Sessions Summaries

CMU IMPLEMENTATION

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CMU: state of play and way forward

1. Update on the implementation of CMU

1.1 Progress made and proposals underway

Panellists agreed that the Capital Markets Union (CMU) project is progressing. A policy-maker noted that the first two action plans published in 2015 and 2017 have been implemented and the focus is now on the implementation of the third action plan of 2020, which encompasses 14 additional measures. In November 2021, a first package of initiatives was proposed for implementing this action plan with four important initiatives currently under discussion.

First, the European Single Access Point (ESAP) project aims to provide investors with all necessary information at one point at no cost, making investing easier and cheaper. Second, adjustments to the MiFID II / MiFIR[1] frameworks are under discussion, including the proposed implementation of a consolidated tape, which will introduce post-trade transparency. Pre-trade transparency can be considered at a later stage. Third, the European Long-Term Investment Fund (ELTIF) fund framework will be modernised. Uptake has been very limited so far and it is hoped that changes to the regulation will make it more attractive and will allow the collection of money that can contribute to long-term sustainability objectives. Fourth, the rules of the Alternative Investment Fund Managers Directive (AIFMD) will also be enhanced to ensure its continued success. Other initiatives in the pipeline include a framework on open finance to facilitate the reuse of data by financial institutions and the circulation of investor and client information, a review of the Central Securities Depositories Regulation (CSDR), the publication of a retail investment strategy and a reconsideration of insolvency rules and withholding tax. This latter area is very challenging and has been discussed for many years, but the time is now right to address it with some targeted adjustments.

Some additional comments were made by the panellists on the ESAP proposal. An official stated that the ESAP project will address the lack of adequate investor information and the fragmentation of accounting standards used by small and medium-sized enterprises (SMEs) which results in differing presentations of financial accounts across EU countries. The International Financial Reporting Standards (IFRS) that exist for public companies are not used for non-listed companies, which is a major obstacle for auditors and investors in a cross-border context.

Another official clarified that the general IFRS can be used by SMEs that do not invest in derivatives and are not a part of mergers, but this is not the case at present. The official added that the revision of the Capital Requirements Directive (CRD)[2] concerning SMEs is also welcome, as well as the referral rule proposing that if a bank declines a loan to an SME, the SME requesting the loan should be directed to alternative funding providers.

1.2 Speed of implementation of the CMU

A policy-maker stated that the pace of progress on the CMU has been steady. It was clear from the beginning that the CMU project could not be delivered overnight. It is hoped that political support will be maintained for the upcoming proposals and that, ultimately, all the objectives agreed at the outset of the initiative will be reached.

An official agreed with the characterisation of 'steady progress'. While many actions are in the pipeline, it will take many decades to build a true European capital market and there will always be room for improvement. Realism and pragmatism is needed in this respect.

A regulator agreed that building the CMU is a long journey, but warned that the credibility of the whole CMU project could be at stake if some progress is not made sufficiently fast from now on. The proposals already on the table must be delivered rapidly, with some compromises if necessary, otherwise discouragement may gain. The recent European Court of Auditors report on the performance of the EU single market for investment funds, which is thought to be the most integrated part of the EU capital market, concludes that, although a single market for investment funds has been established with passporting, true cross-border activities and related benefits for EU investors remain limited. In addition fund supervision and investor protection are considered to be insufficiently effective at the cross-border level. This illustrates the scope of progress still required to achieve a true CMU.

An industry representative had mixed feelings about the progress on CMU. Nobody challenges the need for CMU and for a more integrated capital market to support the post-Covid recovery and there is an alignment on the sense of urgency of this project, which is positive. There has also been tremendous growth over the past few years in capital market volumes in the EU and also significant progress in the market structure, with important developments such as TARGET2 Securities (T2S) and related harmonisation efforts, the implementation of the CSDR, extensive efforts on shareholder transparency and settlement efficiency and delays, as well as an increase in

1. Markets in Financial Instruments Directive (MiFID)/Markets in Financial Instruments Regulation (MiFIR).
2. Aiming to avoid undue impacts from the implementation of Basel III on long-term SME equity investments by banks and on banks' and investment firms' market-making activity.

resilience and risk management requirements. However, despite calls for a step change, there is a feeling in the industry that the impact so far of the CMU initiative on securities markets, beyond these actions which were already in the pipeline mostly, is too limited and that the pace of change is too slow.

The industry representative moreover suggested that the international competitiveness of European financial institutions and market infrastructures is an objective that should be more prominently put forward in the CMU. There are some achievements in this area. More than one third of euro denominated corporate bonds issued are from companies outside of the EU 27 countries, showing the attractiveness of the euro and related bond markets. Half of the holdings in euro-denominated debt in the books of Euroclear for example, a major European CSD, are held by non-EU investors. The Next Generation EU (NGEU) programme has also attracted significant interest from international investors. However international competitiveness is a permanent challenge and it is important to monitor closely the potential impacts in terms of competitiveness of the implementation and recurring costs of the capital market regulations proposed.

An industry representative also welcomed the general direction of progress on CMU. The ESAP, the consolidated tape and ELTIF are all very important topics. However, there is execution risk. As mentioned by a previous speaker, proposals on the table must be implemented as soon as possible to maintain the overall confidence in the project, because there is a risk that changes in the market will outpace regulation and may make part of the project irrelevant by the time it is implemented. Three examples were given to illustrate this. First, inflation may have significant impacts for investors. The entire regulatory framework has been built around cash being the safest asset, which no longer applies in a context where households may be losing 5 to 8% per year from their purchasing power if money is held in cash deposits. This should be considered in further regulatory initiatives. Secondly, there is a very strong demand for more sustainable investments, but EU regulation lags behind with no common thread for the time being. There is still a lack of clarity around some of the measures and categorisations of sustainable investments in the Corporate Sustainability Reporting Directive (CSRD). Consequently, investors still do not have the relevant corporate data and are forced to make decisions based on very poor information. The Markets in Crypto-assets (MiCA) proposal on digital assets is a third example. The proposal is welcome, but it focuses on stablecoins and tokenisation, and is silent about decentralised finance (DeFi), the fastest-growing segment in digital assets at present.

A regulator agreed that DeFi is not explicitly covered in MiCA, but it can be addressed indirectly with the regulation of stablecoins, which are key for the functioning of DeFi platforms, and with rules imposed on digital asset service providers. Fine-tuning the Level 2 requirements of MiCA will be essential. The pragmatic approach would be to finalise MiCA and then address DeFi in a second step, because otherwise that may delay MiCA significantly.

2. Further steps concerning retail investors and SMEs

An industry representative considered that there is insufficient ambition in the CMU on retail investment and SME funding, which are key areas for the growth of the EU economy. SMEs that are eventually listed on a public market create three to four times more jobs than other similar companies. Getting access to capital allows them to expand beyond their home country into the rest of Europe and in some cases globally. In addition capital can be raised in several stages to support their growth. The planned Retail Investment Strategy and Listing Act are relevant objectives, but more needs to be done to support these two areas and a stronger priority should be put on these actions. While proposals for a consolidated tape for example are welcome, they will not be decisive for developing EU capital markets.

Rather than waiting for the EU to make progress with its policies, market stakeholders should take action themselves, the industry speaker suggested. Sweden, where the whole financial industry joined forces to promote equity financing for SMEs, is a convincing example in this respect. An SME market, Nasdaq First North, was built in Sweden 10 years ago, where 219 companies are now listed and 174 new IPOs were recorded last year, among which more than 100 were SMEs. Listing procedures were simplified and the prospectus was replaced for certain types of companies by a shorter company description, cheaper and faster to produce. More than 100 of the SMEs listed on the First North market have been lifted to the main stock market, growing from being small SMEs to mid or large-cap companies, which is a significant achievement.

A policy-maker indicated that proposals for a Listing Act and Retail Investment Strategy are upcoming. The Retail Investment Strategy proposal will include elements on disclosure and reporting, investor protection and also financial literacy. The objective is to offer every investor the opportunity to be better informed. While education is outside the remit of the European institutions, there is scope for supporting the Member States in putting in place actions for improving financial literacy.

The industry representative agreed that initiatives to develop retail investment are important. Time spent by the financial industry educating retail investors in the Nordics has led to high levels of retail participation. As a result, Sweden probably has the most sophisticated retail market in Europe and a high level of retail participation in SME equity markets. 40% of the capital in the First North SME market comes from retail. Retail investors are also a significant part of liquidity and price formation in SME markets now, with trading in SME stocks gaining in popularity, which enhances the level of confidence of investors in the market. Another factor is that transactions are conducted in a very transparent way, with retail investors putting their orders in through their bank's broker, who then sends them directly to the exchange.

An official considered that building confidence is essential for achieving the objectives of the CMU. There are important institutional investors such as pension funds and insurance companies, but they hold the money of retail clients who make the decision to invest in capital market instruments and need to be confident in the market. With the pan European pension product (PEPP), this will be even more the case. The confidence of retail investors diminished following the 2008 financial crisis, but Covid has led to a rise in retail investment. With the current low interest rates, retail investors are looking for yields and this will continue with inflation. The capital market however has to compete with cryptocurrencies and demonstrate that there is an advantage in investing in a regulated market. The MiCA regulation is also essential in this regard for tokens which are not securities.

The official stated that enhancing financial literacy is also important for entrepreneurs, meaning the CFOs or CEOs of SMEs, who need to be educated about the capital market and its possibilities, whereas the CFOs of larger companies usually have sufficient knowledge about this. Together with the European Commission, the Czech Republic Ministry of Finance for example has created a website outlining how SMEs can be financed in the capital markets. SME go through different stages: personal funding and crowdfunding, then venture capital and private equity; and finally public markets. The funding can be made in equity or bonds, but it is usually easier for SMEs to issue bonds in the first place, because it is psychologically the same as taking out a loan. Equity is different from a governance perspective, which is a potential obstacle to the development of equity financing that needs to be overcome.

3. Main pending issues and remaining challenges

The panellists mentioned a number of topics related to legal and fiscal barriers and EU-level supervision where further focus would be needed in the CMU initiative. The Chair suggested that increased attention must also be paid to securitisation and pensions. The situation in EU securitisation markets is worse than it was 15 years ago, despite the implementation of a new EU regime of simple, transparent and standardised (STS) securitisation. On pensions, which are one of the great strengths underlying the US capital market, further consideration is needed on how to build a deep pool of savings for long-term investments. At present it is uncertain whether the Pan-European Personal Pension Product (PEPP) will work.

3.1 Legal and fiscal barriers

An official noted that there are many language, cultural and legal barriers to achieving the CMU. Deeply entrenched legal cultures in member states concerning for instance financial reporting standards or the management of insolvency procedures, must be addressed. Some of these issues are outside the responsibility of finance ministries and are covered e.g. by ministers of justice, who tend to have different priorities than finance ministers in relation to capital markets. Reconsideration by the Commission of the possibility to enhance the consistency of insolvency rules is key, because there is a clear link between creditors' rights and capital provision and in domestic laws there are very different ideas about the appropriate balance between the rights of creditors and debtors across the EU. Reform on this point is difficult, because some of the ideas are very deeply entrenched, however real progress on the CMU cannot be made without tackling this issue. Tax harmonisation is an even more difficult area on which there are few initiatives. Even harmonising the procedures (rather than the level of taxes) such as the withholding tax procedure is hugely controversial. A policy-maker indeed explained that unanimity is required to address the issues around taxes at a European level.

An official commented that the Czech Republic is keen to open discussions on the long-standing issues of the harmonisation of securities law, in addition to insolvency rules and taxation. This should not be a major challenge, the official felt, because it could be achieved by implementing the Hague Securities Convention and the Geneva Securities Convention as EU regulation. The Giovannini report also provides useful guidance in this regard. The harmonisation of corporate taxation and a consolidated basis for corporate tax would be useful as well. As for language barriers mentioned by a previous speaker, they are disappearing online with the use of translation apps.

A regulator reiterated that, before addressing such challenging issues as insolvency laws and taxation, which are essential, it is important to realise that the credibility of CMU relies on timing and on delivering first and rapidly what is already on the table.

3.2 EU-level supervision

A regulator stated that the digitalisation of financial services means that there will be more cross-border services and investment in the future, but the framework for supervising cross-border retail markets and addressing investor protection concerns in this context does not yet exist in the EU. At present, investor protection relies entirely on the home supervisor and is fragmented across 27 jurisdictions. Supervisors have different levels of competence depending on the size and activities of the financial sector in their jurisdiction. With increasing digitalisation, firms might locate in countries with a lower level of sophistication in terms of capital market supervision and distribute their products throughout the EU. Moreover large jurisdictions will increasingly be host supervisors with a difficulty to appropriately address customer protection issues in their jurisdiction posed by firms and products based in other EU countries.

The regulator suggested that after having delivered the proposals of the current CMU action plan, a review of the supervisory framework is needed to support the development of cross-border investment, which is one of the objectives of CMU. An option, considering the way the Single Supervisory Mechanism (SSM) for banking activities is structured, could be to have a different

supervisory approach for entities that are above a certain size and are truly cross-border.

4. Way forward

The Chair suggested that a timeframe is needed, together with a political agreement to deliver the planned initiatives of the CMU sufficiently fast i.e. in this European cycle and before the next parliamentary elections.

A policy-maker summarised that the comments made by the panellists essentially go in two directions: the need to deliver quickly and the suggestion to do more on CMU. These two objectives are valid but contradictory to a certain extent because the more that is done and the more ambitious is the action plan, the harder it is to deliver quickly. Best efforts are being made by the Commission to find the right balance between these two conflicting objectives. Reacting to some suggestions made by the panellists, the policy maker agreed that further work on securitisation could be beneficial, but there is resistance of some stakeholders towards this. Concerning SMEs, a Listing Act is in progress, however, the more that is put in that, the harder it will be to deliver quickly. The priority is first to deliver the initiatives that are on the table as fast as possible. Strong political support is essential for moving the CMU forward, but it must go beyond commitments in principle and materialize in compromises on the legislative texts proposed.

An official agreed that there is a trade-off between ambition and speed and that many good proposals have been made. The difficulty in making progress is that there are many divisions not only within the Council but also among market players. The Council is split on securitisation for example between those who want a more competitive banking market and those who favour customer protection and regulatory stability. It is the same for market participants about the importance of the consolidated tape and how to implement it. There are also different views about reinforcing EU level supervision through ESMA. This latter issue is further complicated by the fact that within the EU some countries have developed capital markets that require sophisticated supervision and others have practically no capital markets and limited supervision functions in this area. In any case, creating a true, functional European supervisor raises many challenges in terms of resources and budget, which are difficult to tackle in the short term.

An industry representative stated that they would encourage the Commission to take a 'minimum viable product approach'[3] to the CMU next steps in order to put sufficient conditions in place to move as fast as possible. The digital space must not be forgotten in the CMU debate. Otherwise, the 27 countries will impose their own rules, and this will result in a new layer of dis-harmonisation on top of the existing one. In order to create more support for the CMU among political decision makers and the wider public, the industry speaker suggested that consideration could be given to renaming CMU with a view to putting savers and the financing of the economy, notably SMEs, at the centre of it.

A second industry representative stated that regulators face a difficult task. However, the contrast between either working on a large scope of proposals slowly or a smaller scope quickly is too restrictive. Another option is adopting a more iterative approach to regulation, rather than the current sequential approach. MiCA for example includes asset reference tokens in the definitions of crypto-assets, derived from the Libra concept, which is now dead. If legislation was developed iteratively, starting with a broad framework and then adjusting and refining the detail, a great deal of speed could be gained.

A third industry representative reiterated that there are two priorities for the CMU, SMEs and retail, where focus at the EU level should be increased. If retail investors get used to investing in SMEs, SMEs will see the benefit of accessing capital at the stock exchanges and will know that they can rely on this source of funding. Investors will get better returns than on their savings accounts and play an active role in developing economic growth and job creation. Achieving this combination should be the main priority of the CMU.

The Chair concluded that while CMU has to be democratically negotiated, the CMU project cannot be delayed indefinitely while agreement is found on all topics. At some point there must be a priority given to achieving progress on the building up of a European capital market over the detail of the substance.

3. The MVP approach is based on the premise that sufficient customer value can be provided by delivering minimal features that early adopters will use. Feedback can then be collected and used to build a better product that will resonate with future users.

Retail investment strategy: what priorities?

1. Overview of retail investment trends in the EU

An investor representative gave an overview of retail financial investments in the EU. Firstly, financial savings in the EU are not only in bank accounts, which represent 33% of retail financial assets. They are also – and more - in life insurance and pension products, which comprise 38% of financial assets. This means that 71% of financial assets are mostly in fixed rate or fixed income related underlying assets. Third are listed stocks and bonds, representing 9% of assets. Lastly, investment funds represent about 9%. Retail investors only have a limited direct exposure to funds, but they are also exposed to them economically via unit linked products within life insurance and pension products. In terms of regulation, this means that retail investors are currently affected by a range of different rules; this is a consequence of the silo approach adopted by European law in which rules differ across product categories. The Retail Investment Strategy will hopefully mark an attempt to develop a consistent approach to investor protection rules throughout these different product categories.

A regulator highlighted the similar evolutions in every country since the beginning of the Covid pandemic. There has been a huge inflow of retail investors into the market. The fall in stock prices was seen as a buying opportunity. People also had more time on their hands, had saved money with restricted spending opportunities and had easier access to financial markets thanks to digital apps. Surveys conducted in the Netherlands have shown that these newcomers to the capital markets are younger than the average investors, are relatively confident about their capacity to make appropriate investment decisions and use execution only services, relying mostly on social media and 'finfluencers' for stock market advice. However, surveys have also concluded that roughly one third of these new investors had suboptimal investment strategies. They traded in and out too frequently and did not spread their investments sufficiently across assets and time, making them vulnerable to potential market fluctuations.

An industry speaker emphasised that saving rates hugely increased in 2020 and 2021 with the Covid crisis. There were some newcomers to the capital markets, but most European households saved in bank accounts and savings products. The normal rate of savings for a European family is around 12%. During the last two years, it was closer to 20%.

2. Opportunities and challenges associated with retail investment

2.1 Opportunities related to the development of retail investment

The Chair observed that the current macroeconomic environment of low interest rates provides an opportunity to encourage more household investment in capital market instruments, however also potentially generating new risks.

A regulator emphasised that the main policy objectives concerning retail saving should be to address the pension gap, build more pension adequacy in old age and enhance the long term funding capacity of the European economy. This long term perspective should underly the objective of developing retail investment. In Portugal and Spain, the average replacement ratio of pensions will be 40% of the salary in 40 years' time if nothing is done, compared to around 70 to 75% at present. When considering the macroeconomic environment and the risk of inflation, a push of the value for money offered to retail investors is also necessary. It is therefore necessary to propose simple, cost effective products for people to complete their savings for retirement. The regulator described digitalisation as a major opportunity in this regard, because it will facilitate the provision of simpler, more cost effective and more comparable products and services. Many of the costs supported by retail investors are due to the complexity of products. This should also lead to a simplification of regulatory requirements. Building a truly single market for capital is a further opportunity to support retail investment.

An industry speaker agreed that the objective of increasing retail participation in the capital markets should focus on achieving better outcomes for investors in terms of pension adequacy and long term saving. It is possible to generate much better value for investors by providing products corresponding to their long-term savings needs and adequate advice for facilitating their investment decisions.

An industry speaker emphasised that the development of retail investment also provides the opportunity to massively support a transition towards a more sustainable and digital economy. Asset managers in particular have a key role to play in channelling retail savings towards these investments.

2.2 Challenges faced by retail investors

Considering the challenges associated with the objective of developing retail investment, an investor representative stated that this is one of the worst times for retail investors because 'financial repression' is at an all time high. The current combination of monetary and prudential policies is resulting in investors obtaining a negative return in real terms on their investments and this will worsen with the upsurge of inflation since 2021. This is not a temporary issue and retail investors will be hit hard because 71% of their financial savings are in savings accounts and mostly fixed income related products. For example, in France, where capital guaranteed life insurance is the main saving product with €1.6 trillion of assets in 2021 alone, savers lost €43 billion in real terms in purchasing power in 2021 with

an inflation of 3.4%. In addition, savers are taxed in most cases on nominal income, which is partly a fictitious income, and they are also being encouraged to move their assets to unit linked products, which are riskier, more expensive and more complex, at a time when stock markets are at an all time high. In the same way, the biggest saving pot in Belgium, which is bank saving accounts, lost €22 billion in purchasing power in 2021 alone.

An industry speaker agreed that inflation is a game changer that is due to last and increase. There could even be a stagflation situation because the price of energy is going to rise quite dramatically, especially due to events in Ukraine. The consequences of inflation for retail savers are quite significant. Statistics show that €10,000 left in a bank account over the last 10 years has lost at least 10% in value in real terms. The same amount invested in an average diversified portfolio fund would have generated around 60% in real terms and net performance during the same period. This shows that savers need to invest in more diversified assets, which is an objective that investment funds can contribute to achieving. However, only 10% of retail savings are invested in funds at present, which needs improving.

A regulator stated that, while many savers are showing a new interest in investing in capital markets, it is important not to lose them as investors in the future due to foreseeable disappointments. Cost and trust are important in this respect. 'Cost' means that people should be offered products at fair prices. These products should make sense for retail investors and work under various economic circumstances. There should also be no inherent conflicts of interest that work to the detriment of investors in the system. Retail investors should also be protected from fraudulent or excessively risky propositions. In this new world of digitalisation, it is still very difficult for supervisors to go after foreign firms. Therefore, it is necessary to address investor protection from a cross border perspective. A further issue is that the strong interest in meaningful environmental, social and governance (ESG) investments means that way too much money is currently chasing too few ESG assets, leading to risks of greenwashing and a green asset price bubble.

The Chair stressed that ensuring investor protection for cross border investment is a significant challenge. A specific area of concern raised notably by the International Monetary Fund (IMF) concerns the way supervision is organised in the cross border context with the growing digitalisation of financial services.

A regulator added that the current geopolitical challenges will induce more volatility in a system that was already heated due to liquidity and risks that were probably inadequately measured. This will also impact retail investors.

3. Objectives of the Retail Investment Strategy

A policy maker explained that the Commission is considering putting forward a Retail Investment Strategy centred on the retail investor. This is the first time that the objective has been presented in this way at the EU level. Moving in this direction is a significant priority for the Commission.

The Commission's key objective is to develop retail investors' access to capital markets to better cater for their long term saving needs. The Commission's assessment of the present situation is in line with the comments made by the panellists. Capital markets represent opportunities and risks for retail investors. Changes in the profile of investors have been observed since the Covid crisis. Challenges include the limited level of financial literacy and the way the regulatory framework is currently structured, which may need some streamlining.

No decision has been taken yet, and consultations are ongoing. A first area that the Commission is considering is enhancing financial literacy. There is no legal basis in the treaty for interventions at the EU level in the field of education, but support can be provided by the Commission to member states. A second area is the streamlining of disclosure rules on which a study has been commissioned. Advice has also been asked from the three European Supervisory Authorities (ESAs) on possible improvements to these rules. Inducements are being assessed to determine whether they contribute to creating a conflict of interest that may hinder the provision of unbiased advice. This is a very divisive subject on which there are different views.

More generally, the Commission is assessing whether a more investor centred perspective can be developed in the regulatory framework, the policy-maker explained, because rules are mostly product based at present. The intention is to evolve towards a perspective of individual portfolio creation in the advice provided; this involves reconsidering whether the current product suitability and appropriateness regimes are still fit for purpose and how information that is currently provided for each product in great quantities should be presented to better suit the needs of investors. All these issues also need to be considered together with the opportunities and risks stemming from digitalisation. Finding the right balance between innovation and investor protection is not easy, but this is the objective that the Commission is endeavouring to achieve with the input to the ongoing consultation.

An investor representative stated that the Retail Investment Strategy is a once in a lifetime opportunity to improve the issues affecting individual investors in Europe that should not be missed.

The Chair emphasised that encouraging the participation of retail investors in EU capital markets is a priority in the context of the Capital Markets Union (CMU). The Retail Investment Strategy is a welcome initiative, as it should allow for breaking barriers to cross border investment, providing long term investment options to European households and ensuring that they have access to strong investor protection. This objective is particularly relevant in a context where households have accumulated significant savings during the pandemic and are facing low returns on their savings account due to the low interest rates.

An industry speaker considered that the Retail Investment Strategy, is a great opportunity to reflect on what is

needed to strengthen the current pension environment and foster longer term saving in Europe. The objective to assess every step of the investor journey is the right approach as there is no silver bullet for achieving better outcomes for investors. Investment funds can provide an instrumental contribution to this objective, supporting wealth creation rather than just wealth management.

Another industry speaker was looking forward to the recommendations of the Retail Investment Strategy. Targeted changes to existing rules are needed rather than an overhaul of current frameworks and additional requirements and a more holistic and streamlined approach should be favoured rather than the current work in product silos.

A regulator added that simpler products and investor information would probably necessitate less regulation but more effective supervision. It is necessary to have stronger conduct supervision in Europe, and this needs to be much more centralised in European institutions.

4. Key areas of the Retail Investment Strategy

4.1 Financial education

An industry speaker believed that improving investor education is essential, which requires developing access to qualified advice. Retail investors should not rely on tips from social media or YouTube and should be able to make their own investment decisions. The level of financial literacy is very variable across EU Member States at present. Not much can be done at the European level in the area of education, which is under the remit of domestic authorities. The strong presence of pension funds in certain countries such as the NL has contributed to a higher level of financial literacy, but this is not widespread across the EU.

An industry speaker stressed that while financial education and literacy are very important pillars for the development of retail investment, they are also a long term goal. There is a role for mechanisms that can help individuals to think about financial planning and how to plan for retirement at different periods of their life, creating the right incentives along their wealth creation journey.

A regulator agreed that nudging people towards a periodic financial health check, as suggested by the previous speaker, that would examine whether their financial situation is still fit for purpose, given possible changes in their lives or projects or evolutions of the economy would be a good idea. There are questions about how recommendations can be made, the form that they may take, whether some may be compulsory, who is going to do the health check and who is going to take the necessary follow up actions, but this is worth thinking about in the context of the preparation of the Retail Investment Strategy.

The regulator added that empowering retail investors to be able to make their investment decisions should be the objective rather than educating them about finance. This does not mean them receiving more information, but rather better information. Indeed, it is not certain that better trained investors would make better financial decisions, because there are many behavioural factors at play: individuals are prone to biases, can be over-confident, excessively short-term oriented… Therefore, individuals will still need to be provided with an appropriate level of protection.

An investor representative stated that improving financial literacy is at best a quite long term solution that is often mentioned but cannot realistically be implemented at the EU level because there is no legal basis for the EU to intervene in the area of education. In addition, adults are not interested in being trained in this area, therefore a first critical step is should be to better inform them and advise them at the point of sale. The second objective should be to facilitate the engagement of investors. Developing responsible investment, especially for environmental reasons is a way to involve the younger generation. Facilitating the exercise of shareholder rights, particularly cross-border within the EU should be another objective. The new Shareholder Rights Directive (SRD II) was introduced in 2021 but it is not working and it is still extremely difficult and costly for small shareholders to exercise their voting rights within the EU. This would nevertheless be the best way to encourage companies to apply ESG criteria and invest in a responsible way, as shown by many studies including assessments conducted by Better Finance.

4.2 Product distribution and advice provision

An industry speaker welcomed the reassessment of the inducements regime in the context of the Retail Investment Strategy and suggested that this should be done from the perspective of improving the advice provided to retail investors in terms of quality and access. There is already significant evidence from the Netherlands and the UK showing that the suppression of inducements has not led to a shortfall in the provision of advice; in fact, it has led to more competition and higher levels of quality in the services and products provided. The objective to enhance the level playing field between investment funds or insurance products is also relevant.

Another industry speaker emphasized that in the continental Europe distribution model, banks play a key role in terms of advice and distribution of investment products and that suppressing inducements would accomplish exactly the reverse of the objective in this context. A range of advice from face to face to simple digital advice can be provided, but it has to be paid for. In addition there is a huge challenge in terms of advising customers about sustainable investments and assessing their preferences in terms of ESG. If people are asked to pay for something that is currently free, most of them will choose the cheapest option with very limited or no advice as is the case for low-cost flights. Assessments conducted in the UK show that the average customer benefitting from advice has investments amounting to around £150,000, but the median amount held in securities in Europe is around €10,000. With the current bank centric distribution model in Europe, a full inducements ban would really risk excluding most investors from suitability tests and advice. There could be further unintended consequences from the

suppression of inducements such as limitations to the development of open architecture distribution, as mentioned in an ESMA technical advice in 2021.

A regulator acknowledged the wide range of views that exist on the impacts of inducements. In the Netherlands, there has been a full ban on inducements since 2014 because of a major mis selling scandal. Eight years later, the authorities are satisfied because the costs for investors are the lowest in the EU. The advice industry was forced to become more innovative developing a range of advisory packages with different price tags, because there was no longer easy money to be made with inducements. Those who were not able to react left the industry and the others managed to innovate. It is true this change raises some challenges, but these are more of a short term nature and can be overcome, the regulator believed.

An investor representative emphasized that advice must be 'bias-free' (a main objective of the EC's retail investor strategy), because there is massive evidence of the damage caused by biased advice. Taking the example of France, two-thirds of the retail equity fund market is constituted by unit linked products promoted by insurance companies and banks, that returned on average 4% per year over the last five years, whereas cheaper exchange traded funds (ETFs) on the French stock market returned close to 8% over the same period. This is wealth destruction that shows the damage caused by the advice provided by biased financial advisors. An industry speaker agreed, stressing however that the number of retail investors finding their way to lower cost products that are easier for them to access, such as ETFs, is increasing.

The regulator stated that cost and trust are essential for retail investors. In particular, this requires rigorous product governance on the part of the financial industry and appropriate supervision. Products that are sold to retail customers should be cost effective and should work not only in good times, but also in bad ones. They should be marketed to the right people, and firms should be encouraged to guide customers towards products that make sense for them instead of the seller. This is part of product governance.

4.3 Digitalisation

An industry speaker emphasised that cost and value-for-money are a critical element for the growth of retail investment. One trend that should support this objective is an increased use of digital tools for executing transactions and also accessing different types of advice and guidance services. Providing a sliding scale of advice that includes digital options such as digital enabled advice or simpler digital guidance models is an effective way to attract a wider range of customers to financial advice. This reduces the barriers to entry and people of all ages may prefer digital interaction. Technology and its use in an open finance environment can also create efficiency and add value in other related areas such as the onboarding of clients, product comparison or the analysis of market data. All of that potentially paves the way for a far more scalable investment industry that reaches more people of all ages, incomes and stages.

A regulator stated that a huge part of the initial cost of advice lies with the product suitability and appropriateness tests. New technologies and open finance mechanisms can be used to streamline and standardise these tests, potentially reducing their cost significantly. This could work for a vast majority of customers.

4.4 Product disclosure and labelling

An industry speaker stressed that further standardising and streamlining investor disclosures should be a key objective, starting with an assessment of the present degree of divergence of disclosure across financial products. The amount of available information is overwhelming for retail investors and current key investor documents (KIDs) or prospectuses do not help much, as they are not easy to use and do not allow an easy comparison.

A regulator confirmed that KIDs are not often used by retail investors and that a new paradigm should be proposed for disclosures. This is a long-standing issue that needs to be tackled rather than repeating the same mistakes. The principles stated in the EU directives are correct, requiring to provide easy to read, comparable and understandable information. The problem is that this objective is then translated into a long list of items that need to be part of a KID, contradicting the initial objective. A way of providing radically simpler information needs to be found. The starting point should be the client to whom the product is going to be sold and the client's objectives and not the product itself. A way of doing this is layering the information. If some people want more detail they should be able to access it, but the first level of information should remain simple.

The regulator added that in some areas, labelling should also be part of the solution. This is the case for example of ESG investment. This is an area where a great deal of information is going to be provided to customers to inform them and understand their preferences. Retail investors should also get an upside from ESG investments, which means fighting against greenwashing and favouring the emergence of long term, ESG compatible investments, that may also be adequate for preparing retirement. Labelling could be of great help in this perspective.

Improving SME equity financing

1. Overview of the financing of SMEs in Europe

The Chair introduced the discussion by emphasizing that the issue of small and medium-sized enterprise (SME) equity financing is a longstanding one. The new needs around the digital and green transitions will require more equity financing and at the same time, the Covid crisis has added more debt to SME balance sheets, which will necessitate a rebalancing of financing sources. The growth of retail participation in public equity markets observed since March 2020 is a trend that may be leveraged in this perspective. These objectives are at the heart of the new Capital Markets Union (CMU) action plan published in November 2021.

An official explained that SMEs are the most numerous and fragile enterprises in the EU economy. They represent two-thirds of gross domestic product (GDP) and in some countries almost 99% of enterprises are SMEs. Prior to the Covid crisis, SMEs were already quite indebted. The additional financing provided during the crisis to support SMEs was mostly in the form of debt, leading to higher SME indebtedness. The result was a 5 10 percentage point increase in indebtedness as a proportion of GDP and in terms of the debt to equity ratio. These figures are now reverting to their pre crisis levels, but there is still a substantial need to further diversify the financing of SMEs in the EU, notably with more equity investment.

Thanks to the interventions of central banks and public institutions, the European economy was kept afloat during the Covid crisis and is expected to return to a pre crisis level in 2022, the official added. While this evolution is positive, macro reports produced last year for example by the International Monetary Fund (IMF) and the European Capital Markets Institute (ECMI), estimate that Europe has an equity deficit of €600 billion, which is significant compared to other jurisdictions, notably the US. This gap is particularly acute for certain segments of enterprises such as start ups. The number of start ups in Europe has increased over recent years, but still lags behind the US. As a percentage of GDP, there is 10 times less investment in venture capital in Europe than in the US. Improving the financing of European scale-ups is also essential, because many of these companies end up being financed by US and Asian investment funds as a first step to listing on the NASDAQ or other non-EU exchanges. In Europe today, up to 75% of these fast growing companies are refinanced at a later stage by US or Asian funds. An industry speaker confirmed that at present many innovative SMEs in Europe turn to other countries to be listed, because there are less obstacles and more liquidity available.

A policy-maker noted that the European economy has emerged from the crisis with more debt on the private and public sides and agreed that it is important to ensure that enterprises access new sources of finance in order to finance their development.

A second official emphasised the heterogeneity of the EU capital markets landscape. In Western Europe, there are countries with large and buoyant capital markets such as France, Germany or Luxembourg, but in Central Eastern Europe (CEE) bank financing remains prevalent and capital markets are under-developed. There are similar contrasts between the North and South of Europe. In this regard, it is worth considering concrete examples from the Baltic countries. All three Baltic countries have a stock exchange and an increasing capital market turnover, but the market capitalisation in these countries remains low, ranging between 3 and 10% of GDP[1] compared to 120% in Finland and even more in Sweden. Retail participation, crowd funding and investment funds are growing, but figures are limited compared to the EU countries with highly developed capital markets[2]. There are also very few initial public offerings (IPOs) happening in these countries. Many of the IPOs concern enterprises that were previously state-owned and these IPOs generally happen in the local market.

The official also stressed the importance of enhancing SME financing in the CEE region. Lithuania's economy for example is composed mainly of SMEs with 90% of enterprises having fewer than 10 employees. According to a survey carried out by the Bank of Lithuania, bank loans are the third most popular source of SME financing after internal savings of the owners and their relatives and state aid, which is mainly European assistance provided notably by the Cohesion Fund.

2. Obstacles to the further development of SME equity financing in the EU

2.1. Demand-side issues

An industry speaker observed that retail clients are interested in buying SME shares, but there are some

1. Lithuania's market capitalisation is 9% of GDP and Estonia's is 10% of GDP, but Latvia's is only 3% of GDP. The annual turnover In the Lithuanian stock market was between €70 million and €90 million, but it has now increased to €100 million. The overwhelming majority of this is shares; bonds are non existent.
2. In terms of retail participation, only 16,000 of Lithuania's population of 3 million participate in the stock market. 40,000 mainly younger people participate in crowdfunding, which is an important channel for SME financing. Crowdfunding has grown by €53 million to €650 million. While the investment fund market in Lithuania is substantial, Lithuania only has 14 domestic UCITS funds out of 64,000 in Europe, according to data from the European Court of Auditors (ECA). There are also 100 Alternative Investment Funds (AIF) in Lithuania, but 64 of these are purely real estate. Financial market instruments are almost non existent.

practical obstacles that need to be considered. First, there is a lack of research on SMEs, which is being addressed by the MiFID II Quick Fix with amendments proposed to the current research and execution cost unbundling rules with respect to small and mid-cap issuers. Secondly, transaction costs in the EU are too high due to market fragmentation, particularly in the post-trading space, which increases the costs of intra-EU cross-border transactions. Fiscal fragmentation is another key issue here. As a result, French investors for example mainly purchase shares on their domestic market and if they purchase foreign shares, they tend to invest in US stocks rather than EU ones. Purchasing SME stocks also tends to be more expensive than blue chip ones, even on a domestic basis, due to the cost of clearing and settlement. The limited liquidity of SME markets is a third challenge, which has a particular impact when markets are volatile. If investors who need the money are trapped with SME shares, they may not re enter the market in the future.

These different issues show that SME markets remain fragile, the industry speaker stressed. Investors must be able to have trust in SME markets, otherwise they will purchase blue chip stocks or investment products such as exchange traded funds (ETFs), which are not appropriate for financing SMEs. More generally, there is a challenge around building investor trust and developing their level of autonomy. Digitalisation can help and some e brokers are making considerable efforts to train clients interested in trading on equity markets, but these investors often want to meet an advisor in person before initiating transactions. Additionally, the implementation of environmental, social and governance (ESG) standards by SMEs could create a real appetite for these shares. However, with the standards proposed, companies are considered to be either green or brown, which does not encourage investment. Savers want to see progress and invest in companies transitioning to higher ESG standards or contributing to the transition.

Another industry representative highlighted the challenges around financial literacy and investor incentives. It is encouraging to see that more young people are investing in stock markets, but there are major differences in the financial culture across European countries and across generations. The CMU action plan has proposed some actions to improve the engagement of retail investors such as the Retail Investment Strategy, but investors will not buy equity products if they do not consider them to be profitable. This is where tax becomes relevant. Tax incentives should be developed to encourage people to invest in equities. The Chair agreed that tax incentives could have an important effect on retail investment behaviours, although this is an area mostly outside the remit of European institutions.

An official emphasized the challenges that exist in the cultural landscapes of many CEE countries, where there is a heritage of reliance on state paid pensions. Previously, people did not have investments; they had a salary or a pension and just a few savings. Therefore, the older generation does not trust shares and considers bank deposits and liquid savings to be more reliable. CEE citizens need to be educated about investment, business initiative and entrepreneurship. There are often heated debates in domestic parliaments of the CEE region about the need to protect citizens from the risks of financial investment. There is also a generational split: the younger generation is tech savvy and ready to invest in crowd funding and foreign stock markets, but they do not have the money to invest.

2.2. Supply side issues

An industry representative described several key issues that SMEs are facing when seeking to raise equity funding on the public markets and which make European markets less attractive and less advanced than those in the US or Asia. First, are the costs of going public and maintaining a listing, mainly due to disproportionate regulatory requirements, which lead many SMEs to seek other financing options, such as private equity. Investor protection is often put forward as the underlying reason for these requirements. While this is an essential aspect, a better balance should be found between the objectives of risk mitigation and economic growth with more proportionate listing requirements, allowing these companies, which are fundamental for the EU economy, to obtain the financing that is needed for their scaling up. This will in turn support the growth of the EU economy and provide investors with higher returns. Secondly, the lack of research on EU SMEs, which the MiFID II Quick Fix is attempting to solve, also has implications for SME issuers in terms of visibility in the market, access to funding and liquidity. Private initiatives have been set up in certain countries to alleviate this issue. For example in Spain, the stock exchange and the Spanish Institute of Financial Analysts (IEAF) have launched an initiative, which aims to increase the research coverage by providing free information on listed Spanish stocks. Thirdly, there is a need for a consistent definition of SMEs across the EU, which varies at present across regulations and member states. A homogenous definition would enable initiatives to be implemented more consistently with a stronger impact at EU level. Fourthly, many innovative companies do not have a regular cashflow, which means they have limited access to bank funding and due to their limited size they do not have sufficient visibility in the markets. Specific measures are also needed for these companies.

A regulator emphasised that tax also plays an important role on the supply side. The fiscal bias towards debt has huge consequences for the decisions made by SMEs about their financing structure.

3. Policy initiatives to support SME financing in the EU

3.1. Actions related to the Capital Markets Union (CMU) initiative

A policy-maker described the actions being taken by the European Commission to support and diversify the financing of SMEs and to develop investor demand in the context of the CMU. Progress is being made and now actions need to be implemented on the ground. The latest CMU action plan published in 2020 proposed actions in three main areas: supporting the twin green

and digital transitions and a resilient economic recovery; making the EU an even safer place to invest; and integrating national capital markets into a genuine capital market. This action plan includes measures aiming to remove some of the obstacles to the supply of financing for SMEs. For example, there is a proposal to redirect SMEs that have not obtained financing from banks to alternative providers of funding. There is also a proposal to implement a dedicated platform at EU level, the European Single Access Point (ESAP) to facilitate the access to financial and non-financial information on EU enterprises, including SMEs. A Listing Act review aiming to simplify rules for companies, particularly SMEs, wanting to raise funds on public markets is also due to be published in the coming months.

On the demand side of capital markets, the European Commission is also seeking to empower citizens through initiatives to improve financial literacy, the policy-maker added. The objective is to make them more aware of the risks and opportunities of investing and to help them to make their own investment decisions, rather than relying solely on investor protection rules which may hinder investment. The European Commission is working with the OECD on actions to improve financial literacy in a number of Member States. In Italy, for example, with the Financial Education Committee, a Netflix-type series has been created on investment in an attempt to reach a wide audience. Actions are also conducted in France and Portugal to make younger retail investors more aware of the benefits over time of regularly investing small sums of money. Banks across the EU are also doing a substantial amount of work on youth education regarding financial matters.

An industry representative stated that the CMU action plan is a very welcome initiative. The four legislative proposals published in November 2021 should indeed contribute to developing SME financing[3]. The ELTIF review is a step in the right direction, but the framework should not be limited to companies involved in the green and digital transitions and should also include scale-ups, which have important investment needs. The ESAP initiative could also increase the visibility of SMEs and should be linked to actions to increase the research available on these companies.

Some of the other actions in the CMU action plan should help develop equity investment in EU SMEs, the industry speaker believed. The Listing Act review proposed by the European Commission is an opportunity to improve the conditions under which SMEs can list their shares on public markets. This is happening alongside national initiatives. This review should address the direct cost of listing, help to simplify prospectuses and also make it easier for companies to move from growth markets to regulated ones. The simplified recovery prospectus[4] facilitating secondary issuance was an adequate initiative in this perspective, although it has not been widely used. More generally, there should be more proportionality in the rules applying to SMEs (e.g. around sanctions and governance) and a harmonization of definitions across EU regulations (e.g. concerning the definition of SMEs and semi-professional clients). There are also some important issues to fine tune on the investor side. The actions to improve financial literacy and the information available to investors are highly relevant, because they will contribute to building investor trust. The dual voting structure is an interesting idea for encouraging more long term investment. Lastly, suitability tests for retail clients should be entirely reviewed and should be harmonised between the different regulations concerning retail investors or savers.

3.2. Regional initiatives

An official suggested that the heterogeneity of capital markets in the EU means it is necessary to develop smaller capital markets in parallel with their integration into a single EU capital market. The European Commission should help Member States achieve this through its Technical Support Instrument[5], in particular in smaller markets which do not benefit from economies of scale and lack investor interest. There could be several benefits to including a regional approach in the building of the CMU. The three Baltic countries provide a relevant example of this. Specific legislation on covered bonds and securitisation has been drafted in the three Baltic States with the support of the European Commission and the European Bank for Reconstruction and Development (EBRD). There have also been initiatives to harmonise corporate law in some Baltic and Nordic countries which have similar legal systems. Another idea that has been suggested is the indexation of the Baltic countries into a single region in the MSCI index, which would create a larger market and increase their attractiveness for foreign investors. There could also be a benefit in consolidations of market infrastructures at the regional level, such as merging the Baltic stock markets. A further initiative could be an enforcement of European structural reforms through country specific recommendations. The intention of these proposals is not to create additional barriers between this region and the rest of the Europe, but to support the development of capital markets in Europe by creating stronger and more effective regional building blocks, the official explained. This approach was suggested in the recent report of the European Court of Auditors (ECA) on the CMU[6].

A policy-maker agreed that the work conducted jointly by the European Commission and the EBRD was very

3. In November 2021, the European Commission put forward four legislative proposals for implementing the September 2020 CMU action plan: (i) set up a European Single Access Point to provide financial and sustainability related information on EU companies and financial products in a digitally useable format; (ii) improve the ELTIF (European Long-Term Investment Fund Regulation) framework in order to make ELTIFs more attractive for investors and easier for asset managers to operate and market; (iii) enhance the Alternative Investment Fund Managers Directive (AIFMD) to better integrate the EU AIF market, improve investor protection and better monitor the risks to financial stability posed by AIFs; (iv) review the Markets in Financial Instruments Regulation (MiFIR) in order to tackle the transparency and level playing field issues posed by current rules and enhance the international competitiveness of EU capital markets.

4. The recovery prospectus is a temporary regime that simplifies the procedure for raising capital for issuers during the COVID 19 pandemic. This prospectus focuses on essential information and is only available for the secondary issuances of shares.

5. Regulation (EU) 2021/240 of the European Parliament and of the Council of 10 February 2021 establishing a Technical Support Instrument, *https://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:32021R0240&qid=1650611651118&from=en*.

6. Capital Markets Union – Slow start towards an ambitious goal ECA report November 2020.

relevant and has helped to create a regional market for certain financial instruments. While there should be an endogenous will within member states to reform their markets and ask for assistance from the European authorities, the European institutions should also be able to propose reforms to member states.

3.3. The potential role of digitalisation

A policy-maker emphasized that digitalisation should also help to drive further investment in SMEs. Banks need to further digitalise their processes and regulators also need to adapt regulation and supervision to the increasing use of technology through the use of tools such as regulatory sandboxes. To this end, an EU Supervisory Digital Finance Academy is currently being launched with the participation of 26 European supervisors. However, digitalisation will also require an improvement of financial literacy, which is essential for customers to make the most of digitalisation.

An industry speaker confirmed that retail investors are increasingly interested in the opportunities offered by digitalisation such as tokenised assets. Digitalisation can also contribute to reducing post trading costs, which will benefit cost sensitive clients and issuers. Ultimately, this could create more liquidity for SME stocks. Digitalisation should also facilitate cross-border investment and enable market making on a cross border level.

3.4. The role of public support and investment programmes

An official agreed that the actions proposed in the context of the CMU action plan are going in the right direction. Improving regulation will benefit scale ups and growth markets and contribute to attracting more private sector money into equity investment. However, these market gaps can also be addressed through other kinds of public action. Public investment programmes can bring more liquidity to certain markets and also attract more private investors, thus creating more financing and more support for European companies. Public programmes can also facilitate the provision of additional data, which can make the market more transparent, more liquid and attract private sector money. The Scale-Up Europe initiative[7] conducted under the aegis of French Presidency of the EU is an example of a programme supported by the public authorities aiming at making proposals for increasing investment in start-ups and fast-growing companies.

SMEs were also at the core of the response of the European institutions to the Covid crisis, the official noted. Massive support was provided to the economy by the European Union in coordination with member states. Equity, particularly for SMEs and start-ups, was a key component of this. The volume deployed in the context of these programmes was three times the volume that has been deployed in recent years.

7. Launched by President Macron in March 2021, with the support of the European Commission and other Member States, the Scale-Up Europe initiative brings together a cohort of over 300 start-up and scale-up founders, investors, researchers and corporations, all sharing the same bold objective: for the continent to become home to 10 tech giants each valued at more than €100bn by 2030. https://presidence-francaise.consilium.europa.eu/en/news/press-release-scale-up-europe-spurs-collective-action-to-accelerate-european-tech/.

AIFMD / ELTIF reviews: are the proposals up to the challenges of the CMU?

1. European long-term investment funds (ELTIF) regulation review

1.1 Current level of development of the ELTIF market and improvement objectives

The success of the ELTIF framework aiming to channel long-term financing to small and medium-sized enterprises (SMEs) and infrastructure projects has so far been limited. A regulator highlighted ESMA's June 2020 survey which indicated that almost five years after the implementation of the ELTIF regulation there are only 17 ELTIFs actively marketed in the EU. The majority of those are based in only four countries: France, Luxembourg, Spain and Italy. There has been a slight uptick over the last couple of years, particularly due to some local fiscal incentives, especially in Italy, but the market remains limited.

The regulator emphasised the need to look at what can be changed in the framework to make ELTIFs a more significant instrument for the financing in the European economy and a more attractive investment for retail and professional investors. Retail clients going into these instruments need to be adequately protected against potential liquidity and maturity issues. However, sufficient flexibility should also be provided in the framework to ensure that ELTIFs can invest in a wide enough range of assets consistent with the long-term investment aim. An industry representative fully supported the strategic importance of a vehicle facilitating infrastructure investment in particular and benefitting from a European passport, given the importance of infrastructures for the European economy.

An industry representative was favourable to developing ELTIF funds in the retail space, which is one key objective of the ELTIF review. This will support the financing of SMEs and infrastructure projects and also engage European citizens more in the development of the European economy. In France some domestic alternative investment funds (AIFs) investing in infrastructure or SMEs launched in 2021 have been quite successful in the retail market. More than 80% of the investments were made by mass retail investors with tickets below €10,000, showing the potential of such funds. But currently, such AIFs do not benefit from a European passport, which limits their development potential.

An official stated that ELTIFs are an important part of the Capital Markets Union (CMU). The objectives of fostering longer-term investment and providing capital to the real economy should not be forgotten in the technical discussions about the legislative proposal. However, there is much work to do, when considering the present level of development of the ELTIF market. Bringing retail savers into this framework will provide such investors with new investment opportunities while at the same time providing the EU economy with additional sources of capital. That said, involving retail investors will require a focus on investor protection and this may require trade-offs. Building trust and confidence among retail investors will be needed, in addition to improving financial literacy. These are part of the key objectives of the Capital Markets Union (CMU).

A public representative agreed about the importance of improving financial education in Europe. For capital markets to function appropriately, it is necessary to provide investors with the right information, but they also need to have the capacity to understand and use that information in their investment decisions.

1.2 Regulatory changes proposed

The Chair noted that ESMA had sent a letter to the Commission at the beginning of 2021 with recommendations on how to review the ELTIF regime covering areas such as eligible assets, the authorisation process, portfolio composition, redemptions and disclosures. A regulator stated that ESMA is in favour of the proposals made for reviewing the ELTIF framework. It has to be ensured however that more retail investor participation is accompanied by the right level of protection.

An official considered that the provisions proposed by the Commission for developing retail investment in ELTIFs, such as the lowering of the entry threshold, as well as the proposals for facilitating the administrative management of these funds and reducing compliance costs are heading in the right direction. However their impact will need to be evaluated and it should be ensured that they do not undermine investor protection. There is a fine line to walk there.

An industry representative agreed that many tricky issues with ELTIFs are being tackled in the review proposal, including the possible opening of these funds to retail investors and related liquidity issues, and also how the burden and costs of managing these funds can be alleviated for asset managers. Another industry representative added that the ELTIF review proposal is addressing many issues that were obstacles to the launch of ELTIFs in the initial framework. These include the widening of the eligible assets on the real estate and infrastructure side and the reduction of the minimum investment threshold for retail investors.

The Chair noted that finding the right balance in terms of liquidity rules is an important issue, because retail investors must not have the impression that ELTIFs can be redeemed at any moment. A regulator agreed that liquidity provisions are instrumental in defining the way that these funds can be used by retail investors. Level 2 empowerment on the matching mechanism will allow a fine-tuning of these rules.

2. Alternative Investment Fund Managers Directive (AIFMD) and UCITS Review

2.1 Overall objectives of the AIFMD review and challenges to overcome

The Chair pointed out that, in fact, this reform was much more than an AIFMD reform, since it touched also on a number of important UCITS provisions. The panellists were generally supportive of the proposal made by the Commission to amend the AIFMD directive. An industry representative remarked that the existing AIFMD and UCITS frameworks have largely contributed to creating two major investment fund markets, which are among the most successful ones in the world. This success is due to the frameworks striking the right balance between investor protection and innovation, allowing the development of products corresponding to the main needs of investors. The AIFMD framework also proved its solidity during the 2008 financial crisis and the Covid crisis. It is important in this review exercise to not try to rebuild what has proven to be solid. Adjustments should be focused on areas that have evidenced problematic weaknesses or gaps.

An official noted that AIFMD has developed into a global brand and agreed that a major overhaul of the directive is not desirable. It is founded on a very successful passporting regime balancing financial innovation and expertise with the safeguards of investor protection and financial stability. What is being considered in the AIFMD review is evolution rather than revolution, which is the right way forward. Though there are points of concern which have to be addressed to ensure there are no vectors of instability, it should not be forgotten that the guard rails of AIFMD have worked so far including during the Covid crisis, which was an unforeseen extreme period of stress for the overall economy.

A public representative emphasized that AIFMD is a key element of the wider CMU strategy aiming to facilitate investment in EU businesses as well as provide attractive investment opportunities. The European Parliament is in the process of listening to different stakeholders in order to identify what changes are potentially needed in the AIFMD to enhance the legislation. A calendar has now been approved for the review with an objective to schedule the final plenary vote on the AIFMD review report in the first or second session of October in order to finalize the revision as soon as possible.

Agreeing with the previous panellists, the public representative suggested that while a revision is needed, the benefits and strong points of the current legislation must be preserved. The aim is to have the right balance between enhancing the competitiveness of the EU fund market and investor protection. The proposal for the review of AIFMD is moving in the right direction in this regard. The ambition is for the EU to become the first market for funds at the global level over time. Supervision is a further issue to be tackled for supporting the development of the EU fund market and more broadly the CMU, because at present it works in a fragmented way across jurisdictions and financial sectors in Europe. There is a need for a real European supervisory authority equipped with appropriate tools to conduct supervision across the EU in connection with the national competent authorities (NCAs).

A regulator noted that supervisory convergence actions such as peer reviews are already conducted on a regular basis in order to achieve common supervisory outcomes. There have been suggestions that the frequency of peer reviews should be increased and more clearly mandated in Level 1, but the intensity of supervisory convergence and the convergence tool used should primarily depend on the potential risks and the desired outcome.

2.2 Delegation arrangements

An industry representative noted that delegation is an important aspect of the AIFMD directive and has proven its added value, allowing an optimisation of portfolio management activities in particular. The aim is to give investors the best possible product. The current delegation framework also proved its resilience during the recent market turmoil and is a solid basis. There should not be a distinctive treatment between delegations inside the EU and delegations outside of the EU, because the responsibility in the two cases remains with the management company based in the EU. In addition one idea, which could be preferable, could be to task ESMA with carrying out a common supervisory activity on delegation to determine if all the delegation arrangements put in place by a given management company are working adequately.

A regulator noted that delegation remains a controversial topic. Rules were put in place in the Brexit context to avoid empty shells and clarify responsibilities, but there is no intention of forbidding delegation. The new proposals made in this area are important for achieving further supervisory convergence and collecting the data and information needed for ensuring a more effective oversight of market practices and risks. It may be helpful also to have a common view on the breakdown of activities included in the portfolio management function in order to facilitate the assessment of delegation arrangements by the NCAs.

A public representative stated that the proposals made on delegation are on the right path. Funds need to be profitable, which includes allowing delegation so that portfolio management activities can be organised in an optimal way. However, access to information and investor protection must be preserved in a context of delegation. An official suggested that improved financial literacy and investor trust and confidence would facilitate the tackling of issues such as delegation and the location of asset management activities, along with the use of liquidity management tools (LMT).

2.3 Liquidity management tools (LMTs)

An industry representative considered that the proposal to provide a minimum set of LMTs at the Level 1 of AIFMD is an improvement. There is too much diversity across member states at present and some of them do not allow a sufficient use of LMTs. However, caution is needed regarding the mandates given to ESMA in this context. In the current drafting, the proposed Level 1 indicates that

ESMA should define the conditions for using LMTs. While the intention of defining ex ante the way that LMTs may be activated, is understandable, the risk is that there ends up being very specific conditions for using LMTs. Flexibility is needed in this regard. The use of LMTs should remain in the hands of the asset managers. In the most exceptional circumstances regulators may also have the power to activate some tools such as suspensions and gates, but for swing pricing, for instance, it would not make sense.

A second industry representative agreed on the need for flexibility and approved of the starting point regarding LMTs in the AIFMD review proposal, notably the fact that LMTs will be available in all EU member states in the future. Ultimately, the decision to trigger the LMTs should be with the management company, under the close supervision of the NCAs, one of the main reasons being that the appropriate tools to use may vary from one fund to another.

An official was also supportive of the proposals concerning LMTs. A number of member states would agree with the responsibility for the deployment of LMTs being with the fund manager and limiting the powers of NCAs to very exceptional circumstances. However, some member states have no experience of these tools and need to gain some understanding of their functioning.

A regulator agreed about the importance of clarifying the use of LMTs further and appreciated the sensitivity and possible concerns around NCAs being involved in the activation or deactivation of those tools. ESMA is indeed tasked with establishing the conditions under which NCAs could request managers to use these tools. The first-line obligation needs to be on the managers. The question is whether an NCA should have a 'stick', which hopefully it will never use, to be able to ultimately force the use of these tools and if so in which circumstances.

The Chair noted that CNMV, the Spanish supervisor, published recently a new set of technical guidelines on LMTs that are broadly consistent with the comments made by the panellists. The responsibility for activating LMTs lies with the manager but there are procedures defining how the fund should react to certain stress situations and the 'stick' will remain in the hands of the NCA in extreme cases where the fund manager would not take appropriate action.

2.4 Reporting requirements

An industry representative suggested that reporting requirements could be streamlined. For UCITS, fund inventories are reported in a very granular way (i.e. line by line, asset by asset, for each fund) to the national central banks of the jurisdictions where the funds are domiciled, particularly for France and Luxembourg. However, this data is not shared by central banks with their local securities regulators, leading to potential duplications. The sharing of reporting data provided among the authorities should be requested in Level 1. An official agreed that reporting should be conducted in a way that does not over-burden the fund industry with duplication or inconsistencies. There is a need to be smart and streamlined in this regard and ensure that the data flows across the different authorities.

A regulator was thankful for the closing of the reporting gap on UCITS. There has been AIFMD reporting for a long time, but this was not the case for the UCITS market. ESMA is very supportive of achieving integrated reporting and aligning reporting requirements. The most needs to be made out collectively of the reporting, which means that it needs to be properly channelled to the authorities who need to work on the data and shared among them, rather than setting up separate reporting requirements. One area where information to supervisors remains insufficient is transaction reporting for market abuse monitoring purposes.

A public representative noted that the Parliament is generally in favour of increasing transparency, improving the access of supervisors to information and data sharing. The key is to find the right balance and to propose the right procedure for providing the information and sharing it in an effective way and also to define what type of information needs to be constantly available. This is currently being assessed and is likely to be one of the most controversial topics in the negotiation on the AIFMD review.

The Chair mentioned that Spain has had monthly reporting of line-by-line ISIN level positions since 1990, which is a primary source of information for CNMV's supervision. For instance, on 14 March 2020 with the Covid crisis and the biggest plunge in the stock markets in recent history for Spain, it would not have been possible to identify quickly enough which management companies were experiencing problems without these end-of-month reports. This detailed monthly reporting will also allow a review on the ESG features of funds compared to what they actually invest in for instance.

2.5 Loan origination funds

An industry representative stated that concerning loan-origination funds some aspects need considering in the fine-tuning of the Level 1 of AIFMD. For example, there is a 5% retention obligation in the current proposal. The underlying aim is to ensure that managers have some 'skin in the game' and do not put all the risk on investors, but this rule should be softened, the speaker felt, either with exemptions in some specific cases or being applicable only during a limited holding period.

An official agreed that common guidance and participation should be sought on loan origination funds. ESMA could be turned to for enhancing supervisory convergence in this area and identifying best practices.

MiFID II / MiFIR review priorities

1. Overall objectives of the MiFIR review and key issues at stake

The Chair noted that the Markets in Financial Instruments Regulation (MiFIR) review is underway. The UK proposal on the same issues is expected in the coming weeks as a follow-up to the consultation on the Wholesale Market Review (WMR). Enhancing transparency and price formation are at the core of both of these initiatives. For the EU, a number of important issues are covered by the MiFIR review including: the definition of a consistent approach to waivers and deferrals, the role of systematic internalisers (SI), the implementation of consolidated tapes, the acceptability of payment for order flow (PFOF) and ultimately how best execution and efficient price formation may be achieved.

An industry representative emphasized the importance of contextualising the MiFIR review debate in the EU macroeconomic environment. Currently there is a risk of durable high inflation and very weak economic growth in Europe, together with unprecedented levels of public debt and constrained public finances. In this context, developing capital markets is essential to advance on the ESG and digital transformations, and also to solve key societal questions for EU citizens such as the future of pension systems. However the development and integration of capital markets in Europe are at a standstill. Of the 1,800 initial public offerings (IPO) globally last year, only 10% took place in the EU. In terms of market cap of listed companies compared to GDP, the US is roughly at 150% while the EU is at around 52%. Fragmentation is also prevalent in the EU with about 500 trading and execution venues compared to about 100 in the US, which is a larger market. The MiFIR review is critically important for improving the structure and functioning of EU capital markets, the industry speaker stated and the legislative proposals from the European Commission on the MiFIR review are a good starting point in this regard, also bringing in some broader thinking on the financial autonomy and competitiveness of the EU and the importance of capital markets for the EU economy.

A regulator observed that the work on the MiFIR review is part of the broader context of the Capital Markets Union (CMU) initiative aiming to develop, enhance and further integrate EU capital markets, which is essential for the growth and resilience of the EU economy.

2. Level playing field among trading venues

A regulator considered that a key objective of the MiFIR review should be to achieve a level playing field among the different types of execution venues that are really 'multilateral' and to do so with a future-proof approach. Indeed, after the first years of implementation of MiFID II it was identified that a significant number of equity transactions are still not executed on lit markets, which needs to be addressed. In addition, some systems that allow the pre-arranging of buying and selling orders represent a threat to the level playing field and to transparency.

The regulator also stressed that Systematic Internalisers (SIs) should not be subject to exactly all the same MiFIR rules as multilateral venues. SIs that deal on own account are intrinsically different from other trading venues, because they face different underlying risks, although their activity appears to be quite similar. Although there are nuances across instruments, for many transactions executed by SIs the underlying products are not that much standardised or liquid. Notably for derivatives, the tailor-made trades executed by SIs serve the purpose of specific needs, are out of scope of the derivative trading obligation, and are of limited interest for the price discovery process. Imposing full transparency to SIs may expose them to liquidity and trading risk in connection with possible herding or opportunistic behaviour by other market operators. This could in turn hamper the function of sustaining liquidity that SIs normally perform. The Chair noted that the proposal had previously been made to limit the scope of SIs to large-in-scale trades, which would simplify transparency issues, solve the problems posed by Payment For Order Flow (PFOF), and ultimately enhance price formation. Simplification regarding double volume caps, that are too complex, would also be welcome. In any case, equity and non-equity must be distinguished in addressing these questions, the Chair underlined.

An industry representative emphasised that preserving a sufficient diversity of trading mechanisms is essential. Level playing field measures may impact the competitiveness of EU capital markets, if they restrict too much the choice of execution venues or how they may be used. Investors indeed optimize their choice of venue depending on the size and type of transaction, which means appropriately calibrating the requirements imposed on venues so that users are not penalized. Sufficient choice in terms of execution venues also contributes to fostering competition and decreasing execution costs for end investors.

Another industry representative confirmed that for equities the proportion of transactions executed on lit venues is limited in the EU, where it amounts to 35 to 50% of volumes compared to 60 to 65% in the US and about 80% in Japan. The EU trading landscape is also very fragmented with a significant share of internalisation of flows, which also has impacts on post-trading, with a high proportion of settlement fails.

The industry speaker moreover considered that the MiFIR review measures to enhance the level playing field among

trading venues will not limit competition or investor choice. The different types of trading venues established by regulation should correspond to different investor needs and be subject to tailored rules. Concerning SIs for example, it is important to bear in mind that the initial objective of these venues was to handle large institutional orders in order to avoid market impact. However assessments conducted by the French Autorité des Marchés Financiers (AMF) have established that the median order size on SIs is lower than €6,000, which is quite far from the original intention of SIs. Changing the definitions in the directive regarding multilateral trading is therefore welcome, although proper enforcement will be key. Care should be taken also to capture the market holistically and not allow for new loopholes to develop. For example frequent batch auction-based systems could create new loopholes and their development should be closely monitored.

3. Transparency requirements

3.1 Opportunities and challenges associated with the enhancement of transparency

A regulator stated that there is a need to increase transparency particularly in the non-equity market and for post-trade data. Opaque markets are indeed a threat to financial stability as demonstrated during the 2008 financial crisis. Although measures to improve transparency were taken, a report issued in 2019 highlighted that a complicated deferral regime under MiFIR, along with the fragmented publication of transaction information, decreased transparency in the bond markets in Sweden. In March 2020, Sweden experienced a fund run, due to the malfunctioning of the underlying corporate bond market, which was basically opaque. A large number of investors tried to take their money out of corporate bond funds, which were trying to sell their assets in the market and subsequently 40 mutual funds had to be temporarily closed. Since then, Sweden has started a reform agenda for the corporate bond market. The Swedish authorities have initiated measures to improve post trade transparency by working with the industry to adopt an industry agreement where they voluntarily publish aggregated information about transactions end of the day. Transparency should be a guiding principle in the review of MiFIR, the regulator emphasized because otherwise the effectiveness of the EU capital markets will be reduced and some players will exit the market at a time when EU capital markets need to develop post-Brexit.

An industry representative agreed that there needs to be more transparency for fixed income and derivative transactions in the EU. Another industry representative was also in favour of enhancing transparency in EU capital markets, but observed that transparency measures could have a negative impact in certain areas of the market, such as a reduction of market liquidity and an increase of costs for end investors if they are not implemented in a balanced way in terms of speed and scope. The mistakes of the initial implementation of MiFID II which had very ambitious objectives in terms of pre- and post-trade transparency, but ultimately failed to deliver meaningful transparency, should not be reproduced. Although the information on transactions is published, it is fragmented across multiple venues and provided in different formats so it cannot be consolidated and is not usable.

A regulator noted that banks usually claim that there is a trade-off between liquidity and transparency but, for the most part, increasing transparency will lead to more liquidity as it will make the markets more credible and foster consumer protection, attracting new investors. Another regulator however observed that this trade-off may exist for certain types of venues such as SIs, as illustrated by the previous comments made.

3.2 EU consolidated tape (CT) proposal

A regulator considered that the CT proposal of the MiFIR review is a step in the right direction, but may not be sufficient to provide an appropriate level of transparency in the market. One issue is that there is still some uncertainty as to how the CT will function and whether a private sector solution will emerge or if ESMA will need to step in.

An industry representative stated that the CT will provide a consolidated and real-time view of transactions, which will help to make a better use of the available information. This will benefit investors, including retail investors, who should be a focus of this initiative, and also regulators for designing data-led policies.

Another industry representative emphasized that a CT has the potential to support further investment in the EU, provided certain conditions are respected. Data quality and availability is a first condition and will not be solved solely by a review of deferrals and waivers and by the implementation process of a CT. The main issue concerns SIs, dark pools and other non-lit parts of the market for which data is not readily available. Secondly, an adequate use case needs to be defined for the CT. The rationale and approach for a CT has to be defined for each type of instrument, depending on the market structure. A CT for OTC derivatives makes sense because in the EU 92% of derivatives trading is OTC with insufficient transparency. However, the situation is different for equities, where data quality issues are mainly focused in certain areas of the market, such as SIs and dark pools, which need to be tackled first, as previously mentioned. In addition the publication delay in the CT needs to be carefully considered because a close to real-time tape for example could potentially favour robots over human investors. The Chair agreed that greater data quality is key for the usefulness of the CT, because this will ensure that a greater amount of relevant information is embedded in it.

A third industry representative considered that, generally speaking, the more real-time the CT is, the more valuable it will be. For retail investors the ability to actually see the post-trade execution data in close to real-time would be incredibly helpful, because this information is not available at present for them, which undermines best execution. A real-time post-trade CT would also help to even the playing field between exchanges and SIs and probably encourage more on-venue trading. The CT can moreover contribute to the resilience of capital markets. Having a post-trade CT during exchange outages is indeed very

helpful for the market to figure out where the price is for example. However, 'real-time' can be interpreted in different ways for different asset classes,. For equities it would be seconds but for fixed income about 15 minutes is likely to be the right measure.

The industry speaker added that the EU CT proposal, as it is currently framed, should be relatively uncontroversial because it is limited to post-trade reporting. This should not impact exchanges that much, because the vast majority of market-maker fees paid to exchanges are for pre-trade data and smaller exchanges may actually benefit from the CT because it will increase their visibility. In terms of business case, potential CT providers (CTP) will be interested in setting up a CT provided the reporting to the CT is mandatory and free.

3.3 Deferral regime

A regulator stated that the post-trade deferral regime should be simplified because the current system, based on different criteria such as sizes and ratings, is too complicated. The US TRACE (Trade Reporting and Compliance Engine) system, which publishes prices of bond transactions with a 15-minute deferral, could be a source of inspiration. European market players often consider that reducing deferrals would make market-making impossible, but such transparency would on the contrary help to increase the liquidity and the credibility of the market.

An industry representative considered that the current proposal to reduce post-trade deferrals is too inflexible. For certain pockets of the market where instruments are quite illiquid and where transactions are large, a two weeks' deferral for volume and end of day for price publications will not be sufficient. TRACE is not a real reference for the EU because it has a narrower scope than MiFID; it is mainly focused on US-denominated corporate bonds and does not introduce any real-time transparency for US Treasuries. It is moreover surprising that the Commission's proposal includes a harmonisation of deferrals for corporate bonds but not for sovereign bonds.

An industry representative explained that Treasuries are reported to TRACE in the US but transactions are not made publicly available. This situation should not be reproduced in Europe. Given that Treasuries are one of the world's most important markets, there should be greater transparency and the Federal Reserve and the US SEC are taking steps at present to address this issue. There are legitimate reasons to have some delay in reporting in certain cases, particularly to afford hedging, and price and volume should be treated differently in terms of deferrals. There can be a 15-minute delay for price reporting and a longer deferral for volume reporting e.g. 48 hours or some reasonable amount of time. The proposals of the Commission seem quite adequate in this regard.

A regulator considered that deferrals should be limited in liquid markets, so the argument for deferrals holds more for corporate bonds than for government bonds. The deferral regime should also change for government bonds to make it more transparent. Another regulator noted that while being more liquid, sovereign bonds are less amenable to fast monetisation in the view of the European Commission. The deterioration of liquidity is also probably a bigger threat for sovereign bonds than for corporate bonds, because they are more exposed to different destabilising factors (e.g. credit ratings, credit default swaps, … as the past experience demonstrates).

3.4 Fine-tuning of the MiFIR transparency regime

A regulator acknowledged at large the need to further fine-tune the current MiFIR transparency framework beyond reconsideration of waivers and deferrals, for instance to improve transparency of quotes made available by SIs. However, the new requirement for SIs to publish firm quotes for equities relating to a minimum of twice the standard market size seems to go too far, as moving the threshold from 10% to 200% seems excessive[1]. Following a specific question by the Chair, the regulator also replied that the proposed simplification of the double volume cap system is welcome.

An industry representative added that the accumulation of changes proposed in the MiFIR review needs to be carefully thought through, bearing in mind the balance between liquidity and transparency. There are proposals to increase real-time post-trade transparency while also increasing pre-trade transparency by removing the size specific to the instrument (SSTI) exemption and at the same time the phased-in approach for both derivatives and bonds is being removed.

Another industry representative was favourable to moving to a single volume cap, maintaining only the EU-wide threshold, is adequate since the double volume cap is not functioning properly. The increase for SIs of the pre-trade quotation size to two times standard market size for publication requirements is welcome, as are the changes to the reference price waiver to avoid the matching of smaller trades at midpoint. Moreover, a ban of payment for order flow (PFOF) is needed. A work by the French AMF based on real transaction data has indeed identified execution services which involve a part of retail flows being diverted from lit markets to the benefit of the handful of institutional investors that are members of the various programmes targeting retail investors, with strong evidence that end-customers are often disadvantaged.

4. Competitiveness of EU capital markets

4.1 Share and derivative trading obligations and open access measures

A regulator stated that concerning derivatives the objective put forward by the Commission to strengthen EU central clearing is valid from a competitiveness standpoint, as well as the proposal to align the scope of the clearing obligation under EMIR and of the derivatives trading

1. At present SIs are required to make public, on a regular and continuous basis during normal trading hours, firm quotes for equity and 'equity-like' instruments when there is a liquid market. Where there is no liquid market, SIs must disclose quotes to their clients upon request. The requirements apply only when dealing in sizes up to standard market size. SIs are able to decide sizes at which they will quote, provided they are at least 10 per cent of standard market size.

obligation (DTO) in MiFIR. This objective is justifiable on technical grounds, as the contribution to the price discovery process and the benefits of the straight-through processing for transactions that occur on exchanges do materialise for derivatives with marked features of standardisation and liquidity, which are the ones already subject to the clearing obligation. From a more strategic perspective, keeping these transactions in the EU market could also contribute to building up the EU clearing capacity.

The regulator was moreover in favour of keeping some flexibility in the process of activating a possible suspension of the derivative and share trading obligations (DTO and STO) in order to be able to cope with market disruptions. The flexibility available for suspending the STO proved very useful for tackling the challenges connected to Brexit for example. However, while the exemption foreseen for non-systematic, ad-hoc, irregular and infrequent transactions should not necessarily be maintained as it is, given it could prove very general and difficult to enforce, a certain degree of flexibility in the suspension of both the DTO and the STO would be beneficial. In particular, the possibility of suspension of the STO could be modelled along the lines already proposed by the European Commission for the DTO. Such suspensions could be activated by a single national competent authority (NCA), possibly in coordination with other NCAs and also ESMA, to ensure convergence of approaches. Maintaining this power to suspend the DTO and STO on an ad hoc basis is also important because the EU authorities do not have the possibility to adopt no action letters in the same way as authorities in some other jurisdictions.

An industry representative agreed about the proposal to align the scope of the DTO with that of the clearing obligation. The industry speaker also stressed the importance of deleting the open access framework. No other jurisdiction has such a framework in place and its elimination is currently being considered in the UK. Open access may indeed hinder market competitiveness because if all of the trading venues and CCPs are linked up, then there is access to all of the other services and products, which reduces incentives to compete on the basis of better services and products and cheaper prices. In addition, on the clearing side, it is important for financial stability that clearing should be as centralized as possible rather than interconnected. Open access rules also need to be considered in the context of future market developments, as they may make it more difficult for certain market infrastructures to move to a Distributed Ledger Technology (DLT) environment, which may have further implications for the competitiveness of EU markets.

The Chair observed that the topic of the competitiveness of EU capital markets is potentially more sensitive for bonds, for which there is no trading obligation, than for derivatives which is a truly global, international market.

4.2 Impact of MiFIR review transparency proposals on the competitiveness of EU capital markets

Answering a question from the Chair about the possible impact in terms of competitiveness of the MiFIR review transparency measures for bonds in particular, an industry representative considered that the current deferrals are too limited to cater for the very wide scope of instruments that come under MiFID II with different liquidity characteristics. For sovereign bonds, MiFID II covers any sovereign bond that is traded or needs to trade in Europe. This regime does not currently cater for all of the different liquidity profiles that will be seen in those instruments. There is a real risk that the EU could be at a disadvantage as a result of the measures proposed.

An industry representative stated that generally speaking more transparency will lead to more competitive and resilient markets. The US grappled with the same questions about post-trade transparency and whether to implement a close to real time reporting system about 8 years ago and academic studies have since shown that spreads tightened for institutional investors by about 10%, more entrants came into the markets with smaller dealers enhancing competition and the overall market volume did not decrease. This shows the positive impacts of transparency measures in the US market, which is however only one reference point.

4.3 Comparison with the UK Wholesale Market Review (WMR)

An industry representative noted that although the end result of the WMR is not yet known, the direction of travel is different than in the EU. The UK is taking a more liberal approach, proposing to eliminate certain requirements that do not provide end investors with appropriate outcomes such as the shares trading obligation and the double volume cap. There is also a different approach to dark trading, which the UK perceives as potentially playing a positive role in certain pockets of the market. Concerning pre-trade and post-trade transparency, the UK Treasury considered in a recent consultation paper, that the specificities of equities and non-equities and how liquidity is created in those markets are not sufficiently well taken into account in MiFID II. They are notably looking to potentially restrict pre-trade transparency obligation in the UK in the fixed income and derivatives markets to only automated order books. The UK Treasury is also proposing to provide regulators with more power and a secondary objective around economic growth and competitiveness, which Europe should also consider.

Another industry representative added that the UK Treasury indicated that they would start with a post-trade CT in fixed income and in OTC derivatives as that would have the biggest potential benefit. While there should be consideration of what the UK is doing, if it takes a step back from transparency then Europe should not follow it.

Consolidated Tape: prospects for delivery

1. Objectives of the EU consolidated tape (CT) project and related opportunities

An industry representative was in favour of the MiFIR[1] review proposal to set up an EU consolidated tape (CT). The aim is to make European securities markets more attractive for investors and to increase liquidity, which should support the financing of the EU economy and make European markets more resilient. The CT should provide investors with the data they need to make investment decisions with a consolidated view of all EU markets. The objective should also be to make this data available as widely and as cheaply as possible, in order to attract more investors to the market.

Another industry representative agreed on the benefit of setting up a CT providing a view across transactions executed on- and off-venue in the EU, including systematic internalisers (SI) and over-the-counter (OTC).

An investor representative also supported the CT initiative, which should help to enhance costs and competition in the market by providing institutional and retail investors with a consolidated view on the pricing of transactions. This should also facilitate the access of companies to capital market financing and support the green transition. European markets indeed remain fragmented despite the implementation of the MiFID[2] and MiFIR legislations. Transaction data also continues to be relatively opaque and best execution is not delivered, with retail investors in particular paying the price for this market dysfunction in terms of spreads being unnecessarily wide. Systemic internalisation is widespread and loopholes from best execution are not serving the market well.

A regulator emphasised that beyond serving the interests of investors by addressing the present fragmentation, cost and difficulty of accessing adequate transaction data, the tape will also support the activities of regulators and supervisors analysing the market and working on the improvement of regulation. Another regulator stressed the potential contribution of the CT to building a single European capital market and addressing the current fragmentation, by making data available to investors across the Union.

2. Main characteristics and content of the CT

2.1. Type of data available on the CT

An industry representative stated that the CT project, which proposes the setting up of a unique CT providing close to real time data for equity shares and bonds is moving in the right direction. Some aspects however need to be reconsidered from an investor perspective. Only post trade data will be available in the first phase of implementation, but this should be extended to pre-trade data for equities because equity markets work with an order book, the visibility on which is necessary to make investment decisions. While a phased implementation starting with post-trade data is understandable, it should not be limited to this for equities because the use case of the CT will be insufficient.

A second industry representative was on the contrary in favour of a post trade delayed tape and not a pre-trade tape. A pre-trade tape is not feasible due to the latency issues that will be seen across the geography of Europe. In addition, it may lead to the creation of a two-tier market with some financial firms able to afford low latency services and others only using the CT where part of the liquidity will no longer be available, thus creating a false reference point. A phased approach is therefore needed, starting with a delayed 15 minute tape. Since data provided by the exchanges is free after 15 minutes, this would also solve remuneration issues. Once this has been done, an impact assessment of introducing a real-time post-trade CT can be conducted to plan possible further steps of the CT.

An investor representative agreed that the post-trade CT should be the primary objective, as it is timestamped, traceable and includes information on the market venue on which the transaction was executed. It would allow the tackling of the main data fragmentation issues. Although a real-time CT would normally be the ultimate goal, this might lead to a potential increase in trading costs due to the investments required for collecting, consolidating and distributing the data in real-time, which does not seem worthwhile at present. In addition, retail investors who are not able to engage in price arbitrage between a variety of markets, unlike high frequency traders, will probably not benefit that much from a real-time CT. In the initial implementation a 15 second delay could be an acceptable compromise for the equity CT, since this would still allow the validation of best execution without disrupting current market practices.

A third industry representative explained that for fixed income the focus should be on post-trade data because of the nature of the product. Post-trade data will have more value than pre-trade data in this case. The majority of bonds are trading via the RFQ (Request for Quote) negotiation protocol, which means that the pre-trade price and the post-trade price actually print very close to each other. Someone would rather wait for the certainty

1. Markets in Financial Instruments Regulation
2. Markets in Financial Instruments Directive

of the post-trade price than bank on pre-trade prices, which may not have actually executed.

A regulator stated that a staggered approach leaving the possibility to adjust the project if needed is the best way forward, because such a project is difficult to plan upfront entirely. The MiFIR review proposal is right to start with a post-trade CT for bonds and equities, before considering going to pre-trade data. The implications of a pre-trade CT for equities, i.e. the delays, its purpose, and the cost and complexity of implementation, need to be further clarified, because views vary on these issues.

The first industry representative observed that a further element that needs to be considered is the phasing in of deferrals. At the moment the Commission wants to reduce deferrals significantly and build the CT at the same time, however waiting for the CT to be built and fine-tuned before addressing data deferrals would seem more appropriate. This would allow a better definition of transparency needs based on an assessment of the market structure, the liquidity in the market and current transaction flows, before deferrals are adjusted. The regulator suggested that regarding deferrals, there should be one single regime in Europe, because harmonising the existing patchwork of national specificities will be very complicated.

2.2. Priorities in terms of coverage of instruments

An industry representative pointed out the breadth of the range of asset classes due to be included in the CT according to the current proposal and the need to establish priorities. Implementing 4 CTs in 12 months in a big bang type approach seems very ambitious. Previously the introduction of MiFID transparency requirements in January 2018 for example faced major data quality issues resulting in significant delays. The priority should be given to equities and bonds, as they are simple instruments for which clear use cases have been established, which is less the case for ETFs and derivatives. The CT for other asset classes could come later if clear use cases are defined.

An investor representative agreed that priorities should be established. It would be costly to go for the full 4 CTs at once, as it would mean imposing many requirements concerning the provision and analysis of the data in order to ensure best execution. Bond markets should be a priority, because of the lack of data. Only a quarter of bond transactions take place on lit markets. It is necessary to ensure that the different trading venues including SIs and the approved publication arrangements (APA) are required to provide the trading data to the consolidated tape provider (CTP) free of charge, and in highly harmonised, high-quality formats to have the most cost-efficient way of distributing the data.

A regulator suggested that a staggered approach should also be used for rolling out the different CTs. It is possible to start with one asset class, learn from that, and then move to a more complex one. This would give enough time to ESMA to stop and correct things if needed. The CT should first be implemented in the markets where fragmentation is highest and where the data is the most difficult to gather. That is both bonds and equities, for different reasons, in the first case because of the market structure and the way fixed income markets function, and in the other case because of the proliferation of equity trading venues.

A regulator stressed that it is important to keep the momentum. Four years were given to see whether a CTP would emerge, and it has not. It is important to be ambitious but at the same time pragmatic and thus a staged approach would be beneficial.

The Chair observed that a challenge with the staged approach is that while it allows progressive learning and adjustments to the CT in terms of functioning and business model, it will make it more difficult to establish clear rules up front and therefore market players may not know what point they are moving towards. One idea would be to provide ESMA with more discretionary powers so that rules can be tweaked at a later stage if needed.

3. Data quality and availability issues

The Chair emphasized the importance of data quality for the CT and the related challenges to be considered including deferrals, waivers, and data publication delays.

An industry representative considered that data quality issues should be fixed before the CT is put in place. While good quality transaction data is easily available from the exchanges, this is not the case for SIs and OTC transactions, which should be first required to meet their publication obligations in the right format.

A second industry representative stated that data quality depends on the asset class, and is simpler to accomplish for equity and bonds than for derivatives. Achieving sufficient data quality requires constant work on the part of financial institutions and also of the APAs, who check the transactions reported in their systems, identify potential outlier trades and correct errors. Solving certain issues also requires a collective effort of the whole ecosystem. SIs have an obligation of post-trade transparency and already publish on APAs. There are only a few APAs on equity, and one of those is preponderant. That data is available and it is as real time as possible, since SIs have the obligation to send it in less than one minute. It is up to the APAs to make it more accessible.

A third industry representative considered that data quality is a slight misnomer when it comes to fixed income. There is not a data quality issue as such in these markets, but an issue around the clarity of existing regulatory standards and the way they are interpreted, which ESMA could contribute to fix.

A regulator noted that for data quality there is a need to have appropriate preparation and definitions ex ante in the Level 1 and 2 texts and in the regulatory standards before the process of data collection is started, otherwise the risk of failure is high. The Commission has done excellent work with its proposals on data quality and data standards, but there is some confusion with the multiplicity of consultative committees currently working

on data. These assessments should be coordinated by ESMA, which would then be able to advise the Commission on these issues or propose changes in the delegated acts.

Another regulator highlighted the importance of collective work on the improvement of data quality. It is essential that this work takes place across all the asset classes and venues, not just regulated markets, and that all trades are reflected on the CT. ESMA is reviewing the relevant Regulatory Technical Standards (RTS), and also working on a day-to-day basis with the national competent authorities (NCAs) and financial firms on the improvement of data completeness and quality, considering however that perfect quality is difficult to achieve. The CT will be an incentive to further improve data. It makes sense to keep data quality requirements as technical standards and not change them into a delegated act.

4. Implementation challenges

A regulator stated that one of the first challenges in terms of implementation of the CT is in having a process with realistic timings. The selection procedure of the CTPs is due to be run by ESMA for the four different CTs. It is important to define high level criteria on which decisions will be based in order to ensure that the process is transparent and clear for all candidates that come forward. There is an issue of timing however, because the criteria will need to take into account the data that the CTPs will be providing and that will be specified in Level 2 measures. Those Level 2 measures will therefore be needed before ESMA can decide the criteria on which it will judge who will be selected. The three months that is currently envisaged for managing the selection and the authorisation process would be problematic both for ESMA who will be running the process and also for the candidates who will be applying. An industry representative agreed that it is vital to be careful with the selection criteria, as shown by the first iteration of the US tapes which was a failure.

A second issue, the regulator felt, is the current combination of the selection and authorisation process. The selection process is about assessing who best meets the selection criteria, and the authorisation process is about making sure that the entity retained actually complies with the requirements to run the tape. By merging the two there is a risk that applicants will have to make significant investments which could be lost if they are not selected, or that ESMA may have to make a decision without all the elements of information needed. Splitting the selection and authorisation processes would therefore be beneficial, as well as separating and phasing the selection procedures for the four CTs.

An industry representative sympathised with the challenges faced by ESMA in the implementation of the CTP. The current timelines are incredibly tight and may lead to a bad outcome if they are maintained. Any potential applicant to be a CTP would likely need to make significant investment and run the risk of not actually winning the tender itself, leading to sunk costs. Another issue concerns APAs. Incumbent APAs are the main players in the market who could provide a CT in a relatively short timeframe, as their technology stack performs very similar tasks to a CTP and their commercial model is up and running. In addition APAs are already regulated by ESMA. However in the explanatory notes of the MiFIR review it is clearly stated that ESMA should consider independent providers, potentially outside the incumbent providers such as APAs, which reduces their probability of being selected. There is nevertheless a good chance of getting a CTP due to the fallback option, whereby the Commission would request ESMA to interject and create a CTP. But to allow a commercial solution to emerge the observations made previously concerning non-equity instruments need to be addressed, requiring a different approach for equities and fixed income in particular.

A regulator was concerned about the fallback option mentioned by the previous speaker. If no commercial provider with all the necessary experience emerges then it will not be easy for ESMA to take on the responsibility of developing the CT. More time is needed before declaring that no commercial CTP solution is viable. Another regulator stressed the importance of appropriately planning the development of the CT, taking into account the time needed to move from the Level 1 text to data standards and detailed specifications.

The Chair agreed that sufficient time and effort needs to be spent in the market to see whether there is a possibility to make the CT commercially viable in a reasonable timeframe before there is any discussion of a fallback.

5. Governance and business model issues

An industry representative stated that further clarity is needed regarding the governance and commercial viability of the CT. In terms of governance, a precise definition of who conducts the oversight of the CT is needed, as well as who is in charge of data quality and ensuring that SIs and firms executing OTC transactions are meeting their publication requirements in the proper format.

The business case and the conditions for ensuring the commercial viability of the CT also need to be more precisely specified, the industry speaker suggested. Making a CT function correctly for the market cannot be done cheaply and requires a significant amount of work. It is important to have more detail on remuneration and how it will be ensured that data providers are rightly compensated and that small exchanges do not lose a vital revenue stream. A business case where exchanges are mandated to furnish their data and users have no obligation to use it would not work. Moreover, a badly designed tape could harm the smaller exchanges and the capital markets in which they operate. For example, the three exchanges in the Baltics heavily rely on their revenue from data because their activities are not very diversified and data revenues finance their other listing and trading operations. Removing data revenue would reduce the contribution of those exchanges to the development of the capital markets in which they

operate. The impacts however depend on the choices made for the tape. A post-trade delayed tape would not significantly affect the main exchanges that have diversified revenue sources, but will impact the smaller exchanges like the Baltics, whereas a real-time post-trade tape would also affect the revenues of the larger exchanges. This depends also on the position that exchanges have on different instruments.

A second industry representative considered that the revenue redistribution aspects of the CT proposal need to be reconsidered, because at this stage it adopts a mechanism that maximises profits from market data instead of focusing on getting the data available as cheaply as possible for investors. The speaker also noted that professional investors and market makers will continue to pay direct fees to every single exchange in every market, because quick access is needed when trading electronically. The tape will therefore probably result in a loss of revenue for exchanges and an increase of the direct fees paid by professional investors and market makers. A participant in the audience confirmed that fees paid by market-makers keep rising. There is hope that volumes will increase in European markets when pre and post-trade transparency reach the desired level, but it is uncertain.

A third industry representative emphasized the potential impacts of the CTP proposal on APAs. A CTP will consolidate data from APAs and trading venues into a publishable format and then publish it for consumption. Suggestions have been made that APAs should give their data to the CTP for free, but if this is the case their revenue will likely be cut in half, which could lead some of them to exiting the market. The industry speaker moreover emphasized some commercial challenges associated with the CTP for APAs. Operating a CTP is not a technical challenge since nine major APAs already exist in the EU conducting similar activities, but a commercial challenge, which is impacted by the regulatory requirements applying to the CTP. One issue that CTPs could be facing is the responsibility for the appropriate implementation of waivers and deferrals. Bringing that upstream to the CTPs, rather than leaving it with trading venues will result in a duplication of effort and another commercial burden for the CTPs.

The industry speaker was also concerned by the viability of the bond and derivative CTs. Many of the regulatory requirements applying to fixed income CTs were initially defined for the equity CT and do not fit the fixed income market. This explains why no CT has emerged for fixed income for the time being. The current proposal corrects some of the challenges that existed in the incumbent legislation for equities, but this is less the case for fixed income. As for derivatives, the industry representative considered that a CTP is not viable until the International Securities Identification Number (ISIN) challenge is solved. For example, if someone wants to use a derivative CT for comparing a 10-year swap over 250 business days of the year that will require dealing with 250 ISINs, which is impossible. Until this issue is solved, there is no use case for a derivative CTP. A regulator agreed that this ISIN problem has to be fixed for derivatives. A derivative CT can make sense, but these feasibility issues need to be addressed first.

An investor representative was also worried by potential impact of the cost of implementing the CTs on retail investors. The anticipated annual revenues for equity and bond CTPs are about €100-$150 million per annum; it should be ensured that this does not translate into price increases for investors. This should be taken into account in the assessments conducted by ESMA.

The Chair summarised that there is broad support for the CT, which is a concrete project which can drive EU capital markets and the CMU forward. It is important to keep momentum, but a sensible way forward needs to be defined, according to the panellists, which could possibly be a staggered approach, allowing learning over time. It is also important to delve into the details and make sure that the CTP is viable, because it is a highly technical subject. In particular, unnecessarily wrecking existing business models which have positive externalities in smaller exchanges should be avoided.

Clearing: priorities for enhancing financial stability and the EU clearing ecosystem

1. Approach concerning UK-based CCPs

1.1 Update on risk assessments and temporary recognition decisions

A regulator noted that ESMA has issued the outcome of its comprehensive assessment of the issues around systemically important third country central counterparties CCPs (TC CCPs). Three clearing services were identified as being of substantial systemic importance for the EU: SwapClear in LCH Ltd in relation to euro and Polish zloty, the credit default swap (CDS) and short term interest rate segments in euro within ICE Clear Europe. After a comprehensive cost-benefit analysis, ESMA concluded that the costs of derecognising these services would outweigh the benefits in the current situation, but identified a range of important risks and vulnerabilities associated with these clearing services which need to be addressed.

A policy-maker explained that clearing is an essential part of the Capital Markets Union (CMU). The Commission decided to extend the temporary equivalence decision covering the UK framework for CCPs by 3 years in order to avoid a cliff-edge, which would pave the way for ESMA to extend its recognition of UK CCPs under EMIR for the same period (i.e. until 30 June 2025). This delay will also give the Commission time to put in place a strategy for increasing the EU clearing capacity and ensuring greater financial stability. Initial ideas have been proposed through a public consultation.

1.2 Potential financial stability issues posed by the dependency of the EU on UK CCPs

A policy-maker stated that the Commission is paying considerable attention to clearing, because UK CCPs offer services that are critical to many EU players, but are now outside the EU regulatory and supervisory perimeter. This raises questions about how to manage potential financial stability risks posed by these CCPs. There have been some moves from European market participants over the last few months to open accounts at EU CCPs and engage with these CCPs for clearing but, according to the assessments conducted by ESMA, there continues to be an over-reliance on systemic third-country CCPs which could threaten financial stability, particularly in periods of stress.

A Central Bank official agreed that UK CCPs continue to pose financial stability risks to the EU, given the high volume of clearing occurring at UK CCPs. While clearing volumes for over the counter (OTC) interest rate derivatives have grown at EU CCPs, the current market share amounting to around 21% is insufficient and shifts to the EU have remained marginal. London also controls around 90% of euro swaps cleared and has a 90% global market share in interest rate derivatives. The exposure of EU market participants to UK CCPs therefore continues to be very high, which is not sustainable because of the dependency it creates and the exposure to possible disruptions in the operations of UK CCPs this may lead to, even though this is a tail risk.

An industry speaker disagreed with the remarks of the previous panellists about the financial stability risks posed by UK CCPs to the EU, emphasising that LCH Ltd for example is directly supervised by ESMA and subject to the EU EMIR law, and this will not change. LCH also has a deposit account with the European Central Bank (ECB), which is important for financial stability because collateral in Europe is held in cash at the ECB.

A Central Bank official agreed on the importance of ensuring financial stability in the clearing space, suggesting that the G20 decision that CCPs should be part of the solution to the financial crisis and problems in derivatives markets was made in full awareness that CCPs had to be cross-border and multi-currency. As a result of this deliberate G20 policy, clearing has grown. Regulators have to ensure that CCPs do not pose a risk to their financial markets. But this can be done without sacrificing the benefits of cross-border clearing, by developing tools to make sure that home supervisors, through cooperation, can provide safety and by moving in a direction to be able to give those assurances and avoid fragmentation.

1.3 The importance of EU-UK supervisory cooperation

A Central Bank official considered that major UK CCPs will remain systematically important for the EU in the foreseeable future, which means that close and constructive cooperation between the EU and UK authorities will be needed in the coming years. EMIR 2.2 already grants enhanced powers to ESMA to supervise and oversee Tier 2 systemically important CCPs, and ESMA has made several suggestions about how to improve its supervisory capacity in this regard. Legislative action to support this evolution will also be needed and in this respect the Commission's ongoing consultation is welcome.

An industry speaker emphasised that the solution for ensuring financial stability is to strengthen supervisory responsibilities and powers and also supervisory cooperation. Derivative markets are global by nature and any action to fragment them may create risks which cannot be foreseen. LCH is comfortable working with different countries; it has 11 different licences. With the adequate supervision, market forces will allow the market to evolve towards a structure that is relevant for the marketplace. For example five years ago the share of euro CDSs, single names and euro indices, cleared at LCH SA the Paris-based sister entity of LCH Ltd was 5%. Now it has grown to nearly 50%. Regulation did not push this

to happen; it was achieved through efforts made by the CCP to provide products and services relevant for the marketplace.

A Central Bank official described how the Bank of England, as it implements its own version of EMIR 2.2, will ensure that there are very high standards of cooperation and transparency between regulators, especially where CCPs have a significant market share in a domestic market. Communication between the Bank of England, ESMA and other relevant authorities is frequent and the Bank of England believes it has the necessary tools and information to make sure that financial stability aims can be achieved with regard to CCPs.

In the UK, the Bank of England has consulted on an approach called 'informed reliance', the Central Bank official explained, whereby the UK authorities would not need to regulate a foreign CCP directly if there is a high level of information and cooperation. The level necessary will depend on the risks posed by a CCP to financial stability in the UK. The objective is to ensure financial stability without undermining the global clearing market. This system will only work if there is mutual trust however, which is why cooperation is important. UK regulators are also taking steps to make very clear that, even in times of crisis, they do not discriminate clearing members on the basis of nationality, because there is a need to consider financial stability from a global perspective. The path forward is to build more trust and comfort about cross-border activities and more visibility and reassurances about what may happen in the event of a crisis. This will make it possible to preserve the financial stability benefits of global CCPs. Moving in the other direction would be a mistake.

A regulator observed that cooperation is the underlying principle of both the UK and EU approaches. EMIR reflects this. For Tier 1 non-systemic CCPs, there is a principle of mutual reliance. For systemic CCPs, however, there must be consideration of the specific issues that these CCPs raise in terms of elevated exposures and supervisory approach needed for tackling crisis situations, in order to define appropriate further steps. The regulator added that the goal of supervision is both the safety and efficiency of infrastructure. This can be a difficult balance to strike, but it is an objective that is shared between supervisors across the world.

A policy-maker stressed that supervisory cooperation between the EU and the UK will remain crucial, but not all issues can be tackled that way. Reducing the over-reliance of the EU on foreign CCPs and the related risks also requires assessing options to further strengthen the EU clearing ecosystem.

2. Issues raised by the recognition of non-UK third-country CCPs

An industry representative suggested that there is a growing point of tension for EU clearing members and counterparties concerning the equivalence and recognition process of non-UK third country CCPs. The 'qualified CCP' status that is applicable to many foreign clearing houses that operate under a framework that has not yet been recognised as equivalent by the EU will no longer be available after June 2022. This status currently allows EU stakeholders to treat these CCPs in terms of capital requirements as if they were recognized as equivalent. If nothing is done to address this, the risk weighted assets (RWAs) allocated to transactions involving these third country CCPs will need to be multiplied by roughly 50 times, which will make it difficult for EU clearing members to continue providing services to their clients for these CCPs at a reasonable cost.

While the 3 year equivalence granted to the UK CCPs allow sufficient time to review and implement relevant solutions, the June 2022 deadline applicable to these other Third Country CCPs will come fast and the issues raised will need to be addressed shortly, the industry speaker emphasized. The CCPs affected by this problem fall into three categories. First, there are the US CCPs which are very important for EU stakeholders; the US framework is recognised as equivalent by the European Commission, but the process of formal recognition is still underway at ESMA and it is uncertain whether it will be achieved before the deadline. Secondly, there are local market CCPs based in China, Turkey or Latin America, which currently have neither equivalence nor recognition. Finally, there are authorised CCPs recognized by ESMA e.g. in India that are undergoing reviews in respect of EMIR 2.2, which will require agreement on a new memorandum of understanding (MOU). The range of market activities covered by these different CCPs is very wide, making this a significant issue for EU banks. The problem concerns mainly the second group of CCPs in local markets, because for the US and Indian ones there are recognition processes underway. Specific proposals have been made by the financial institutions concerned for addressing this issue on a case-by-case basis, for example solutions are being implemented in the US and UK to allow the non EU peers of EU banks to continue clearing with these CCPs, at least the Chinese ones.

A regulator agreed that this issue, which shows that clearing markets are global should not be obscured by the focus on Tier 2 CCPs. ESMA is currently reviewing another 33 existing recognitions under the new EMIR regime and renegotiating MOUs with around 17 jurisdictions. This will help to foster a common understanding among authorities about cross-border cooperation needs in a non-systemic context. All efforts are being made by the EU authorities to resolve the outstanding issues within the timeline.

3. Strengthening the EU clearing ecosystem

3.1 On-going consultation on the competitiveness of EU CCPs

A policy-maker emphasised that the Commission's consultation on how to improve the competitiveness of EU CCPs and clearing activities as well as ensure that their risks are appropriately managed and supervised is very open. It aims to create the conditions to make the EU

a more attractive place to clear. Market participants are invited to put forward their ideas for improving the current situation. The consultation considers both the supply and demand sides. On the supply side, an important question is how to make it easier and quicker for EU CCPs to offer new products. At present, EU CCPs do not offer the full range of products needed by clients. On the demand side, various issues are being considered. One is the role that capital requirements could play, another one is the idea that market participants could open active accounts at EU CCPs. Another question is whether to broaden the clearing obligation itself. A third question is about the supervision of EU CCPs and whether it should remain local or be more centralised at EU level.

3.2 Current dynamics of the euro clearing market

An industry speaker considered that Europe is already an attractive place to clear and is already globally competitive in the clearing and market infrastructure space. There are more than 70 CCPs in the world at present, but only four are globally relevant: CME and ICE in the US, LCH in the UK and Eurex in Frankfurt. Eurex clears a wide range of products including benchmarks for European equity markets and exchange-traded derivatives. In risk management terms, a strong portfolio based margining approach is in place. The EU has also shown thought leadership on many CCP risk management issues, such as anti procyclicality, margin models, and how to manage recovery and resolution.

The industry speaker stated that the EU could have a greater level of sovereignty in euro clearing. The market was previously concentrated in London for many instruments, but now about 20% of the clearing volume has shifted to the EU through a market-led approach, although it is only 10% on the trading side (which is consistent with the figure previously mentioned of 90% of cleared euro swaps handled in London). This is not a question of technology or risk management standards, but of incentives. EU CCPs have the infrastructure and technology needed to handle significant volumes of transactions. On risk management, EU CCPs have all the necessary tools in place and this is not an area where CCPs compete. What needs to be recognized is that while London has developed as a hub where supply and demand for euro instruments meet, this situation may not last forever because this is not where the supply and demand originate. Inherently, the principal issuers of euro instruments are EU countries, followed by banks and corporates. London is not where euro exposures are ultimately housed either. These exposures are located in pension funds, the European insurance sector, banks and such. The EU has the ingredients to create a healthy and balanced alternative market for the euro, in competition with the UK CCPs. A market led proposal has been put in place by Eurex for example for initiating progress towards this objective with the incentivisation of 10 EU and non-EU banks and institutions to set up a liquidity alternative within Eurex, which also involves adjustments in the governance of the CCP.

Another industry speaker stressed that the euro is not only a European instrument but an international currency. It is a testament to the success of Europe as an economic zone and of European regulations, which have allowed the euro to become so internationally important. 73% of new trade registrations in LCH Ltd originate from non EU entities. This shows that there is a desire, with the discussion about the clearing of euro instruments, to create something local from a currency which is intrinsically global.

3.3 Possible measures to strengthen the EU clearing ecosystem

A Central Bank official considered it necessary to shift more clearing activities towards the EU over time in order to strengthen the EU financial market, but this will only happen if there are effective incentives. This can be achieved via three measures: improving clearing services in the EU, bringing additional market volume to central clearing in the EU and ensuring that EU market participants concerned build up their clearing capacities in the EU. Achieving these objectives will require the industry to develop a robust long-term strategy and make concrete improvement proposals.

An industry speaker was convinced that attracting additional clearing volumes to the EU could be done, agreeing with previous comments that the EU has some way to go to achieve higher market shares. The question here is around the supporting measures, which can be determined hopefully with the output of the Commission's consultation. A first measure could be to broaden the scope of application of clearing requirements. Many EU institutions, sovereigns and quasi sovereigns exempted from the central clearing obligations are or have become large issuers of euro instruments. Some exemptions, such as the one for pension funds should be reviewed, as proposed by ESMA, in order to get more institutions that hold euro exposures into the clearing ecosystem. Additionally, there are some obstacles that need to be lifted. For instance there are still outstanding issues in the area of hedge accounting. Banks must be able to switch their portfolios in a tax neutral way, if they move from a UK to an EU CCP. Finally, the idea of increasing the number of active accounts is a good one, because it will be possible to avoid cliff edge risks in 2025 if most clients have properly prepared for the transition by opening an account with an EU CCP and test-driven this alternative. At present, out of 600 potential counterparties, only 300 have active accounts at Eurex for example.

A Central Bank official suggested that there is an opportunity to improve the clearing landscape in Europe following the consultation process, with some time in hand to make changes. There is the scope for a fair rebalancing of risks between the EU and UK, because there is no point in having a global monopoly in derivatives. This will require a collective effort from the industry and from the regulators, but it should mainly be an industrial project. Regulators can help in their role as catalysts, but it is essential that they target the most efficient measures. Enhancing the offer for clearing will be essential. A number of proposals made by the Commission in its consultation paper are worth exploring, such as extending the clearing obligation for certain products or extending the scope of participants, if the risks can be properly managed. Another avenue could be to ensure that CCPs systematically offer the use of EU-based CCPs to clients.

The Central Bank official was also favourable to the objective of increasing the number of active accounts. However this action will only be efficient if it is accompanied by regulatory measures to ensure there is a sufficient flow of transactions going through these accounts, and it will not be a success if the measures can only be used if there is a problem. Quantitative aspects are also important, because volume will be required to build up the EU clearing offer. This effort should be supported by incentives and also targets to provide market participants with sufficient visibility. Thresholds for systemic CCPs or systemic clearing segments are already enshrined in EMIR. It would make sense for regulators to show the path for EU clearing by defining quantitative objectives that can be reached with a reasonable and gradual approach. In terms of supervision, the actions proposed should be pragmatic. There is no need for a major overhaul of the EU supervisory structure for clearing which seems quite efficient. It is essential to continue the current collegial approach, especially for CCPs, which have important liquidity needs and for which it is important that the central bank of issue is very much present in the discussion.

An industry speaker highlighted the need to be aware of the directionality of risk in clearing, when speaking about having more clearing activity in Europe. If a European CCP has a concentrated direction of risk, this may actually weaken EU financial stability rather than enhance it. In addition, it would not be surprising if LCH SA were to become systemically relevant for the UK, given the number of participants in the service which are based in the UK. Despite the fact that LCH SA is a euro CCP in terms of the underlying currency, it is very international because many of its participants emanate from the UK and not the EU. This shows again that it is challenging to tamper with markets that are intrinsically global. Every time there is fragmentation in the approach, it creates new and unforeseen risks for regulators.

As a concluding remark, a regulator agreed that tampering with the market could cause issues, but the European public authorities have a responsibility for financial stability and also preserving monetary policy when there are issues that concern the usage of the euro. It will be important to consider carefully the adequacy of the EU's existing supervisory structures in the context of increasing EU clearing volumes. There is also a global dimension to this and it will also be necessary to take a global perspective on how to address globally relevant financial market infrastructures.

How can banks contribute more to the CMU?

1. The complementarities between bank financing and capital market financing

1.1 The roles of banks and capital markets and areas of synergy in financing

An official outlined the synergies between banks and capital markets. Banks can be enablers of more liquid and deeper capital markets by acting as issuers of securities, as intermediaries for issuance, as intermediaries for institutional and retail investors and in some cases as investors. Banks are well positioned to help companies diversify their sources of financing and to contribute to channelling the unprecedented levels of savings created by the pandemic. These synergies should be taken advantage of particularly for the financing of start-ups and scale-ups, which lack equity financing. 2021 has been a record year for initial public offerings (IPO) in Europe and many new unicorns have emerged, but capital market financing needs to be more widely promoted from a public policy perspective. In addition to the role as intermediaries previously mentioned, banks can also play a more direct role in the financing of scale-ups, as investors or as promoters of venture capital funds investing in such companies.

An official explained that banks contribute to efficient capital allocation and risk diversification. In terms of capital allocation, banks help to connect investors and issuers. On the investor side, they can play a key role in particular in terms of encouraging savers to invest in capital market instruments in Europe, which does not have the same broker dealer and financial advisor ecosystem as the US. On the issuer side, banks can provide support notably through advisory work for small and medium sized enterprises (SMEs); market making; direct investment, which the new Capital Requirements Regulation (CRR) proposal facilitates using lower risk weights; and creating growth funds.

The official agreed that supporting the growth of scale ups is a particular challenge in Europe, because at a certain stage of their development, many of these companies turn to funding provided by non-EU investors and then get listed in the US, which may have consequences in terms of management control and growth potential for Europe further down the line. Countries such as Canada or the UK have created common bank funds to support scale-ups, which is an option that should be further considered in the EU. The development of a broader range of issuers in the EU, with more start-ups and scale-ups to invest in, would also provide investors with greater diversification. Moreover, a further integration of the EU banking sector with the implementation of the Banking Union could help to support issuers and investors across borders, contributing to a better allocation of capital across the Union.

An industry speaker added that banks raise their own funds both from deposits and the capital markets, issuing their own securities. They tend to raise funds in their own domestic market but should endeavour to attract more funding from other EU countries, although managing 27 different sets of legal rules is challenging.

1.2 Leveraging the complementarities between banks and capital markets to relaunch growth post-Covid

A Central Bank official noted that complementarities have developed between bank based and market based financing in Europe. In the wake of the 2008 financial crisis, the growth of capital market funding has reduced the EU's over reliance on bank funding, which was procyclical. Conversely, during the COVID 19 crisis, the banking sector countercyclically substituted the thinner market funding provided by capital markets and provided additional liquidity to the corporate and sovereign bond market. Going forward there are major opportunities for banks to further contribute to the growth of capital markets in the EU.

An official agreed that the response to the Covid crisis was different to the response to the financial crisis. The banking sector contributed in a significant way to all three stages of the response to the Covid crisis. Taking the example of Spain, banks in the first stage of the Covid crisis, granted more than €135 billion in publicly guaranteed loans to meet firms' liquidity needs. This helped SMEs in particular to cushion the fall in revenue that they experienced at the outset of the crisis. In the second and current stage of the crisis, the banking sector is a key tool used by the public authorities to ensure that credit flows correctly and that financing conditions are stable. In the third stage towards which the European economy is evolving, with public stimulus moving towards more targeted actions, it will be essential to drive excess savings from the pandemic into completing the twin green and digital transitions. Banks can play a key role in this perspective as intermediaries and also with their capacity to conduct risk and viability assessments. They can also encourage retail investors to engage in capital markets by familiarising them with these instruments.

Another official stressed the importance of capital market financing going forward and of the Capital Markets Union (CMU). The Russia Ukraine conflict will increase expectations of inflation, and decrease expectations of growth in Europe, potentially creating further economic damage and increasing the leverage of the corporate sector.

An industry speaker emphasised that Europe is in a novel historical moment: Covid has led to record saving rates among the retail population, even though interest

rates are at zero. Economies being switched off also meant that the revenues, turnover and profits of most enterprises went down, which resulted in an erosion of equity. Alongside this, awareness of the need to fight the consequences of climate change rose significantly. As a consequence, banks are sitting on a huge pool of liquidity which needs to be put at work to support the economic transformation that is needed in Europe. Banks will need to create products and platforms, as intermediaries rather than direct investors, to make this cash available to the economy. Deepening the integration of the European financial sector and capital markets with a consistent implementation of regulations such as MiFID II should be a key objective in this perspective in order to facilitate the distribution of capital market products across the EU.

1.3 The role and potential of securitisation

An industry representative suggested that securitisation is an example of how banks can contribute to the development of capital markets and how the transition from relying entirely on bank lending to introducing more direct institutional investment in the market can be facilitated. The Simple, Transparent, and Standardised (STS) securitisation legislation was one of the first actions implemented in the CMU initiative, establishing standardised issuance rules and features that enable investors to compare one transaction to another. STS securitisations, which have become the benchmark across Europe, allow banks to alleviate their balance sheets in order to raise their lending capacity and may also contribute to the development of capital markets, by transforming lending portfolios into securities that can be issued to institutional investors. SME loan securitisation programmes which are put in place in Spain and Portugal on a yearly basis for example allow institutional investors to get exposure to the lending portfolios of banks. As they become more familiar with SME risk, these investors may consider taking direct exposure to SME investment. The same mechanisms are used in a variety of loan markets such as residential mortgage, auto-loans and consumer credit.

An official agreed that securitisation could work on both sides by ensuring that risk is unloaded from banks and developing a bigger capital market. This type of cross fertilisation between banks and capital markets should be further encouraged.

Another official considered that securitisation has very promising potential in creating space on banks' balance sheets, which is necessary in a competitive banking market. There might be too much emphasis however being placed on securitisation as a way to develop capital markets. The official queried the potential of SME securitisation in particular, because it can be quite hard to bundle SME loans. While STS provides securitisation standards, the underlying SME loans are not easy to standardise. Where banks could help SMEs to go to the market would be handling the issuance part.

The industry representative acknowledged that SMEs are not the largest asset class, although regular programmes exist in countries like Spain and Portugal and projects are being put together in other countries. One key challenge is the fact that SMEs are heterogenous. This is where securitisation can pave the way to further capital market financing, because banks can assemble a diverse pool of different types of SMEs, rather than having investors make bets on individual SMEs.

2. Obstacles to the CMU and to the role of banks in capital markets

An official considered that the Commission's CMU action plan covers many important issues for the development of capital markets in the EU, but it also faces two key challenges. First, its implementation is taking a long time, because underlying issues such as Banking Union and the fragmentation of securities rules are genuinely difficult to tackle, even though the CMU action plan is not addressing in depth the most difficult issues in terms of harmonisation (i.e. related to insolvency, taxation and withholding tax regimes). Because Europe is bank based, a considerable proportion of intermediation takes place through banks, both conventional intermediation such as loans and also capital market intermediation supported by banks. Without Banking Union, there will be no integrated CMU. In addition, capital market rules such as MiFID are not sufficiently consistent across the EU, because they have been implemented differently. Achieving CMU will be impossible if these issues are not addressed properly.

The official explained that the second issue is around the importance of cross-border banking activities for the CMU action plan. If Banking Union remains unfinished and cross border banking flows continue to be limited, banks will be unable to catalyse sufficiently the development of the CMU. This is not about issues such as the European Deposit Insurance Scheme (EDIS), which are very difficult to tackle. Even for simpler topics such as home host issues, the ring fencing of liquidity or resolution, progress is insufficient, which means that Europe is still not treated as a single jurisdiction by the Basel Committee. If banks cannot seamlessly perform the issuance and distribution of securities on a pan European scale, it will be impossible to overcome the national barriers to capital and achieve the single market aims of the CMU. Taking the securitisation example previously mentioned, it is very difficult at present to bundle securitized loans from different EU countries together because of their underlying nature. It would be easier to achieve this if there was a sufficient level of cross border banking. This would allow the creation of larger pools of assets with similar characteristics and could appeal to more institutional investors.

A second official agreed that tackling the obstacles to a more integrated banking market in Europe, such as ring-fencing issues, is needed for fostering greater cross border activity. However this cannot and will not happen single handedly, because countries in Europe have understandable risk considerations and want protection. This is why these issues have to be addressed in the context of a wider package including subjects such as EDIS, taking into consideration the interests of the

different stakeholders concerned, in order to make progress on the Banking Union. A third official agreed that a holistic and pragmatic approach is needed on Banking Union to get everybody on board and make the project sustainable.

A Central Bank official agreed that the main issues on which progress is needed have been identified in the CMU, but there are challenges around implementation. An industry representative concurred with the previous point on securitisation. It is indeed difficult to pool securitised portfolios across borders, because there are different regimes for the underlying loans, different regulators, and different sets of practices. The CMU plan is the right way forward, but there is now a need for execution. For example the promise of the STS securitisation legislation has not been fulfilled. There has been moderate progress in terms of issuance, but not the step change that was envisioned.

The industry representative highlighted several obstacles that need to be tackled regarding securitisation. First, legislative activities are too siloed. In the attempt to harmonise securitisation legislation, it was forgotten that using a best in class benchmark type securitisation should be recognised in the liquidity ratio, because a separate working group was handling this aspect of the legislation. There is a similar issue on the capital requirement side which makes it very difficult to incentivise this type of activity within banks The speaker was however hopeful that the 'silo mentality' could be addressed in the same that it has been possible to produce a common and well accepted legislation on securitisation. Secondly, improving transparency remains a challenging task. Some efforts have been made in the market, for example with the European DataWarehouse securitisation repository, established by a certain number of banks, where loan level detail is made available to all investors. ESMA also included in the new legislation a template aiming to harmonise information related to securitisations, which is a good idea, but the template does not work at present in several areas. Changes should be made for transparency to become a reality in the European securitisation market.

3. Possible actions to further develop EU capital markets and related role of banks

3.1 Better managing the supply and demand for capital

An industry speaker agreed with previous speakers that the CMU proposals contain most actions that are needed for developing capital market financing in the EU. However, to define the appropriate course of action it is essential first to define the problem and then, without any preconceived ideology, discuss the solution. The problem that needs to be addressed most urgently in Europe is unlocking the potential of retail investors to contribute to the growth of an economy that is lagging behind other competing jurisdictions. The scattered regulatory environment around MiFID and some consumer protection rules are unnecessarily impeding the demand of retail investors. There are also issues on the supply side and the power of the combination of supply and demand also needs considering in the CMU initiative. On the supply side, there are issues with the European Long term Investment Fund Regulation (ELTIF) for example, such as the minimum investment threshold for retail investors and a lack of flexibility in the rules applying to portfolio composition. Removing these different barriers will be a long-term project, but should help to unlock the growth potential there is in the European economy. If retail clients are put in the right position, they will take informed decisions.

The industry speaker emphasised the importance of improving financial literacy in particular, noting that there are several ways to drive this. This topic is moving slowly in national financial education curricula, but it can be addressed via private public partnerships or private initiatives. In Slovakia for example, curricula are being developed by the speaker's bank in partnership with schools, in which financial literacy is not a particular discipline but features in many subjects covered e.g. languages, mathematics, history or geography. As a second example, a digital museum for financial literacy has been created in Vienna, which is visited by more than 35,000 pupils per year who learn how money works, how a budget works, how the global economy works and about the role of central banks.

An official was very supportive of initiatives on financial literacy, observing however that this is not sufficient to create a vibrant capital market such as the US. In the US individual savers invest in different ways through banks, brokers or pension funds; however, this does not mean they fully comprehend what underlies the assets in their savings pool.

Another official agreed that turning retail savers into investors is a major objective. This notably means having attractive companies in Europe to invest in, but there is also a challenge for banks here, which continue to sell loan products to those companies in great quantities, when there should also be an objective to move towards more diversified financing and less leverage.

A third official stressed that digital literacy also contributes to financial literacy in today's world and although it is important to set up financial and digital literacy programmes in schools for the future, it is also essential to ensure that the less digitally literate customers and SME owners are not left behind in the rapid drive to digitisation.

An industry representative also suggested that securitisation could play a role in transitioning investors to the capital markets, by making them more familiar with taking risk.

3.2 Supporting the financing of SMEs

An official considered that the main objective that the CMU project is seeking to achieve is providing companies with a more even cost of capital across the EU, especially for SMEs. At present, SMEs are penalized and banks could do more to improve the situation. Banks should

endeavour to graduate SMEs to market finance, whether it is traded equity or debt finance. One of the CMU proposals suggests that banks should support the companies which they cannot finance in finding alternative sources of finance, but this seems odd because it is harder to take a firm to the market if a bank is not willing to lend to it.

Another official described how the Spanish authorities were supporting the development of capital market financing through changes in the Spanish regulatory framework. Recently, new regulations were introduced on promoting the constitution and growth of companies and on removing barriers for start ups. This includes measures to promote crowd funding services, to adapt the Spanish legal framework to European legislation, to improve the venture capital and private equity legal framework, and to improve the requirements for the marketing of those products to retail investors in line with ELTIF.

EU securitisation relaunch: critical political decisions and timing

A public representative stated that securitisation regulation was introduced five years ago, establishing the Simple, Transparent, and Standardised (STS) framework. It now has to be reviewed. It should have been reviewed in the previous January by the Commission, but it was not.

1. Despite the improvements brought about by regulatory improvements, the securitisation market in the EU is not equal to the challenge faced by the banking sector of the €650 billion digital and sustainability transformations investment need

1.1 The EU STS reform reduced the stigma and today securitisation in Europe is perceived as sound

An industry representative stated that the earlier STS reform did not help to develop the market, but it at least helped to smooth out and reduce the stigma to create a safer environment. The regulation has achieved a great deal, with the retention rules, the supervision of ratings agencies and the systematic assessment of the Significant Risk Transfer (SRT) by the competent authority. Psychologically, a change in mindset is about to happen: today securitisation in Europe is sound and has been useful as a tool to transfer risk from banks to educated investors.

An official commented that a very productive framework in Europe has been developed over the past decade to address specific risks stemming from securitisation. Re-securitisation has been prohibited. Risk retention rules have been established to ensure the originator remains exposed to possible losses on the loans being securitised. Disclosure requirements have also been introduced to ensure investors have the information they need to understand the risks they are taking. These safeguards will remain in order to build up trust in securitisation in Europe and to alleviate risks to financial stability. The view of securitisation should be changed. This tool could be used to address the financial needs of the economy, including the green and digital transitions. Securitisation can help free up capital from already very constrained banks' balance sheets and enhance their competitiveness.

1.2 The wall of investment faced by the EU means that the take-off of the EU securitisation market must be accelerated

An official commented that it is urgent that the necessary steps are taken to allow the market to grow to address the wall of investments that is faced. The European Commission has suggested that the additional investments in relation to the green transformation and digital transition will reach around 650 billion per year until 2030, which is not within the capacities of the banking system in Europe or within the supervisors' appetites for banks' balance sheet growth.

1.3 What banks are missing is sufficient regulatory capital, not funding

An industry representative stated that funding is available. However, it is very clear that the banks have ever rising capital constraints and cannot raise all the capital that corresponds to the 650 billion. The only solution is securitisation. The name of securitisation is misleading because it is about risk sharing. Banks need to be able to originate. Banks have the reach, know the companies, and can accommodate the needs of each of their clients. Banks have then to find a way to transfer part of the risk to investors that are eager to take those risks. The current regulation does not allow that kind of bridge.

An expert noted that it is often stated that we [banks] do not issue residential mortgage-backed securities (RMBS) because they have a lot of funding for targeted longer-term refinancing operations (TLTRO) and all the other systems. This is not true. The banks issued €120 billion benchmark covered bonds, which are based on mortgages, while the total issuance of covered bonds in 2020 was €570 billion. This is three times more than the placed and retained issuance of securitisation in Europe, suggesting that there are other factors involved.

A public representative commented that it is correct that risk sharing and raising capital is critical. The banks had a need for that, so it was not that Europeans did not need the capital. Capital was needed in the past years, but covered bonds were chosen.

An expert noted that covered bonds are cheap and easy to issue. The whole system favours the covered bond market. It is often stated that RMBS creates systemic risk with 0.5% of gross domestic product (GDP), where covered bonds have 50% of the European mortgage market.

An industry representative stated that covered bonds do not address the capital issue. In covered bonds, the investor is protected by the mortgage, but the bank keeps all the risk. Standard securitisation is about risk sharing. Covered bonds are not helping banks reduce their risk-weighted assets (RWA). Covered bonds address liquidity, not the capital as needed.

A regulator stated that the securitisation market in Europe is underdeveloped. This is a problem because capital is scarce within the banking sector, and it is becoming even scarcer, because there are more things requiring financing while bank prudential requirements will be tightened in the future. An instrument is required

to enable the banking sector to efficiently use available capital in front of the risk that needs to be retained. The absence of this has been possible up until now for a variety of reasons, including the presence of other refinancing tools, such as covered bonds. Covered bonds only address the very specific issue of refinancing and do not allow the freeing up of capital.

1.4 As a risk sharing tool, securitisation should make an important contribution to deepening the banking union

A regulator commented that banking union progress has stalled due to the choice to make progress as far as possible in terms of risk reduction. Reviving securitisation could adjust the degree of exposure the banking sector has to the risks that stem from the real economy by using private risk-sharing agreements rather than public risk-sharing agreements with the banking sector.

2. Policy makers must answer the question of why, despite the benefits of the STS regulation, the EU securitisation market is a fraction of the size of similar markets in other parts of the world

An expert stated that, in 2008, the European securitisation issuance was 75% of US securitisation issuance. It is currently 6%. There has been a collapse of the European securitisation market. In the US, Australia and China, securitisation issuance is 2-4% of GDP. In Europe, it is 0.5%. Last year, Europe issued €90 billion of securitisation, versus €750-800 billion in the US. A common belief is that this is because the US has agency, but this is incorrect as the figures completely exclude the US agency market. Australia does not have an agency market and still issues significantly more securitisation as a percentage of GDP relative to Europe. STS was needed, but what it contributes is questionable. Of the €90 billion issued last year, non-STS was €60-65 billion. STS is more relevant to political recognition of securitisation than market stimulation. Only €7 billion of the €25-26 billion STS issuance last year was RMBS.

2.1 The cost of securitisation impedes swift development of the market

An expert stated that there are many reasons why banks did not resort to securitisation when capital was needed. First, there was massive support from the monetary system. Secondly, there was a very long period of implementation of the output floor. Securitisation is difficult to do and expensive. It takes one to two hours to syndicate a covered bond. A repeat issue of 20 experience of RMBS will take at least a week. There is very little disclosure for covered bonds. Securitisation disclosure is loan by loan and there is the prospect of having two parallel disclosures under the European Securities and Markets Authority (ESMA) and the European Central Bank (ECB).

2.2 The investors regulatory framework does not help

An expert noted that securitisation holdings in European insurance dropped from 10% in 2010 to 2% in 2020. This is partly because the regulatory capital is incredibly high for insurers. For a deal in the US[?], the aim is for 10-30% participation of insurance companies. In Europe, 2-4% is considered a success. All the issues outlined make securitisation very expensive, which prevents the bank moving the assets to share the risk and reduce the capital. In addition, the velocity of the balance sheet of the European banks and their competitiveness relative to US banks are reduced.

2.3 Fragmented EU financing needs also explain the limited success of securitisation

A regulator commented that regulators should be humble because there are fundamental reasons why the securitisation market in Europe is not as successful as that in the US. These reasons are not always easy for regulation to circumvent. An example in relation to RMBS was provided. In securitisation, the law of large numbers is used to predict the credit risk on a pool of assets. The pool of assets must be homogenous, but mortgages are not homogenous in Europe. These difficulties do not mean that financial regulators should not try to do something.

3. Investors in the EU are eager to invest in securitisation and the multiple tools to share risk with banks

3.1 The various forms of securitisations make it possible to address a wide range of risk appetite specificities of the investors

A public representative noted that there has been a change in the regulation, where synthetic regulation was used.

An industry representative commented that it is helpful to distinguish between true sales securitisation, which has been a flourishing big market and should re-flourish, and balance sheet synthetic securitisation, where the loans stay with the bank. Institutional investors and banks teaming up will be a win-win, because banks have an excellent network, know their clients well and have long-term relationships that we [investors] could never mimic. We [PGGM] is looking to diversify its credit risk as an institutional investor. Securitisation is vital for the European economy to prosper and flourish. Expansion by investors will be possible if good investments are available.

A better term for 'synthetic' is credit risk-sharing transactions. STS rules are very helpful in creating a solid and sustainable market. A significant part of the true sale securitisation is there to also attract the senior funding of a bank. It is a different kind of market. Very often, banks hold the first losses themselves. It is an efficient way to attract liquidity into a bank. The current risk sharing transactions are focused on providing the

capital that banks need. Synthetic securitisation and true sale securitisation are both very important markets. Investments are needed for the transition to help fight climate change. There is technological risk inherent in this. It will be important to spread risks across the banking sector and institutional investors.

3.2 Tailoring securitisation transactions to both the bank's and the investors' needs is necessary, though it makes securitisation a more complex financing tool

An industry representative stated that it is incorrect to believe that securitisation is about taking a loan, putting it into the form of a bond and selling the whole thing. Loans are tailor made for specific clients. When a bank wants to offset or share the risk with investors, it has to consider the needs of the investors. It is not exactly what the borrowers require, so the risk must be changed and cut in another way. It is not possible to take a loan and sell it to somebody else. The originate to distribute (OTD) is not like a bond. Securitisation implies some work on the pool of loans in order to propose tranches with the relevant level of risk, which can be bought by investors, with the rest remaining in the bank, so not everything will be sold. This is more complex. Securitisation will never be simple.

3.3 The stability of the investors regulatory framework regarding securitisation is a prerequisite for investors

An industry representative stated that, for a long-term strategy, a good, solid, and sustainable market is needed. Rules that change all the time discourage banks and investors. Clear rules must be set for these investments, because they are new to many investors. New investors joining the market is a very positive development for credit risk-sharing transactions, but new investors should be supported to interact with the market in the correct way. The last few years have been benign in terms of credit risk, so the risk is that people's standards become looser.

4. Main reasons for the current poor performance of the EU securitisation market and ways forward

4.1 General reasons

An official stated that there are three main reasons for the weak performance of this market in the EU compared to the US. First, there are more attractive sources of financing, for example covered bonds. Second, the prudential framework discourages holding securitisation positions, which is why the investor base has not broadened in the last decade. In particular, insurance companies remain marginal in the European securitisation market. Third, there is a degree of legal uncertainty to be tackled, particularly regarding the SRT test, which creates uncertainty around the ability to obtain prudential deconsolidation. It may be too early to judge the STS regime because the label was extended to synthetic securitisations in 2020 as part of the recovery package.

4.2 A remaining stigma among policy makers, which is driving unnecessarily restrictive regulations, is the possible overarching problem, according to the High-level Expert Group

An industry representative noted that the high-level working group identified five gamechangers. One of these is the overarching problem that there is still a stigma within the authorities. Tone from the top is needed on securitisation in order to smoothen the old restrictions in the regulation and in terms of the way the regulation is implemented by the supervisors. The regulation should be reviewed and implemented with an open mind. Banks are supposed to practice OTD. Banks lend money and then have to distribute. The supervisor does not approve each lending transaction. Similarly, there is no need for constraints and limits when banks are selling part of the risk. It is the normal day-to-day job of banks to originate and distribute. It is a problem if supervision is such that in practice banks can only originate and not distribute.

4.3 Fixing regulation excesses is essential to bring issuers and investors back to the market but also to levelling the playing field among the various bank financing tools

An expert stated that the investors must be brought back in, so the insurers are needed. The opportunity to fix Solvency II is being missed. As there is the synthetic risk transfer and many banks are systemically importing sophisticated banks, the securitisation internal ratings-based approach (SEC-IRBA) and securitisation standardised approach (SEC-SA) must be fixed. The P factor must be fixed. The P factor is a constant input in a formula that increases the capital for securitisation because of a number of issues like agency risk and so on, which do not exist.

An industry representative outlined that bank loans have an associated RWA, because there is a certain level of risk. When the loan is securitised, suddenly the regulatory capital associated with that loan becomes P times the previous figure. The P factor is the multiplier of capital requirements required just because a loan is securitised. Up to a certain level this is acceptable because there is a little more operational risk with securitisation, but it should be 1.2 or 1.3, not two to three times as it is now.

An industry representative commented that STS provides good, standard rules, robust structures and a benefit to the bank. In the original rules, there is a lot of slack in how much capital must be allocated after having securitised. STS already corrects this a bit. It has a lower risk weight for the senior tranche that is kept by the bank, which improves the metrics. This could be further improved. If all the tranches are compared to the original portfolio, it is ridiculous that the amount of additional risk weighting is much higher. That reduces the economic basis for the transaction.

An expert added that the playing field among capital market instruments should be levelled. It is not possible to have 2.7 trillion of mortgages out of 5 trillion into covered bonds, state that this is not systemic risk, and, at the same time, try to revive the RMBS market.

A regulator stated that there is no level playing field between securitisation and covered bonds because covered bonds are very different instruments. Covered bonds are claims on a bank that are secured by the asset, so there is no direct exposure to the underlying assets. Considering whether securitisation, RMBS and covered bonds are treated equally is not necessary. There are legitimate reasons why they are treated differently.

An industry representative commented that the STS rules intended to make the collateral rules clear for investors. Unfortunately, the result is that a straightforward cash deposit with a bank, without collateral, is what STS requires. That is a risk to the investors. To ensure the market is good and stable, it should be collateralised and opened up to repos money market funds (MMF). The money is there and safe in escrow, but not with the bank. Otherwise, in a dire situation, the hedge is lost and the capital is lost because it was on a cash deposit, which is in the bank. This is not logical.

An official stated that the prudential treatment has been dealt with already and there is a great deal to be done. Discussions are ongoing on Solvency II and Basel III. It is obvious that there is an issue. The requirements for private securitisations are too burdensome and redundant. Streamlining these would be welcomed. The EU Commission would need to ask ESMA for an assessment of this.

4.4 One key added value of the STS regime is the mandatory portion of risk retained by the bank, which is intended to reduce moral hazard and ground investors' confidence, particularly regarding less transparent securitisations

An industry representative stated that it is welcomed that STS has a clear rule on risk alignment. The big lesson from the global financial crisis is that the originator, even if it does some OTD, should take ownership and keep risk. There is a 5% risk retention rule generically in the market for securitisation, specifically for credit risk-sharing transactions. True sale transactions is a different market. On credit risk-sharing transactions, we [PGGM] puts money in to cover the bank's losses, but the bank is fully independent. Banks should continue to have responsibility and for a bigger percentage. 20% is in our [PGGM's] mandate and this should be retained as a market to protect the stability of the market. If this project is successful, it will be a structural way for banks to capitalise their lending books in a very cost efficient way. More progress has been made in the EU than the US up to now. Very clear and high-risk alignment measures must be retained, to avoid market players originating to get rid of the risk.

An expert commented that it is necessary to differentiate between black box transactions and transparent transactions.

4.5 The predictability for banks of the effectiveness of the credit risk transfer is an essential area for progress

A regulator acknowledged that the prudential debate is not within the market regulators' remit. There are issues with the parametric treatment of securitisation exposures on the asset side of the banks, but the main issue is the credit risk transfer, meaning the proof that the supervisor requires that the risk of the assets has been transferred to a third party outside the banking group. This frees up capital. However, this credit risk transfer is completely unpredictable. Greater clarity on the expectations of supervisors regarding risk transfers is needed. However, is not possible to have a point beyond which supervisors cannot question risk transfers.

4.6 Further clarity is required regarding EU/Third Country securitisation transactions

A regulator stated that the territorial scope of the regulation in terms of disclosure and transparency requirements should be clarified. This would be a significant help to EU investors in securitisation. Currently, the most likely reading of the regulation is that EU rules should be applied, including for third-country investors and in countries that have their own regime for transparency and disclosure, which does not make any sense.