDP, average by decade)

Source: World Bank

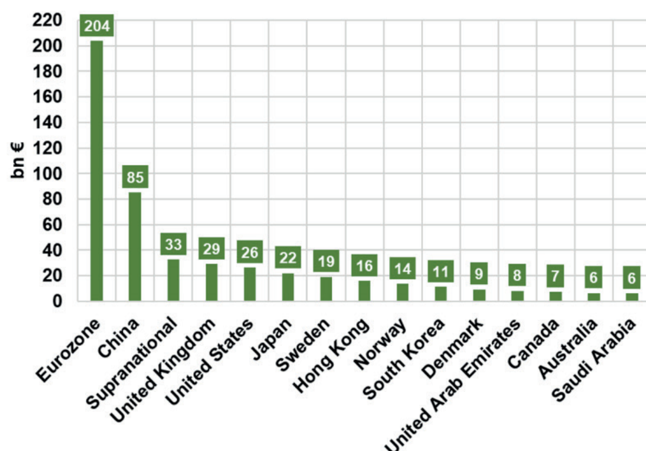
We still need to identify and remove legal and fiscal obstacles to "European-scaled" and therefore genuinely cross-border funds, both in terms of investors and investments. But we should complement this with much stronger public-private partnerships, with European public capital supplementing pari-passu cross-border private funds. In this respect, the pan-European Scale-Up Initiative and the launch of the European Champion Tech Initiative supported by the EIB Group have an initial funding of EUR 3,75 billion; we should quickly at least double its size. More broadly, the European Investment Fund notably plans to leverage EUR 11 billion through guarantee and equity instruments;[14] Delivery will be key. In complement, we should develop European saving products, going beyond the redesigned regulatory framework for ELTIF.

2. Looking forward, technological innovation is not only a purpose, but also a "design changer" of the CMU itself. Let me explain: technology - blockchain, tokenisation, smart contracts, etc. - is set to revolutionise, not only the payments sphere, but the whole market infrastructure domain. We are set to «tokenise» financial assets and the central bank money used to settle them - in the form of a digital wholesale euro –, as well as bank deposits. On the one hand, in Europe we have too many post-trade internal borders which slow down flows and limit our scope. On the other hand, the BIS is calling for a «unified ledger»,[15] which is a "creative frontier" on a global scale. Between these two considerations, the path to action seems clear to me. The CMU should now include the building of a **European "unified ledger"**: it could include all kinds of tokenised assets under a unified European governance supported by the Eurosystem. The two-tier monetary system would be maintained thanks to the anchoring role of a wholesale central bank digital currency (***Slide 5***). Such infrastructure could reduce costs, counterparty risks and operational risks. It would facilitate the provision of various connected services 24/7 all around Europe, ensuring rapid and secure transactions, and thus having a catalysing effect on the CMU.



Slide 5

3. Green finance is clearly a highway for the Financing Union for Transition. Europe is a pioneer on this front with the adoption of a single rule book (Taxonomy, SFDR, CSRD)[16] on green finance, and is a key issuer of green bonds, accounting for 40% of the global market in 2023 (***Slide 6***).



Slide 6: Green bond issuance in 2023 (volume, all issuers combined)

Source: BloombergNEF, Banque de France

I would suggest forging a link here with another lever that is often mentioned but has made little progress - namely securitisation. We have a massive need for investment in mobility and energy infrastructure, and we have the basis for a common label thanks to EuGBs. Combining these two factors in green securitisation, around a common European securitisation platform, is probably the best solution in the face of political reticence and fears over financial stability. To accompany the development of green finance, in the long run the use of labels could be made mandatory for all instruments deemed sustainable, and controlled by external entities supervised by the ESMA to avoid greenwashing. Moreover, the specific characteristics of tokenisation such as transparency and programmability could prove particularly promising in the field of green finance thanks to the automated integration and verification of ESG criteria in smart contracts.

4. Turning to governance, as the old proverb says "too many cooks spoil the broth". In the same vein, Europe's capital market integration is hindered by the fragmented application of EU rules, implemented by several national regulators. Hence Christine Lagarde's call for a "European SEC",[17] with which I fully concur. We should seriously consider granting more supervisory power to the ESMA, at least over systemic cross-border entities. As a first step, we could offer an opt-in mechanism to such entities, which would greatly benefit from a single **supervisory regime**. It also means implementing a **single rulebook** on capital markets and associated areas. Moreover, Europe should take the lead in emerging areas, as has been the case for MiCA or for ESG rating agencies, to ensure a unified legal framework from the outset.

This Financing Union for Transition is certainly a decisive economic and financial project, but it carries higher political significance. Ultimately, a strong and deep Financing Union will be key to ensuring Europe's strategic autonomy, unlocking and channelling its key domestic resource – private savings – to our priorities in a troubled and fragmented world, to which the upcoming elections add another layer of uncertainty. Let us not miss our chance and move forward as soon as possible, in the next European legislative term. Rest assured that we, central banks, will do everything in our power to make this Financing Union a reality. Thank you for your attention.

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John Berrigan

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

CMU – where do we go from here?

Good afternoon, ladies and gentlemen. Unfortunately, Commissioner McGuinness could not be here today due to trialogue negotiations on the Anti-Money Laundering and Countering the Financing of Terrorism Authority (AMLA) seat, so I am afraid she sent out the B team, but I will do my best to substitute.

My remarks will focus on CMU, currently a hotly debated topic in political circles. I want to talk about why we believe that CMU is as important as ever. I will briefly touch on some of the achievements of this mandate, but also I want to look at what more might need to be done and what might be holding back progress in this area.

So let me start a bit with the rationale for CMU. In the EU right now, the overwhelming policy focus is on competitiveness, and I think rightly so. Competitiveness is crucial for healthy economic growth and the financial system, including capital markets, plays a decisive role in supporting competitiveness. EU capital markets, as you will all know, are still highly fragmented and therefore inefficient, and I believe we are paying a very high price in terms of competitiveness for that. We may have the free movement of capital as one of the four fundamental freedoms, but to date there is no real single market when it comes to accessing finance.

For corporates and households this means putting up with fragmented rules and accepting reduced financing and investment opportunities. It constrains the ambitions of EU companies and puts them at a disadvantage when compared to their US or Chinese peers. Young, innovative companies in the EU may have a promising business model with huge growth potential, but they lack the financing opportunities to scale up. These companies too often end up being owned or co-owned by owners outside the EU, or they move out of the EU altogether to find financing elsewhere. Ultimately, this means missed opportunities for the EU in terms of economic growth and welfare.

Now, needless to say, this diagnosis is not new. Certainly, you in this room have heard it many times. You have heard it from many people many times. But I believe the situation is now more urgent than ever.

The EU has been falling behind its global competitors in capital market development for some time now, and frankly, the outlook is bleak if this trend is not reversed soon. We are, in effect, in a crisis, albeit a more slow-burning crisis than we might find on the banking side of the financial system. The ongoing discussions of CMU in the Eurogroup are encouraging and we hope for ambitious and tangible outcomes. After all, if we cannot deliver on CMU under the current political spotlight, when will we be ever able to deliver on CMU?

As I just said, the rationale for CMU has been evident for some time. The Commission has been tabling proposals for many years and we have made progress. Let me just give you a few recent and fairly random examples. We have agreed on the European Single Access Point (ESAP), where all financial and sustainability data of listed companies will be put onto one central portal. We have agreed on a consolidated tape, where market participants will be able to see price and volume information from trading venues across the entire union for different financial instruments. We recently reached agreement on the Listing Act to make it easier and cheaper for companies to be listed on public markets.

In fact, the Commission has undertaken all actions in our CMU Action Plan set out back in 2020, just as we did for the CMU Action Plan set out in 2015. Most of those actions have actually been agreed by the co-legislators as well. So why is it that we are not where we need to be on the ground?

Well, on the one hand, new legislation can take time to come into force, can take time to bed in. As we have said many times, the CMU is built step by step, proposal by proposal. So that is a matter of time. On the other hand, there is also a matter of ambition. Where the Commission has proposed legislation, the co-legislators and member states in particular have often not lived up to their stated ambitions.

One such example, and it will not surprise you that I picked this example, is the clearing package. The recent agreement on European Market Infrastructure Regulation (EMIR) 3.0 will help make our clearing system safer and more attractive, and that is essential for economic resilience. But I

am not going to try to hide from you that this agreement is pretty disappointing when it comes to the active accounts and to a lesser extent supervision. EMIR 3.0 was never about closing our markets to others. It was about rebalancing exposures and addressing over-reliance on specific providers, but all the time while remaining fully engaged internationally. Yes, there was an implied cost, at least a transitional cost, but it seems we are not prepared to pay that cost.

Another example where ambition is a problem is the Commission proposal to harmonise certain aspects of insolvency proceedings. Having to consider 27 different sets of insolvency rules when assessing an investment opportunity is a major hindrance to cross-border investment in the EU. We all know that because the industry puts this on the top of its list of asks whenever we ask them. But co-legislators have not even read through the whole text of the proposal yet. Now, for a relatively concise text compared to some of the texts we have sent – and it was adopted back in December 2022 – this seems to be a bit slow.

In other areas too, such as taxation, insolvency and supervision, actions to address the problems have too often failed to match the stated ambitions.

So how should we approach CMU in the next mandate? Of course, it depends on the political aims of the next Commission. However, as I have mentioned, there has been remarkable political support for CMU in recent months. And I know many policy makers, even outside the financial regulatory sphere, are thinking about the way forward as progress is essential for the competitiveness of the economy. The reports from Enrico Letta and Mario Draghi will be important contributions to this debate. But I have to say at this point, after 20 years of effort including with David, that I strongly suspect we have picked all the low-hanging fruit, and much of that fruit as I have always said may have been low-hanging but was very tightly fixed to the tree.

I think we can do more to make things work better as we look forward. For instance, many EU citizens will need to take steps to maintain their living standards after retirement. However, the current offer of occupational or personal pension schemes falls short of the needs in most member states. More pension investments will also strengthen the EU investor base as an important indirect benefit, and this is possibly the most effective way to grow the scale and competitiveness of EU capital markets.

Securitisation could also be looked at again. It can help free up banks' balance sheets and allow banks to further lend to EU corporates and households. Securitisation can also be an attractive asset for investors.

Another important element to further integrate our capital markets and for the EU's competitiveness is more consolidation of market infrastructures. This is a point also made by the ECB President Christine Lagarde a while ago in her CMU speech. She also attributed an important role to the private sector in this process. This is right, because clearly, we cannot force consolidation through legislation at EU level, but we can and should identify and remove the regulatory or market obstacles which stand in the way of the organic consolidation of market infrastructures. That said, we can anticipate that such a consolidation process will be influenced by political considerations. Member states have long taken pride in having a specific market infrastructure as symbols of their capital market. However, I ask myself, is this view still valid in a world where capital market activity is digital and no longer involves proximity or physical access to an infrastructure to transact with other market participants? Surely what is important is not having a national capital market, but having access to a shared EU capital market that is deep and liquid enough to compete globally.

Financial literacy is another area where more work needs to be done. We had an opportunity to explore this in detail on Tuesday when we had a very successful joint conference with the Belgian financial regulator, the FSMA. My thanks to Jean-Paul Servais for his cooperation here. The Commission has, together with the OECD International Network on Financial Education (OECD/INFE), developed two financial competence frameworks that aim to establish a shared understanding among member states and practitioners of the essential financial literacy competences that youth and adults need. In addition, the recent retail investment strategy includes measures to encourage member states to promote the education of retail clients and prospective retail clients in relation to responsible investment. A lack of financial literacy can result in financial fragility or even financial exclusion. Conversely, financial education makes people more likely to invest in capital markets.

Finally, I must just mention supervision as another important, albeit highly controversial that must be considered again.

So to conclude, past efforts to build CMU have been important and have secured progress in quite a few areas, but very clearly more needs to be done. We need to be bolder when we look to the future. We must distinguish between those often-challenging measures which improve the single market we already have, and those even more challenging measures that build the single market further. Of course we must, and the Commission will, continue efforts like reform of prospectus law and listing requirements to improve the existing single market. But it is the measures of a more fundamental nature like laws on supervision, taxation, accounting, insolvency, which should be the main focus of the next steps in the CMU project.

So, I will finish my remarks today as I often finish my remarks when I am speaking about CMU. Capital markets will not, cannot be built in Brussels. Brussels can facilitate the process, but building markets requires collective and determined action by all stakeholders across the EU. Of course, we can talk endlessly about harnessing the benefits of a single market. Here I am talking about it again. But surely the time has come to stop talking and start taking some actions that will actually deliver.

Thank you very much for your attention.

Enrico Letta

President, Delors Institute

Priorities for the single market

Let me start by saying that having the opportunity to be heard by Jacques de Larosière is indeed a great honor. I must emphasize that the content of the report I'm preparing for the upcoming European Council meeting on April 17th remains confidential for now. However, I was granted an additional month to extend my travels across various countries, aiming to shape this report through collective insights. This approach underlines the significance of today's gathering for me, offering a splendid chance to absorb diverse perspectives, assimilate knowledge, and contemplate the intricate balance between the single market's functionality and emotional resonance.

I know there is this famous phrase of Jacques Delors that it is impossible to fall in love with the single market. As president of the Jacques Delors Institute, I've had numerous conversations with him over the past eight years, questioning this assertion. In my view, and for many of my generation, this statement doesn't hold. We, who witnessed the fall of the Berlin Wall, dreamt vividly of the single market and its four freedoms. For us, it symbolized not just a concept, but a deeply emotional journey towards genuine liberty, offering unprecedented opportunities for travel and living across borders. This emotional bond was a key factor in the single market's success, bridging desires with tangible freedoms.

Today, while the connection between the single market and positive emotions seems more complex, I propose to reframe this link through the lens of 'responsibility'. This encompasses both the duty to make decisions and the ethical obligation to avoid wrongdoing. Our generation risks being guilty on many topics. We face the potential guilt of delaying climate action. We face the risk of culpability due to excessive inertia in unifying Europe, a crucial step in preserving our way of life, our value system, and the rule of law. We are at fault for overly concentrating on introspective, domestic issues at the expense of broader concerns. When the single market was established, the national aspect served as a catalyst for numerous professions and fields. My conviction is that today, we must unequivocally state that the national perspective has become a limitation or an obstacle, no longer serving as a catalyst.

At the same time, we are also culpable of perhaps being too slow to recognize that the geopolitical landscape is currently transforming everything. For example, it comes as a great surprise to me, but I find myself compelled to initiate a new file on the single market, one that unexpectedly includes the aspect of defense. The integration of defense into the single market is an aspect that was previously not included in our considerations. Today, it is one of the most important aspects. The matter of defense compels me to advocate for the view that both the single market and its financial services sector are vital strategic assets crucial for the European Union's economic security. This approach has never been applied to the topic before, but it is essential we begin now. Without a robust and unified financial services system at the European level, our economic security is compromised.

I've discussed finance and defense, specifically how to fund defense and address new defense requirements. Perhaps I stand alone in my astonishment at the defense spending figures—not the amount we spent, but the manner in which it was spent. Over the past two years, we rightly allocated substantial funds to support Ukrainian defense, upholding the rule of law and our civilization. Yet, it's concerning that around 80% of this money was used to purchase non-European military equipment.

This highlights our challenges, and I must state unequivocally that in today's rapidly changing world, inertia leads to decline rather than maintaining the status quo. I repeat it, inertia, for us, means decline. This is why I come back to quoting Jacques Delors, "Quel est le niveau de nos ambitions?". I believe this is the right question. We have to give an answer to this question. I aim to connect our level of ambition with the reality that, for reports like mine, Mario Draghi's report in June, and Paschal Donohoe's report on the Capital Markets Union (CMU) for the Economic and Financial

Affairs Council (ECOFIN), the geopolitical context is increasingly becoming the pivotal framework transforming every aspect of the single market.

I intend to address a few specific points quite directly. Initially, the geopolitical landscape necessitates an approach to the single market that entails significant vertical implications. By 'vertical,' I refer to the fact that when Jacques Delors initiated the single market, he identified four crucial areas—key aspects of our economies and governance—that were excluded from the single market's agenda due to the decisions of member states.

These four areas—telecommunications, energy, defense, and finance—were set apart for various reasons. Defense and energy were excluded due to treaty stipulations, with the Lisbon Treaty later bringing significant changes to energy policy. For telecommunications and to some extent energy, the decision was made to leave strategic control with the member states, a stance taken 30 years ago. It's now crucial to reclaim the central importance and European scope of these sectors. The challenges facing our telecommunications industry on a global scale are well-documented. The fact that the 1990s' telecom technological revolution was predominantly European, yet today we lag behind, is no coincidence. This underscores the need to reassert the significance of these sectors within the European framework.

Similarly, the energy sector has demonstrated significant needs, especially highlighted by the recent crisis. This underlines the importance of focusing on energy, alongside defense and finance, for clear reasons. These four sectors—telecommunications, energy, defense, and finance—were initially overlooked, which has inadvertently led to less than stellar performance in these areas today. This situation introduces a horizontal challenge related to 'scale,' a term I will emphasize in my report due to its critical importance both financially and across various sectors. Presently, at the European level, we seem to be moving in the opposite direction, whether by choice or inertia, away from scaling up. Instead, there's a tendency to maintain a smaller scale in sectors like banking and finance, contrary to what might be expected. This reflects a broader issue where incentives are misaligned, favoring a status quo that limits growth and expansion.

We must acknowledge the critical need at the European level to champion the message that scaling up is beneficial and essential. Throughout my five months of work across Europe, engaging in discussions at universities and within the academic community, I have advocated for this viewpoint. My stance has led some to critique me for purportedly supporting the idea of an overly super power Europe. However, I am firmly convinced that Europe's strength lies in its dynamic balance between the large and the small; this balance must be preserved. It is crucial to recognize that what constituted 'large' in the past does not suffice for today or the future. We need to aspire for greater scale. It's important to understand that within this balance, we must support and encourage growth in various areas, making 'large' even larger.

The concept of a «28th regime» for various policy areas is something I am endeavoring to comprehend more fully. It's evident that fragmentation, particularly in taxation and corporate law, is a significant barrier preventing many companies from prioritizing scaling up. This begs the question: How can we unify our efforts? Is it feasible to establish a singular corporate law framework? Despite the challenges, I acknowledge the complexity of implementing such a regime across diverse jurisdictions. However, for certain areas, or specifically within the context of a 28th regime, moving towards greater harmonization might be achievable. I am committed to advocating for this direction. The issue of scaling up and the broader discussion around it must also be elevated to a political discourse, requiring a resolute stance and concerted effort.

Regarding supervision, I've taken note of various points. I listened to François Villeroy de Galhau and found common ground with many of his views. After reviewing your paper, David, I am persuaded that the model and the successful experiences of the European Central Bank (ECB) should serve

as crucial benchmarks for all of us. Additionally, the concept of establishing a singular entry point for foreign products into the European Union represents a significant challenge that warrants our attention, especially in terms of consumer protection. A key insight from Jacques Delors that has stayed with me is the principle that the single market prioritizes its people, the citizens, above all else. Ensuring their protection is paramount.

My fourth point concerns the intricate relationship between the banking union and financial services within the single market. Admittedly, I'm still in the process of gaining a deeper understanding of this dynamic. My goal is to bring forward some well-considered ideas by the 17th of April. In my concluding remarks, I intend to articulate the need for establishing connections between these elements, particularly in the context of securitization—a topic I've taken note of based on recent discussions. It may be necessary to revisit the enduring impact of past crises, recognizing that Europe has borne significant consequences over the last decade due to the global financial crisis of 2008 and the EU sovereign debt crisis of 2011. Addressing how we can adapt or transform this legacy is crucial, with a particular focus on securitization and a reevaluation of our approach to risk-taking. The question then becomes: how can we align the emerging financial union with the urgent needs dictated by our current political climate, such as the transition to a new economic and social paradigm?

In my opinion, addressing this issue is also key to unlocking the major challenge at the European level of financing the transition. With two more years of Next Generation EU funding ahead, I aim not to oversimplify in this concluding section, but recent observations of trucks and farmers protesting in the streets have prompted a series of reflections. As European institutions and national governments, we have committed to a green transition and have outlined this agenda clearly. Subsequently, we announced that the transition would require an investment of €800 billion over the next decade. However, we then acknowledged a significant hurdle: the uncertainty of financing beyond the next two years. Farmers, among the first to voice their concerns, essentially communicated, «I understand the necessity, but I cannot bear the cost alone. It's imperative that you find a solution.» This sentiment is likely to persist and points to the broader necessity for innovative financing solutions for the green transition.

To conclude, and this is where I draw my remarks to a close, we require political ownership, as highlighted in your paper, David. You referred to the involvement of the three presidents, a point with which I concur. However, political ownership extends beyond mere agreement; it signifies seizing the current momentum. This momentum presents us with two pivotal challenges: financing the transition and guaranteeing Europe's economic security. These challenges, symbolized by two white horses, have the potential to lead the Capital Markets Union (CMU) out of its current deadlock. I perceive a significant political opportunity in this context. I am committed to leveraging this opportunity to the fullest in my report. Thank you very much.

Jean-Paul Servais

President, Financial Services and Markets Authority, Belgium & Chair of the Board, IOSCO

IOSCO priorities for 2024

Ladies and Gentlemen,

Hailing from Belgium, it is a pleasure to welcome you all in Ghent today.

It is a good moment to reflect on the intense past few weeks under the Belgian Presidency, but also to raise the significance of IOSCO's recent achievements for the years ahead.

The prospect of the European Election in early June implies the legislative work has been frontloaded to the first half of the Belgian presidency.

And to be frank, I am extremely proud of the progress made in the files within my remit in just over 6 weeks, notably on ESG ratings, on the Listing Act, on EMIR, and on the AML package

Besides the legislative progress, I am thankful to Commissioner McGuinness's initiative to co-organise a high-level conference on financial literacy at the FSMA yesterday. You know how passionate I am about this issue and I was amazed to welcome 400 people to gain insights about the importance of financial literacy for building trust, resilience and integrity in financial markets.

On Friday, I will be attending the informal Ecofin to provide feedback

about the role of financial literacy in increased access to capital markets for our citizens.

Let me know put my hat of IOSCO Board Chair.

I am pleased to report that under my leadership, we have made significant strides in key areas of IOSCO's ambitious work program on sustainable finance, crypto-assets, and non-bank financial intermediation (NBFI).

First, our focus on sustainable finance has yielded remarkable progress and a solid foundation for the work ahead of us.

IOSCO's historic endorsement of the first sustainability disclosure standards of the International Sustainability Standards Board (ISSB) underscores our commitment to fostering consistent, comparable, and reliable sustainability information.

We remain dedicated to collaborating with global stakeholders to ensure widespread adoption of sustainability disclosures, and IOSCO is rolling out a capacity-building programme to support jurisdictions and regulators in this journey.

IOSCO acknowledges also the ongoing efforts of the ISSB to develop an adoption guide to support jurisdictions in their implementation considerations of its standards.

In addition, it is our view that trust in sustainability related disclosures will be enhanced when they receive external assurance based upon globally accepted technical and ethical standards, and also around independence of assurance providers.

This is why IOSCO welcomed the consultations by the global audit standard setters on standards regarding audit/assurance for sustainability disclosures and on the independence of relevant assurance providers.

IOSCO was also present with a strong delegation at COP28, to reiterate our commitment to promote financial integrity and orderly functioning of Voluntary Carbon Markets (VCM) on which we will continue working this year.

Second, and also in 2023, IOSCO delivered on its promise to bring clarity and consistency in the regulatory approach towards crypto-assets and Decentralised Finance with the publication of two complementary reports on Crypto and Digital Assets and on Decentralised Finance in the last semester of 2023.

Our final report will foster regulatory consistency among our 130 members. Recognising the inherent risks posed by cross-border crypto markets.

The report on crypto and digital assets attest that crypto-asset activities are indeed comparable to activities observed in traditional financial markets, with associated risks familiar to our members, including conflicts of interest, market manipulation, insider trading, custody of securities, and cyber risks.

We acknowledge that some jurisdictions have and enforce existing regimes applicable to crypto-assets, while other jurisdictions must develop new, bespoke frameworks.

IOSCO has agreed a comprehensive implementation roadmap to

ensure the due, fair and timely implementation of IOSCO recommendations across its wide membership.

2023 was earmarked by rapid developments of Artificial Intelligence technology. These developments of AI technology in the field of financial services and financial markets pose new forms of risks and challenges, at both micro and macro levels.

I truly believe that this global phenomenon should be understood and addressed globally, and that IOSCO has a role to play in helping its members when they consider policy responses to the risks posed.

Lastly, our efforts to address structural vulnerabilities in non-bank financial intermediation (NBFI) have been steadfast. In partnership with the Financial Stability Board (FSB), our recommendations will enhance liquidity risk management and the availability and use of anti-dilution liquidity management tools in open-ended funds (OEFs).

The joint publication of FSB and IOSCO reports underscores our commitment to bolster investor protection and financial stability.

We will continue to collaborate with the FSB in 2024 to mitigate financial stability risks stemming from leverage in NBFI.

With this, ladies and Gentlemen, I would like to thank you for your attention and wish you a pleasant evening in Ghent.

Shigeru Ariizumi

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

Changing dynamics ? How should regulators respond to new challenges

Thank you, David, for your kind introduction, and hello, everyone. I am very pleased to be here. First of all, I would like to thank David and the team at Eurofi for inviting me to this high-level conference in this historic and beautiful city of Ghent in Belgium. My colleague Jean-Paul is also here, so I am very honoured.

As all of us are aware, the world is becoming more integrated, not only in terms of finance but more broadly. For example, in the area of goods, the increasing volume of global trade and the importance of global supply chains are well-known evidence. In the area of finance, we have witnessed a complete transformation during recent decades, particularly before and after the global financial crisis, underpinned by rapid financial innovation and the need to tackle climate change.

However, it is ironic that the more we are becoming integrated, the more the world seems to be fragmented. Recent global developments have amplified such fragmentations. Structural shifts such as geopolitical tensions, elevated energy prices and mounting pressure on global supply chains, not to mention the Covid-19 pandemic, have all exacerbated this trend. This has become one of the most pressing policy agendas at hand. You may have seen the International Monetary Fund (IMF) come up with a report, and they have sounded the alarm on the risk of geo-economic fragmentation. The G7 and G20 presidencies are both eagerly looking into this, but fragmentation is not confined to the economy as a whole but is everywhere, including in the financial sector.

Today, I would like to talk about the changing dynamics that we are facing in the world of finance, and how regulators should respond to it. As you know, market fragmentation has long been recognised as a challenge in the area of financial regulation, and financial regulators have striven to make the global financial system more resilient and to maintain an open and integrated structure. When introducing new regulations to this end, there have been efforts to minimise market fragmentation through continuous jurisdictional coordination and cooperation.

Robust international standards and international coordination and cooperation are important in avoiding fragmentation. At the heart of this role is the FSB and the standard-setting bodies (SSBs). During its presidency of the G20 in 2019, Japan identified addressing market fragmentation as one of its top priorities and has continued to lead discussions at the FSB and elsewhere. Since then, the FSB, IOSCO and other organisations have been working on this issue. To this day, IOSCO is following up on the issue on a regular basis, and I would like to thank everyone involved for their efforts.

Unfortunately, we may be witnessing a new surge in fragmentation due to emerging technologies, and challenges that all of us on this planet face. The changing dynamics are making it necessary to revisit the issues that we discussed intensively in 2019 and 2020. Let me touch upon two notable developments – crypto assets and stablecoins, and sustainability issues such as climate change. I will then briefly mention Basel III implementation.

I would first like to talk about crypto assets and stablecoins. We all know about the benefits and risks associated with financial innovation, given its remarkably rapid progress and its borderless nature. It is always important to remind ourselves of the importance of achieving policy objectives such as financial stability and investor protection, in a way that does not hinder innovation or growth, but rather promotes them.

The world of crypto assets can easily be fragmented. This could be attributed to, firstly, differences in regulators' emphasis on regulation and/or innovation, secondly, rapid innovation and, lastly, borderless characteristics. These aspects have prompted regulators to urgently come up with an appropriate global response. The FSB and IOSCO swiftly discussed and issued high-level recommendations last year on the regulatory and supervisory framework on crypto assets and stablecoins, which was a welcome development.

Furthermore, responding to a call from the Indian G20 presidency last year, the FSB and IMF produced a synthesis paper covering a wide range of policy issues, including implications for financial stability and regulation, and macroeconomic policies, including monetary policy, capital flows and taxation, as well as

for other risks such as anti-money laundering (AML) and countering the financing of terrorism (CFT). However, this is not the end to our endeavour to address fragmentation, but rather only the beginning. FSB members need to lead by example in implementing the recommendations.

Japan has one of the most comprehensive regulatory and supervisory frameworks in place, and these are already in full implementation. Our framework is not exactly a result of our foresight, but rather of the hard lessons that we learned from various incidents, including the collapse of Mt. Gox in 2014, and hacking at Coincheck in 2018. We are delighted to see the Markets in Crypto-Assets (MiCA) Regulation taking up many of the features of our regulations and working beyond them. In addition, given the cross-border nature of crypto assets, we need to engage with non-FSB jurisdictions to avoid fragmentation and regulatory arbitrage in the crypto space. In other words, it is extremely important for us to work with non-FSB and non-G20 jurisdictions.

There are two additional points that I would like to emphasise. The first is the importance of leveraging the work of various international organisations in our path forward. One would think of the collaboration between the FSB and SSBs. For example, cooperation between the FSB and IOSCO at the regional level could also help build a comprehensive approach.

Another point that I would like to emphasise is that the work under way at the Financial Action Task Force (FATF) that aims to identify regulatory gaps in jurisdictions where investor and market activities are concentrated could also be highly relevant. Leveraging this FATF work may be a useful way to find an effective path to engage with non-FSB jurisdictions. Given the borderless nature and rapid innovation, supervisors should have regular exchanges of views on recent activities and developments. Coupled with such information sharing, outreach to various stakeholders will be critical moving forward.

Another area at the risk of fragmentation is that of sustainability, and particularly climate change. Given that climate change impacts all of us on this planet, we have a broad consensus on the urgent need to address this issue. However, there is an undeniable difference as to the extent, the speed and the approaches that respective jurisdictions take, which could lead to fragmentation. One area in which we are grappling with such differences is disclosure.

Last year, the International Sustainability Standards Board (ISSB) finalised International Financial Reporting Standards (IFRS) S1 and S2 for the disclosure of sustainability-related financial information, which represents the emergence of a global framework for consistent, comparable and reliable sustainability reporting that can effectively and efficiently influence capital investment decisions.

There are some jurisdictions that take different approaches and have even stronger ambitions, and we welcome the efforts of the ISSB and other jurisdictions to provide for interoperability. However, the future challenges will be very difficult, as we need to consider our approaches and engagement, particularly with small and medium-sized enterprises (SMEs) and developing and emerging economies. I do not have any clear or concrete answer right now, but only an inclusive approach would be workable to avoid market fragmentation in the implementation of standards.

Now let me turn to Basel III implementation. As all of you know, Basel III was finalised seven years ago, in 2017, with a subsequent amendment in 2019 on minimum capital requirements for market risks. However, as we all know, implementation timelines differ among jurisdictions. From a European perspective, you may think that Basel III implementation is something to happen in the future, say in 2028. However, for Japanese banks, it is happening right now. There are already Japanese banks that opted for early implementation from fiscal year 2022, and the majority of major banks will have been complying with our Basel III regulation from fiscal year 2023, meaning that they will come up with financial statements based on Basel III standards in June this year. That is how quickly we are moving on that issue.

Needless to say, differences in implementation timelines may lead

to similar exposures being treated differently across jurisdictions, also resulting in market fragmentation affecting the liquidity profiles of financial instruments. In addition, internationally active banks will have to implement different versions of the standards in different countries in which they operate, creating significant operational challenges. Moreover, and perhaps more importantly, it will raise level playing field issues.

An important lesson from the banking turmoil last March is that regulatory reforms in the aftermath of the global financial crisis have played a significant part in ensuring the resilience of our banking system. That is why member jurisdictions should implement all aspects of the Basel III framework in full, consistently and as soon as possible. The Group of Central Bank Governors and Heads of Supervision (GHOS) has made this point clear, and we need to live up to our commitment to avoid fragmentation and to ensure our credibility in what we have agreed.

So, how can we avoid market fragmentation? As I mentioned, robust international standards and international coordination and cooperation are the answers, but they require ingenuity in both the process of introducing new regulations and their implementation. For example, in the process of rulemaking, we tend to be ambitious in our approach to fully pursue our respective mandates. While being ambitious is completely understandable and needed, we should also consider whether such regulations could be effectively implemented in respective jurisdictions.

The FSB and SSBs have been mindful of these aspects, introducing impact assessments and conducting public consultations. During these multilateral efforts, if certain standards are agreed, each jurisdiction should consider whether they can really put such regulations in place. In such consideration, it would be helpful to thoroughly discuss these standards with various domestic stakeholders, making a strong case for credible standards. While this process could be resource consuming, this approach may yield better results in the end – namely, prompt and full implementation globally, avoiding market fragmentation.

Japan may sometimes seem overly cautious in the discussions on international standard setting, but, once we agree to a standard, we have generally been successful in full domestic implementation. This could be attributed to close communication with various stakeholders in the course of impact assessments and public consultations. It is not an easy path and may not be applicable to all jurisdictions, but it would be useful to explore ways to ensure the full implementation of any agreed standards.

It is also true that domestic regulations and supervisory frameworks need not be identical across jurisdictions, but could be tailored to the uniqueness of respective jurisdictions and domestic considerations. These differences could be acceptable, but, even in such cases, we need to continuously assess whether such differences are aligned with international standards. Peer reviews and the implementation assessment frameworks conducted by the FSB and SSBs will help assist with such alignment. As highlighted by the FSB report in 2019, we also need to leverage our supervisory cooperation frameworks and mutual recognition among jurisdictions that aim at ensuring consistency at the outcome level in the application of regulations.

As I mentioned at the outset, there are immense benefits in avoiding fragmentation, including in finance. This may sound somewhat extreme, but avoiding market fragmentation is as important as setting international standards. In the end, what counts is whether we can deliver what we have agreed and promised in each jurisdiction. Of course, this is not always easy – and I admit that – but we should at least make our best efforts to implement the agreed standards. If there are substantial discrepancies, we should strengthen our supervisory cooperation to mitigate the fragmentation. The changing dynamics will remind us of the challenges ahead. Thank you very much for your attention.

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