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THE **EUROFI** MAGAZINE

SEPTEMBER 2024

MIHÁLY VARGA

Minister of Finance, Hungary

Competitiveness always grows out of cooperation

G. MATOLCSY

Time to rethink economic policies

M. NAGY

We must find ways to restore the economic and financial competitiveness of Europe

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Building a more resilient economy: a robust insurance sector and sustainability

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THE EUROFI
VIEWS MAGAZINE

SEPTEMBER 2024

The Eurofi Views Magazine, published twice a year alongside Eurofi events, features insights from a diverse range of public, private, and civil society representatives.

The articles explore Europe's macroeconomic challenges and their implications for the financial sector, key industry trends such as digitalisation and sustainable finance, and issues related to financial stability and environmental risks. They also provide in-depth analysis of the major policy proposals made in the different sectors of finance, assessing their potential impact on the industry, its clients, and the broader economy.

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This edition of the Eurofi Views Magazine is published on the occasion of the Eurofi Financial Forum in Budapest, organized in association with the Hungarian EU Council Presidency. The Forum will address Europe's macroeconomic challenges, key regulatory and supervisory developments in the financial sector at both European and global levels, and major industry trends such as digitalisation and sustainable finance, along with their policy implications.

As a new political cycle begins, discussions will also focus on the priorities of the incoming European Commission, particularly regarding the financing of the European economy and the regulation of financial services.

In the following pages of this Magazine, you will find over 230 contributions from public, private, and civil society representatives participating in the Budapest Forum, offering valuable insights on the topics under discussion. We are grateful to the contributors for their input, which provides a comprehensive overview of current trends and issues affecting the financial sector, as well as the policies needed to address them. We trust you will find their perspectives both informative and engaging.

Additionally, the Eurofi Secretariat has published several papers on these topics in the latest edition of the Eurofi Regulatory Update, which we encourage you to read as background to the Forum discussions. The updated Eurofi Macroeconomic and Monetary Scoreboards also offer an in-depth review of Europe's macroeconomic environment and its potential implications for the financial services sector.

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Contact: contact@eurofi.net

DAVID WRIGHT

President – EUROFI

A warm welcome to the 38th edition of EUROFI in the famous city of Budapest. We are honoured to be here and we thank the Hungarian Presidency of the European Union, the Ministry of Finance, the Ministry for National Economy and the Central Bank of Hungary for their invaluable assistance in helping to organise our proceedings. We look forward to two and a half days of vibrant discussion, with more than 45 panels, many speeches from leading public and private personalities plus a host of other meetings at a crucial juncture for the European Union. Indeed, the timing of EUROFI, Budapest could not be better - we meet as the new European cycle rapidly approaches for the 2025-2029 period, with the nomination soon of a new European Commission and with the recently elected new European Parliament.

We talk too frequently, do we not, of inflexion points, key, pivotal moments...etc but this time it does seem to me we are really at a moment in European political history when crucial decisions are needed about the future. When effective European political plans need to be agreed and implemented urgently because the waves are lapping at our doors and the lions are circling. In short the plurality of risks to the European Union's future are growing in depth, scope and size every day.

In my lifetime I cannot recall a more dangerous geopolitical context facing the European Union in the post-war period. The war in Ukraine, 2 years on with no signs of it ending ; the highly dangerous tinder box in the Middle East with all-out war an explosive possibility; the increasing tensions in Asia with Chinese expansionism, North Korean aggression; very serious daily environmental degradation; and the crucial U.S Presidential election in early November which, depending on the outcome, could result in a spat of ugly EU-U.S tension, about NATO defence and trade to name but two.

Faced with the sum of these and other major challenges, such as immigration and Europe's ageing population there are two ways forward for the European Union : determined political, economic and social progress or stasis and fragmentation, an EU battered between the political and economic forces of the other great global powers. In fact, the world wants a strong, balanced European Union, able to play its rightful role in the world.

All the detailed background papers produced by Didier and his team for EUROFI Budapest show, unequivocally, that the European economy is underperforming its major competitors, in some areas alarmingly so. Indeed the analyses show there is virtually no area where the European economy is ahead - in macroeconomic terms, finance, industry, technology.... EU long-term investment is lagging and behind the curve; productivity is static ; Eurozone public debt continues to grow unsustainably, a trend, which if not curtailed, could at worst, undermine the future stability of the euro.

The challenges then are immense and growing. They will not be fixed by tinkering at the margin, opting for the lowest common denominator, slow co-decision ping-pong among EU institutions nor punting the problems into the long grass for future generations to tackle, and yes ....pick up the bill.

So as the new European cycle begins, we surely need a renaissance of political courage and honesty to face up to the risks and challenges the European Union faces. Not easy by any means, but history shows not impossible either.

To illustrate just the magnitude of the capital expenditure challenge facing the EU, that for just one of the so-called mega Magnificent 7 U.S companies, their mainly cloud and AI investment for the quarter to June 30 hit $19bn, nearly 80 per cent higher than the same period a year ago, with a forecast of $70bn to $84bn for the 2025 financial year. Massive figures. Where are the EU equivalents ? All the Magnificent 7 were small companies at one stage in their life. The U.S capital markets propelled their rapid growth. The EU has produced nothing comparable and is simply not developing, through its capital markets, world-beating companies. This is a major, on-going failure. In fact many of our best prospects leave the EU to seek financing and better valuations in the U.S.

To briefly focus further on financial matters, Banking Union is completely blocked and paralyzed by a lack of trust. This hampers the logic of cross-border banking and economies of scale. Host countries need legal and effective assurance and insurance in case of banking collapses. Without banking union the EU's primary financing arm, the banking sector which accounts for over 70% of EU finance, is hobbled, its productivity and profitability seriously compromised, not helped by a crippled EU securitisation market. And the dynamic, clustering, scale effects of banking and capital market unions are lost in the ether magnifying the competitiveness gap with the United States. Banking, in relative competitive terms, is far more important to the EU than the U.S.

As for Capital Markets Union, in spite of major efforts for the last decade or more, the glass is barely half full. In my editorial for EUROFI, Gent in February this year I made the following points, and I stick by them today:

1. Delivering CMU, BU and improved EU financial competitiveness will not happen without much stronger, hand-on political support at the highest level by all the EU institutions. A TriPartite political agreement should be signed and ruthlessly delivered.
2. The European Commission should carry out a Financial Checchini report to demonstrate, once and for all, intellectually and robustly that these projects will benefit the economies of all Member States.
3. A small number of cross-border infrastructural mergers need to be triggered to dynamise market forces and to convince international investors that the benefits of a single financial market are underway.
4. Set some bold financial technology targets, on AI, T+1, robo-advice etc.
5. Define a smaller number of major legislative initiatives for the next cycle and carry out thorough legislative cross-sectoral competitiveness checks. Among the priorities should be securitisation reform, delivering efficient pan-European pension products, insolvency reform and sorting out withholding tax procedures…
6. Reform the Governance of the EU Financial institutions, notably the European Supervisory Authorities, along the lines of the ECB's governance model so as to enhance European decision-making, ensuring that all major, cross-border systemic risks are managed at the European level in the future.

A plethora of reports from the European Council, European Finance Ministers, Enrico Letta, Christian Noyer and others have all underlined the vital nature of integrated, dynamic capital and banking markets for EU economic growth. We await to see President Draghi's report and the priorities he will highlight.

In President Von Der Leyen's political guidelines for the next Commission we read that the Commission "..will develop a proposal in the Letta report for a Savings and Investment Union…" although few details are supplied. Among the benefits it is stated could be that these projects could attract €470 billion of investment to the EU.

I would go further and say that without integrating the EU's Capital Markets, delivering Banking Union and controlling public debt, the EU's growth prospects will continue to be sub-optimal, possibly substantially so. Without sustained economic growth all the other laudable projects listed in the President Von Der Leyen's' Political Guidelines mentioned may well be at risk.

Creating pan-European market depth, liquidity, dynamic cross-border capital market and bank trading are the sine-qua-non for enhancing European growth. Markets that must be properly regulated and supervised at European level in line with the subsidiarity principles of the Treaty.

This can be done. The missing ingredient is the political will. It is now more urgent than ever to find it and deliver.

Q&A

MIHÁLY VARGA

Minister of Finance, Hungary

Competitiveness always grows out of cooperation

What are the main priorities of the Hungarian Presidency in the economic and financial areas?

The Hungarian Presidency will devote particular attention to reinforcing the EU's global competitiveness, and thus, the well-being of European citizens. These uncertain and turbulent times increase geopolitical tensions and bring in longstanding structural economic challenges. All these call for timely, coordinated and tangible policy responses. In economics and finance we plan to focus on areas where EU action has real added value in promoting macroeconomic stability and increasing the resilience of our economies.

In the light of these ambitions we are now putting the new economic governance framework (EGR) into practice. The Hungarian Presidency is committed to facilitate smooth implementation of the new set of fiscal rules in this transitional year. In line with these new rules, we will also launch the next cycle of the European Semester. Hungary remains committed to facilitate the implementation of the Recovery and Resilience Facility. In this field we intend to ensure timely approval of the modified national programmes.

Building on the achievements of previous presidencies, we will continue the negotiations on all seven ongoing legislative dossiers. In line with the guidelines of the European Council, we advance discussions on the Capital Markets Union. The expected Draghi report might be a valuable contribution in that context. The Hungarian Presidency also aims to start trilogues with the EP on the Retail Investment Strategy (RIS), on the Crisis Management and Deposit Insurance (CMDI), and on the Benchmark and Reporting Requirements Regulations frameworks. Concerning the latter, we see a good chance to reach a political agreement soon.

We will also continue working on the Financial Data Access (FIDA) and Payment Services Packages. Concerning the digital euro package we need a more cautious approach. We will work with the Member States on reflecting better on the text and the goals.

As regards taxation, we will take forward measures aimed at consolidating member state budget revenues. This basically means effective actions against tax avoidance and aggressive tax planning structures. Finally, competitiveness of European businesses can also be increased through digitalisation, the efficient use of information, and simplification.

What are the main reasons why Europe's economic performance has fallen behind that of its global competitors, particularly the United States, over the last fifteen years? What priorities should Europe focus on to enhance its competitiveness?

There are several factors that have contributed to growing the competitiveness and productivity gap between the European Union and its global competitors.

A certain part of the difference is coming from our different economic structure. The US has a very strong ICT sector with digital giants. Europe's global presence is much weaker in the digital industries and in other emerging sectors linked to the technological transformation and green transition. On the other hand, in traditional manufacturing sectors of Europe, including the car industry, productivity growth has recently decelerated.

The innovation gap between the EU and the US is also widening. Europe is heavily lagging behind in such emerging sectors as AI, big data, cloud computing, cybersecurity, robotics or microelectronics.

Apart from that the problem of ageing is present in most developed regions of the world, but the EU is in the worst position. In 2022 the median age was 44 years in the EU, while in the US it was 39. The shrinking workforce affects our economic potential, hindering competitiveness and productivity. In relation to this, there are also challenges in human capital

formation. This involves Europe's scientific excellence as well as its general educational performance.

Compared to our major competitors, the EU is more vulnerable to supply chain disruptions, notably linked to raw materials, batteries and semi-conductors. And due to our geographical proximity, the EU is more affected by current regional crises such as the Russian – Ukrainian war or the conflict in the Middle East. We are more severely affected by higher energy prices, especially compared to our competitors.

In order to increase the innovation and growth potential of Europe, these underlying problems need to be effectively addressed.

At this stage, NGEU, Europe's response to the IRA and Member State public spending have not significantly boosted productive investment. What are the reasons for this and what additional or alternative measures may need considering to improve Europe's competitiveness?

Public spending and direct subsidies are insufficient to address some of the root causes of Europe's competitiveness problems. In order to achieve a breakthrough, the various financial interventions need to be coupled with accurate framework conditions.

First of all, the heavy burdens on European businesses must be reduced. This involves the topics of complex regulation, high taxes, and extensive bureaucracy. The establishment of a competition and a business-friendly environment is key to economic success - as we practice this in Hungary. The EU's financial programmes are equally affected by excessive administration. Concerning the Recovery and Resilience Facility, this issue was acknowledged by both the Commission and the Council of the European Union. The Belgian Presidency has already made significant efforts to reduce the administrative burden by 25% through streamlining and coordinating reporting standards within different pieces of legislation. We also stand ready to constructively cooperate on such initiatives.

Long-term economic stability also requires the restoration of fiscal discipline in highly indebted countries. However, this alone may not be sufficient to boost growth. Structural reforms, investment in human capital and innovation are also critical for sustainable growth.

In Europe, in order to improve our competitiveness, it is our common interest to avoid a subsidy race or a trade war. Rather than decoupling, it is essential to keep a strong trade and investment relationship with dynamically developing economies such as China. This also affects our energy policy. Inexpensive and secure energy supply presupposes stronger integration of the European energy markets. We need to expand our energy networks including renewables and nuclear power, and need more funding for research in these fields.

Finally, the EU needs to adopt a genuine industrial policy. Hungary has set itself the goal of reindustrialisation and is investing heavily in this area in order to increase competitiveness and reach a sustainable growth path. We focus on industrial development linked to decarbonisation and electro mobility. In order to reduce Europe's dependency on imports, the establishment of EU owned battery factories and chip producing facilities must be encouraged.

10 years after the creation of the Single Supervisory Mechanism and 9 years after the launch of the first CMU action plan, European banking and capital markets remain fragmented. Should more be done to integrate and develop financial markets in Europe and what should be the way forward?

The Banking Union and the Capital Markets Union are really important initiatives for the single market. I believe that the EU has made progress with these initiatives. After the Single Supervisory Mechanism, the Single Resolution Board has been established, the first CMU Action Plan has been followed by the second Action Plan, and convergence in the single market has continued to develop. The banking and financial sector in the EU is one of the most integrated and harmonised policy areas compared to other issues in the EU. The level of integration is also very high in a global perspective. In fact, the EU is in many respects a standard setter for financial regulation worldwide. But there is room for improvement, we need to reduce fragmentation.

It is important to take into account the differences between the banking and capital market sector. We need to focus on local specificities, because the local markets are oriented by them. In general context, the level of development of the market, the market structure, the financial literacy are key, but these aspects manifest differently in the banking sector and in the capital market sector.

There are initiatives that are always surrounded by political debate and it is almost impossible to make progress. We need to avoid to put so much effort in such initiatives, instead we need to focus on policy areas that are in the common interest of Member States and the consensus is easy to reach.

Q&A

GYÖRGY MATOLCSY

Governor – Central Bank of Hungary

Time to rethink economic policies

Has Europe fully reaped the potential benefits of the single currency and single financial market over the past 30 years? What are the key challenges the European economy must address going forward?

Europe celebrates the 25th anniversary of the introduction of the single currency in 2024. During this quarter of a century the euro has provided a symbol of unity through incredibly testing times, and motivation to support each other through the darkest of hours. The single currency has shielded the member countries from external shocks. In the shadow of the decades of crisis, the great achievement is the existence of the euro. The euro was born at a good time, but it is not certain that it will experience good times, as economic difficulties and crises affecting the eurozone pose challenges to the common currency. Although the number of countries using the euro has risen from the initial 12 to 20 in the past 25 years, there remains much cause for debate due to the region's results in terms of economic development, competitiveness and cohesion. The facts indicate that the euro area is still lagging behind in the global competition compared to other regions. The weight of the euro area has fallen within the global GDP from 21.8 percent in 1999 with 12 member states to 14.7 percent in 2023 with 20 member states. The 12 founding countries achieved an average annual GDP growth of 1.5 per cent in the last 25 years, less than the over 2 per cent figure achieved by the United States of America.

Boasting an outstanding performance throughout its history, Europe is falling increasingly behind in terms of innovation, with a particularly prominent lag in terms of the growth in intangible investments and productivity. In the two decades since 2004, US productivity growth, as measured by the value of output per hour worked, has been more than double that of the eurozone. Whereas eurozone productivity has flat-lined and even fallen slightly since the outbreak of the COVID-19 pandemic, US non-farm output per hour has risen by more than 6 percent over the same period. Demographic trends in Europe are worsening, compounded by the failure to effectively adapt artificial intelligence technologies. There are significant labor market imbalances, with a notable East-to-West migration of the workforce and increasingly divergent fiscal policies across member states.

Europe still does not fully utilize the benefits of the single market, despite the fact that European consumption is high in international comparison. Therefore, it is important to strengthen connectivity in individual markets, financial markets, consumer markets, and infrastructure. There are key technologies in which progress must be made for Europe to continue developing, such as finance, which is one of the most important innovations of the 21st century. A financial system needs to be developed that can allocate savings quickly, securely, and efficiently.

This alongside with the megatrends emerging in the 21st century, pose significant challenges to government budgets, which means that their role must be fundamentally reconsidered. The green and digital transition is of paramount importance but cannot be implemented without budgetary commitments. Also, the changing geopolitical landscape and the increasing need for security lift the expenditures on security and defence. Finally, ageing societies and higher interest rate environment will automatically increase social and interest expenditures. We should strengthen competitiveness and ensure sustainability at the same time in both advanced and emerging countries. In this regard, a positive change of the new EU fiscal framework is that the national medium-term fiscal structural plans can take country-specific factors into account to a greater extent and more relevant factors are accounted for (national defence spending, increase in interest expenditures, structural reforms).

What are the main economic challenges facing the CEE region, and how are they evolving? What are the key medium- and long-term public policy objectives for promoting growth in the region?

In 1999, the development level of the CEE region, measured by GDP per capita as a percentage of EU average was only 47.8 percent. By 2004, this figure had risen to 56.5 percent, and by 2023 it had increased to 78.3 percent. The pace of economic convergence was different among these countries. Czechia, Slovenia or Lithuania have already approached or exceeded 90 percent of the EU average GDP per capita level, while others have been at the top of middle-income status.

The challenges of the 2020s made it clear, that the European Union must follow the formula of balance and growth. Extensive growth models of the 20th century cannot be continued in the 21st century, a transition to an intensive growth path is required, the competitiveness is the key to the future. Due to the narrower monetary and fiscal room for maneuver, the role of structural policies has increased in value.

- In the light of demographic challenges globally, the importance of quality workforce has increased remarkably. Investments in high-quality education, lifelong learning and digital skills are inevitable to develop human capital and strengthen the quality of workforce.
- We must build our own future. Instead of the quantity of investments, emphasis should be placed on the quality, as smart and green investments are keys to winning the next decades and to increase our competitiveness.
- The future is green. High energy consumption and imports are unsustainable, expensive and cause vulnerability. We must strive for energy sovereignty and a competitive energy mix based on internal renewable energy sources in the EU, and particularly in the CEE region. 9 out of the EU's 10 most energy intensive countries are located in the CEE region. MNB was the first European central bank to obtain a green mandate to encourage and lead the economy and the financial system onto a climate-friendly path.

The CEE region possesses significant growth potential and could serve as the engine of European growth in the future. Kenneth Rogoff, professor at the Harvard University also highlighted the growth potential in the CEE region. According to Rogoff, the CEE region holds significant promise due to its economic reforms, integration into the European Union, and relatively high growth rates compared to Western Europe. Rogoff has pointed out that these factors collectively contribute to the region's potential to drive economic growth within Europe, indicating its emerging role as a key growth engine for the continent.

What is the expected impact of EU initiatives such as NGEU, CMU, and digital and green policies on growth in the CEE region? Are these initiatives well-suited to the specific needs of the CEE region and are additional initiatives required?

The goals of the NGEU are appropriate, yet the speed of execution and the political threads that appear as a condition of use do not support a quick economic recovery.

Hungary supports the deepening of the Capital Markets Union (CMU). Some progress has already been made in the CMU initiative, but further work is needed. In this context it is crucial for Hungary to focus on the development of smaller European capital markets too. For the improvement of retail participation in the capital markets, we believe that reducing regulatory and administrative burden and increasing financial literacy are key drivers. There are significant private savings within the EU, estimated to be around EUR 33 trillion. It is important to effectively channel these savings into productive investment that creates innovation and drive economic growth. Furthermore, it is important that the investments being realized take into account not only the interests of the larger countries but also those of the smaller ones.

Digital and green policies drive the region's transition to a digital and sustainable economy, modernizing industries and promoting renewable energy. This will be key in the current and the next decade, hopefully the CEE region will become a European hub in the GreenTech and the CleanTech industries.

However, to fully realize all the economic opportunities, additional measures are needed, such as targeted regional funds, sector-specific investments, capacity building, skills development, and strengthened institutional frameworks. These tailored initiatives will address the unique challenges and opportunities within the CEE region, ensuring comprehensive and inclusive growth.

Q&A

VALDIS DOMBROVSKIS

Executive Vice-President for an Economy that Works for People, with responsibility for Trade – European Commission

Staying competitive in a changing world: building a Europe fit for the future

What are the key challenges affecting Europe's competitiveness? How can they be addressed and what are the priorities for the next Commission in this regard?

Improving Europe's competitiveness is a longstanding challenge.

Our productivity growth has been lacklustre for many years. We are facing structural challenges such as ageing and more recently, geopolitical uncertainty. Also, in the context of the green and digital transitions, we must ensure that we sustain our competitiveness.

We need to do more to improve global conditions for competition, strengthen our innovation capacity, reduce labour and skills shortages, as well as address EU companies' high energy prices and improve their access to financing.

For the next Commission, the 2024-29 political guidelines show that its first priority will be to boost the EU's sustainable competitiveness and prosperity. They include a wide range of initiatives that will together substantially boost the competitiveness of EU companies.

Above all, this involves strengthening the single market, and completing it in areas such as services, energy, defence and finance, to unlock its potential for innovation and growth.

Investments and reforms such as those supported by the Recovery and Resilience Facility, are paramount, both now and in the coming years.

Our companies also need the right conditions to flourish. This means making it easier and faster to do business in Europe: in a transparent environment, with legal certainty and underpinned by simple, smart and targeted regulation.
This will help to unlock the innovative investments needed for the EU to remain competitive. However, innovation requires a lot of risk capital, which is why we need stronger and more integrated capital markets since the bulk of the funding will have to come from the private sector.

Financial markets integration will remain firmly on the agenda for the next mandate, particularly with a proposal for a European Savings and Investments Union as recommended in the Letta report. As part of its proposal for a reinforced budget in the forthcoming multiannual financial framework, the next Commission will prioritise research spending and include a European Competitiveness Fund. It also plans to boost and refocus skills funding.

How is economic convergence evolving in the EU and how can it be improved? What can be expected from the revised EU fiscal rules?

Each crisis puts EU convergence at risk. In the two decades before 2019, we managed to reduce the dispersion in per capita GDP across the EU. While the pandemic and Russia's war against Ukraine partially undid this progress, we must still be serious about addressing convergence. Countries in central and eastern Europe, as well as the Baltic States, are more affected by the war in Ukraine and this entire region needs our support.

Convergence needs to be supported by policy. This is where EU instruments play an important role, such as cohesion policy funds and the Recovery and Resilience Facility.
For example, the RRF has provided more funding to vulnerable Member States hit hardest by the pandemic. This gave extra impetus to strengthen the EU's economic convergence.

Overall, macroeconomic imbalances in the euro area have reduced over the last years. However, fiscal positions have become more divergent.

Pursuing gradual fiscal consolidation where debt is high, along with investments and reforms, will be vital to address

the causes of divergence, build up resilience to shocks, and improve productivity by allocating resources more efficiently.

This is the key objective of the revised EU fiscal rules.

All Member States must present medium-term fiscal-structural plans. For those with fiscal sustainability challenges, it is important that their plans set out how they will adjust in a realistic, gradual and sustained way, while protecting growth-enhancing spending.

The Commission is working intensively with Member States so that they can submit plans on time and start putting them into effect from 2025.

Sustained convergence will also be underpinned by deepening the single market.

Creating a Savings and Investments Union is vital for making the EMU more resilient. The resulting stronger economic, fiscal and financial integration could support real convergence and make it sustainable over time.

How to explain the lack of productive investment in Europe during the past years and how can it be increased? What can be expected from NGEU in particular?

The EU's productivity growth has slowed since the early 2000s and still lags behind that of economies such as the United States and China.

We are also far off our 3% GDP spending target on research, development and innovation.

There are several ways to boost productive investment – for example, by reducing administrative burdens, incentivising R&D investments, removing barriers to the single market, as well as creating attractive and supportive business environments.

NextGenerationEU is a good example.

It has the potential to boost real GDP in the EU by up to 1.4% in 2026, raise employment by up to 0.8%, and increase raise real wages in the medium term.

Its centrepiece instrument, the Recovery and Resilience Facility, allows for public schemes to be created that stimulate private investment and develop capital markets.
For example, Spain will channel €76 billion to incentivise private investment in key areas. These include a regional fund to support public and private entities to invest in social and affordable housing, urban development, sustainable tourism and the energy transition.

Italy is stimulating private investment via several channels. As part of its national recovery plan, it is providing companies with tax credits to finance assets linked to specific policy objectives such as digitalisation and energy efficiency.

More broadly, we are trying to limit the high amount of administrative work - especially unnecessary burdens - that is required for Member States to implement the RRF.

What are the key priorities for enhancing the integration of EU banking and capital markets? To what extent are the Banking Union and Capital Market Union initiatives complementary?

Deeper integration of Europe's banking and capital markets is vital for unlocking Europe's sustainable prosperity and competitiveness. This is at the core of the European Savings and Investments Union announced in President von der Leyen's 2024-29 political guidelines.

EU banking and capital markets have a vital role to play to ensure our long-term economic growth. Firstly, by making sure that our banking system is sound and resilient; secondly, by deepening EU capital markets and broadening options for our companies to access resources.

On financial services more specifically:

Strong banks operating across the EU single market can provide better and cheaper banking services and products, allowing investors and banks to allocate funding more efficiently.

Deep and integrated capital markets would reduce the EU economy's reliance on bank funding; facilitate financing for innovative companies, especially mid-caps; help to diversify financial risks and reduce the probability that European companies relocate abroad at the IPO stage or earlier.

It is possible, and also desirable, to advance on banking and capital markets integration at the same time. This would greatly increase the ability of EU companies to raise financing, as well as boost their competitiveness and that of the EU economy as a whole.

Developing a true Savings and Investments Union would be facilitated by a more integrated market for banking services.

Banks operating on an EU-wide scale are the necessary vehicle to exploit economies of scale and provide the essential services to develop a single European capital market, such as trading and listing activities, investment banking, treasury, and depository services.

Developing a European Savings and Investments Union will be a priority in the next mandate as a way to unlock financing: we need to sustain the EU's growth and competitiveness as well as the green and digital transitions.

Q&A

SHIGERU ARIIZUMI

Vice Minister for International Affairs – Financial Services Agency, Japan (J-FSA)

Building a more resilient economy: a robust insurance sector and sustainability

What are the key risks, trends facing the global insurance sector and the related priorities for the IAIS for the coming years?

The IAIS assesses emerging risks and trends in the insurance sector through the annual Global Monitoring Exercise (GME). In July, the IAIS published preliminary findings of the 2024 GME in a mid-year Global Insurance Market Report (GIMAR). The interim results show stability in the insurance sector.

The 2024 GME will cover two risk themes that are top-of-mind for supervisors:

- The first theme is on interest rates, liquidity and credit risks. The global economic growth could be negatively affected by factors such as prolonged high interest rates and high level of debt. We will look at transmission channels from geopolitical risks, second round effects from commercial real estate exposures, debt sustainability of fixed-income assets and the impact of digitalisation and AI on the insurance sector.

- The second theme is on structural shifts in the life insurance sector and covers two elements: First, the impact of growing investments by insurers in alternative assets. Supervisory concerns could include: discretionary valuation of assets; liquidity risks; hidden leverage; credit risk; and transactions with affiliated parties. Second, the growth in cross-border asset-intensive reinsurance, whereby a material part of an insurer's investment risk is transferred to the reinsurer. Supervisory concerns could include knowledge gaps regarding non-domestic prudential frameworks, limited information exchange and potential conflicts of interest within corporate structures. Possible financial stability risks include concentration risks at the jurisdictional and reinsurer-level, as well as potential herd behaviour amongst insurers.

- A more comprehensive update will be included in our December 2024 GIMAR and in an Issues Paper that we aim to receive public consultation on in the first half of next year.

- Additional focus areas for the 2024 GME are operational resilience to cyber risk and climate-related risks. In August, the IAIS published for consultation an Application Paper on objectives for supervisors to support insurers' operational resilience, including cyber resilience. The IAIS will also publish a GIMAR special topic edition next year on the potential financial stability implications of natural catastrophe protection gaps.

For the period 2025-2029, the IAIS will remain vigilant in its assessment of key risks and trends impacting the global insurance sector and will continue to enhance its GME and strengthen the link between its risk assessment and globally coordinated supervisory responses.

What are the main challenges for the adoption of IAIS standards (ICS) at the global level and the outcome of the IAIS process to achieve an effective consistency in this area?

The IAIS is currently finalising the global solvency standard for internationally-active insurance groups, the Insurance Capital Standard (ICS). We remain on track with respect to the timelines for finalization. With the ICS clearly in sight for adoption in December, the IAIS set high-level timelines to assess the comprehensive and consistent implementation of the ICS across jurisdictions. These timelines recognise that it will take some time for jurisdictions to finalise necessary regulatory and supervisory changes to align with the ICS, taking into account jurisdictional circumstances. For the IAIS to prepare for implementation assessment:

- The ICS implementation assessment will follow a two-step approach. In 2026, the IAIS will coordinate a baseline

self-assessment by IAIS members of their progress in implementing the ICS, which will be a foundation for future implementation progress monitoring. The IAIS will aim to start in-depth targeted jurisdictional assessments in 2027.

- In preparation, the IAIS will begin developing an ICS implementation assessment methodology in 2025, leveraging the IAIS' general principles and methodologies for assessing its standards, while considering the quantitative nature of the ICS. It will specify an appropriate level of granularity and articulate the quantitative and qualitative analyses to be used in the assessment.
- The IAIS is beginning work to define the need for and scope of any future ICS-related data collection from insurance groups and group-wide supervisors that may be needed to facilitate the consistent implementation of the ICS. Any such data collection would be more targeted than the data collection undertaken during the monitoring period, which supported the development of the ICS. It would continue to be voluntary, and coordinated with the data requests made in other areas of IAIS work, to avoid any duplication.

What are the views at the international level on the transition path and the balance between market-driven transition and formal transition policies? How is Japan managing these dynamics?

- While transition finance, which Japan has advocated from the very beginning at the G20, has gained broad support globally, its operationalization remains a challenge.
- This is particularly because transition paths could vary depending on the policy frameworks the government puts in place reflecting the national net-zero target, while benchmark pathways, through which the credibility of each corporate transition plan would be assessed, are often framed on a global basis.
- Simply put, we need to be ambitious in our aspiration but practical in our approaches. In this regard, market-driven transition and formal transition policies should work in tandem, complementing each other.
- As such, formal transition policies should anchor the direction of market-driven transition with certain safeguards. The government can demonstrate its commitment with a high-level of ambition through formal transition policies, including regulations, tax incentives and subsidies. A market-driven approach can also be a powerful tool, using the private sector's appetite for innovating energy and industrial processes towards net-zero.
- The view within the Japanese government is that collaboration among stakeholders provides a useful basis for a sustainable path towards achieving net-zero. The government has published the Green Transformation Strategy and sectoral road maps, thereby providing national benchmark transition pathways for industries. It not only outlines future transition paths but also includes necessary public support, even for SMEs, for easier transition planning. The FSA has issued guidance encouraging financial firms to engage with clients to better support them in achieving their climate goals. These multi-faceted, on-the-ground, practical approaches will help create a fusion of formal transition policies and market-driven transition approaches.
- In addition, Japan has started to exchange views with ASEAN countries on how to operationalize transition finance, for example, by identifying good use cases. Given Asia's large GHG emissions, such regional approaches can help to consider Public Private Partnerships and to reflect on targeted flexible approaches of regulatory frameworks on climate-related risks.
- We should steadily advance efforts even against geopolitical tensions and inflationary pressures. However, we also must be mindful how it fits into our overall macroeconomic policy management. Ambitious targets but practical approaches will be needed to achieve a sustainable path towards net-zero while avoiding sustainability fatigue.

How is Japan addressing the challenges posed by the lack of definition of financial sector climate change transition plans and the need to align them with the national transition plan?

- Financial institutions (FIs) can play a pivotal role in encouraging real economy corporations to transition to net zero, even though direct GHG emissions from FIs might be insubstantial. This important role of the financial sector could be well supported by the deployment of transition finance.
- Japan has developed its national transition finance framework in line with its commitment to net zero by 2050 and consistent with its NDC and other policies. The framework is comprised of guidelines and sectoral roadmaps, as described in Q3.
- These efforts are expected to help reach a closer alignment of private sector transition plans (TPs) with the national TP.
- In this regard, for real economy corporations, TPs are often a strategy document. But, while TPs are used for various purposes, for FIs, ensuring the implementation of a credible TP by their clients may also lead to their management of climate-related risks. This will not only reduce immediate transition and physical risks at their portfolios but also ultimately bring down risks for the whole system.
- One of the candidates for FIs' TP metrics is financed emissions. Given its backward-looking characteristics, however, we need to find a set of forward-looking metrics that can measure how financial activities, ranging from provision of finance to engagement with clients, contribute to emissions reduction and alignment of clients' TPs with net zero goals.
- Building on the above-mentioned guidance, the FSA aims to develop an effective monitoring framework for climate-related risk. This framework will emphasize the dialogue with FIs to identify the progress on how they manage climate-related risk through supporting clients' alignment of its TPs, ultimately reducing climate related risks for the whole financial system.

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Q&A

MÁRTON NAGY

Minister for National Economy, Hungary

We must find ways to restore the economic and financial competitiveness of Europe

What are the primary objectives for revitalizing the European financial services sector and improving its competitiveness vis-à-vis US and Asian financial institutions?

In the last 4 years, our continent's economic perspectives have been highly influenced by turbulences deriving from the international environment. First the COVID 19 pandemic, then the Russian-Ukrainian war have generally elevated risks and uncertainties, the subsequent energy crisis has created an environment, in which European companies will have to pay energy prices 4-5 times higher than American corporations on a permanent basis.

The aforementioned crises have amplified the long-standing competitiveness struggles of Europe, which is easily traceable among most indicators. Let me mention three of them. First, Europe's share in the global GDP has shrunk more than 6 percentage points in the last 20 years. Second, while in 2018 there were 22 European companies on the list of the 100 biggest global corporations, in 2023 there were only 17. Third, according to the Global Financial Centres Index, last year no more than 6 European cities could be found amongst the 20 most important financial centers, but only 3 of them were located in the European Union.

Although Europe is the cradle of modern banking, unfortunately the drop back of competitiveness in the European financial sector is likewise noticeable. The data clearly indicates, that the development of the European and American banking system is going on two largely diverging tracks since the 2008 financial crisis. From an absolute perspective, the market capitalization of European banks almost got halved – dropped from 2700 billion dollars to 1400 billion – between 2007 and 2021, meanwhile their American competitors' grew by more than 60 per cent during the same period. The differences are also evident on a relative basis. While the Stoxx 600 Banks composite index of American banks has caught up to the pre-crisis levels by 2018, its European equivalent has barely moved upwards from the rock bottom levels of 2009 ever since. The European banking system lends significantly less to the public sector than overseas banks, and they allocate funds more costly and less efficiently.

Hungary was amongst the first ones that attempted to raise awareness on the competitiveness issues of Europe. From the 1st of July Hungary began its six-month rotation presidency of the Council of the European Union. As one of the cornerstones of our Presidency, we will present a New European Competitiveness Deal, which places a great emphasis on holistically facilitating the conditions for sustainable growth, supporting small and medium-sized enterprises, and furthermore promoting green and digital transitions.

I believe it is clear, that no competitive economies exist without a competitive financial system, therefore we must dissolve the bottleneck characteristic of the European financial system, which currently faces substantial limits in innovation. We must continue to be the pioneers of the sustainability and digital transformation of the global financial sphere, as these areas will be crucial preconditions of generating future competitiveness. Regulatory efforts must facilitate the development of efficient financial products from the banks' side and the preparation of clients, both corporations and retail clients, for the rapidly changing environment.

What are the priorities to move the single financial market forward?

The single financial market is one of the most valuable assets of the EU, as it ensures resilience in times of crises and it is also a great tool to address strategic dependencies. Moving it forward involves setting several key priorities to provide a clear response to the challenges of our time. Our continent is lagging behind its global competitors, therefore the Hungarian Presidency will place a strong emphasis on improving the competitiveness of the EU, integrating this objective into all

policies, applying a holistic approach, taking into account the different characteristics of Member States and respecting national competences. We have identified five priorities to move forward the single financial market: 1. Determine the future of Capital Markets Union. 2. Improve the resilience of the financial sector. 3. Address the challenges and opportunities of digitalization. 4. Promote sustainable finance. 5. Increase consumer protection. However the successful implementation of these priorities must consider the regulation gap that often hinders consistent application across the Member States. Therefore, bridging this gap is essential to ensure a harmonized approach that can effectively support innovation and address the changing demands, while respecting national practices. To keep up with our global competitors, we need to integrate these considerations into adaptive regulatory frameworks that requires the openness and cooperation of Member States and the European Institutions as well. The implementation of the Strategic Agenda 2024-2029 should lay a sustainable foundation for future growth and stability, addressing immediate challenges to reinforce the EU's position in the global economic area. The Hungarian Presidency will promote dialogue about EU-level solutions to move the single financial market forward by creating a flexible, yet cohesive strategy that respects national competences.

Can the Banking Union and Capital Markets Union deliver a well-functioning single financial market in the EU? What are the synergies between these two initiatives and what are the conditions and game-changers for their success?

It is important to highlight that the financial system in Europe is predominantly bank-based. While the banking industry has made significant progress, the capital markets of the EU still require further development. To achieve a well-functioning single market, it is essential to advance both these areas simultaneously. The Banking Union and the Capital Markets Union represent two distinct approaches, yet both are crucial.

The simultaneous approach I outlined arises from the synergies between the Banking Union and the Capital Markets Union. Improvements in one area have a positive knock-on effect on the other. Market confidence is a crucial factor in this regard. The confidence gained by one area has a positive impact on the other. It is therefore important not to neglect any of these areas.

With regard to the conditions and 'game changers', I would like to make a few general observations. It is crucial that the conditions and "game changers" are based on accurate and reliable information. It is of greater consequence to focus on quality rather than quantity. We need to conduct a comprehensive analysis of the current situation and to take into consideration the outcomes of the ongoing initiatives in order to assess them.

I would like to draw attention to two key aspects: the reduction of administrative and regulatory burden, and the enhancement of financial literacy. The mentioned burdens can present a significant obstacle, as they can increase costs and prolong processes. Financial literacy is crucial for Hungary, it is part of the national curriculum and I believe plays a pivotal role in boosting confidence. In the current era, the prevalence of fraudulent activities in the financial markets is on the rise which can undermine confidence. It is imperative that we dedicate ourselves to combating these illicit practices. I want to highlight that Hungary is taking significant steps to combat financial sector fraud, and I encourage everyone to do so.

What are the main strategic autonomy challenges in the retail payments market? What are the implications of electronic and instant payments in this regard?

We promote European retail payment solutions that are safe and efficient for society, and it aims to meet the rising challenges to European sovereignty in the payments market. The main goals are to reduce our dependence on non-European payment service providers, to develop pan-European solutions for payments at the point of interaction, with these solutions governed at the European level, and to further strengthen the Single Euro Payment Area, primarily through the full deployment of instant payments.

Digitalisation, changing consumer habits and legislation are impacting retail payments. Electronic retail payments are increasingly being transformed from bank-based payment services, to commercialised payment solutions. The rise in the use of digital payments has also been spurred by the COVID pandemic, with the continuing shift to cashless payments.

While the European payments market's openness to global competition is crucial for fostering efficiency and innovation, an overdependence on a small number of non-European payment solutions and technologies is undesirable.

The dossiers and regulations under negotiations aim to achieve economic efficiency and strategic autonomy in Europe for retail payments, to make retail payments more resilient and to cater for varying use cases and user preferences.

The new regulation for fast money transfer expands the sphere of payment solutions. It comes with many positive effects but it implies fraud risks as well.

Financial literacy plays a crucial role in comprehending the mechanics of digital transactions with their associated risks and avoiding scams related to instant payments respectively.

Q&A

VITTORIO GRILLI

Chairman of Italy and of the Corporate & Investment Bank, EMEA – J.P. Morgan

The new political cycle brings an opportunity that cannot be missed if we want to achieve a true CMU

How can we achieve tangible progress towards more unified banking and financial services markets during the next European legislative cycle? What are the main obstacles to overcome?

A deepening of the CMU will be achieved through true political will, intensified efforts to finalize the Banking Union and legislation that helps remove the frictions that currently exist in the EU's financial system. I am delighted to see the renewed focus on Capital Markets Union – or a Savings and Investment Union – for the next EU mandate. Reports from Enrico Letta, Noyer (French Tresor) and ESMA on how to develop the Single Market have indeed put a strong focus on the need to continue our work on the CMU, and it will be interesting to see the specific recommendations from Draghi to increase EU's competitiveness. An equilibrium will have to be found balancing the open strategic autonomy while increasing EU's financial resilience and allowing for cross-border market financing.

Recent geopolitical events and banking turmoil have become ongoing reminders that our financial system is not perfect, and needs all countries within the Union to accept the efforts being made to de-risk the sector and increase resiliency. In order to increase the support in these projects from the more reluctant Member States, it will be important to ensure Europe is made stronger when it comes to the flow of capital across the Union. A focus on the development of EU-wide standards to banking rules and regulation done in close collaboration with regulators and industry experts will be essential to build trust and belief in these projects. The EU has proven the benefits of a deeply integrated single market for goods, and a similar process should follow in the single market for services, particularly financial services.

The sector has seen good progress achieved in recent years, especially the creation of the single supervisory and resolution mechanisms. Indeed, the recent proposal to strengthen rules for bank crisis management and national deposit guarantee schemes (CMDI) is very welcome and EU policymakers should seek to find a common position during upcoming trilogue discussions as a priority for the new political cycle.

What are the synergies between Banking Union, Capital market Union and the single market for financial services? Is it possible to simultaneously progress on these three projects or is one a prerequisite to the others?

A true Capital Market Union requires a Banking Union and an integrated and frictionless single market. Considering the amount of work that remains to be done in order to achieve the three, moving ahead simultaneously on all issues would be greatly beneficial to help grow the appeal of the EU's financial markets, as well as build trust and confidence in financial services from consumers across Member States. It would allow for the natural deepening of cross border integration across the Union.

Specifically, it is paramount that the EU develops deep and liquid Capital Markets Union, which would allow free movement of capital and ensure investment is deployed in an efficient way, which in turns increases the economic resilience in the EU. However, the lack of a single integrated market is currently one of the most important barriers preventing EU corporates to scale.

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

Another benefit of such reform would be the fact that it would significantly free up capital in bank's balance sheet. This increase in capital available could be deployed into corporates, making it easier for them to raise capital in the traditional banking system.

Is further integrating its financial markets a key objective for the EU to remain competitive vis a vis the US and Asia? What are the conditions for making progress?

As it stands, the fragmented market in Europe puts the EU at a competitive disadvantage vis a vis other jurisdictions. Idiosyncrasies of the EU, including the diversity in languages, an embedded regulatory patchwork across Member States or the continued difficult movement of services compared to the free movement of goods, makes the EU an difficult union to navigate for financial services.

In the US, on the other hand, corporates can raise capital and scale with less difficulties, regulatory burdens and barriers, which makes it a more attractive market for companies to relocate there if they want to significantly grow. In fact, in the US there are currently around 700 unicorns, versus the 130 in the EU. In addition, even when EU corporates manage to scale within the Union, almost half of the venture capital investment comes from outside of the EU – with the US being one of the largest investors in European deep-tech startups. Therefore, I believe that incentives to achieve a more diversified funding system would also be significantly positive for the EU, together with efforts to increase competitiveness (and therefore attractiveness) of EU corporates, and allow flow of capital in all stages of the life cycle of corporates.

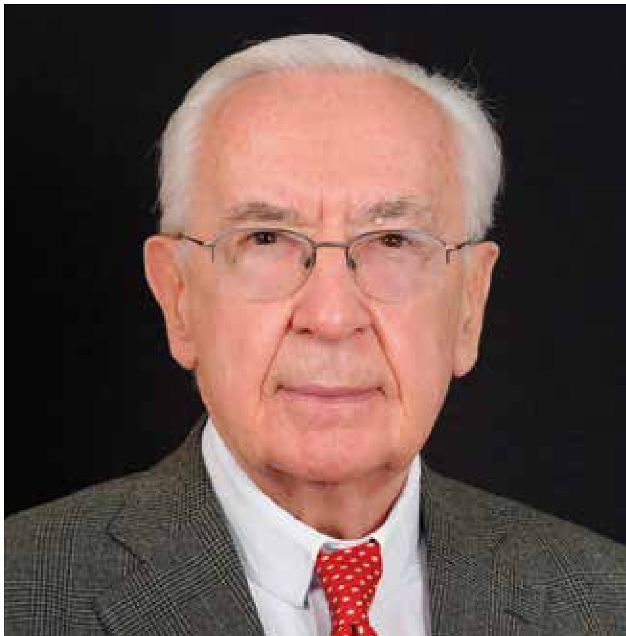
Without suggesting replication, other international comparisons are helpful to analyse as they give an idea about the possibilities that could be unlocked with a successful and integrated financial services market in the EU. For example, securitisation represents 12.5% of GDP in the US (excluding GSEs) and 12% in the UK vs. 3% in the EU-27. We can therefore see the potential that securitisation has in the EU to advance capital markets union and green finance, although it does not mean that the same levels should be replicated in the EU.

The EU should also continue to develop its private markets, both through cross-border investment and scaling up venture capital, as acknowledged in the Eurogroup CMU March Statement. If the incentives are right, the development of private markets would significantly facilitate the raise of capital by corporates at the same time as it would decrease the current dependency that some corporates have on banking funding/ raising capital through debt.

To what extent would the achievement of a true Banking Union and CMU contribute to the advancement of a unified banking and financial market in Europe?

I would firstly like to caveat my answer by reinforcing the idea that we are unlikely to see a moment when the CMU nor the Banking Union are declared "complete". Instead, they will be ongoing processes, with progress depending on incremental steps, continued political momentum as well as the avoidance of 'pitfalls' that could be detrimental to cross-border market financing.

I fully support the EU's ambition to build financial markets capabilities and achieve further market integration, and fundamentally believe that the EU's financial resilience is best achieved through the Capital Markets Union (CMU) and Banking Union projects. By their nature, banking and financial markets increase their resilience and quality through the strength and breadth of their network. A true Banking Union would in fact generate a wide array of benefits across the Union by reducing market fragmentation, developing strength, solvency and resiliency of banks. It would help generate a growth of trust and confidence in financial services where citizens would enjoy more competitive and effective banking structures, which would in turn increase the appeal of investors into the EU, as well as achieve the much needed additional financial integration in the Union. My hope is that we see some additional progress into the Banking Union package in the next political cycle.



Q&A

JACQUES DE LAROSIÈRE
Honorary President – EUROFI

The EMU: what priority for the next five years?

What is hindering economic growth in Europe and how can productive investment be revitalized?

The central issue behind the modest economic growth in Europe over the past 20 years revolves around productive investment. Investment is the lifeblood of competitiveness and productivity. After the global financial crisis, net investment in the United States (US) and Europe fell significantly, but the decline was particularly pronounced in Europe. This has resulted in a sluggish economy in Europe, characterized by a decrease in medium- and long-term projects. These risky long-term investments are less likely to occur when real interest rates are zero or close to zero, as fund holders (savers, investors) prefer to hold liquid assets that they can mobilize at any time.

The environment in the US is very different. The bulk of future financing (long-term investments) is conducted through markets and equity. Although household savings are low in the US, the American financial market is highly developed and global. Significant portions of national savings from EU countries tend to flow to the US, either because interest rates and return on assets are higher or because the prospects for stock market valuation are more attractive to investors.

Acceptance of the risk of loss is at the heart of American financing: 80% of investment in stocks for a typical institutional portfolio. In Europe, the figures are more around 40 to 50%, which already constitutes an improvement compared to a few years ago. Moreover, European regulation tends to favor the holding of bonds over stocks because debt servicing is tax-deductible, whereas dividend distribution is not.

In summary, while the design of regulation in favor of a single financial market is important, addressing the core of the problem requires prioritizing other aspects as well.

What role has monetary policy played here? What can be done to encourage more productive investment in Europe and thus stimulate economic growth?

It is an illusion to think that a highly accommodative monetary policy with real interest rates close to zero or at zero can promote productive investment. As we have seen over the last fifteen years, such a policy results in a shortening of savers' investment horizons, as they prefer to keep liquid and easily mobilizable assets, like demand deposits, due to the lack of returns. A zero-interest rate monetary policy favors speculative bubbles, particularly in real estate. As recently noted by I. Schnabel, real estate investment is predominantly in existing properties to gain from increased valuations rather than creating new spaces, with 95% of real estate investment focused on existing assets.

The disparity between American and European banking systems significantly impacts the effectiveness of monetary policy on productive investments. American banks finance only a quarter of the economy, while in Europe, banks finance three-quarters of the economy. This difference influences how monetary policy affects the market and market intermediaries' willingness to finance productive investments. Additionally, American households are much less risk-averse compared to European households, and investment funds in the US do not hesitate to allocate a significant portion of their investments in stocks (80%). In contrast, European investment funds are more reluctant with stock investments ranging from 40-50%.

In addition to these inherent weaknesses of Europe compared to the US, there is a fundamental flaw in the way monetary policy has been conducted over the past 25 years that is exacerbating Europe's economic problems.

Indeed, this policy has inevitably contributed to a widening of the economic gap between North and South. The ECB's key interest rates are, by construction, an average for the eurozone economy as a whole, which makes it easier for countries with

higher inflation, higher public deficit and current account deficit. Since the creation of the euro, this factory of growing economic disparities between the countries of the monetary union has been able to flourish, even if the inflation differentials between countries have narrowed since the Covid crisis. This situation could have been remedied. To do so, macroeconomic policies would have had to be personalised and tightened in those countries that were prone to higher inflation. But this was not done.

Should we shift the monetary paradigm?

A change of monetary paradigm is critical. it is necessary to refrain from fixing administratively ("or directing" the market) long-term interest rates and to accept to let the market remunerate medium – and long-term savings – according to supply and demand – the only way to remunerate long-term savings, without which there can be no productive investment or productivity gains.

Should we also shift the economic paradigm?

Europe also needs to systematically promote productive supply by investing in research, innovation, and new technologies, rather than relying on grants or allowances to stimulate household consumption and internal demand. In highly indebted countries, this shift requires a reorganization of their public finances to achieve primary surpluses, thereby prioritizing public investments over expenditures that meet the current needs of households.

Reorienting national economic policies towards supply involves channeling long-term savings into productive investment. This approach is essential to enhance the economic attractiveness of economies and improve the returns on the assets developed there. Unlike Europe, the US can afford budget deficits because it issues the world's currency and benefits from the largest, most liquid, and deepest markets.

How can Europe boost private risk sharing to stimulate productive investment?

Everything must be done to ensure that venture capital, private equity, and equity financing develop in EU countries, allowing companies of all sizes and locations within the Union to find the financing they need in Europe. All regulatory actions in Europe should focus on this objective. The European legal and regulatory system must not discourage private equity players; rather, it should encourage them through favorable investment fund regulations. Ensuring that savings are invested where they can be most productive requires allowing market forces to set interest rates rather than relying on administrative controls.

By addressing these core areas, Europe can create a more dynamic and resilient economic environment, capable of sustaining long-term growth and innovation.

Should the European Union modify its competition policy and develop an industrial policy?

EU competition policy should be revamped to help companies scale up and better compete in global markets. It would also be valuable for Europe to design and implement a genuine industrial industry to boost its industry and to accelerate the single market while re-establishing a community preference.

European projects financed by European companies should also be encouraged. The development of Important Projects of Common European Interest (IPCEIs) and collaborative projects between Member States is undeniably a way forward, given that they align their objectives, they identify qualifying and profitable projects and that they find adequate funding. This would facilitate and foster the emergence of competitive European companies, champions and SMEs, as they would benefit from economies of scale in the single market.

You have just published a book on the economic decline of France. Why is it necessary to turn the tables?

If we do not turn the tables, France will remain in a state of permanent decline, culminating in catastrophe in a few years' time. The truth is that we have been investing far too little in France for the past 20 years. Continuing this policy of monetary and budgetary ease would lead to further disinvestment in this country. If this is what we seek, we should say so. The surreptitious return to a monetary policy of zero real interest rates, particularly to finance excessive deficits in heavily indebted countries like France, is a way of lying to the nation. The purpose of this book is to show that there is an alternative.

STRENGTHENING THE EMU

LEENA MÖRTTINEN

Permanent Under-Secretary – Ministry of Finance, Finland

Towards a new-old paradigm of EU economic policy

Since the global financial crisis, economic growth in the EU has lagged behind the US and other global competitors. This persistent slow growth has been compounded by unanticipated shocks that have tested the EU's economic resilience. The COVID-19 pandemic and Russia's invasion of Ukraine have required significant responses to support economies and improve resilience. The EU faces formidable long-term challenges related to aging population as well as the need to digitalize and decarbonize its economy. At the same time, the negative impact from Russia's war against Ukraine and conflicts globally weaken economic growth and threaten to fragment the global economy. Challenges are further compounded by the US and China adopting protectionist measures to reduce critical dependencies and strengthen their strategic advantage in green technologies and digital capabilities.

In response to these challenges, the EU has introduced a new policy approach, which includes the creation of new financing instruments, relaxation of state-aid rules and introduction of new tariffs on imported goods. More recently, there have been calls for new EU-level industrial policies to tackle the challenges.

The reactionary approach to the polycrisis with increased protectionism and active industrial policy can drive EU off its course economically and politically. Instead, chosen policy tools should tackle Europe's key challenge of growing productivity gap with respect of other large economies. EU needs the most effective technological solutions to solve the challenges of decarbonization and digitalization under decreasing labor force. For the Single Market to work, the traditional EU economic policy paradigm of limiting state's role and allowing market forces to drive economic activities should be allowed to prevail. However, at the same time there is a need to contain EU's largest handicap: its tendency to over regulate.

At the moment Europe is lacking investments in high tech R&D. The relaxation of state-aid rules is an expensive and potentially fragmenting policy decision. It can adversely affect resource allocation and, consequently, productivity. Instead of subsidizing large incumbent companies, EU should encourage competition through re-levelling the playing field to allow growth oriented small and medium size companies to challenge the traditional players.

Furthermore, it is crucial to keep the Capital Markets Union on a right track. It should not be distorted by making it part of active industrial policy. Deeper capital markets would help retain the EU's most productive and fastest-growing firms and enable them to scale up into global companies, thereby driving the frontier of productivity forward.

State-intervention may be in some cases necessary. However, as a general principle, industrial policies should be limited to correcting evident market failures. This is because even well-intended policies can end up being poorly designed, often due to excessive political compromises. Uncertainty about the type of policies and their economic effects can deter firms from investing. As regards the role of EU public funds, they should be targeted to finance true EU public goods such as infrastructure that benefits all Member States.

Preserving the four freedoms as cornerstones of the Single Market is even more relevant now than before.

It is clear that the increasing trend towards protectionism as well as risks from geoeconomic fragmentation and geopolitical conflicts cannot be overlooked. Europe needs to be able to defend itself against aggressors irrespective of the nature of the threat. However, bringing back tariffs on wide set foreign goods in the name of economic security are likely to be reciprocated with similar levies on European exports, reducing benefits from economies of scale and comparative advantage. Instead of turning to protectionism under the pretense of economic security the EU should continue to support an open and rule-based system of trade and use this as an opportunity to build new trade partnerships.

To conclude, addressing the challenges facing the EU does not require a new policy strategy. Instead, we should continue to deepen the Single Market, refraining from policies that restrict competition and limit international trade. This approach is crucial for fostering prosperity and promoting overall well-being.

MINDAUGAS LIUTVINSKAS
Vice Minister – Ministry of Finance of the Republic of Lithuania

A pragmatic approach to strengthening the EMU

Strengthening the Economic and Monetary Union is a universally accepted policy priority. Policymakers tend to agree that it is essential for enhancing Europe's competitiveness, boosting productivity growth, and improving the resilience of our economies.

However, while everyone seems to agree on the direction of travel, there is a divergence in views on what is the final destination of this journey.

In this context, we need to be pragmatic when considering the priorities for EMU deepening over the next 5 years. We should avoid delving into proposals that are not at this point viable given political differences and focus on areas where actual progress is possible. I see 3 key areas going forward.

First, it is critical to capitalize on the political momentum to advance the Capital Markets Union. Lack of substantive progress thus far has harmed EU competitiveness and growth potential, as EU capital markets remain fragmented along national borders.

We need a better and more efficient single capital market to ensure that European savings are used to finance the EU economy, particularly SMEs, start-ups, and growth companies. For instance, just in Lithuania, households hold 22 bn euros in savings, which constitutes financial firepower of ~30% of the country's GDP that could be directed to productive uses. To achieve this, we need attractive saving and investment instruments, as well as enhanced financial literacy among companies and individuals.

The CMU project should be a top priority for the next Commission and the cornerstone of a broader EU competitiveness agenda. We need decisive steps that would lead to a tangible impact on the real economy, particularly when it comes to structural issues like the convergence of national insolvency frameworks and supervisory practices. The Eurogroup March statement on the future of the CMU should serve as a blueprint for the next Commission's work agenda.

Moreover, we need to move towards the completion of the Banking Union. While the creation of the third pillar – EDIS – remains a politically challenging step to make, it is essential to overcome our redlines to reach an agreement, as an incomplete BU harms the functioning of the Single Market and may expose financial stability risks in times of stress.

Second, we must focus on enhancing the scope of the MFF as the main fiscal instrument of the EU. The Commission will table a new MFF proposal for 2028-2034 in July next year, which will kick-start the negotiation process.

The EU budget must have increased capacity to address common strategic challenges. We should admit that the current size of the EU budget (~1% of GNI) is insufficient.

A more ambitious approach is needed to ensure sufficient investment in strategic EU objectives, such as boosting defence capacities, enhancing competitiveness, and implementing the green transition. On top, we must ensure sufficient assistance for Ukraine, while preparing for future EU enlargement.

The EU budget, together with the EIB, should play a catalytic role in mobilising private financing as investment needs are far too high to be covered just by public funds.

The next MFF must have increased capacity to address strategic challenges.

Third, it is important to effectively implement the new economic governance framework, which has built-in incentives to foster much needed supply-side reforms.

Countries are already working on their fiscal-structural plans (FSPs), with some likely to request an extension of the adjustment period which will come along with the structural reform agenda. In this regard, it is crucial to kick-off the implementation of the new framework with credible and ambitious reform commitments that would boost growth potential and ensure fiscal sustainability in the long run.

While ownership is expected to be the primary motivation to follow the new framework, the Commission's role will be crucial in ensuring that the rules are fairly and equally enforced on all the countries. Moreover, annual monitoring will be equally important to ensure that reforms and fiscal targets stay on track. The Commission must be resolute in cases of noncompliance and should actively seek corrective actions employing all measures at its disposal.

In conclusion, the EU is in a situation where global economic and security challenges call for swift action, with the EMU at the forefront of policy priorities. The key goal moving forward is to ensure that structural conditions (completed CMU and BU) and sufficient EU financial resources (enhanced MFF, EIB) are in place to address these challenges in a fiscally sustainable manner.

PAULA CONTHE CALVO

Secretary General of the Treasury – Ministry of Economy, Commerce and Business, Spain

Enhancing the financial sector's contribution to EU strategic objectives

The EU is at a juncture and the Letta report is the latest call to action to improve its competitiveness in an increasingly challenging geopolitical and economic context, underscoring the urgency for a collective response. The investment needs are significant: ECB estimates point to an additional 5,4 trillion euros in 2025-2031 to address the twin transitions and strengthen military defense.

Public expenditure must play a significant role in spearheading the necessary investment and transformation, both at EU level, with the Resilience and Recovery Facility as a successful example, and at national level, but public resources alone will not suffice, as fiscal space remains limited. Mobilizing private capital, including through public and private risk sharing mechanisms, remains key. We need a collective effort for both banks and capital markets to play their part to ensure European companies can access the necessary funds throughout their different stages of development. We need more liquid and profound capital markets as well as strongly capitalized and active cross-border players providing credit across the EU for our entrepreneurs to be able to implement their projects and companies to grow and compete globally. The Banking Union (BU) and the Capital Markets Union (CMU) are mutually reinforcing projects to this end, but progress remains limited.

> **We need concrete steps for a financial union supporting EU competitiveness and strategic autonomy.**

Banks play a pivotal role in intermediating financing in the EU, but the reality is that their focus remains national. Despite significant progress with the Single Supervisory Mechanism and the Single Resolution Mechanism, an incomplete BU limits the benefits of cross-border shock absorption. The new legislative cycle brings an opportunity to improve the crisis management framework, including through better access to common safety nets. to ensure sufficient funding in resolution, based on internal loss-absorption as a first line of defence but also on an efficient use of industry funds when needed, avoiding financial spillovers in case of bank crises and protecting the taxpayer. However, the current focus on national safety nets creates a risk of financial fragmentation and generates an unlevel playing field that undermines our internal market and limits private risk sharing across the EU. Ensuring that costs are borne at the same level at which supervisory and resolution decisions are taken is one of the many issues that must be addressed to achieve a more complete BU.

At the same time, access to more diversified and profound capital markets is crucial to financing investment opportunities in the EU. As the Letta and Noyer reports point out, the problem is not a lack of savings in Europe, since paradoxically European savings are funding the development of companies in other regions. What is key is to channel these savings to European companies, through the development of the CMU. And achieving this requires political determination to implement the package of measures reflected in the roadmap agreed at the Eurogroup and which, individually, one by one, may not appear to make a difference but, taken together, have significant potential of transformation. We must create attractive investment opportunities for savers, support companies' growth and set up an efficient supervisory architecture. And we must do so through concrete actions. Designing a European financial product able to mobilize European savings to companies and common investment priorities, streamlining and simplifying procedures for SMEs and accompanying them in the path to becoming listed companies through successful experiences such as the pre-market initiative put in place by BME in Spain, and undertaking the case by case analysis that can serve as the basis for providing stronger powers for European Supervisory Authorities for sectors and actors with systemic importance and cross-border activity are only some examples of effective steps to take. The EU also has many success stories in the use of public funds to leverage and channel private funds towards common priorities. The EIB in particular has a long-standing track record of crowding-in private investment through key experiences, such as the European Tech Champions Initiative to deepen Europe's scale-up venture capital markets, which have inspired in Spain the recent set-up of the Regional Resilience Fund, a fund of funds which is a critical part of the Spanish RRP and which should continue to inspire new initiatives at EU level.

The Commission and we, Member States, must move forward decisively on these concrete policy initiatives in the new cycle to enable our banks and capital markets to contribute effectively to the EU competitiveness and strategic autonomy.

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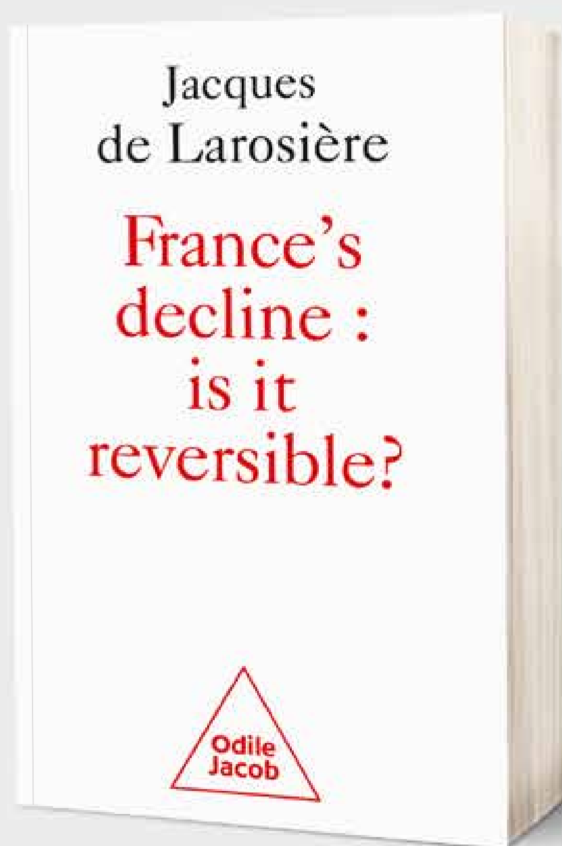

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DEEPENING THE BANKING AND FINANCIAL SINGLE MARKET

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CMU and EU economic competitiveness

For the EU to maintain its competitive position in the global economy, massive investment will be required in the coming years. While the EU relies heavily on the banking sector for its financing, it is increasingly clear that a much larger share of financing in a modern economy must come via capital markets. However, the EU is currently lagging behind other major economies in terms of capital-market development. With a relatively high level of domestic savings, the EU remains a net exporter of capital. Among other things, this clearly reflects the inadequacy of the EU's capital markets in effectively channelling savings into productive investments for the benefit of EU companies and investors.

On this basis, there is an evident need for renewed efforts to create a capital markets framework that is more attractive for savings and more effective in channelling those savings to productive investment. Larger EU capital markets, which are more liquid and developed, would make the EU a more attractive place to do business for all relevant economic actors. This is the rationale that has underpinned the Capital Markets Union (CMU) project since 2014 and it will underpin further policy actions under the Savings and Investment Union.

CMU-related actions over the past decade have tried to address EU competitiveness by boosting the efficiency of capital markets. However, it is fair to say that these actions have not been entirely successful in addressing structural challenges to competitiveness linked to market fragmentation along national borders, often reflecting deep-rooted divergences in legal structures.

A priority for boosting EU competitiveness in the next legislative cycle must be more meaningful advances in CMU, which can ultimately translate into increased capital market activity on the ground. The creation of a single, integrated capital market across the EU that allows the free flow of capital, and the diversification of funding sources for businesses will enhance investment opportunities. This will be to the benefit of European financial services firms, many of whom are among the biggest advocates of the CMU project, and especially households and companies, who will see improved access to finance and investment opportunities.

The effort to build a large and liquid capital market should be partly at the EU level and focus more on tackling those deep-rooted barriers to cross-border activity e.g. related to insolvency law, taxation, supervision etc. However, there will also be a significant role for Member States to implement reforms at national level, in particular by taking measures outside EU-level competence, such as pension reforms, tax incentives etc. This need for this combined effort is reflected in the European Council Conclusions of earlier this year, as well as the Eurogroup statement.

A successful CMU will necessitate action well beyond the financial-services field. It will require a strong and stable EU economy and will leverage on a vibrant single market for goods and services. This implies that, in order to attract more capital market financing to the EU economy, policymakers must aim to lower economic risks and increase economic returns more generally. At the same time, CMU can contribute to economic growth by enabling funds to flow most efficiently from savers to borrowers. In efficient markets, capital will flow to projects and economic undertakings which offer the best perceived return for a given level of risk.

> **A priority for boosting EU competitiveness in the next legislative cycle must be more meaningful advances in CMU.**

In building CMU, there may be certain trade-offs triggered by considerations of open strategic autonomy reflecting a need to avoid overdependence on third country providers for key financial services. Open strategic autonomy is about improving the fundamentals for financial service providers in the EU to promote their competitiveness, and to reduce, where appropriate, systemic dependencies on third country operators. Global capital markets have a high degree of interconnectedness: more market participants mean greater liquidity, more competition, and more innovation. The idea is to make sure that the EU financial system interacts with other financial systems on terms that are sustainable and robust, also in times of crisis. These factors are of particular concern given the current challenging economic and geopolitical environment.

Over the longer term, CMU can unlock substantial economic gains for the EU economy by providing firms with access to a broader pool of capital, reducing the cost of capital, enhancing financial stability, modernizing financial infrastructure, and increasing competitiveness. Achieving CMU is also essential for putting pension systems on a more sustainable path and for achieving the green and digital transitions. The benefits of CMU will contribute to stronger economic growth, job creation, and greater economic integration within the EU, ultimately fostering a more resilient and dynamic European economy.

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BERTRAND DUMONT

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

A competitive Europe needs competitive financial actors

Competitiveness is a key priority for the next European Commission. It requires massive investments to upgrade the long-term economic potential of our economies, as well as its resilience and sustainability[1].

Europe being an open economy, we welcome investments from the rest of the world and count on them to contribute to funding our own transition and growth.

But we also need to keep strategic autonomy in this matter his means we need competitive European financial players able to withstand and overcome international competition in our domestic markets. Otherwise, there will be no alternative to becoming dependent on third-country groups providing key financing and services to Europe.

The problem is that European financial actors are currently losing ground on the global stage, and even in their own market, in most of the relevant segments.

In asset management, over ten years (from 2013 to 2023), the market share of American firms has risen from 30% to more than 42% among the top 30 players, whereas the market share of European players in the United States has stagnated at 2%[2]. On a global scale, the market share of European asset managers among the top 20 global players has fallen from 48% in 2008 to 20% in 2022.

European corporate and investment banks (CIBs) have seen their market shares steadily eroded over time under the effect of competition from their US counterparts. Between 2012 and 2022, the share of CIB income accounted for by US banks increased from 53% to 64% globally and from 39% to 51% in the EMEA region Consequently, in 2022, only three of the ten largest CIBs in the EMEA region were European.

A similar trend can be seen in the trading platforms segment, with increasing competition from non-continental players focusing on the secondary market and 'blue chips'. For instance, the American firm Cboe Europe had a market share of 24% in the volumes of European equities traded on trading platforms in February 2024, equivalent to the volumes traded on Euronext's primary markets.

Moreover, American brokers have also taken an increasingly dominant role in transactions at the expense of European banks and local brokers. This shift can weaken the ecosystem that benefitted small and mid-cap companies, as global players focus on larger capitalizations.

Such a state of play is of concern, but Europe holds all the cards to reverse that trend.

In fact, the current domination of American financial players can be attributed to multiple factors. Among them, banks' business models, deep capital markets and securitisation opportunities, the regulatory environment are critical. In particular, US CIBs owe a large part of their success to a deep, integrated and more profitable domestic market with a stronger focus on corporate and investment banking. On average, between 2020 and 2022 and on a like-for-like volume basis, commissions on mergers, acquisitions, and equity and bond issuances were between 1.3 and 1.7 higher in the United States than in the EMEA region.

On the contrary, the lower profitability of European banks is an illustration of the more fragmented and narrow European domestic market, where it is more difficult to build large-volume at-scale profitable operations, as well as a factor that weighs on the ability of EU banks to generate and attract sufficient capital to grow market share. As a result, in 2023, the average return on equity (RoE) of European banks was 7.6%, compared with 9.9% for American ones[3].

Because these are structural differences, they call for decisive and bold transformative action.

That is why we need an urgent relaunch of the Capital Markets Union to further integrate our domestic markets. Several proposals on the table will benefit the competitiveness of European financial actors.

First, the European securitisation market needs to be revitalised as soon and as strongly as possible. Here we need changes in the regulatory and prudential treatment of securitization as well as exploring the option of a common issuance platform. This will offer more possibilities to all financial actors and in particular give banks more ways to manage their assets.

We also need a more centralized supervision system for financial market actors to reduce fragmentation and to foster bigger pan European actors, able to better sustain international competition.

At some point, we will have to find a way to overcome the home-host issue in banking supervision so that our European actors can truly leverage the internal market to its full potential. If this means we need to further share the risks among our national systems, we are ready to do it. This will be the crucial nexus for the next legislature on banking regulation.

More generally, incorporating the impact on the competitiveness of European financial actors should now be a reflex when we draft and assess new regulations, at every level of text and for each public body involved.

To sum up, Europe's financial sector should be seen as a strategic asset which can help to improve significantly the competitiveness of our continent. Delivering its full potential will require bold action. Such vision can only succeed if it is embraced by all our policymakers, and factored in all their decisions and future pieces of legislation or regulation.

1. *Europe's moment: Repair and Prepare for the Next Generation, European Commission, 2020*
2. *Broadridge, November / December 2023*
3. *Developing European Capital Markets to Finance the Future, April 2024*

PHILIPPE BORDENAVE

Senior Executive Advisor to General Management and the Chair of the Board – BNP Paribas

Strong European banks and financial markets are at the heart of Europe's future

Over the last ten years, the EU has accumulated 15 full points of growth lag versus the US and US big banks have increased their CIB market share in Europe to over 50%. Over the same period, average CET1 of the banks supervised by the ECB/SSM has increased from 12,5% to 15,7% while the corresponding figure in the US remained stable around 12,5%.

Who could reasonably think that there is no link between those facts ? Beyond higher CET1 requirements EU banks suffer from other differences in regulation (e.g. MREL vs TLAC rules). Also, different rules in the US have fostered a securitization market that is now more than 10 times the size of Europe's, thereby giving US banks much more capacity to provide financing to the economy and feed the growth of US capital markets. These reasons and the existing obstacles to integration in the financial sector, as highlighted in the recent Letta report, contribute to Europe's slower growth and declining strategic autonomy. Indeed the Letta report stresses that the neglected EU financial sector must be brought back to the fore.

The previous EU mandate has yielded sweeping new legislations, which now will have to be implemented, leading to a very significant increase in capital expenditures. But where is the financing of the EU economy going to come from as public funds are scarce and will remain so in the foreseeable future? What is thus important to have in mind to move decisively forward?

Enable European banks: Until now, banking related European policies have unfortunately been mainly grounded on "demand-driven" approaches that are not conducive to growth. A real game-changer therefore would be for the EU to at last adopt a "supply-driven" policy posture to support the competitiveness of its financial sector. This would deliver a broader financial services market and result in greater access to finance and in a more comprehensive offer of financial products and services for EU companies and consumers.

Given the already high level of capital reached by EU banks, the EU must now take a more pragmatic stance as regards any further capital requirements; this is the necessary path to release the financing potential of banks, allow them to be more active on financial market and bring the much-needed fuel to the economy. The ECB's mantra to justify ever-higher prudential requirements is that "the more capital banks have, the more they will lend". But the fact is that a bank will only lend more when it has more ***available*** capital to do so. Faced with prudential requirements that are too high with prospects of them becoming even higher in the future, it will just lend less. Higher capital **requirements** cannot lead to more lending.

> **The neglected EU financial sector must be brought back to the fore.**

Get CMU done: After a decade of sluggish progress, the further development and completion of the Capital Markets Union has become an absolute priority. The Letta and Noyer reports have identified important recommendations that EU policymakers need to consider carefully. Revitalizing the securitization market is one of them: it would allow European banks to accelerate the rotation of their banking books and share risk with investors, thereby boosting their capacity to lend more to the economy and contributing in parallel to more dynamic capital markets. It is an effective tool that Europe cannot afford to not use, all the more as it is conducive to increased financial stability.

Another observation is that CMU cannot be reduced to the idea of a "single supervision" as a necessary and sufficient condition. What is there to supervise, if there is only a fragmented and shallow market that does not function at European level?

Make optimal use of the ECB's mandate: under the ECB's secondary objective, the ECB is obliged to support the general economic policies in the Union with a view to contributing to the Union's objectives. Let's in particular recall the new European Competitiveness Deal, one of the goals shared by the Council in April 2024. The ECB cannot advocate its primary objective of price stability and refrain to play its role in the proper articulation of the financing of the economy. Supporting a competitive and strategically autonomous economy is indeed within the ECB's mandate. The ECB has demonstrated its capacity to articulate secondary objectives with its primary objective, for example in its recent climate related initiatives in pursuit of the Union's objective of addressing Climate change; likewise, a competitive European economy supported and funded by a dynamic European financial sector should be at the heart of its policy.

STÉPHANE BOUJNAH

Chief Executive Officer and Chairman of the Managing Board – Euronext

MEGA… "Make European Equity Great Again"

In recent months, several initiatives have emerged that will serve to strengthen the integration of European capital markets. The Dutch banking and market supervisors, former Italian Prime Minister Enrico Letta, and former Governor of the Bank of France Christian Noyer have put forward concrete proposals to better drive European growth, and the European Council has embraced this ambition.

The Capital Markets Union, now renamed the "Union of Savings and Investments," is no longer a political orphan. Rather, it will be one of the pillars of the next European cycle, which has started with the European elections on 9 June and the appointment of a new European Commission.

A consensus is finally emerging on the need to resolve a European paradox. European household savings amount to €35,500 billion, driven by one of the world's highest savings rates at 13.3%. However, Europe exports much of these savings by purchasing foreign debt securities and relying on foreign resources to finance the equity of its economy. We therefore need to rethink completely the way in which savings and investments in Europe are connected.

Seven pillars are emerging to build the Union of Savings and Investments in Europe:

1. Consolidate access to capital markets for mid-sized companies and tech firms;
2. Integrate clearing and settlement infrastructures;
3. Revive securitisation by supporting it with a genuine European platform;
4. Implement a set of identical rules for capital markets across Europe;
5. Create an effective single supervisory framework for major capital market players operating in multiple member states;
6. Transform the market liquidity framework to direct a much larger portion of European savings into the shares of listed European companies;
7. Create a real global competitiveness test to allow the consolidation of European markets, in order to create global leaders in the capital markets sector in Europe.

To achieve these transformations, we need powerful market infrastructures capable of scaling up. In under 25 years, Euronext has become a central element of the Capital Markets Union in Europe. Today, Euronext is ready to contribute actively to the new phase of capital market unification, by bringing its expertise in two areas.

First, to continue reducing the fragmentation of post-trade activities, by deepening the initiatives we have already implemented at Euronext, so that the unique European liquidity pool is supported by a simplified, streamlined, and fully integrated post-trade structure.

European savings must finance European growth!

Second, in creating a single European access point for mid-sized companies and tech firms, in partnership with other exchanges that wish to engage in this project and with clear support from the institutions and market participants. This will provide companies with an integrated and efficient financing mechanism across the continent.

If we mobilise collectively, I am confident that we will be able to catch up with the United States in funding innovation. But two essential changes do not depend on European decisions and must be taken immediately by member States.

First, we must eliminate all mechanisms that artificially divert long-term savings from equity investments to debt instruments. This means removing fiscal distortions for households and revisiting prudential ratios applicable to institutional investors. Increasing the share of European savings invested in equities will not only yield higher long-term returns, but will also support competitiveness, economic development and employment in Europe. More investors in European equities are needed to reduce the liquidity gap with the United States. This will not happen as long as European households and insurance companies are incentivised to buy debt rather than equity.

Second, we must quickly enable the emergence of funded pension schemes. We cannot lament the gap between the United States and Europe in the proportion of individual investors in equity markets – 30% and 3% respectively – without considering that most households in the United States must invest in equities to secure their retirement, while most European households must rely on the hope that their fellow citizens will continue to pay taxes and social contributions to fund their retirement.

A strong political leadership is essential to establish a Union of Savings and Investments in Europe. This union will heavily depend on national decisions taken by member States to direct savings towards listed companies, by creating the most suitable conditions for households and institutional investors. Such a combination of European level efforts to integrate capital markets in Europe and member States initiatives at the national level will make European equity great again.

EU ECONOMIC COMPETITIVENESS CHALLENGES

MARIO NAVA
Director General – DG Employment, Social Affairs and Inclusion, European Commission

Tackling labour and skills shortages in the EU: a strategic EU Action Plan

The labour market in the EU has stayed robust despite the challenges related to the COVID-19 crisis, Russia's war against Ukraine and high inflation. The employment rate is at a record high, and even though the economy slowed down recently, labour and skills shortages remain at a historically high level in all Member States. No company, regardless of size or sector is immune to this issue. Nearly two thirds of small to medium-sized enterprises (SMEs) in the EU report difficulties finding employees with the right skills. Shortages are particularly persistent in healthcare, science, technology, engineering, and mathematics fields (STEM), notably information and communications technology (ICT), construction, transport, and certain service-based occupations (e.g., cooks and waiters).

While labour shortages can be a sign of a dynamic economy that gives workers more leverage, such as through higher wages and more flexible working conditions, they have many negative effects. For instance, labour shortages can hinder productivity and innovation in both companies and public institutions, weakening the EU's competitiveness and potentially slowing down the green and digital transitions.

Key factors driving labour and skills shortages

The European Commission's Employment and Social Developments in Europe 2023 report highlights **several key factors** behind these persistent labour and skill shortages:

- **Demographic change:** the EU's working population is expected to shrink by almost 27 million people by 2050, an average decrease of almost 1 million workers per year. Additionally, the ageing EU population also increases demands for health and long-term care, further straining sectors already experiencing shortages.
- **Transition to a net-zero economy:** new technological developments linked to the decarbonisation of the economy, as well as artificial intelligence, and evolving defence and security needs will lead to the demand of new skill sets.
- **Poor working conditions and low wages:** they reduce the incentive to work, contributing to labour shortages.

A comprehensive policy framework to address shortages

In March 2024, the Commission presented an **Action Plan to tackle labour and skills shortage**s, in close cooperation with social partners. Building on numerous EU initiatives, Member States and social partners outlined **88 new actions**.

These **measures** focus on **five policy areas:** activation, skills, improving working conditions, enhancing intra-EU mobility and legal migration.

1. **Activation:** A key to reducing labour shortages is to make full use of the untapped labour market potential. It is essential to establish measures that help activate women, young people, individuals with lower educational attainment, persons with disabilities, older workers, as well as migrants, who often experience a lower participation rate in the labour market. Through the social innovation strand of the ESF+, the Commission is currently financing projects on zero long-term unemployment and on activating and upskilling NEETs (not in employment, education or training).
2. **Skills:** Skills policies are vital for better job performance and access to higher quality jobs. In March 2024, the Commission proposed to enhance the Quality Framework for Traineeships to improve pathways for young people to gain professional experience, and boost their skills and their access to the labour market.
3. **Working conditions**: Improving working conditions is a priority for addressing labour shortages in specific sectors and occupations in Europe. Following the European Parliament's resolution, the Commission launched the first-step social partners' consultation to propose an initiative on the right to disconnect and telework.
4. **Intra-EU mobility:** While activation, skilling, and working conditions are essential for improving labour market participation, supporting fair intra-EU mobility for workers and learners can help address labour shortages. In cooperation with the European Labour Authority, the Commission will enhance synergies between EURES and EUROPASS to promote fair mobility within the EU.
5. **Legal migration:** Complementing efforts to harness talent within the Union, orderly mobility from third countries also plays a crucial role in addressing labour and skills shortages. In 2023, as part of the Skills and Talent Mobility Package, the Commission proposed establishing an EU Talent Pool to help recruit jobseekers from non-EU countries for EU-wide shortage occupations.

Comprehensive action is crucial for unlocking the EU's growth potential, boosting innovation and investment, and ensuring competitiveness and overall social cohesion. The Commission is committed to supporting Member States and social partners in effectively using available funds and instruments to advance ongoing EU initiatives and promote collective efforts to address labour and skills shortages in the EU.

ALFRED KAMMER

Director, European Department – International Monetary Fund (IMF)

Scaling up the single market to grow Europe's firms

Europe's startling income divergence from the US began around the turn of the century, coinciding with the onset of the tech boom in the US, and has deep firm-level roots. Today, per capita incomes in the EU are on average one-third lower than in the US. While fewer total working hours explain some of this gap, the primary driver is a productivity gap at the firm level.

Among large leading firms, productivity and innovation have diverged markedly across both sides of the Atlantic. Since 2005, the stock market valuation of US listed firms has more than tripled, while Europe's has grown by only 60 percent. This reflects different growth expectations, but our analysis shows that US listed firms' productivity growth has also far outpaced Europe's. The divergence is present in all sectors, but particularly pronounced in the tech sector: While European productivity in tech has stagnated since 2005, US productivity has surged by nearly 40 percent. This is supported by a significant difference in innovation efforts: R&D expenses account for around 10 percent of sales for listed US tech firms, but only a meagre 4 percent for their European counterparts.

Europe also lacks the productivity gains coming from innovative young firms that expand rapidly. Instead, it has an overabundance of very small firms that grow little. Firms with at most 10 employees account for nearly twice as much of employment in Europe as in the US, indicating a lack of scale. This contrasts with the dearth of young, high-growth firms that often drive disruptive innovations in the US. Firms under the age of two represent 20 percent of all firms in the US, versus only 8 percent in Europe. Upon entry, these promising European firms find it more challenging to grow, with the share of total employment of top-performing young firms being around 6 times larger in the US.

Europe's weaker business dynamism reflects constraints to scaling up—particularly in innovation efforts. In forthcoming work, we highlight insufficient market size and access to finance as key forces behind the lagging performance of European firms.

- Market size. A European firm cannot exploit economies of scale as a US firm does—which is especially crucial in tech, where network effects are important. While the EU and US markets are comparable in size, the EU's market is fragmented. Trade intensity within the EU is less than half the level observed between US states.
- Access to finance. US listed firms access equity issuance at twice the rate of European firms. Equity is crucial to protecting intangible investments against short-term economic fluctuations. Equity is also better for intangible investments, which cannot easily be pledged as collateral. Indeed young, high-growth European firms with a high share of intangibles pay 2 percentage point higher rates on debt than incumbents. Venture capital (VC) can help these firms, yet VC in the EU is only one-fourth of what it represents for the US economy.

Addressing the root causes of Europe's lagging performance is essential for restoring competitiveness and preparing for future technological waves. This will require significant action at both the EU and domestic levels.

Deepen the single market to significantly lift constraints on firm growth: Removing remaining barriers to trade within the EU would incentivize firms to undertake R&D and other investments that only pay off with a large customer base. Completing the banking union will improve the allocation of bank credit across the EU. Advancing the capital markets union will be critical for innovation-intensive firms. It would lead to more consistent R&D efforts from large firms by increasing the availability of equity financing, and promote innovative startups without tangible collateral by reducing constraints inhibiting VC. And increasing the portability of pensions can create a larger pool of cross-border long-term capital and promote innovation clusters requiring talent agglomeration.

A deeper single market and a thriving business sector are key to closing Europe's productivity gap.

Strengthen domestic efforts that match EU-level ambitions: Easing administrative barriers would encourage new business formation. Innovation-enhancing labor market regulations should protect workers, not jobs. This means combining more flexible layoff procedures with adequate unemployment benefits and strong active labor market policies that support job search and skill development. Firm size-based tax and regulatory incentives should also be made temporary to incentivize firm growth. Closing performance gaps in education will also help foster ideas creation and diffusion.

Deepening the single market and creating a thriving business sector is key to closing Europe's productivity gap. This bold and comprehensive approach will not only restore Europe's competitiveness but also better prepare it for future technological advancements. The time for action is now.

TIBOR
TÓTH
State Secretary –
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Bridging the gap: revitalizing European competitiveness

Since the beginning of this decade, Europe has been facing continuous challenges. These include the twin transition towards a green and digital economy, addressing the productivity and competitive gap, ensuring the energy security of the EU and manoeuvring through the increasingly challenging geopolitical environment. Additionally, there is a significant high-tech, research and innovation gap that needs to be bridged. The efforts to fight climate change, managing slow growth, high indebtedness among member states and the process of enlargement also present substantial challenges.

The crises of recent years inflicted significant negative shocks on the EU's economy compared to the USA. Although the EU is one of the leading economies, it suffers from its structural deficiencies, such as high vulnerability to supply chain disruptions especially in regard to its energy import dependency, the low level of R&D investments and an aging population. Concerning human capital, despite having a skilled human capital base, Europe faces severe shortages in many professions essential for future growth for example in the field of science and technology. Declining educational standards coupled with an aging population may significantly disadvantage Europe competitively.

The European economy is still highly dependent on its automotive industry. Although, the European car producers are carrying out investments in the EV sector, their position significantly deteriorated in the new technology compared to their stand within the traditional vehicle production segment. Whilst the phase-out of traditional combustion engines is on the way, production of electric vehicles faces challenges with cost-effectiveness and innovation, despite achieving technology quality comparable to leading global manufacturers. While the political support for the EVs expands in Europe, the current trends show a major fall in their sales (around 10% in 2024) as many countries have started to terminate their subsidy programmes.

European firms also lack political support as their main competitor, the USA, introduced the Inflation Reduction Act in 2022, which allocates $400 billion in federal aid until 2030 to support clean energy, electromobility and the rebuilding of the US industrial base. Europe is yet to find an answer to this measure, which targets sectors where European firms were traditionally strong. In 2020 the EU also launched its own support package, the NGEU, which aims to help member states recover from shocks caused by the pandemic. The NGEU also focuses on digitalization and the green transition, requiring that certain funds be spent in these areas. However, the disbursement of these funds has been slower than anticipated, which could have a further negative impact on European competitiveness compared to the US. Therefore, accelerating the disbursement process is crucial.

Amidst rapid technological advancements and evolving innovation trends, R&D expenditures are crucial for overcoming current challenges, particularly in improving productivity. Regarding R&D expenditure, the EU's most dire problem is its low business spending, which shows the largest gap between European and American companies. Whilst US firms maintain their lead among the top 2,500 corporate R&D spenders (with more than 40% share of total R&D investments), the global trend of declining shares of the EU continues with around 18%. The competitive edge increasingly comes from frontier technologies, yet Europe lags in areas such as microchips, AI and quantum computing. The US invests significantly more in AI than Europe, which will deepen competitiveness gaps unless human capital and financial capacity can shift the trajectory.

Enhancing competitiveness in Europe involves several strategic priorities. Increasing productivity across sectors through technology adoption and workforce upskilling is crucial. Transforming the innovation environment requires robust support for R&D and fostering collaborations between academia, industry and start-ups. Europe's economic size can be leveraged through joint procurement, collaborative R&D initiatives and strategic mergers to drive down costs and boost innovation in energy, defence, telecommunications and other critical sectors. Developing deeper capital markets will facilitate greater private investment, particularly in emerging technologies and innovative enterprises. Increasing R&D investments, especially in high-impact areas like healthcare and digital transformation, is essential for improving competitiveness and addressing social challenges.

Increasing R&D investments is essential for improving competitiveness.

Investments are pivotal for sustainable development, focusing on renewable energy, green technologies and securing supply chains for critical raw materials. It is important to stress that, if investments are not accompanied by growth enhancing framework conditions, the different incentives will not be sufficient enough. Regulatory and tax policies can also be vital for European firms to compete on the global stage.

PAWEŁ KARBOWNIK
Undersecretary of State – Ministry of Finance, Poland

Regaining competitiveness and preserving European way of life

The productivity and income gap between the EU and the United States has been widening for a long time. The differences in productivity mean that although both economies were of the same size in 2011 (GDP in current prices of around $15 billion according to the IMF), today the US economy is by 52% larger. Among the 50 biggest global companies measured by market capitalization, only five are from the EU, while 31 are from the US. If Europeans continue on a declining path, our way of life will be jeopardized sooner than one might expect.

To avoid the doomsday scenario, Europeans debate how to close these gaps and enhance EU competitiveness. The single market is Europe's biggest asset. Its completion is the most cost-effective measure to increase EU's productivity and welfare. The top priority in this context should be the completion of the single market in all its aspects, not least services. Instead of fully exploring this phenomenon, we are quite often taking steps back on this road, notably in the transport sector or concerning regulated professions. On top of this, fair taxation should be the backbone of the European economic model. The EU and its Member States should avoid any discriminatory tax practices. Harmonization of EU VAT legislation, including for digital services, and the Union Customs Code would be important milestones in this context.

Another pillar of the single market is the free movement of capital. However, the Union's capital market still does not meet expectations. The European economy is already mostly financed by banks, and not by capital markets. In the EU, banks account for 90% of household debt and 70% of business debt. By comparison, these figures are just 40% and 20% respectively in the US. The problematic issue is overregulation. The capital market infrastructure should be used for providing capital to the economy instead of focusing on implementing increasing regulatory requirements. Further integration of capital markets is an opportunity to increase the EU's capital liquidity and market attractiveness, but it also raises the risk of deepening a multi-speed Europe and capital peripheralization. Therefore, it is necessary to include a pan-European view and not just focus on needs of the most developed markets. A pan-European view that would take into account concerns of smaller jurisdictions, while creating an attractive enough global market for capital to compete with the US or Asia thus ensuring that ever more European savings are invested in the EU.

Ensuring a level-playing field in the single market is key to its effective functioning. Nevertheless, there are significant disruptions in this regard. According to the most recent data, in 2022 just two Member States were responsible for 51.9% of total state aid expenditure in the Union. This is a clear threat to the cohesion of the single market. On the other hand, the EU should develop its toolkit to protect the single market from exogenous disruptions. Existing trade defence instruments should be used assertively to protect our interests against unfair trade practices of our global partners.

Finally, cheap and reliable energy is key for the competitiveness of European companies and preserving our social model. In this context, we must adjust our climate policy, so that necessary green regulation is followed by adequate private and public funding to allow for a smooth energy transition. Otherwise the risk is that people will continue to reject the green transition for its lack of funding. The rethink is also needed regarding technology neutrality – nuclear energy seems to be the low-hanging fruit – and developing new technologies in electricity generation, transmission, and storage. The EU investments in research and development should be geographically balanced and European patents more accessible, also for smaller entities to ensure cohesion. We should also remember the bitter lessons learnt from dependence on resources and technologies provided by undemocratic partners.

Completion of the single market is the most cost-effective measure to increase EU's welfare.

Since 2019, we have experienced at least two large external shocks: the pandemic and Russia's full scale invasion of Ukraine. The EU's response was quick and decisive in the short term, but once we had weathered the initial storms, we returned to business as usual. The Recovery and Resilience Facility, which provided a very useful fiscal stimulus in 2020 and 2021 with its relatively-easy-to-get prefinancing, has in the following years become too often a bureaucratic nightmare. More trust and less control are much more efficient in dealing with similar challenges as proven by the US Inflation Reduction Act. Hence Europe needs to become less regulated and more business friendly if it wants to preserve its global role.

Last but not least, to maintain our way of life we must be able to protect ourselves. This will require massive investments in our defence industry and European capabilities. The European project has emerged from the lesson of war and we cannot allow this lesson to be forgotten.

HARALD WAIGLEIN
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Innovation is the key to competitiveness

Competitiveness is again high on the agenda. But this time, it comes with strings attached: decarbonisation, digitalisation, economic, energy and military security should be strengthened, while remaining competitive against countries less committed to climate protection and less exposed to security challenges. Finding the right balance between rival objectives is the EU's main challenge in the coming years.

How large is the competitiveness gap? The euro area's current account is in surplus and the IMF's External Sector Report considers it broadly in line with fundamentals. The 2022 energy price-induced decline was short-lived. The euro's real-effective exchange rate (CPI deflated) has been broadly stable since 2012, while the US and China saw appreciations, suggesting they rather than we have lost competitiveness. Based on these aggregate figures, the EU's external sector seems to be relatively strong.

And yet there are problems. The IMF estimates[1] that output per hour worked has grown 30% less than in the US since 2000. Scarce business R&D is one factor explaining the divergence. Another factor is a weakness in commercialising new technologies and scaling up innovative start-ups. This is related in part to burdensome regulation and in part to the limited availability of risk capital. Absent collateral, Europe's bank-based financing system cannot provide funding. Weak innovative capacity is reflected in the trade balance: the EU imports significantly more intellectual property and R&D services than it exports.

The incomplete nature of the Single Market is another problem. Fragmentation relates to national regulation, taxes and insolvency regimes. Barriers have remained particularly high in services trade, limiting economies of scale. Accordingly, intra-EU trade in services has barely grown during the past years and the EU has not been able to benefit from the global rise in services trade. This does not bode well for an advanced economy that generates 65% of its GDP from services.

In the energy sector, a variety of national subsidy schemes, combined with uncertainties around the future regulatory environment (regarding the phase-out of subsidies, taxation, the future of the combustion engine and of Russian gas), have rendered it impossible to calculate net present values of investments into the green transition. According to the EIB's 2023 Investment Survey, uncertainty around prices and regulation is almost as much a concern to businesses as the level of energy prices itself.

> **The Single Market, our most important asset, should be prioritised over external competitiveness.**

Supply-chain disruptions, coercive practices by trade partners and Russia's war in Ukraine have eventually exposed trade-related vulnerabilities. Strategic autonomy and economic security concerns have since reshaped the EU's policy agenda. The increase in energy prices is just the tip of the iceberg. Yet the answer to vulnerabilities arising from political decisions elsewhere cannot be putting EU money at the service of external competitiveness. Political threats have to be addressed by political means, even if this implies foregoing some of the benefits from trade.

Most of the recipes to strengthen competitiveness are well known, but need to be pursued more rigorously. Tax incentives should be used to promote business R&D and the green transition; the overhaul of the Energy Taxation Directive should be a priority at EU level. The momentum regarding the capital market union should be exploited to improve access to finance for innovative start-ups. State aid should be scaled back and only used where markets fail or public goods have to be provided. CBAM and trade defence instruments should be the first line of defence towards unfair or polluting practices in trade partners.

The Single Market, our most important asset, should be prioritised over external competitiveness, i.e. safeguarded from further distortions and deepened by removing barriers, in particular in the area of services. EU funds should be used only for purposes with positive externalities, such as innovation or projects of common interest. Common funding for state aid should be a no-go. Instead, all EU funds should be "Single Market proof", i.e. support rather than undermine the basis of our success.

The RRF can clearly not be a model, as it allocates the largest amounts of funds to the economically weakest spots. It is an instrument for convergence, but not for innovation and external competitiveness. Similarly, pouring money into ailing firms will not generate the innovation we need to remain competitive on the world stage. Still, there is room to further exploit the use of the EU budget to stimulate reforms in Member States.

There is no need for additional funds, but there is need to use EU money wiser. There is also a need to refocus on the EU's fundamental values: the free flow of goods, services, capital and labour and perhaps a need to expand these four freedoms. A deeper and broader Single Market can better power competitiveness than NGEU or state aid.

MICHAEL WEST
President – Moody's Investors Service

Rethinking Europe's economic performance vs the US in a changing world

Europe's economic performance lags peers in some areas and outshines them in others. The reasons for both can be found in a combination of natural and historical factors, societal preferences and policy choices.

As we look ahead, how will relative performance evolve? The answer depends on whether Europe adapts to shifts in technology and climate in ways that spur greater economic dynamism. With its diverse economies, robust social systems, and commitment to sustainability, Europe is well-positioned to navigate this new world order - if policies can fully realize its economic potential.

Whether Europe is considered an economic laggard or leader depends on the metric you choose.

Europe's average GDP growth rate has trailed the US, Canada and Australia since the 1980s. Europe's average labor productivity growth was 0.7% between 2010 and 2023 compared to 1.3% in the US as reported by The Conference Board.

However, European economies exhibit consistently improving life expectancy rates, while US life expectancy has declined to the shortest in nearly two decades. Moreover, income inequality in the US is substantially wider than in any European economy.

Performance on credit trends varies, deep capital markets in the US support dynamism

Household and government debt as a percentage of GDP are lower in the euro area than in the US. But corporate debt levels are higher in Europe. Bank non-performing loans as a share of gross loans are generally higher in Europe than in the US, with large variation across countries. Still, the trailing 12-month corporate default rate as of June 2024 was 1.5% for Europe compared to 2.9% in the US, driven by the larger high-yield debt market in the US.

The well-developed, capital markets in the US, characterized by high liquidity, diverse financial products, and a broad investor base - something the EU is still striving for - also support economic dynamism and innovation.

Technology and renewables offer new avenues for productivity and growth

Aging populations and high government debt levels mean it is critical to find new sources of growth and productivity. These could include renewable energy and the adaptation of physical infrastructure to climate change. Digital technologies could also spur productivity, cost efficiencies and new revenue sources.

In both climate and technology, Europe again exhibits lags and leads.

Europe's leadership in climate policy is reflected in its clean energy investment, sustainable finance issuance and decarbonization.

The share of energy generated from renewable sources in 2022 was 23% in the EU compared to 20% in the US. In 2023, there were 11.2 million electric cars in Europe vs. 4.8 million in the US, according to the International Energy Agency. European issuers accounted for half of sustainable bond volumes and nearly two-thirds of green bond volumes in the first quarter of this year. US emissions per capita remain twice those of Europe.

Europe's initiatives, such as the EU Green Deal in 2021, recognize the importance of policies in spurring adaptation. However, Europe isn't pursuing these goals alone and the US is catching up.

The US Inflation Reduction Act (IRA), along with the CHIPS and Science Act and the Infrastructure and Investment and Jobs Act, has encouraged clean energy investment and we expect it to further boost US green investment, productivity and innovation, and accelerate carbon transition. The 55% increase in manufacturing construction in the US in the year following the passage of the IRA, including in sectors such as semiconductors and electric vehicles, shows that crowding-in of private investment is underway.

Complementing strong guardrails around technology with incentives for innovation, investment

The US is a global leader in investment in innovation. US 2022 R&D spending among the top 2,500 companies globally exceeded €500 billion compared to €219 billion in the EU. 17.2% of all global patent applications in 2022 came from the US, compared to 5.6% for Europe. The US's robust financial markets, especially in venture capital, are pivotal in supporting new and transformative technologies and driving advances in a wide range of sectors from biotechnology to AI.

> **Policies can revive Europe's dynamism by strategic adaptation to technology and climate shifts.**

Protections around cybersecurity and data privacy are crucial to promote digital innovation and growth. Here Europe tends to lead and Europe's General Data Protection Regulation (GDPR) is an example of legislation addressing these issues. Still, to bridge the innovation gap, Europe will need to complement guardrails with policies that promote strategic investments in digital infrastructure and digital skills.

In conclusion, as the global economic landscape evolves, the debate is shifting from the past drivers of Europe's relative performance versus peers to how future policies can revive economic dynamism by strategic adaptation to technology and climate shifts.

PIER CARLO PADOAN

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Closing the competitiveness gap with the US leveraging on NGEU lesson

Over the last 25 years, labor productivity in the EU increased annually well below than in the US (on avg 0.9% vs 1.5%), but EU still lacks a comprehensive strategy on how to address its increasing underperformance and make its economy more resilient to shocks.

Several factors fuel this gap. Investment in R&D and intangible capital is far lower in the EU, with negative implications for the adoption of new productivity-enhancing technologies. Moreover, the EU economy suffers from structural rigidities that hamper the allocation of resources to the most productive sectors. Acting on these fronts requires a comprehensive strategy aimed at channeling necessary public and private resources towards key strategic investments, primarily in the twin transition, at a time of shrinking fiscal space, and at reducing red tapes and enhancing coordination of national policies.

Currently, EU savers allocate an excessively high share of their financial assets to low-yielding investments, while fragmentation of EU capital markets often leads to diversion of domestic savings towards the US. In this context, fully progressing on the Capital Market and Banking Unions is key.

Two key questions have to be addressed: the macroeconomic scenario and the channels through which the private sector is involved. The Initial impact on productivity and growth of climate change strategy is negative according to most analysts. A necessary condition for the sustainability of green growth is that capital turns from brown to amber and then to green. This is the big reallocation effort which requires that the major financial support must be directed to companies that are able to quickly move towards green capital. Initial evidence on capital markets reallocation towards green investment is mixed at best.

The sustainable growth strategy must rest on three pillars: investments to replace brown energy-intensive capital with green capital, resources to facilitate the transition to a new paradigm of consumption and welfare, resources to activate private investments in innovations.

Investments in the transition process are driven by public spending while private contribution will become important in the m/l term. Involving the private sector requires appropriate incentives and a set of instruments that are up to the challenge, including pollution taxes, R&D subsidies, a transition fund to minimize the costs of adjustment and an effective regulation.
A more coordinated approach to investments in strategic industries is also needed. Looking at growth of patents for green innovations, it emerges that applications in the peripheral countries of the EU have underperformed, increasing the risk of widening disparities. Due to its features, the EU cannot develop, finance and roll out large-scale measures such as the IRA in the US. Therefore, the EU should strengthen its governance framework to enhance coordination across policies. Over the longer term, the EU should move towards EU-wide supervision of national polices to reduce the risk that fragmented national measures disrupt the level playing field and fail to deliver the needed scale of investments.
EU should also refrain from endorsing wide-ranging protectionist policies that endanger the openness of the Single Market, fair competition and the supply of critical materials/products the EU cannot produce, particularly those that are important for the twin transition.

NGEU provides an interesting lesson. The first goal of NGEU, i.e. boosting the post-pandemic recovery particularly in the weakest member countries, seems to have already been largely achieved, as such countries have recorded stronger growth rates.

The jury is still out on whether the second goal of NGEU, fueling reform momentum and raising potential growth, will be fulfilled. It takes time for reforms to bear fruit and most of the program's funds are yet to be spent. However, conditionality attached to disbursements of NGEU money should increase the likelihood of a successful reform effort.

NGEU has also succeeded when it comes to a third goal, i.e. enhancing confidence in the commitment of member countries to the European project. Although it is difficult to disentangle this effect from other concomitant factors, the compression of sovereign spreads across the eurozone has, to some extent, reflected the bold political message embedded in NGEU.

NGEU has shown that financing common strategic priorities through extra funds is an important option.

Going forward, it is not clear whether an NGEU-like framework can be replicated but it has shown that financing specific common strategic priorities through extra-budgetary, temporary funds and the issuance of common debt is likely to be an important option available to European policymakers. Ideally, however, this set-up should serve as bridge towards a framework for the longer term where more comprehensive action should be designed within the EU budget, which should provide a meaningful central fiscal capacity.

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ADDRESSING EUROPE'S INVESTMENT NEEDS

DECLAN COSTELLO
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Enhancing competitiveness and safeguarding fiscal sustainability

After successfully weathering the pandemic and the fallout from Russia's aggression against Ukraine, the EU stands at a critical juncture. The unprecedented policy support enacted at Union and Member States' level helped save jobs and protect businesses and citizens but resulted in legacies in the form of higher public debt and more vulnerable fiscal positions. While public investment held up well and even increased thanks to the strong and coordinated policy response during the crisis, private investment dynamics remain sluggish and hence total investment in the EU has not yet returned to pre-pandemic levels.

At the same time, Europe needs to tackle long-standing and newly emerging challenges to secure economic prosperity for its future. A concerted effort is needed to enhance competitiveness, to accelerate the green and digital twin transition, and to bolster investments in security and defence considering geopolitical tensions. Crucially, these investment needs emerge at times of still elevated inflationary pressures and supply chain vulnerabilities.

Moreover, the European Union needs to continue addressing the challenges emerging from demographic changes in the form of a shrinking workforce and ageing population. Old-age dependency ratios are expected to rise sharply over the next decades, further increasing pressure on public budgets and the functioning of the welfare systems.

The answer to these challenges lies in an effective coordination of well-timed and targeted economic policies. The period of ultra-low interest rates is not expected to reappear any time soon. While the ECB has slightly eased the monetary policy stance in June, financing conditions remain restrictive. It will there be essential to maximise the impact of limited resources to address the pressing challenges effectively. Policymakers need to effectively prioritise public investment projects and pay even more attention to the quality of public expenditure. Restoring sustainable budgetary positions will also allow us to build buffers to deal with future shocks.

Against this background, the reformed economic governance framework will play a key role to address debt and structural challenges and help Member States navigate these difficult trade-offs. The new fiscal rules give more prominence to both fiscal-structural reforms and public investments. National ownership is at the heart of the new framework, as Member Stats will submit their own country-specific plans setting out the fiscal trajectory for the years ahead. The fiscal adjustment path can be extended if underpinned by credible sets of reforms that will ultimately benefit fiscal sustainability, growth, and resilience. As such, the new framework allows more breathing room for Member States to finance important investments while putting public debt on a sustainable path.

Moreover, the RRF will continue to support investments and reforms in the Member States. Projects financed by RRF grants will have no impact on public deficits and debt, providing further room to tackle the significant investment needs emerging from the green and digital transition, as well as investments into defence capacity and critical technologies.

Public investments alone will not be sufficient to address these challenges and foster the structural transformation. Removing barriers to and incentivising private investment will be of equal importance to reclaim EU's competitive edge. In particular, European firms are still lagging peers in other regions when it comes to innovation and the adoption of digital technologies. To close the innovation gap, more investment in R&D and better access to finance is needed, especially for SMEs.

> **Europe needs to tackle long-standing and newly emerging challenges to secure economic prosperity for.**

Europe needs a framework that supports effective resource allocation to restore productivity growth and close the gap notably vis-à-vis the US. Better equity and venture capital financing can play a role. Moreover, progress on the Capital Markets Union will be key to address fragmentation and facilitate greater private investment.

To plug the knowledge gap and promote human capital formation, the EU needs to raise the performance of education and training systems. As demographic changes are affecting Member States at different speed, greater intra-EU labour mobility and legal migration can help address skills shortages and mismatch, together with well-designed initiatives on re- and upskilling. Skills shortages especially for digital and scientific skills appear more severe in the EU than in the US, and the rapid rise of AI technology underlines the importance of these professional profiles, also considering existing gaps when it comes to ICT and digitalisation.

While the multiple challenges that the EU is facing can appear daunting, the recent experience during times of crisis has shown that Europe is strongest when it works together effectively. Continuing with decisive, impactful, and well-coordinated policy response at national and EU level will help Europe tackle the challenges of today and the future.

DENIZ IGAN

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Brightening Europe's productivity future: time for unified, brave action

Europe has fallen behind. For more than two decades now, total factor productivity growth trailed that in the United States. The slower productivity growth has been the key contributor to the large income gap that opened up between the two jurisdictions. The differences in productivity growth outcomes since the pandemic have continued to be stark, with the United States GDP per hour worked well above the level implied by its pre-pandemic trend and the euro area GDP per hour worked barely above the same level as it was in 2019.

What ails European productivity? The diagnosis has long identified several key factors, including unfavourable demographics and structural rigidities limiting business dynamism and required reallocation of resources in the face of large shocks. More recently, the disproportionate impact of geopolitical shocks on Europe compared to other parts of the world has imposed an additional drag on productivity as firms have been forced to re-optimize their energy use and re-consider their dependence on certain sources of energy.

Most notably, however, and long before the shaking of energy markets by the war in Ukraine, a widening gap in innovative, productive investments has emerged between Europe and many of its peers. Business spending on research and development (R&D), relative to the size of the economy, has hardly grown since the turn of the century. Public expenditure has not made up for the shortfall in private investment, leaving overall R&D investment well behind competitors. Further, when R&D investment occurred, it has remained focused on traditional sectors and methods rather than new technologies that offer general applications across industries and push the innovation frontier, including on much-needed technologies to address climate change.

This sluggishness in investment has in large part reflected financial fragmentation and uncertainty, in addition to the lower potential output growth in the region relative to the rest of the world.

The path to closing the gap in innovative, productive investments goes through the completion of the Single Market.

Removing the remaining barriers in the integration of goods and services trade would open these markets to more intense competition and strengthen incentives for adoption of and investment in productivity-enhancing technologies. It would also allow the most innovative and competitive firms to scale up. Enhanced trade integration within Europe would have the added benefit of positioning the region better in a world that remains under increasing risk of geoeconomic fragmentation.

Beyond goods and services, the other crucial aspects of the Single Market are capital and labour.

Making further progress on the Capital Markets Union is imperative to ensure that capital can flow where it has the most innovative, productive use. The challenge in the case of Europe, unlike many emerging market economies, is not a matter of fostering more savings: European pension funds and insurance companies can and do extend funding for long-term investments and most European firms can and do raise capital globally at a reasonable cost. The challenge is misallocation of the available funds, hindered by prohibitive costs of operating in different jurisdictions with their own, complex regulations and tax treatments, accounting and bankruptcy frameworks, and supervisory rules. These costs are a problem particularly for startups, which find it difficult to access venture capital and scale up in Europe. Reducing segmentation across national borders would also improve market liquidity and could encourage investors to fund high-return-high-risk opportunities by reducing the cost of exit from risky investments should they not pan out.

Turning to labour markets, measures to enhance mobility across borders and sectors should be priority. Easing integration of cross-border workers through language training and recognition of qualifications obtained in other countries could improve flow of skilled labour into faster growing areas and industries. This could be complemented with lifelong learning programs and a more general enhancement of education programs to focus on adaptive skills in a rapidly changing world.

> **The path to closing the gap in productive investments goes through the single market.**

Fiscal policy would be an important part of a strategic plan towards the completion of the Single Market. Unleashing the available capacity at the regional level would be necessary, to be a catalyst for private investment in priority areas and move towards reducing segmentation. A common policy for the region as a whole supported with strong rules to ensure credible medium-term sustainable debt paths should be considered. A European safe asset could serve as the needed risk-free benchmark, enable greater risk sharing, and facilitate financial system union.

These are not new priorities. Europe needs to act now, to achieve the transformation it aspires to face the challenges from technological advancements, climate change, geopolitical tensions and aging populations.

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Director – Recovery & Resilience Task Force, European Commission

Boosting productive investments in the EU: the RRF reforms and investments

The Recovery and Resilience Facility (RRF) is a major instrument to make Europe more resilient and better prepared for the future. The RRF, as the major performance-based EU funding programme, has delivered on its recovery goal: its mere announcement had an immediate effect on markets, narrowing sovereign debt spreads and restoring confidence for the pick-up in economic activity. EU funds started flowing to Member States immediately after the approval of their Recovery and Resilience Plans. With close to EUR 650 bn committed in total (EUR 357 bn in grants and EUR 291 bn in loans), the scale of financial support provided by the RRF between 2021 and 2026 is unprecedented in the EU's history. In June 2024, more than EUR 240 bn have been disbursed to Member States.

The full implementation by Member States of their RRP commitments is set to reinforce Europe's long-term competitiveness, sustainability, strategic autonomy and resilience against future economic shocks. Member States are well on track to deploy RRF funded investments. Almost three million enterprises have already received direct RRF support – either monetary or in-kind. By the end of 2023, direct support to companies accounted for more than EUR 82 bn (or 13% of the total estimated RRF expenditure), while the broader support to companies, such as financial instruments or the digitalisation of public administration, represented at least EUR 164 bn (or 25% of the total estimated RRF expenditure).

The Recovery and Resilience Plans (RRPs) go beyond direct financial support, spearheading significant reforms to cultivate a business-enabling environment across Member States. One of the core distinguishing features of the RRF is that reforms and investments go hand in hand and reinforce each other. These reforms address long-standing structural challenges that facilitate the delivery not only of investments supported by the RRF but other EU and national funds. One focus of the RRPs is on simplifying regulations and cutting red tape for businesses, and SMEs in particular. In the RRPs, Member States tackle challenges across the whole business life cycle, from the opening to the closing of a business. Reforms in various Member States aim to simplify and shorten the process of obtaining licenses for renewable energy facilities, advancing the green transition in this way. Measures across RRPs are tackling barriers to entry to stimulate competition, research and economic growth. Several reforms included in the RRPs focus on digitalisation to improve businesses and public administration's services. The RRF also drives substantial reforms to improve the efficiency of the judicial system, through court digitalisation for example, and to modernise public procurement. The RRF has an important impact on other drivers to increase competitiveness of EU businesses, such as public governance, digitalisation, skills, research and innovation.

The RRF also supports certain cross-border and multi-country projects. In particular, Important Projects of Common European Interest (IPCEIs) in the fields of strategic investments, such as hydrogen technology, microelectronics and cloud infrastructure receive RRF funding.

The RRPs chart the course towards a stronger and deeper Single Market and economic integration. Beyond their direct impact in a specific Member State, investments in the RRPs generate positive spillover effects that reverberate throughout the Single Market, bolstering intra-EU trade.

Europe's competitiveness hinges on the quality of its human capital. The RRF drives initiatives aimed at enhancing businesses' access to skilled labour and equipping individuals with the right skills for an evolving economy. The RRF fosters improved labour market access through the creation and simplification of hiring incentives for businesses, aligning skills supply with the demands of the labour market.

The RRF is reinforcing Europe's competitiveness, sustainability, strategic autonomy and resilience.

The RRF is complementary to other EU, such as cohesion, and national funds which promote public and private productive investment. In addition, public funding in key common challenges are expected to help crowd-in private investment. For instance, initiatives such as STEP, an innovative platform that intends to reinforce and leverage existing EU funding programmes to support the development and manufacturing and related value chains of critical digital tech, bio tech and clean tech, can help boost productive investments in the EU. Other initiatives will be developed by the Commission as announced by President von der Leyen in the Political Guidelines for the next European Commission on 18 July 2024.

LÁSZLÓ BALOGH

Special Envoy of the Minister of Finance – Ministry of Finance, Hungary

Do current EU policy tools address critical investment needs in Europe?

Europe faces critical challenges: climate change, green and digital transition, affordable energy security, technological gap, ageing society, global economic fragmentation, and geopolitical tensions requiring bigger defence capacities. Meanwhile, the EU confronts substantial competitiveness issues compared to global players: lower productivity, sluggish growth, lagging high-tech investments and low R&D activities. In a trading system where all adhered to the rules, China and the US are now implementing highly subsidised industrial policies to bolster their economies. This diverts investments from the EU. The EU's share in global manufacturing dropped from 27% in 2000 to around 15% in 2022, due to loss of competitiveness, mainly in high-tech sectors. The EU must address these equally important challenges by setting up a comprehensive pro-business economic strategy combined with important additional funding.

Achieving zero emission by 2050 requires annual investments of cca. 2% of GDP from EU countries in the next decades. Europe's decarbonisation efforts increase dependence on rare minerals for batteries and solar panels. While EU-based battery factories may reduce dependency and safeguard the EU industrial base, however, this is not conceivable without China. This requires targeted strategy and fiscal support to the European industry. Strengthening EU's defence capacities also requires new investments for decades in a yearly value of 2% of GDP as an average.

Defence industry goes hand in hand with IT, AI and other high-tech industries development. More funding is indispensable for high and deep tech industry development in the EU. Europe invests less in digital and advanced technologies compared to the US and China. Roughly half of the world's investment in AI currently happens in the US. Disparity in frontier technologies investments hinders Europe to be leader in new technology sectors.

The EU must address these challenges by setting up a comprehensive economic strategy.

Agriculture also requires investments. Food security and local food supply in Europe has become a strategic issue. High quality, controlled and healthy food production needs further investments to keep up with the global competition, to implement state-of-the-arts know-how, to strengthen environmental sustainability and not let the countryside to transform to unpopulated areas. Human capital and demographic concerns must also be addressed: EU faces shortage in critical professions partly due to ageing and declining education. Investing in high quality education for future's skills is indispensable. Share of active population declines while pension payments are increasing, leading to serious sustainability issues. Safeguarding long-term sustainability and competitiveness also requires demographic turning point and to boost birth rates across Europe.

Regional disparities: since joining the EU in 2004, regions have narrowed their GDP per capita gap, rising from 50% to nearly 80% of the EU average. Yet, over a quarter of EU citizens still live in regions where GDP per capita remains below 75% of the EU average, a higher proportion than in the US. Further convergence is needed with targeted investments.

Current EU investment tools are not adequate to tackle this situation: RRF struggles with too slow and extremely bureaucratic implementation. RRF was designed to be a quick support mechanism after Covid-19 for EU economies to recover rapidly. However, so far hardly 40% of available funds are disbursed to recipients. Cohesion funds' budget is shrinking, R&D support favours major players and not the EU as a whole. CEE countries are hardly benefitting from it, and CAP conflicts with other EU policies. Defence specific funds are non-existent, enlargement budget is insufficient. EU infrastructure developments in energy grids or climate friendly railway network in all directions are lacking. Present EU funding facilities and regulatory framework do not effectively mobilize EU private capital as private investors' participation is bureaucratic and burdensome. Occasionally EU regulations are not predictable and transparent for business. Europe must enhance renewed, more flexible and enlarged funding mechanisms, ensuring fairness and coherence in distribution, and incentivising private investments. Increased EU funding is needed through larger EU budget with higher MS contributions instead of relying on regressive own resources or further debt creating EU bond issuance.

Disbursements must be more transparent and merit based, particularly in R&D. The EU must focus on a functioning Single Market. Mobilising the EU private savings stocks may ensure the needed funds for vital EU investments. EIB could better contribute to policy goals while safeguarding its financial sustainability. Most EU Members are largely indebted with fiscal deficits, so MS must ensure a sustainable and balanced fiscal environment creating the necessary business confidence for investors to engage them with the European economic strategy. The Economic Governance Reform is key step in this direction.

BJÖRN STORIM

Chief Executive Officer – BNY Mellon's European Bank

Tackling the structural problems in European long-term investment

The road that brings the savings of a private individual to the financing and delivery of a long-term investment project is long and full of obstacles.

Europe's rates of long-term capital investment are too low, and structural problems along the road are a major cause.

Many of these problems are well-documented. They include a lack of scale through the lack of a fully completed single market, inadequate financing structures, regulatory and fiscal biases towards the short term, and changing regulatory frameworks for long term infrastructure projects.

We have long called for an ambitious approach to building an EU capital markets union as a way of improving a critical stretch of this road.

When the EU capital markets are compared to the US, the focus too often shifts to large public sector interventions, e.g. the Inflation Reduction Act (IRA) vs Next Generation EU. But it is the business-as-usual capabilities that support productive investments, which allow personal savings to be channelled into longer term investments.

The EU has made progress in designing financial products, through legislation, that allow for savings to be invested in assets, whether UCITS or ELTIFs, which support longer finance projects. But further steps are needed, including the development of the securitisation market.

And many of the underlying reasons why the EU continues to lag behind the US in mobilising private savings for investment in capital market assets remain.

One key reason is the disparity in member states' pension policies. There is no EU-wide framework encouraging workers to invest their retirement funds in pan-European stock markets. This helps push about €300 billion in European savings abroad each year – mainly to the U.S., as the Letta report pointed out. And as Letta suggested, this could be rectified with a pan-European savings product, maybe an EU 401k.

The second 'business-as-usual' approach to broader productive investments is transparency. The EU has led the way in pursuing a Green Deal and ensuring Next Generation funds are at least in parts distributed in alignment with sustainability objectives. But investors still lack a clear, transparent and - critically - standardised approach to access and understand where and how to invest and support these goals. The advent of the European Single Access Point will at least provide standardised access to corporate information, but critically EU capital market infrastructure that is essential to allow access to pan-EU investments is still fragmented and difficult to access.

> **Using pensions and private savings, we can bridge the gap to a more effective capital market system.**

A driving principle for any initiative to drive greater capital market participation in the EU should focus on making EU market infrastructures more interoperable and standardise how they interact and communicate with market participants, thus allowing EU investors simple and effective access to all European securities.

The final key ingredient to encouraging and supporting greater EU investments in capital markets, to bridge the gap to the United States, is a more unified approach to taxation. This is often a red line from a member states' perspective but sometimes misunderstood as approaching the level rather than the process of taxation. To date, every member state has a different approach to capital market taxation, and this creates problems for cross-border investors. Double taxation on securities income, and inadequate relief procedures, often result in lost revenue on the part of investors, stuck in a reclaim process that can take months, sometimes years, to conclude.

The FASTER proposal was a first step in the direction of harmonising the withholding taxation process but the negotiation outcome between member states did not match the ambition of the original proposal. To truly become a unified EU capital market and support pan-EU investments, in the same way that the European single market in goods has a common pan-EU framework for value added tax, the single market in savings and investments should have a common pan-EU framework for the taxation of income on securities.

In summary, as we look ahead to the next legislative phase and agenda, we have the instruments but not always the right incentives to support and encourage capital market investments into productive finance. Using pensions and private savings, supported by standardised infrastructure and harmonised taxation processes, we can bridge the gap to a more effective capital market system.

Delivering bigger, more efficient and more liquid European capital markets will eliminate some of the major obstacles on the road to greater investment in European infrastructure and real capital formation.

BERNARD ATTALI

Senior Advisor – Groupe Caisse des Dépôts (CDC)

Putting the long term at the heart of our decisions

While the necessity for an extensive, long-term vision has never been more paramount than it is today, the emphasis on today's immediate needs overshadows such future-oriented planning. Our long-term perspective is undermined by the tyranny of urgency. Long-term investments essential for the transition to carbon neutrality, for the restoration of competitiveness, and for Europe's strategic autonomy remain insufficient, while significant efforts in these fields are already underway across the Atlantic.

In addition, we have seen significant geopolitical changes, including the emergence of war at Europe's doorstep, a rise in economic and commercial tensions, and increased fragmentation of international trade. This has led to a surge in investment needs in the defence and energy sectors and a reconsideration of strategic autonomy and supply security.

All these multiplying challenges confront us with a colossal investment wall. The European Commission considers that "in total, supplementary investments exceeding 620 billion euros annually will be essential to fulfil the objectives of the Green Deal and RepowerEU, and investments of 92 billion euros by 2030 to accomplish the aims of the Net Zero Industrial Act", further adding 125 billion euros for the digital transition. This projected investment gap for the dual transition of approximately €800 billion annually does not yet consider the substantial supplementary investment requirements related to fortifying our defence systems and the escalating pressure on general social protection expenditures due to demographic changes.

Yet our resources are finite. Reaching this amount seems an impossible task unless we completely rethink our financing model that has been in place for forty years. In a recent report, I have addressed this question with a group of experts, offering a complementary point of view to Enrico Letta and Christian Noyer: we have repositioned the actors at the heart of our approach. A genuine transformation of our society requires the integration of the long-term into the behaviour of each of us: citizens, financial intermediaries, public authorities.

First of all, from the perspective of citizens and consumers, financial education and understanding of the stakes of the transition are essential to ensure the political acceptability of the changes induced by the transition. But this is not enough: measures of equity must also be taken to offset the redistributive effects that are certain to accompany this transition.

> A genuine transformation of our society requires the integration of the long-term into the behaviour of each of us.

Secondly, Europe saves, and it indeed saves a lot. In 2023, the European savings surplus over domestic investment amounted to about €370 billion, or 2.6% of GDP. This surplus represents a significant resource, yet it is currently largely underused to finance the long-term and is primarily invested in the US when invested in shares or bonds. This emphasizes the significant gap between the structure of savings and the financing needs of the economy. European savings is ultimately used, to put it bluntly, to finance billion euros of American buybacks of European gems... These savings must be redirected in a more effective manner, with a focus on long-term investments. This can be achieved by providing the right incentives (standardisation, simplification, and improvement of the quality of available financial and extra-financial information, appropriate regulatory framework, financial and tax incentives if necessary), while ensuring the necessary protection in return for increased risk taking. The creation of a European label for savings products invested in Europe, as recommended in C. Noyer's report this year, would allow the EU to move towards common principles by taking advantage of the existing characteristics of savings products.

Finally, fiscal policy may be an important driver of economic growth but cannot be the only driver, as the constraints on public finances remain challenging. Indeed, the updated EU budget regulations offer increased autonomy to member states, are more suitably adjusted to the context of high debt and allow enhanced flexibility for strategic investments. Yet, the budgetary room for manoeuvre remains insufficient to amplify investment funding to the required scale. The catalytic effect of public investment must play on other sources of funding available in Europe, such as those provided by long-term public investors and private financiers. In this regard, the contribution of national promotional banks and institutions (NPBI) play an integral role in this process, bridging the gap between public policy objectives and financing by private savings by anchoring agents' expectations and market practices. Through their public interest missions and their mandate to support public policies, NPBIs may identify projects with high externalities but still unsteady economic models and remove the obstacles that hinder their deployment.

MIKOLAJ DOWGIELEWICZ
Deputy Secretary General – European Investment Bank (EIB)

Investing in tomorrow

The green transition isn't just a "nice to have" idea; it's a strategic imperative for a continent dependent on imported raw materials and already experiencing the devastating effects of climate change. It is a strategy for sustainable growth that will make Europe more competitive, more prosperous, more autonomous and more resilient.

And it's a strategy that others are adopting too. China and the US are investing heavily in the same technologies and industries as we are, racing to become world leaders in the economy of tomorrow and to secure the same benefits that we seek. This is no bad thing. Global action is exactly what the world needs to limit and adapt to climate change. But if Europe wants to secure a leading place in the economy of tomorrow, it needs to invest more, today.

And yet investment in Europe consistently lags. Part of the reason is demographic. Our population is ageing and set to shrink, making it harder for companies to find workers with the skills they need to expand. It also puts pressure on our public finances, which means we can't compete with subsidies and generous incentives. But another reason is that our capital markets are fragmented and inefficient, particularly when it comes to financing new technologies and future champions.

A new report from economists at the European Investment Bank sheds light on the extent on the problem.

Data analysed in the report show that US start-ups raise twice as much money as those in the European Union, and that the gap gets larger as firms grow, reaching five times as much for companies that need to scale-up.

Innovative European firms that reach the age of ten, raise half as much capital as their peers in Silicon Valley and need to go through more funding rounds to raise the same level of investment.

As a result, many promising European tech leaders are forced to either list abroad or sell to foreign acquirers. According to the data, half the European scale-ups that underwent an initial public offering (IPO), listed abroad, mostly in the US. What's more, 60% of Europe's high-tech companies looking to scale-up are acquired by foreign buyers.

This is a serious weakness, which deprives Europe of the rights to its own inventions and the benefits of its own success stories.

Pioneering new financing instruments to serve as building blocks for a European capital markets union is one of the EIB Group's strategic priorities.

The reasons for these failings are a complex mix of regulatory, cultural, and behavioural factors. But the lack of a single European market for capital, to complement the single market that we have for goods, is clearly one of them. Large funds with the capacity to finance big investments are easier to raise and more efficient to operate in a large continent-sized market with lots of opportunities than in a small national market with fewer potential successes.

Pioneering new financing instruments to serve as building blocks for a European capital markets union is one of the EIB Group's strategic priorities.

Last year, we launched the European Tech Champions Initiative (ETCI), a first-of-its-kind fund of funds dedicated to investing in large-scale venture capital funds to support companies in their late growth stage. The ETCI has quickly become a success and has closed deals worth around €2 billion that are expected to mobilise up to five times that amount in investment.

Because of its success, we plan to extend it to attract private capital to support the continued growth of EU scale-ups in other thematic areas as well.

The European Investment Bank Group will also soon introduce new financing programmes to support investment in cutting-edge technologies and infrastructures, like AI, life sciences, microchips, and quantum computing. The Strategic Tech-EU programme, which will cover the entire value chain, including critical raw materials, thus aims to reinforce Europe's strategic autonomy, home-grown innovation and productivity growth.

As part of our Strategic Roadmap, we will also replicate the model of standardised financial instruments, like InvestEU, to crowd in private investment in sectors like energy efficiency for small- and medium-sized enterprises and building retrofitting. These initiatives will advance the EU's capital markets union as well as improve our competitiveness and cut emissions.

With public finances constrained, Europe needs to ensure that every drop of public funding makes a splash. The European Investment Bank Group has an unparalleled capacity to mobilise public and private investment. With just €22 billion in paid-in capital, the EIB Group has mobilised €5 trillion in investment, turning plans into reality, with projects improving people's lives and strengthening our economy.

Modern capital markets began in Europe with the issuance of the first public bonds and corporate shares back in the 17th century. Their emergence at the time was a powerful competitive advantage. Our fragmented and shallow capital markets today, however, are a competitive disadvantage. Europe needs a capital markets union to finance its investment needs.

JEAN-JACQUES BONNAUD
Treasurer – EUROFI

Changing the monetary and economic paradigm in Europe to stimulate productive investment

Investment is the lifeblood of competitiveness and productivity. After the global financial crisis, net investment in the United States and Europe fell significantly, but the decline was particularly pronounced in Europe.

Lasting negative real interest rates and demand-stimulating policies (high public deficits geared to redistribution policies) pursued in Europe over the past fifteen years contributed to reducing productivity in Europe, increased the already excessive indebtedness of certain EU countries, encouraged the development of liquid savings (in the absence of remuneration for long-term savings), the transfer of European savings to the United States and the postponement of structural reforms.

With interest rates set to remain at zero for an indefinite period, investors have been discouraged from investing in risky projects, turning instead to high-yielding speculative assets.

Low or negative interest rates induce a fatalistic state of minds that decreases — and not increases — the propensity to invest. In what John Maynard Keynes called the 'liquidity trap', investors play safe by placing their savings in very short-term instruments rather than deploying them over longer term, as low interest rates generate inadequate returns for higher risks.

Furthermore, a number of major shortcomings characterise the EU and also help to explain why it lags behind the United States in terms of productive investment The European Commission has been unable to ensure effective economic surveillance in Europe and fiscal discipline in indebted countries. The EU's competition policy, focused on preventing market dominance and state aid, has inadvertently stifled the development of European champions capable of competing globally. The EU's lack of a cohesive industrial policy has left it vulnerable to the protectionist measures of other major economies, such as the US and China. The community resources available (NGEI...) are difficult to spend and slow to produce effects in the countries that benefit most from them.

Consequently, a change of monetary paradigm is critical. it is necessary to refrain from fixing administratively ("or directing" the market) long-term interest rates and to accept to let the market remunerate medium – and long-term savings – according to supply and demand – the only way to remunerate long-term savings, without which there can be no productive investment or productivity gains.

> **Europe needs to systematically promote productive supply, that is, invest in research, innovation, and new technologies, rather than seeking grants or allowances to stimulate household consumption and internal demand.**

Moreover, the economic paradigm towards supply-side policies aimed at stimulating productivity (rather than demand needs to change radically in Europe particularly in the EU's over-indebted countries (Italy, France, Spain...) must be encouraged and implemented in all parts of Europe.

Europe needs to systematically promote productive supply, that is, invest in research, innovation, and new technologies, rather than seeking grants or allowances to stimulate household consumption and internal demand. This urgently requires, in highly indebted countries, a reorganization of their public finances to achieve primary surpluses and thus prioritize public investments over expenditures to meet the current needs of households.

This reorientation of national economic policies towards supply - which means channeling long-term savings into productive investment - is essential to also enhance the economic attractiveness of economies and the returns on the assets developed there.

Only the US can afford budget deficits because it issues the world's currency and benefits from the largest, most liquid, and deepest markets.

Every effort must also be made to ensure that venture capital, private equity and equity financing develop in EU countries and that companies, whatever their size and location in the Union, find the sources of financing they need in Europe. All regulatory measures taken in Europe should be geared towards this objective. The European legal and regulatory system must agree not to discourage risk capital players, and even to encourage them.

In addition, the EU needs to design and implement a genuine industrial industry to boost its industry and to accelerate the single market while re-establishing a community preference. EU competition policy should be revamped to help companies scale up and better compete in global markets.

Lastly, we need develop European projects financed by European companies. The multiplication of Important Projects of Common European Interest (IPCEIs) and collaborative projects between Member States is undeniably a way forward, given that they align their objectives, they identify qualifying and profitable projects and that they find adequate funding. This would facilitate and foster the emergence of competitive European companies, champions and SMEs, as they would benefit from economies of scale in the single market.

By addressing these core areas, Europe can create a more dynamic and resilient economic environment, capable of sustaining long-term growth and innovation.

ENHANCING RULE-MAKING AND THE LEGISLATIVE PROCESS

LOUISE CAROLINE MOGENSEN
Director General – Danish Financial Supervisory Authority

From single to simpler: making EU financial services rulebook smarter & stronger

Since the financial crisis, new regulations for the financial sector have been coming at a high pace, both globally and particularly within the EU. Given the extent and severity of the crisis, it was imperative for lawmakers to act quickly to ensure comprehensive regulations in the immediate aftermath. However, this regulatory momentum has continued and now presents a challenge. The complexity and sheer volume of these regulations pose a significant risk for businesses and supervisors to overlook the essentials. As we move into a new legislative mandate in the EU, we need to stop and ask ourselves whether time has come to transform the single rulebook into also being a simpler rulebook.

The EU rulebook should be more simple, proportionate, and entail the least possible number of burdens while at the same time underpinning financial stability and a high level of consumer and investor protection. A simpler rulebook, enforced by risk-based supervision with strong discretionary tools to supervisors, also creates a better balance in supporting a stable, diverse, and well-functioning financial sector.

Calling for a simpler rulebook does not imply advocating for a less strict rulebook – this is very important to keep in mind. On the contrary, a simpler approach could lead to even stricter regulation, with the added benefit of being easier to understand, explain, implement, and supervise.

Consider the current reality: a regulatory rulebook in the EU spanning more than 15,000 pages of regulations that credit institutions, insurance and pension funds, investment funds, and currency exchange offices must comply with.

While much of the task to simplify and shorten the single rulebook lies with the Commission and the co-legislators in the European Parliament and the Council, supervisors must also remain vigilant and strive to achieve a simpler and shorter rulebook, both for market players to comply with and for supervisors to enforce. As a concrete example to follow, the Commission has set an applaudable target to reduce burdens associated with reporting requirements by 25 percent. This is a step in the right direction, and it serves us all well to remember that less is (often) more.

Let me now turn to some concrete recommendations as first steps towards a simpler rulebook. I have four suggestions:

First, we need consistent and better impact assessments. These should address not just the consequences at EU level but also at national level in each Member State. Robust impact assessments will help ensure that new regulations achieve the stated objectives and have the intended impact and implications both for the private and public sectors. This approach would also align with our efforts to improve EU competitiveness, as this would ensure that only regulation with substantial added value is proposed.

Second, we need a regulatory timeout. The financial services sector has seen a substantial amount of new regulation in recent years, including new rulebooks in several areas. However, we need to make sure that when proposing new regulations, it will have an effect, and we must allow time for the effects of already agreed-upon regulations to materialise before proposing new rules. In the coming mandate, we should have proper time for recently adopted rules to be implemented, secondary legislation to be developed, and the regulatory framework to take effect for both the private and public sectors.

Third, we need an easily accessible rulebook. The current rulebook of the financial services acquis comprises a multitude of level 1 legal acts with accompanying level 2 acts and, on top of that, level 3 guidance. To ensure a well-functioning market, the rulebook should strive to be as clear as possible, easy to navigate, and with an accessible overview. This includes establishing a clear legislative hierarchy with legal clarity in level 1 rules, ensuring that technical standards remain technical in nature, not having to deal with unsolved political issues and key decisions.

Calling for a simpler rulebook does not imply advocating for a less strict rulebook.

Fourth, we need to simplify regulation through less product-specific regulation. Part of the recipe for the Capital Markets Union (CMU) has been many different pieces of product regulations. Looking back, success has been clear for some, but less clear for others. As a first step to simplify product regulation, we should harmonise and rationalise existing regulations, potentially scrap those that no longer serve their intended purpose.

In conclusion, transforming the single rulebook into also being a simpler rulebook is a challenging yet necessary task. One that requires collaboration between all levels of government – both national and European – and especially with the financial sector. A simpler rulebook will make it easier for the financial sector and supervisors to focus on the essentials: a robust and proper financial sector which delivers to businesses, consumers, and investors, and contributes to financial stability.

HARALD WAIGLEIN

Director General for Economic Policy and Financial Markets – Federal Ministry of Finance, Austria

Reducing administrative burden: a path to enhanced competitiveness

In today's fast-paced and interconnected global economy, the efficiency of the regulatory framework can have a significant impact on economic performance and competitiveness. Within the European Union, financial regulation plays a crucial role in maintaining market integrity, ensuring the stability of the financial system and protecting consumers. However, the burden of regulatory compliance has become a pressing concern for many financial market participants. It is important to examine why reducing administrative burden and cutting red tape is essential to improving competitiveness in the EU.

The Weight of Administrative Burden

Administrative burden refers to the rules, requirements and guidelines that organisations have to deal with to comply with the regulatory framework. In the financial sector, the legal framework has increased significantly over the years as a result of the numerous directives, regulations, and supervisory requirements imposed by the ESAs. While these measures are intended to reduce risk and enhance transparency, they often come at a high cost to financial institutions.

Experience shows that smaller companies face disproportionate challenges in complying with regulatory requirements, as they often lack the resources and expertise of larger firms. This can hamper innovation, limit growth opportunities and stifle competition.

The Case for Reducing Red Tape

Let me give some examples:

1. Fostering Innovation: A heavy regulatory burden can inhibit innovation. Fintech companies for example, which often do not have large compliance resources, find it increasingly difficult to navigate complex regulatory requirements. By simplifying the rules and reducing administrative burden, the EU can foster an environment where innovative solutions can emerge, stimulating investment and creating better services for consumers.
2. Encouraging Competition: An overly bureaucratic regulatory environment favours incumbents who can better absorb compliance costs, thereby discouraging new entrants. Reducing administrative red tape would lower the entry barrier for smaller firms and startups, thereby fostering a more competitive market landscape. A diverse financial sector would not only benefit consumers through better services and lower fees, but would also strengthen the EU's position as a global financial centre.
3. Enhancing Efficiency: Reducing administrative burden would significantly improve the operational efficiency of financial institutions. By reducing redundant processes and simplifying reporting requirements, resources could be reallocated to core business activities rather than compliance. This operational efficiency can help to reduce costs for consumers and to promote better financial products.
4. Attracting Talent and Investment: A competitive financial environment is essential to attract talent and investment. If the EU is perceived as bureaucratic, it runs the risk of companies relocating to more business-friendly jurisdictions. By streamlining regulation, the EU can retain and attract businesses and foster a dynamic financial services industry that thrives on innovation and competition.

Striking a Balance between Administrative Burden and Financial Stability

While reducing administrative burden is essential, it is equally important to ensure that robust regulatory standards remain in place. The challenge is to strike the right balance between mitigating risk and avoiding excessive bureaucracy. Both regulators and the financial industry can provide insights into areas where simplification is possible without compromising a high level of financial stability and consumer protection. In this context, I very much welcome President Von der Leyen's plans to reduce administrative burden and to ask each Commissioner to propose concrete measures to cut red tape.

I am aware that the Commission will come up with ambitious initiatives in the field of financial services. More work needs to be done as far as the Banking and Capital Market Union are concerned. At the same time, we should come to a point where the legal framework should remain as stable as possible for a specific time frame as too frequent reviews or amendments and a lack of legal certainty can lead to high compliance costs for market participants and not necessarily to a deepening of the financial market.

> Reducing administrative burden is a strategic imperative for the EU's economic competitiveness.

In conclusion, reducing administrative burden and cutting red tape in financial regulation is not just an exercise in regulatory reform; it is a strategic imperative for the EU's economic competitiveness. By fostering innovation, promoting competition, increasing efficiency and attracting global investment, a streamlined regulatory framework can position the EU as a leader in the global financial market. As we consider the future of financial services in Europe, it is crucial to prioritise regulation that makes a difference and supports growth while maintaining the necessary safeguards to protect consumers and preserving financial stability.

JOSÉ MANUEL CAMPA
Chairperson – European Banking Authority (EBA)

Financial stability as a pillar of EU competitiveness

As the EU starts a new legislative cycle, it is appropriate to reflect on achievements and pending challenges. The 2019-2024 cycle witnessed an unprecedented succession of crises, from the onset of a global pandemic to the resurgence of violent conflicts in the European continent. Their consequences on the economy put the resilience of the EU banking system to the test. Most recently, EU banks demonstrated stability in the face of the March 2023 banking turmoil originating from the United States.

This ability to withstand unexpected shocks is a testament to the progress made to strengthen the financial sector since the Global Financial Crisis. Indeed, the 2008 events and subsequent sovereign debt crisis exposed loopholes in the prudential system and in the construction of the single currency. The collective response was to embark on an upgrade of the regulatory framework globally complemented with the creation of the Banking Union in the EU, which set out to shore up resilience by building a common single rule book and a more integrated supervisory architecture. Its third leg, the common deposit insurance scheme, remains a key missing piece of the project.

There has been a fundamental transformation of the regulatory environment. As part of that transformation, European co-legislators decided to create the EBA, within the European System of Financial Supervision, and tasked the independent authority with preserving financial stability in the banking sector, namely by helping harmonise supervisory practices and further developing the single rulebook. To fulfil its mission, the EBA is given by EU primary laws mandates to develop 'level 2 and 3 instruments' such as regulatory and implementing technical standards (RTS/ITS), guidelines, opinions, and questions and answers (Q&As). They are meant to provide the technical bedrock on which EU Directives and Regulations can rest.

Since its creation in 2011, the EBA has sought to utilise these instruments in strict accordance to those level 1 mandates and holds a steadfast commitment to preserving financial stability. Yet that focus has not prevented it from integrating other imperatives when the circumstances called for it. For instance, at the very onset of the COVID-19 crisis, it published guidelines on payment moratoria seeking to publicly back the use of the flexibility embedded within the prudential framework. This helped maintain banks' ability to provide lending and prevent liquidity shortages faced by businesses and households.

The focus is now on implementation and preserving stability.

Looking back, the speed, pace, and depth of the regulatory changes has been historic. Now turning to the legislative cycle ahead, the EBA is set to continue to be guided by the mandates arising from level 1 legislation and financial stability imperatives. Implementation of the regulatory framework put in place over the last years through the banking package, Digital Operational Resilience Act (DORA), Markets in Crypto-Assets Regulation (MiCA), and the new legislation to fight against money laundering and terrorist financing will be a priority. This approach will continue to pursue the full development of a Single Market within the EU that enables economic growth and investment. The banking sector has a key role to play as it provides credit to fuel business developments and can fund major transformations. For this core function to happen, financial entities have to be sound and well managed, markets integrated, and market participants must have confidence in the financial sector and trust that the regulatory framework offers adequate assessment of risks and financial stability.

What is now key going forward, is proper and effective implementation. The EBA was given about 140 mandates by the banking package alone. Our focus is on developing them in the most efficient and predictable way for all parties involved. To facilitate this, we published the EBA Basel 3 Roadmap. It provides stakeholders visibility on the development of these level 2 regulations for their planning, timelines, and prioritisation. Similar attention will be paid to other areas of banking regulation. Emphasis will be placed on facilitating implementation, adequate proportionality and impact monitoring.

ALBAN AUCOIN
Head of Public Affairs – Crédit Agricole S.A.

Europe needs less but better regulation

China invests, the USA innovates, and the EU regulates. We need to change our mindset, as facts and figures demonstrate that Europe is increasingly falling behind in terms of growth, innovation, and competitiveness. For instance, during the last 15 years, the European financial sector has lost about half its global market share, weakening it. Beyond the financial sector, this has far-reaching consequences, since the lack of purchasing power and the accumulation of structural issues in the EU fuel votes for extreme political parties and severe backlashes on crucial issues.

Since it is unlikely that the decline of the financial sector can be explained through a sudden and general lack of skills on the part of European bankers, insurers, or asset managers, we need to look at other causes. Namely, the structural causes: market fragmentation, overregulation, shift of normative power, gold-plating, excessive capital requirements, 'pointillist' supervision, over taxation, fee caps or regulated pricing, both at national and European levels.

Year after year, the flow of regulation has much increased. The implementation of Basel III through CRR/CRD required 500 pages of law and around 60 delegated acts. The so-called finalisation of Basel III required twice as much of very complex level 1, 2 and 3 regulations. We must streamline regulation.

The priorities are: to introduce a credible, independent, competitiveness test ahead of any new regulatory proposal; to add to public authorities' mandates an objective of facilitating the EU's international competitiveness and long-term economic growth; to respect the institutional balance and allow more controls; to allow swift adjustments when the different level of rules or their inconsistencies appear to have unintended impacts.

This regulatory inflation concerns not only directives and regulations but also level 2 (delegated acts, RTS, ITS) and level 3 (guidelines, letters, guides, Q&A, etc.). At the beginning of the last decade, there were few delegated acts every year; in 2022, there were nearly 200.

This inflation of level 1, 2 and 3 regulation leads to a regulatory burden on financial institutions, requiring huge efforts and costs (i.e. burdensome IT changes). The lack of systematic impact assessment, proportionality, transparency, as well as insufficient meaningful dialogue with the relevant stakeholders in the rule-making process, worsen this situation. This leads to conflicting/overlapping provisions, timing/implementation issues, uncertainty as to the effects of EU soft law which is binding in practice even though not in principle.

> **The EU can improve its legislative and rulemaking processes, thus fostering competitiveness.**

The rise in delegated acts also leads to a democratic challenge, since delegated and implementing acts are meant to deal only with technical and non-essential parts of the text. Nevertheless, we observe that they now often cover essential and political measures. On top of that, the Commission, the European Parliament, the Council and even the European Court of Justice (ECJ) do not really use in practice their limited powers of control regarding level 2 or level 3 regulations. Consequently, we are observing a shift in normative power from the EU's co-legislators to the European Commission and ultimately to the European Supervisory Authorities (ESAs).

There are many examples of level 2 and 3 regulations going beyond the level 1 mandates (for instance, the ITS pursuant pillar 3 of CRR3 or the EBA guidelines on loan origination), with limited recourse for the stakeholders. Besides, there are inconsistencies/overlaps between the different texts.

Therefore, it is urgent to improve the European rulemaking in the financial services sector to achieve 'less but better' regulation, in the spirit of the Lamfalussy process and the Larosière report or the Better Regulation principles. We must respect the institutional balance and the principles of democracy by ensuring that European Supervisory Authorities (ESAs) are fully accountable to co-legislators. We should limit delegations and clarify their scope. It is essential to develop a culture of impact assessment, both ex-ante and ex-post. We need to enhance the consultation process and the functioning of expert committees. Moreover, there should be more effective judicial control over Level 3 acts, notably through improved access opened to stakeholders to the ECJ.

To improve the rule-making process, governance is key. It seems desirable to strengthen the governance of the ESAs: A balanced Board would usefully include representatives from finance ministries or non-conflicted former industry professionals and reflect the Union as a whole. It could improve the normative or quasi-normative role of the ESAs.

By implementing these strategies, the EU can improve its legislative and rulemaking processes, thus fostering competitiveness by establishing a more predictable, transparent, and efficient regulatory framework that promotes business and economic growth. This does not contradict the objective of financial stability, quite the contrary.

BERNHARD SPALT
Chief Risk Officer – Commerzbank AG

"Better Regulation": the key to a more competitive Europe

Regulation is a key tool to address risks and create legal certainty. Yet, at the same time, the question whether it acts as business hinderance or enabler is a frequent matter of debate. When discussing measures to improve the EU's global competitiveness, we must acknowledge how regulation affects businesses and innovation. And we need to determine the adjustments needed to make sure it appropriately addresses risk while still enabling our economy. In short: how do we create regulation that is more efficient without being less effective?

Unlevel international playing fields are a clear obstacle for European firms and continued global regulatory cooperation remains key. But also within the EU, we need to ensure that the regulatory framework is i) reliable, ii) consistent, and iii) implemented in a homogenous manner.

Reliability

With the recent publication of *CRR III* and *CRD IV*, a five-year policy making process on the EU banking package comes to an end. Banks are confronted with a short implementation timeline and various implementation challenges due to the large volume of outstanding work on Level 2. Over the next years, the EBA has to complete 140 *CRR III* mandates to render *CRR III* and its reporting obligations practically applicable. But this will also mean an additional 7,000 pages of regulation and an expected 2,000 detailed EBA Q&As that can still impact what banks must consider in their implementation, not to mention the ECB guidelines and inspections this will trigger. The outstanding information translates into a reduced regulatory reliability for the banking industry, as EBA and ECB interpretations may significantly shape legal requirements. The recently announced delay of the *Fundamental Review of the Trading Book* increases uncertainty, even though its aim – to achieve an international level playing field – is well recognized.

But this challenge is mirrored in other areas as well: The *AI Act* will be underpinned by standards with a regular implementation period of 12 months for general-purpose AI. However, only a three-month period between publication of the standard for general purpose AI and its application is currently guaranteed. And the *Digital Operational Resilience Act (DORA)* will apply from January 2025, even though not all technical standards are available yet.

Consistency

Next to being reliable, an efficient and effective regulatory framework must be consistent and avoid overlaps, duplications and conflicts where possible. The complexity of regulation is particularly evident for innovation: The uptake of AI is heavily encouraged to foster competitiveness of EU enterprises, yet compliance with the applicable legislative frameworks is challenging due to their complexity. On top of the *AI Act*, financial sector specific laws like *DORA* lay out provisions on Third-Party Risk Management. On national level, the German Banking Act acts as further binding measure. Other applicable norms stem from the *General Data Protection regulation* or cloud-specific rules. Developers may be subject to different rules than banks. And there is more to come: The EU's new AI Office is expected to publish its own standards on the *AI Act*. A thorough review of already existing rules and their streamlining is therefore indispensable. A focus on principles-based regulation that is less detailed, as proposed by BaFin President Mark Branson, would also reduce the risk of conflicts and make regulation future-proof.

Homogenous implementation

Finally, efficiency is a matter of implementation and supervision. Implementation of European rules diverge between member states – and even where the use of regulations aims to reduce "gold-plating", supervisory practice often remains fragmented. This has happened, for example, during the transposition of ESA guidelines into the German minimum compliance requirements (*MaComp*) and the German Minimum Requirements for Risk Management (*MaRisk*). In both cases, discretionary rules have in part become mandatory, as "can" turned into "should" and "should" into "must", leading to a race to the top. Further fragmentation arises as part of the supervisory examinations, where teams from different authorities interpret definitions differently. All of those "gold-plating" practices hamper harmonization. The establishment of single rulebooks and use of harmonization tools such as the ESA Q&A processes are welcome developments against this backdrop. The benefit of centralized supervision, such as through AMLA or the SSM, could be further explored for additional areas of financial services, e.g. for market infrastructures.

We need to ensure that the regulatory framework is i) reliable, ii) consistent, and iii) implemented.

While the political debate seems more fragmented than ever, there is unanimity on one issue at the beginning of this political cycle: Strengthening Europe's global competitiveness must be our priority. Seeing this agreement is encouraging, but the recent statements must now be followed by actions. The "Better Regulation" principles offer important responses to those challenges if we decide to follow them.

We thank **the partner institutions**
for their support in organizing this Forum

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TACKLING EU PENSION GAPS

JOS HEUVELMAN
Member of the Executive Board – Dutch Authority for the Financial Markets (AFM)

Pension saving? The best time to start was yesterday, the second-best is today

The European Commission should urge member states to introduce measures to increase participation in pension schemes. Auto-enrolment (with opt-out) addresses behavioural biases and has the potential to increase the pool of risk-bearing capital and decrease the pension gap. Pension funds can provide this capital to the Capital Markets Union, financing the green, defence and digital transitions.

The EU faces a worrying pension gap as its citizens age and fewer workers have to support increasing numbers of retirees. Most citizens rely on pillar one or government pensions, which are typically Pay-As-You-Go. Demographic changes make these unsustainable. Policy makers will need to choose between raising contributions for workers or decreasing benefits for retirees. Moreover, few citizens have additional savings in the second or third pillar. Only 23% save through an occupational retirement scheme and 19% own a personal pension product. The European Commission has found that 22.9% of women and 16.7% of men were at risk of old age poverty or social exclusion in 2022.[1] Fewer than half of EU citizens are confident that they have enough saved for retirement.[2]

The Netherlands has one of the lowest rates of old-age poverty globally. This is in large part a result of our highly developed occupational pension sector. Some 85% of Dutch workers mandatorily save for their pension through their employer. Dutch pension funds manage approximately EUR 1,400, nearly 150% of the size of Dutch GDP and almost two-thirds of all IORP assets in the EU.

We certainly have our problems. We are undergoing difficult but necessary pensions reforms to make our pension system future proof and adapt to demographic realities and a modern, more flexible labour market. People outside of this system, however, such as the self-employed, often save far too little for a comfortable pension. People are all too often unaware of an inadequate pension, until it is too late to do something about it.

Nevertheless, the Dutch pension sector may provide valuable insights for European policy makers. The first is that you must start somewhere. The road to pension adequacy is long. If you wait to act before the entire route is clear and planned, you will never reach your destination. The perfect is the enemy of the good. The sooner people start to save and invest, the better their retirement will be.

The second is to minimise behavioural biases like presentism and nudge people in the right direction. People are not interested in their pensions and would rather go to the dentist than read pension information. They value current consumption more than future benefits. Short of a general obligation for both workers and employers, one option to achieve this is to install a system that automatically enrols people while giving them an opt-out. In the UK, this has substantially increased pension saving rates. If people have to take action themselves, they tend to postpone until it is too late.

Short of such measures, policy makers can harness the power of behavioural finance in other ways. Where choices are available, it must be as easy as possible to take action and make the most suitable decision. Information should be personal, clear, and timely. When people do fail to act (which they will), pension providers need to think about suitable default options.

Third, cost and trust are key. Investing is a long-term game and even slightly higher costs significantly hurt long-term returns. To most people, one percent in annual costs may not seem like much, but it will make a world of difference in terms of pension benefits. Ordinary people have better stuff to do than actively look after their pensions and will leave it to professional money managers and pension administrators. They need to be able to trust the professionals will do the right thing and keep their interest front and centre.

Demographic changes mean Pay-As-You-Go government pensions become unsustainable.

In conclusion, the twin problem of insufficient funding for European companies and inadequate pensions for systems persists. The longer we wait, the less likely we are to bridge the pension gap. The most effective policy options are often the most politically difficult. The retail investment package has failed to deliver on its ambitions. The next Commission should look at how pension funds can play a role. As with investing for later, the best time to start was yesterday. The second-best time is today.

1. *European Commission, Directorate-General for Employment, Social Affairs and Inclusion, The 2024 pension adequacy report – Current and future income adequacy in old age in the EU. Volume I, Publications Office of the European Union, 2024, https://data.europa.eu/doi/10.2767/909323*
2. *EIOPA, The EU should build on past initiatives to address growing pension gaps, Eurofi Magazine, February 2024, https://www.eiopa.europa.eu/publications/eu-should-build-past-initiatives-address-growing-pension-gaps_en#_ftn1*

MARIO NAVA
Director General –
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European Commission

Adequacy and fiscal sustainability of national pension systems

National pension systems within the EU are diverse due to historical developments, national policy choices and the economic situation. Nevertheless, all systems are facing similar challenges linked to labour market developments and population ageing.

National pension systems have protected retired Europeans' living standards in face of global challenges. However, the risk of poverty and social exclusion for older people has continued to grow since 2019, due to rising relative income poverty. Women are generally at a higher risk of poverty than men, with differences between countries. These gaps stem from gender pay differences, shorter or interrupted careers, and more part-time work. In 2022, almost one in four women in the EU aged 75 and above was at risk of poverty or social exclusion, a significantly higher proportion than for men.

Further challenges impacting the adequacy and sustainability of national pension systems are a shrinking workforce and an increasing use of non-standard forms of employment. Self-employed, part-time or fixed-term workers often struggle with low earnings and fewer opportunities to build pension entitlements. Many Member States have already taken steps to improve the inclusiveness of national pension systems and make all work count. Yet, more remains to be done. To function effectively, reforms must be accompanied by broad public debates to ensure that citizens will accept them. Reforms should be firmly based on evidence, considering both budgetary forecasts and projections of future adequacy.

Currently, statutory pension schemes are the main source of income for most European pensioners. The 2024 Pension Adequacy Report projects that, in the decades to come, income replacement rates from statutory pensions are set to decrease in most Member States. Simultaneously, the Ageing Report demonstrates that pension spending is the biggest contributor to increases in age-related expenditure. High employment participation, as well as inclusive and robust labour markets are key factors required to maintain adequate pensions in an ageing society.

To facilitate the digitalisation and pension awareness, the Commission supports the development of the European Tracking Service for pensions. This will allow people who have been living and working in different EU countries to consult their pension rights from different countries and different pillars via one platform. Financial and pension literacy is a key pre-condition for raising awareness so people can make informed choices on their savings needs, well before reaching the retirement age. To address these challenges, there is a strong need for multi-faceted solutions that go beyond pension policies.

As called for in the Demography Toolbox, EU and national policies should help ensure that people in Europe, including older generations, can fulfil their aspirations and maintain a good quality of life. Ensuring adequate pensions requires a broad range of policies that address gender inequalities at work, the financial burden of long-term care needs and poor access to social protection. Sustained efforts to implement the Council Recommendation on access to social protection and the Council Recommendation on affordable high-quality long-term care can positively contribute to remedying these issues and improve the standard of living for older Europeans.

During the recent conference on "Challenges and opportunities of longevity in Europe", discussing the findings of the 2024 Pension Adequacy Report and the 2024 Ageing Report, participants agreed that maintaining both the adequacy and sustainability of pensions are inseparable policy objectives that should be guiding reform efforts. Furthermore, in its report, the High-level group of experts on pensions highlighted that Member States should create or retain a pension-friendly legal environment (social, labour and tax law) and an appropriate prudential framework. Respecting each country's social model, Member States should take a long-term and holistic approach to developing multi-pillar pension systems, based on strong public pensions and acknowledging the specific roles of different types of schemes. A European Saving and Investment Union, which President von der Leyen proposed in the Political Guidelines for the upcoming Commission, can help leverage the power of capital markets in the EU to boost pension saving.

Multi-pillar pension schemes can boost adequacy and fiscal sustainability of national pension systems.

Multi-pillar pension schemes can help boost the pension adequacy and fiscal sustainability of national pension systems. The EU supports Member States' efforts to ensure adequate and sustainable pensions through the European Semester, facilitating mutual learning and exchanges of best practices and reform support, notably through the Recovery and Resilience Facility and the Technical Support Instrument. Building well-designed and inclusive multi-pillar pension systems can help address the challenges discussed. The Commission stands ready to support Member States and stakeholders in this work.

PETRA HIELKEMA

Chairperson – European Insurance and Occupational Pensions Authority (EIOPA)

How addressing pensions gaps could help further develop Europe's capital markets

The ageing EU population and declining number of people of working age are exerting pressure on the sustainability of pay-as-you-go (PAYG) pensions. However, reforms to cut PAYG pension spending alone would increase future pensioner poverty, as statutory pensions constitute the primary source of retirement income for individuals.

Pension reforms should address the pension gaps by providing minimum social protection for all existing and future retirees and complementary retirement income sources in the form of private pensions. Privately managed pensions adapted to national circumstances can be designed to complement statutory pensions. Whether they are occupational, personal or statutory funded, these pensions all share the characteristic of being long-term investment instruments and important contributors to building Europe's internal capital market.

Recent reforms have aimed at reducing poverty (e.g. maintaining pensioners' purchasing power, increasing pension entitlements for specific groups), promoting longer working lives (e.g. limiting early retirement, increasing the pension age) and developing statutory funded schemes. Reforms to improve private pension coverage remain rare, representing a missed opportunity three-fold.

Increasing pension participation through compulsory or auto-enrolment can prove effective in reducing pension gaps. Moreover, it can contribute to the development of capital markets, which require broad coverage and scale. Well-developed capital markets can, in turn, provide new investment opportunities that benefit retirement savers and the wider EU economy.

For those reasons, addressing the pension gaps should be a priority for the next European political cycle. To achieve this, Member States should develop comprehensive and robust multi-pillar pension systems that promote secure long-term retirement savings. To ensure private pensions are accepted and trusted over time, Member States will need to foster transparent pensions systems, raise public awareness and develop simple, flexible, appealing and trustworthy private pensions.

Fostering adequate private pensions should be a priority for the new European political cycle.

Pensions dashboards can promote transparency by providing information on existing pension gaps and the adequacy and sustainability of pension systems. Additionally, they can support informed policy decision on how to allocate public funding to close the gap, whether through increased support for PAYG systems, support for auto-enrolment, or tax incentives for simple savings product in pillar 3. EIOPA has offered advice to the European Commission on both of these transparency tools and stands ready to provide additional support.

Private pensions should be flexible and portable to reflect the new labour market realities. As people change jobs, sectors, regions, and sometimes countries, and experience periods of (in)voluntary inactivity, it is essential to avoid situations where savers accrue multiple private pensions that do not contribute to ensuring pensions adequacy.

Private pensions should be simple by design, recognising that individuals often have limited understanding and may procrastinate when faced with complex decisions such as pensions. Policy makers should carefully consider the use of defaults as well as limit and frame choices to simplify pension decisions. Providing low-cost standardised solutions can cater to the needs of the majority of savers. EIOPA believes that product design needs to improve to ensure that products provide value to consumers.

Private pensions should be appealing by offering tax advantages, taking into account people's tendency to prioritise present needs. They should also be genuine in offering a real opportunity to secure a meaningful retirement income over time. However, full annuitisation may not be the best answer for all and may be disliked due to its irreversible nature and impact on inheritance intentions. Innovation seeking to extend savers' investment horizon beyond retirement age could provide opportunities to better match the pattern of people's retirement income needs and further help develop capital markets.

EIOPA has contributed to strengthening EU pensions regulation, namely IORP II and PEPP. While the PEPP is lagging behind expectations, it has many positive features that go beyond its portability: it is flexible, affordable, digital, and consumer-centric. It remains a valid option for the future, benefiting both consumers and providers. Additionally, it addresses pension gaps and demographic challenges while supporting long-term growth of the real economy and the green and digital transitions. However, for the PEPP to realize its full potential, it needs to be simplified, fine-tuned and upgraded to meet today's and tomorrow's challenges.

EIOPA's remit could be extended to assist Member States in implementing private pension reforms as well as explore the potential for an EU label or quality mark. This would foster consumer protection and sound supervision and build trust and confidence in private pensions for the future.

CHRISTOPHE GLOSER

Head of European Distribution – Fidelity International

Enhancing pension systems and investment in the EU: a path to economic growth

The European Union is facing significant challenges in its pension systems and the distribution of long-term capital. Although there are differences across local pensions and retirement frameworks, there is a common challenge related to funding of the pension gap and to long-term wealth creation, which is set to heighten as changing demographics continue to intensify. This is why we believe there is crucial a need to encourage individuals to accumulate retirement savings and increase retail investment, and at the same time to explore solutions that can drive sustainable economic growth.

The EU currently faces a low level of pension assets relative to GDP, with a concentration of these assets in only a few member states. This imbalance poses a significant challenge to the overall sustainability of pension systems in the EU. According to data[i], the size of pools of long-term capital as a percentage of GDP varies greatly across member states. For example, countries like the Netherlands and Finland have well-designed occupational pension systems, with a significant portion of retirement income generated through this scheme. By contrast, countries like France and Germany rely more on a pay-as-you-go unfunded state pension with less developed private retirement savings.

Another key challenge is the lack of long-term capital in the EU, which hinders the development of Capital Markets Union. Transitioning from the prevalent pay-as-you-go pension system to a more funded model is necessary but would require substantial reforms that may take decades to implement with a coordinated legislative approach at European level needed to ensure ease of transfer from one country to another, which would also facilitate cross border occupational plans. The potential benefits are significant, as deep pools of pension assets and increased retail investment can have a transformative impact on the scale of long-term capital in the EU.

Investing for the long-term is highly complex, especially if you take into account the economic, geopolitical, sustainable and demographic factors. But it is a crucial one to tackle for any investors - corporate or retail. Asset managers have a key role to play to help corporate and institutional investors and their clients. Our role is even more relevant today, as we are living through increases in the cost of living across Europe, which is having a significant impact on how people approach their long-term saving plans. To address the problem effectively, a multi-faceted approach is needed. Firstly, it is crucial to encourage individuals to save for retirement by implementing pension reforms that promote funded pension systems. The Netherlands and Denmark serve as excellent examples of a countries with a well-designed occupational pension system as nearly 90% of workers are covered by occupational pension schemes.

Transitioning towards funded pension systems, could unlock substantial amounts of long-term capital.

Drawing from the success of these models, other member states could consider implementing similar reforms tailored to their specific contexts. This would involve promoting the establishment and growth of well-regulated occupational pension systems that supplement state and private pensions. It is imperative to educate and build trust and confidence in these systems through transparent fund management, appropriate contribution rates, and well-designed retirement solutions.

Additionally, retail investment needs to be widened to provide a middle ground between short-term savings and long-term investments. Lower fees, simplicity and easier market access can help attract more retail investors. Best practices from the Nordics, which have a partly funded state pension that supplements mandatory or quasi-mandatory occupational pensions, can be studied and replicated in other EU member states.

Furthermore, policymakers should consider offering tax incentives for investing in European products like ELTIFs to encourage retail investment. Reinventing savings and investment accounts for children can also contribute to building a culture of saving and investment from an early age. An EU-wide public information campaign can play a vital role in raising awareness and promoting better saving habits.

Inconclusion, the EU must address the challenges in its pension systems and the distribution of long-term capital to ensure sustainable economic growth across all member states. By transitioning towards funded pension systems, encouraging retirement savings, and promoting retail investment, the EU could unlock substantial amounts of long-term capital. This would not only benefit individuals by providing better financial futures but also support the development of capital markets, drive innovation, and foster economic growth. It is imperative for policymakers and market participants to collaborate and implement the proposed solutions, drawing from best practices of high standards of governance and robust investment processes, to pave the way for a prosperous future in the EU.

1. *Analysis of data from EIOPA, Eurostat, FSB, OECD and IMF.*

AGUSTIN REYNA

Director General – The European Consumers' Organisation (BEUC)

How to bridge Europe's widening pensions gap

There is a growing pension gaps in most EU countries, meaning a discrepancy between what people will receive in retirement and what they need to maintain a comfortable standard of living.

This largely results from EU Member States reducing their engagement with pillar one pensions, expecting pillars two and three to compensate. This shift was driven partly by demographic changes that rendered the prevalent pay-as-you-go schemes in pillar one less viable. Additionally, the shift of income from labour to capital in our economies undermined pension systems funded through labour income.

Shifting the burden to consumers

The idea then was simple: shift a part of the pensions coverage into the capital markets. However, it's crucial to recognise that about 50% of the European population lacks the financial means to invest for retirement.

Consequently, a significant portion of the social dimension of this issue cannot be resolved through market mechanisms alone. For those who cannot invest, employment pensions will be the only remaining solution, shifting some income back into the labour force through pensions systems. How much this needs to be would depend on how many, and how effectively, people can afford to invest in the third pillar pension plans. So, let's look at pillar three pensions first:

What we see in outcomes for retail investments, including personal pensions, in the EU is grim:

- Poor-quality products lead to suboptimal outcomes, with many burning income potential in real terms over their runtime due to negative returns after inflation.
- These inferior products reduce the ability of individuals to save significantly because the amount of savings needed at the end of a career remains the same. The worse a product performs, the more a person needs to save to meet that threshold. And this means that fewer people have the income to do it.
- Bad products erode trust, a key factor in encouraging participation.
- This general mistrust, fuelled by mis-selling scandals and poor performance, fosters a culture hostile to investment.

A European solution?

The EU's Retail Investment Strategy (RIS) process has thoroughly examined the causes of these failures. Consumers need sound advice for investment decisions but often receive sales pitches instead. Advisors, driven by commissions, prioritise selling products that offer higher percentages rather than those beneficial to consumers.

> Addressing the pension gap in the EU requires a focus on creating high-quality pillar two products.

This misalignment between supply and demand results in products designed to attract distributors, not to serve consumers' best interests. Without addressing this issue, the third pillar is effectively unviable at least for the vast majority of retail investors who must rely on advice.

Since reforming pillar one pensions falls outside the EU's remit and the underlying problems remain unsolved, we must look for other workable solutions. Pillar three products require functional investment markets, but the recent RIS experience has shown a lack of political will to organise such markets in a way that benefits consumers. Thus, the logical conclusion is to focus on a pillar two solution.

Strengthening pillar two

When considering the features of a pillar two solution, we must remember: It is not possible to subsidise an inefficient product into viability. While discussing tax benefits is important, it should follow the establishment of a framework that ensures viable solutions. Injecting public money into the system during product design would reduce the pressure to be competitive, worsening the underlying product and harming both consumers and state finances.

A viable pillar two solution should therefore meet the following criteria:

- It must be cost-efficient.
- It needs a distribution vector independent of the sales interests of the incumbent industry, despite cost restrictions to avoid the fate of the Pan-European Pension Product (PEPP).
- It should offer at least one variant unrestricted by guarantees or other insurance features, allowing for an effective investment strategy.

So, addressing the pension gap in the EU requires a focus on creating high-quality, accessible pillar two products that can provide meaningful investment opportunities for the population, supported by a robust and independent distribution framework. Examples of how this could be done may be found in the UK, but other approaches are possible.

In the interest of citizens and our economy, I do hope that we can manage this. If we fail to establish a functional solution because it may inconvenience entrenched interests, it will not cement the status quo. The pensions crisis, much like the climate one is not going away. If we cannot establish a plausible solution in the EU, consumers will increasingly turn to products from the other jurisdictions like the US to satisfy their needs. The answer to this question may well decide a big part of the question if the EU is capable of being competitive in financial markets. Right now, it is not.

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CEE REGION GROWTH AND FINANCING CHALLENGES

BARNABÁS VIRÁG
Deputy Governor – The Central Bank of Hungary

Manoeuvring through stormy waters – growth prospects in the CEE region

Central and Eastern Europe was among the winners of the EU in the past decades. After joining the European Union 20 years ago, the region has experienced dynamic economic convergence. At the time of accession, GDP per capita levels at purchasing power parities stood between 40 and 60 percent of EU average (excluding Slovenia and Czechia). After two decades, most of the CEE economies have already reached 70-80 percent of EU's relative development (Slovenia and Czechia over 90 percent) and have been knocking on the door of high-income status. Rapid economic convergence was driven by a successful growth model built on expanding labour markets, stable financial markets and vivid trade growth supported by the deepening of value chains. Convergence, for now, is expected to continue in 2024 and 2025, with a projected GDP growth in the CEE region 2-2.5 times higher than the EU-average.

After the prosperous last decade, new challenges have emerged in the stormy 2020s. The global pandemic changed the rules of life and work, while the bottlenecks in global value chains and geopolitical conflicts appreciated the value of energy and all production factors. The CEE region has been among the most affected by the war in Ukraine, mostly due to its geographical location. The gravity of war has proven significant during the centuries, as negative supply shocks dominated nearby the war zone and their effects declined with distance. It is no different in the case of the Russia-Ukraine war. From mid-2021, consumer prices have risen almost twice as much in the Eastern members of the EU as in Western countries. The surplus in inflation was mostly due to the large sensitivity to energy prices in line with high energy intensity and energy dependence of the CEE countries. It is worth mentioning, that 9 out of the 10 most energy intensive EU economies are in this region.

With the intensification of both cyclical and structural challenges, the need for a future-ready growth model based on productivity has increased. High GDP growth of the last decades was facilitated by the availability and relative low cost of labour, financing and energy. Those times are over. Growth models based on the quantity of production factors will be challenged by megatrends such as demography, digitalisation or the green transition. The question of quantity must be replaced by the question of quality and productivity. The strategy of 2T & 2K, which is, technology, talent, knowledge and capital (K) should be prioritised. The proper combination of these factors and the most efficient use of the available resources are the key to future competitiveness and the increase in productivity.

Demographic constraints are becoming even more effective, globally. The old-age dependency ratio is expected to increase dramatically in the CEE region in the coming decades, limiting the amount of employable workforce. Besides the challenge of shrinking and ageing population, keeping and attracting skilled workforce will also become a key objective. As the quantity is limited, the transformation of labour markets should be led by the quality of workers and human capital. Reskilling and upskilling are essential in line with the acceleration of digitalisation, automatization and the revolution of AI. Based on historical experience, technological revolutions and the application of new technologies may eliminate jobs, but they also create new ones and complement existing jobs, thereby increasing productivity.

We have entered the age of great transitions. Recent years have proven the strategic importance of critical infrastructure and energy. The CEE region is deeply integrated into manufacturing value chains, which together with the notable energy intensity translates to a serious vulnerability. The need for a green transition is much more important than ever before, in which central banks play an essential role. The Central Bank of Hungary has been a pioneer and one of the most active with its green mandate, encouraging and leading the transformation. Economic structures must also be updated, as most of our countries in the region are stuck in low productivity activities. To meet the needs of the future and maintain a dynamic GDP growth path, a shift to services and higher value added content is crucial. Targeted and effective R&D, accompanied by a vivid domestic innovation ecosystem may be the foundation of value creation and could also support the transition to a more digital economy.

With the intensification of both cyclical and structural challenges, the need for a future-ready growth model based on productivity has increased.

Central and Eastern Europe is a bridge between East and West. Most of its countries are small and open regarding international trade, therefore we should seize the opportunities arising from global value chains. We must build on our strengths and be open to joining new megatrends and the transformation. The European Union represents cooperation, culture, and prosperity, so with its continuing enlargement we get the opportunity to cooperate, trade and thrive.

LEONARDO BADEA
Deputy Governor – National Bank of Romania

When adequately addressed, most challenges can turn into opportunities

Like most things deeply related to life, the economy evolves in cycles. In the medium and long term, policymakers are primarily concerned with the downward phases of these cycles and their determinants, given the profound negative impact of crises on people's lives. This also warrants that we, as a society, learn from past lessons and use the gained knowledge to test ideas and solutions that may help mitigate similar risks and vulnerabilities in the future. Sometimes, the results are less than perfect. Occasionally, to some extent, we might repeat mistakes. However, during the last few decades, there has been clear progress towards a more developed economy and a more resilient financial system.

The challenges we face today differ from those we have overcome in the previous recent cycles, and many have a pronounced structural nature. Romania is well integrated economically and financially at the European level, thus being directly and indirectly connected to most of the critical issues currently relevant to the single market. These include enhancing productivity and external competitiveness, mitigating adverse labour market trends (particularly those stemming from population ageing), addressing economic changes driven by climate developments, shifting the economy's financing structure towards market-based solutions, and encouraging greater involvement of households savings in capital markets. The drivers that could sustain continued economic growth and competitiveness are linked to the improvement of skills for a highly qualified workforce, the continued development of infrastructure (primarily funded by European funds), the diversification of the internal supply of goods and services, and the development of the innovation and technology sector.

Reducing the persistently high twin deficits is the most pressing issue on Romania's economic policy agenda. This challenge is particularly daunting given their pronounced structural nature. Progress in fiscal consolidation efforts can help reduce the current account deficit over the following years, as fiscal policy influences the national savings and investment balance.

As other CEE countries, we are facing difficulties in improving external competitiveness. Although strides have been made towards developing the technology and service sectors, the external balance remains affected by lower competitiveness in agri-food and high-tech products. Therefore, the resilient household consumption and the rising investment dynamics witnessed during the past years, which were crucial engines for growth during the recent period, have also been accompanied by increased imports. Investments are essential for overcoming the effects of recent crises and for ensuring future sustainable development, and it is noteworthy that up to a significant extent they are funded through European programs. If the internal economy could supply more goods needed for these investments, the significant impact on imports would be reduced. Therefore, focused policies are needed until the structure of our economy improves and adapts so that the internal supply can cover more of the demand from consumption and investment.

The need for intensified climate action grows imperative as time passes, with stronger effects on the environment, society, and economy. This reality affects Romania as well as all EU countries. Simultaneously, advancements in digitalization could enhance efficiency in administrative activities, boost productivity, and alleviate the pressure on labour markets. Both climate action and digitalization present significant investment opportunities and avenues for developing a more resilient economic framework.

The tragedy of the war in Ukraine is profoundly felt in Romania as the conflict unfolds near our borders, impacting our nation in numerous ways. From the very beginning, Romania has stood steadfastly supporting the Ukrainian people, offering unwavering assistance and solidarity. Our country remains committed to being a friend and supporter of Ukraine. Simultaneously, Romania maintains solid economic partnerships with Moldova, whose economy continues to be significantly affected by the nearby conflict. We will continue to stand by our neighbours in these challenging times.

We face overlapping crises requiring coordinated action to transform challenges into opportunities.

The ongoing EU enlargement process holds particular importance for Romania, given our close ties and neighbouring relationships with the countries recently invited to the accession talks. While fully aware of the challenges, we emphasize the opportunities presented by enhanced regional integration: expanded markets and increased trade, higher investment flows, and increased political and social stability by promoting democratic governance and the rule of law. The wise words of Chancellor Konrad Adenauer remain true to this day: "*European unity was a dream of a few. It became a hope for many. Today, it is a necessity for all of us.*"

LĪGA KĻAVIŅA
Deputy State Secretary on Financial Policy – Ministry of Finance of the Republic of Latvia

Latvia`s challenges in new global reality

Over the past years the successive crises have tested economic resilience around the world not sparing Latvia and whole region. Russia`s war of aggression has slowed the recovery from pandemic and led to higher energy prices and disruption in trade and supply chains, weighing on economic growth. A spike in energy and food prices fuelled inflation and reduced the purchasing power of households. Dependency on energy imports from Russia increased uncertainty related to energy security.

The government acted swiftly to respond to pandemic and later to secure energy supply from other importers and support households and firms facing record high energy prices. Expansion of the existing regional LNG infrastructure enabled a quick switching of gas imports to international suppliers. Support to households and companies has been enabled by fiscal space created by prudent fiscal policy – our national legacy from the global financial crisis. Despite the increase in the budget deficit in recent years, the debt level of Latvia is still between the lowest in EU and it is expected that the general government debt will stabilize at 40% of GDP.

Historically, geographical location, defined Latvia's beneficial position in the east-west trade flows. The war and pressure through the economic sanctions disrupted supply chains and trade patterns. But since trade ties with Russia have weakened substantially since 2014, supply chains related to imported materials have been successfully substituted. The current geopolitical situation has diminished Latvia`s role as a transit state since businesses redirected their exports and imports from Russia and Belarus.

Even though the growth of Latvian economy has slowed down due to weaker external demand, the latest macroeconomic forecasts foresee acceleration of growth this year. While high interest rate environment is not stimulating the investments, export is still relatively weak, and government will pursue tighter fiscal policy, there is still a positive trend when it comes to the economy response. With the support of RRF and other EU funds, investments into specific and tailor-made reform measures will ensure that long terms sustainable growth is to be supported.

The geopolitical upheavals have triggered many challenges for Latvia's economy. Geopolitical tensions, increased security risks and weak growth are affecting capital flows and business environment, reducing investor`s willingness to invest. Well known challenges related with productivity developments, demographic challenges, economic impact of climate change, rapid technological development and energy market implications have not disappeared from agenda.

Comprehensive work must continue to implement necessary measures and enhance productivity.

Although the security situation in the Baltic region has improved since the beginning of the war in Ukraine, high level uncertainty remains. In a difficult geopolitical environment, top priority for Latvia is to increase investments in security and defence, as well as to diversify energy mix and to ensure energy security.

Recently adopted government economic growth strategy is to enhance living standards and economic well-being of Latvia`s population considering the extremely rapid geopolitical, economic, and technological changes of recent years. The main goal of this strategy is to double economy`s value within the next years. This will be accomplished by significantly increase productivity of businesses. Strategy considers several steps to increase productivity and competitiveness: move towards a high added-value economy, to increase of human capital, invest in the development of the innovation ecosystem, new technologies and digital solutions, as well as increase the share of high-tech products in exports. Regional balance and growth will stay in the focus. Government is planning to introduce and to promote creation of well-paid jobs and globally competitive businesses while ensuring connectivity of region centres and accessibility of quality public services.

To achieve the government's economic strategy goals, it is crucial to improve access to finance for businesses and households. Latvian companies and households get their external financing from banks. Lending activity is now a third of what it was at the time of the global financial crisis. The reasons for the prolonged and substantial decline in lending volumes can be found on both - the demand and supply sides of financing. Working on development of capital market can help improving access to finance and give opportunities for additional investment instruments.

Some of the structural weaknesses of Latvia`s economy have been vivid already before the pandemic. Today's changing environment has added additional challenges. Comprehensive work must continue to implement necessary measures and enhance productivity and competitiveness in new global reality.

RADOVÁN JELASITY
Chief Executive Officer – Erste Bank Hungary

Convergence 2.0 in CEE: how to unlock the region's potential

There is no doubt that the fast convergence of CEE countries has been a significant success story and has been to the benefit of all EU Member States. A strong European Union presupposes a strong and vibrant Central and Eastern European (CEE) region.

However, convergence has slowed in recent years, which could imply that the current growth model is running out of steam, especially for the most advanced countries of the region. Several structural challenges, which impact growth and competitiveness, can be observed as well (e.g. a lagging quality of infrastructure, a continued brain drain and shortage of skilled labor, underperforming capital markets, and a challenging green transition path).

Hence, despite the CEE's relative success over the past few decades, the economy of the region faces a number of significant headwinds, all of which indicate the need for a new and advanced thinking on future drivers of growth and competitiveness both within the CEE region and at EU level.

Erste Group is not alone with this analysis. A recent report called "A stronger CEE for a stronger Europe", co-written by the well-respected former President of the Eurogroup and Economic and Financial Committee (EFC), Mr Thomas Wieser, as well as the Vienna Institute for International Economic Studies (WIIW), shares the observations mentioned above.

In line with the report, we are convinced that it will take both non-financial and financial services-related measures to boost growth and competitiveness in the CEE region.

Non-financial services-related measures:

- Establish reform programs to promote innovation, competitiveness and transparent institutions;
- Encourage entrepreneurial activity by leveling the playing field for new market entrants, increasing administrative efficiency and creating a stable legal environment without room for corruption and cronyism;
- Invest more in education to secure labor supply for higher value-added jobs in fields such as science, technology, engineering and mathematics (STEM) and establish one or more leading universities in CEE to retain talent and foster innovation;
- Implement a modern industrial policy to promote infrastructure and expertise for the green and digital transitions as well as the creation of higher value-added jobs;
- Refrain from competing for investors solely based on wage cost advantages;
- Promote a high degree of flexibility in labor markets to facilitate shifts away from sectors negatively affected by the twin transition and towards more innovative activities;

Key financial services measure – the Capital Markets Union (CMU):

In our view, the most crucial priority in the financial services area is the further development of Europe's capital markets. While the EU's capital markets have, compared to the United States, not even come close to tapping their full potential, it is certain that CEE countries have an even longer way to go. Speeding up the process and addressing its specific challenges will not only benefit the CEE region, but also help Europe as a whole to find better answers to issues such as the overreliance on bank financing and the lack of financial literacy of retail investors.

It is very clear that real "game-changers" (e.g. taxation, pensions, insolvency laws) need to be tackled by decision-makers at both EU level and national level alike, if they are serious about deepening Europe's capital markets, and will involve a couple of difficult decisions. A major boost for capital markets – not only in the CEE region – could come from funded pension systems. Currently, a large number of countries rely on pay-as-you-go systems, while funded systems have mostly remained underdeveloped. Experiences from countries such as the Netherlands, Denmark, Sweden, and the US clearly show that strengthening the second and third pillars of pension systems is a highly effective way of increasing capital market activity.

Real "game-changers" (e.g. taxation, pensions, insolvency laws) need to be tackled at last.

An additional pathway, which needs to be considered, is to progress the idea of a CMU at a regional level in CEE, aiming for a higher degree of integration than is currently feasible in the EU in its entirety. A regional CEE-CMU could, for instance, try to harmonize major issues such as taxation, create cross-border options for funded pensions systems and launch synchronized programs to promote venture capital and private equity vehicles in a limited number of countries. In this sense a regional CMU could serve as a test ground and blueprint to progress capital markets development in the EU all together.

Action is needed – let's unlock CEE's potential.

GEORGE ZOLNAI
Chief Executive Officer – Raiffeisen Bank Hungary

Lessons from a functioning ecosystem for SME financing

Central and Eastern Europe (CEE) is already the driving force behind the European Union's growth. Raiffeisen Research projects GDP growth in the region to be 2.6% in 2024 and 3.4% in 2025, compared to 0.8% and 1.5%, respectively, for the Euro Area.

The reasons why the region is experiencing higher growth and ongoing economic convergence include several factors such as the relocation trend in the manufacturing industry (nearshoring), substantial external FDI inflows, investments in human capital, and the absorption of EU funds (Cohesion funds, NGEU funds), alongside the green transformation. Importantly, this convergence is also underpinned by the region's departure from decades of distorted economic incentives, institutions, and planned economy structures.

Medium term policy objectives have broadly two objectives: creating ideal conditions for further FDI inflows and secondly to focus on supporting local SME development. As a result of the visible successes in the first goal, FDI inflows have resulted in the emergence of a dual corporate structure in most CEE countries: highly efficient, primarily foreign-owned large companies coexist with a less productive SME sector. In Hungary, over 70% of total employees work within the SME sector, while contributing only slightly more than half of the GDP. Hence, public policy measures aimed at fostering the development of SMEs have gained importance. These policies include a well-developed ecosystem of schemes and institutions designed to support SME growth.

In Europe, banks have historically been the primary source of financing for the corporate sector, a trend that is even more pronounced in Central and Eastern Europe (CEE). Despite various policy efforts to develop capital markets (eg: corporate bonds and equities), these "manufactured" markets have not gained significant importance due to a range of stubborn structural factors such as institutional weaknesses, legal shortcomings, and cultural influences. As a result, their role remains marginal in the overall CEE landscape.

There is nevertheless, considerable potential for growth in corporate lending within CEE. The SME loan-to-GDP ratio is ranging from 10-15% in Hungary, compared to 25-35% in similarly sized countries with more developed financial systems.

International banks bring critical risk-management skills to subsidized SME lending.

The role of commercial banks, working closely with state-supported institutions is particularly crucial in SME financing, as local loan-financing is a vitally important factor for SME growth. The evolution of a successful SME lending ecosystem started in the early 1990s with the establishment of strong state-supported guarantee-institutions specializing on the SME sector (eg: Garantiqa, AVGHA). They gained further strength through long-standing and well-run state-supported loan programs such as Széchenyi Card Program (est: 2002), "Funding for Growth" supported by the National Bank (est: 2013), the Baross Gábor loan scheme (2021), as well as specialized MFB-EU loans, and EXIM supported export-finance programs. Their success is demonstrated among other things by the nearly 75% penetration of Garantiqa among SME loans and a 30-50% share of subsidized lending in the SME sector over the recent economic cycle.

Commercial banks ensure liquidity by utilizing customer deposits to extend local currency and euro loans to other clients. Raiffeisen Bank Hungary, as a leading universal bank, integrates effectively into the local financial sector with particular focus on the framework of various government-sponsored loan schemes.

The involvement of locally based commercial banks in these programs is critical because of the market-based processes and effective intermediation they can execute. Firstly, commercial banks have a vested interest in appropriate risk allocation, leveraging best-in-class international risk-processes. Additionally, banks possess extensive local knowledge of their clients, including their legal and operational histories, as well as knowledge of their management and resilience to economic environments.

At the same time, corporate clients require a broad spectrum of cross-border financial services. As a subsidiary of RBI, Raiffeisen Bank Hungary is well-positioned to meet these demands by providing necessary cross-border financial services as well.

However, achieving faster economic growth presents several new challenges. The economic environment must evolve to find the right balance between intervention and becoming more pro-business, with a concerted effort to reduce bureaucratic red tape at both the European and national levels.

For Central and Eastern European (CEE) countries, the NGEU instrument, along with the regular Multi-annual Financial Frameworks (MFFs), remains a critical factor in their efforts to close developmental gaps and enhance integration with Western Europe. The NGEU serves as a substitute for an absent central fiscal stabilization capacity, generating substantial cross-country spillover effects in addition to stabilization at the national level.

RICHÁRD VÉGH
Chief Executive Officer – Budapest Stock Exchange

Time to shift focus on primary markets to serve the real economy in Europe

Capital markets continue to play limited role in the financing of innovative, fast-growing companies across the EU. The available capital pool for late-stage financing lags behind the US and Asia, the EU's key economic partners and competitors. This goes to the core of competitiveness of European companies. There is convincing evidence that developed capital markets boost innovativeness and ultimately competitiveness, as capital markets are more efficient in funding growth, modernisation, novel products.

In our view, the availability of late-stage financing and hence, the role of public markets remain crucial development points for the EU. This is corroborated by the steady decline in the share of European companies amongst the biggest global peers. Some large European companies turn to US or Asian capital markets to finance their strategic plans. Household savings, with a few notable exceptions in Scandinavia, Switzerland or the Benelux, are not channelled to European companies efficiently, resulting in suboptimal availability of capital and inability of European citizens to benefit from economic success. Thus, the ability of public markets to transfer and transform risks efficiently is key to enable European companies to take risk, innovate, increase competitiveness, grow and increase household wealth.

These trends have been recognised however, the policy approach of the EU to these realities has born limited results. Perhaps the most important reason behind this has been the isolated focus on secondary markets, injecting artificial competition via regulation exclusively focusing on explicit trading costs and fees. Indeed, deep primary markets need well-functioning, deep secondary markets and vice versa.

Therefore, we believe a profound strategic shift in the European capital market regulation and development policies is needed to boost primary markets and their surrounding ecosystems, a new approach to match issuer and investor demand to avoid further structural decline. In our view four key points need to be addressed in the short and medium term.

1. Access to public markets by companies

Currently, both market entry and capital raising are regulated by the prospectus regime. These should be treated as separate economic events. The ability of listed issuers to raise capital on these markets should be significantly simplified and by the same token, existing asymmetries between public and private markets in the fiscal treatment of companies, costs of access, risks should be carefully recalibrated.
The role of regulated markets in ensuring an efficient dialogue between issuers and investors should be recognised, and their competitive position vis a vis their international peers strengthened.

> **A well-developed capital market is a competitiveness issue: primary markets need to be improved.**

2. Access to public markets by households

Regulated markets and companies are under a robust regulatory framework. EU investor protection often acts as a barrier to deployment of household savings into assets deemed riskier. This calls for a rethinking of how risks are perceived and defined in the European capital markets regulations. Instead of restricting household access to markets, focus should be on encouraging the growth of investment vehicles to facilitate deployment of capital by individual investors.

In this context it should be noted that trillions of Euros are currently in deposit accounts across the EU, where a more productive mobilisation to boost growth, jobs, innovation while simultaneously strengthening participation would be desirable.

3. Establishing institutional framework for managing long term savings of households

A key element explaining the rise of successful capital markets is the availability of capital from long term savings structures. The longer investment time horizon and therefore the ability to take on idiosyncratic, market, liquidity etc risks has been a key contributor to a deepening capital pool and hence to both increasing company competitiveness and growth in household wealth.

Whilst this area – particularly pensions – is strictly a member state competence, there is ample scope for EU initiatives to encourage the emergence of national frameworks in the EU. This should build on existing success stories, like in Sweden or the US.

4. Encouraging growth of local ecospheres

An important lesson of the past decade of European capital market development has been the success of SME growth markets manifesting in the visible growth of the number of issuers. Capital market presence of smaller companies ensure the ongoing supply of fast growing, innovative companies.

SME investment however, is local business, as it is done by local actors and importantly, is a local investment decision. If a new, limited sized issuer is unable to attract local capital, its chances outside the boundaries of its own ecosphere are severely constrained. A complete capital market value chain therefore should assist the emergence and development of local ecospheres, where access to knowledge and capital are easily available to local companies.

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Q&A

PETER CSÁNYI

Member of the Board of Directors
and Deputy Chief Executive Officer,
Chief Digital Officer– Otp Bank

CEE – Is Europe's growth engine in need of repair or just maintenance?

What are the main structural challenges that the CEE region is facing in terms of growth and financing model and how are they evolving?

CEE economies strongly benefited from the decades of globalization due to their high openness. Their annual GDP growth reached 3% on average, twice as much as the growth in core Europe, that is, the advanced western countries that founded the euro area. The drastic changes in the global environment, and the shift from globalization to a more fragmented world, again poses significant short and medium-term challenges to CEE. The war, sanctions and the energy crisis in 2022 and 2023 had many unfavorable consequences in the region. These economies faced unprecedented issues in trade, skyrocketing inflation and interest rate shocks, and the purchasing power of wages shrank, leading to a slowdown in GDP growth and even a mild recession. Most of these economies are gradually recovering, but weak growth in the euro area, structural problems in German car manufacturing, the shift to a permanently higher yield environment, and the unavoidable fiscal adjustment, are clear drags on short-term growth prospects in CEE.

The labor markets of CEE economies are changing fast too. In the past decades, the region was attractive due to its relatively skilled and cheap labor. As western FDI and EU funds gradually replaced the capital stock lost around the transition, more and more people in CEE became active. By now, most CEE countries are experiencing a shortage of skilled labor, particularly in fields like technology and digitalization. Employment rates have reached the EU average, unemployment has fallen to multi-decade lows, and labor costs are rising at a double-digit pace.

Regarding financing, the main challenge is to adapt to the recent shift in the global yield environment. CEE economies have lower overall corporate and household indebtedness than Western economies, so this is unlikely to lead to serious problems. However, the financing of public debt could be a more serious issue in countries where the deficit is well above the targets and the credit rating is just above the investment grade level. In CEE external financing, FDI and EU funds play a significant role, and as in the medium term the availability of EU funds will be more restricted, this would require adjustment as well. The role of banks in financing the economy is smaller in CEE than in core Europe. Client loan to GDP is below 40%, while it is 90% in the euro area - partly because of the role of non-resident companies in CEE, which have access to foreign banks and are financed mainly from abroad.

All in all, these factors will likely result in mid-term headwinds to GDP growth in CEE. While we expect these economies to grow faster than core Europe and the convergence to go on, the pace of growth might temporarily slow down compared to that of the past three decades.

What are the expected benefits from a genuine Banking Union? What are the challenges to overcome?

The Banking Union requires strong foundations: robust and harmonized financial regulation, and the ECB as a neutral, supranational supervisor, which now engages in discretionary decision-making previously reserved for member states.

A genuine Banking Union's advantage can lie in its ability to define and implement its integration goals. The EU needs an EU-level strategy in order to respond quickly and effectively to tackle a financial crisis and safeguard financial stability. The benefits of such integration can indeed be significant and visible in times of crises. However, the level of integration is a matter of both the will and capability of the participants. Another relevant factor is that financial regulation is currently a shared competence between the EU and the member states.
The Banking Union's efforts to deepen integration are reshaping the financial regulatory framework. National decision-making has become more limited, while the role of the ECB has increased even in countries where local supervisors

are the designated banking authorities. This creates special situations where, for instance, one of CEE's largest banking groups is not directly supervised by the ECB as a banking group, but some of its member institutions are. In such cases it requires additional attention to comply with both national and European rules and expectations, which are not always aligned, and can be very challenging too. For example, the principle of "same activity, same regulation" is a subject of debate on how to achieve a level playing field for all kinds of providers, both credit institutions and fintech companies. The idea is that to ensure equal treatment, the same regulation should apply to all players that provide the same service, regardless of their legal structure. This is for the benefit of the customers too. But that would require a shift from an entity-based approach to a uniformly applied activity-based one across the EU, and the joint efforts of the regulator and the industry.

How is digitalisation expected to progress in the financial sector in the next 5 years? Will it lead to a significant transformation of the sector? What role are traditional financial players, fintechs and Big Tech companies expected to play in this evolution?

Compared to other industries the banking sector has faced, and still is facing, stricter regulatory barriers when it comes to digitalization. Over the next 5 years, the most obvious expectation for the sector's transformation is that digitalization will transform the areas where its role has so far been less significant. Customers' digital maturity and expectations keep increasing and, as mobile has become the dominant channel of banking, the quality of the mobile app becomes the key factor defining customer experience.

Consequently, mobile-centered service offering becomes standard as banks adjust their product and channel strategies, developing mobile lead enabled end-to-end sales journeys and hyper-personalized digital communication. Besides the ever-expanding sales- and engagement-related features, the redesign of self-service processes relying on virtual assistant capabilities and AI-supported knowledge base become general practice, while robotization plays a crucial role in providing clients with fast, seamless and cost-efficient processes. True digital banking leaders ensure not only that all the banking-related needs of their customers are met within their mobile app but enrich their offers with beyond-banking services too. In the meantime, traditional channels continue to handle complex requests and the advisory role of branches becomes more prominent.

Excellent customer experience and the highest level of trust are the foundation of market leadership. As financial fraud has grown exponentially in recent years, the continuous improvement of preventive measures to secure customers' finances will be key in retaining the client base.

What we also see is that the roles of financial market players have blended, and the boundaries have started to blur. Fintech companies offer a growing range of financial products (although some players' potential impact on the market seems to be overestimated), Big Tech companies leverage their vast consumer data to provide competitive credit services, while banks opened towards granting beyond-banking services as they experiment with expansion. As a result, digital ecosystems offering services from different industries are being built, often via the collaboration of partners coming from different fields.

What is OTP's perception of the priorities for the next European political cycle in terms of digital finance policy? Should the focus be on implementing the frameworks already adopted, addressing emerging trends, new risks or challenges or developing more specific rules in certain areas such as AI or cyber-risk?

In her speech in the EU Parliament on July 19, Ursula von der Leyen very rarely mentioned specific actions in the Financing or Banking sectors that her next Commission will target. When compared to her speech 5 years ago, where a lot of concrete regulatory actions such as MIFID or Taxonomy were anticipated, it clearly shows a different focus.

Naturally, the banking and financing sectors are essential to helping Europe's competitiveness, and financing the infrastructure and technology needed to transition towards a greener economy.

In the digital field, we see that the development of technology can impact how banks manage their ICT risks. A major threat is linked to the upcoming quantum computer technology and the massive cybersecurity risks it represents for many sectors, including the financing sector. Here we support all the initiatives already taken by the Commission such as the Quantum Technologies Flagship; hoping that the R+D budget be increased beyond the 1 billion Euros already committed; the European High Performance computing Joint Undertaking; and of course the European Joint declaration on Quantum Technologies, where Hungary joined seven other Member States to speed up the processes to make Europe the safe Quantum Valley. It is critical for our industry that this new technology be properly regulated and developed in Europe if we want to limit tomorrow's cyber threats.

Nonetheless, DORA, the EU AI Act, among other similar regulatory initiatives, are good examples for the progress already made on the regulatory side.

PRIORITIES FOR THE BANKING SECTOR

JOSÉ MANUEL CAMPA
Chairperson – European Banking Authority (EBA)

Common EU policy action to the benefit of EU banks, corporates and citizens

The EU has set out its ambition to foster a prosperous and competitive Europe in the 2024-29 strategic agenda: deepening the single market for financial services, mobilising both public and private funding and pursuing the green and digital transition. In all this, European banks will need to play a crucial role going forward.

Resilient banks are competitive banks

Banking crises throughout history have evidenced that healthy and strong banks are to withstand shocks and continue to lend in times of stress. Financial stability is the precondition for banks to help the real economy prosper.

Despite turbulent macro headwinds in 2023, EU banks have performed well. Profitability has increased further, albeit at slower pace, liquidity and capital headroom above requirements remain at comfortable levels. Loan growth, however, has been subdued, due to increased banks' risk perceptions as well as lower demand. The EBA's latest risk assessment report shows that banks aim to increase lending again.[1] Still, the uncertain outlook around economic growth and rate trends may lead to higher credit risks and challenge the sustainability of profit generation.

EU Banks have been challenged by structurally low profitability levels. Only last year, EU banks reached similar profitability levels to their US peers, even slightly overperforming them. Looking forward, EU banks will need to proof that their business model will allow them to maintain profitability levels in a sustainable manner. This implies ensuring a good business model, enhancing competition in the single market as well as a robust, predictable regulatory and supervisory environment.

To remain globally competitive, EU banks need to accelerate their effort to transform their business model. Higher profitability should be an opportunity to increase investment in digitalisation, improving efficiency, revenue capacity and resilience. Investments are also needed to enhance risk management and capabilities to finance the transition to a more sustainable economy. These are important, as EU banks continue to face elevated uncertainty going forward due to geopolitical and cyber risks looming.

At the same time, structural adjustments in the industry are needed. High ratios of bank assets to GDP ratios indicate that banks are essential to finance EU economic growth. They are also a reflection of the need for more financial market intermediation in the EU. They also point to overcapacity in some national banking systems, despite past efforts to consolidate and streamline the sector. Further restructuring is needed not only at domestic level, but also through cross-border consolidation. Deepening the single market with cross-border banking activity will be fundamental to ensure the adequate allocation of saving to investment opportunities across the Union.

Finally, a stable regulatory and supervisory framework should provide the context for addressing financing needs while preserving financial stability. The next years will bring the finalisation of the implementation of the Basel III framework in the EU. The EBA will contribute with level 2 mandates and the fine tuning of the Single Rulebook. This work will run in parallel to the implementation by all other member jurisdictions. Supervisors will need to ensure the implementation of the new framework across all institutions.

EU banks' robustness enhances EU competitiveness and supports integration of the single market.

As we implement this framework, we will continue pursuing analytical work to monitor it is functioning properly. A recent EBA report, provided a comprehensive analysis on the granular system of stacks and buffers in the EU, including a high-level comparison with the UK and US, and a detailed description of what management buffers EU banks aim to hold against the backdrop of regulatory requirements and why.[2] The publication reflects the key idea that regulatory clarity, but also transparency, ensures that respective regulation is well understood and interpreted – and potentially further developed.

1. *Risk Assessment Report of the EBA EBA/REP/2024/12 – July 2024*
2. *Stacking orders and capital buffers. Reflections on management buffer practices in the EU - 15 July 2024*

JEAN LEMIERRE
Chairman – BNP Paribas

Allowing European banks to boost their competitiveness is an essential factor to achieve Europe's strategic resilience

According to the letter report, the EU economy has lost ground and is falling behind the US. At the time of the Great financial crisis, the size of the EU's economy was larger than that of the US[1]. In 2024, the stark reality is that the US economy is 50% larger than the EU's. And specifically in the financial sector, in the years since the crisis, American investment banks have taken more than a 50% share of the European market. Similarly, in the asset management sector, at the time of the crisis European actors had a 47% share of the global market versus 51% for US asset managers. By 2022, the European share had fallen to 22% while the US share had increased to 70%[2].

The European Commission has mandated Mario Draghi to make proposals on how the EU can tackle the erosion of its competitiveness and he has already referred to the need for radical change in the policy agenda to boost European competitiveness. The main political groups in the new European Parliament have also called for measures to support a European competitiveness strategy, and this is indeed to be welcomed.

Being mainly bank-financed, the EU economy is critically dependent on the competitiveness of its banks. If the EU wants to achieve strategic autonomy in the financial sector, it must ensure a level playing field with other jurisdictions regarding prudential regulation of banks, as it is indeed a key element impacting their competitiveness. This is all the more imperative given the massive financing of € 750 bn[3] needed annually for the green and digital transitions, which will require a larger share of private sector financing as the public sector has limited fiscal resources and will continue to lack them in the foreseeable future.

The CET1 ratios of European banks have more than doubled since the crisis, reaching 16.4% at the end of 2023[4]. Europe's banks are now strong and resilient, allowing for adjustments in capital requirements and targeted policy reforms that can create the conditions for more dynamic and robust capital and lending markets, while ensuring financial stability. In a bank-financed economy such as Europe's, banks must indeed be incentivized to lend and support investment.

What needs to be done? Three key priorities have to be addressed:

Avoid gold-plating capital requirements. An Oliver Wyman study[5] has highlighted that the higher capital requirements of European banks is an important reason of their lower profitability. It also underlines that MREL requirements as well as the various buffers translate into significant further barriers to achieving a level playing field that would allow European banks to regain in competitiveness. Furthermore, future climate-related capital regulations will have their own impact.

In light of this, European authorities should carefully calibrate capital frameworks and avoid the excessive capture of risks, notably double counting between the implementation of Basel 3 and the application of Pillar 2. The recent UK Prudential Regulation Authority's statement is a useful policy to avoid this and make sure that risks are properly captured.

Revitalize and recalibrate securitization. Over the last decade, the European securitization market has declined and become but a small fraction of the size of the US market. Relaunching securitization will enable European banks to securitise the loans they originate, allowing them to rotate their balance sheets and increase their lending to the economy while also allowing insurers and pension funds to support the economy's transition and future growth.

Complete the Capital Market Union. As underlined by the French and German Roadmap for CMU, economies with deeper capital markets foster more innovation and achieve higher rates of growth. While Europe has a vast pool of long-term savings (25% of EU GDP vs 18% in the US), it is critical that this pool remains in Europe and is mobilized to fund the huge investments needed for the green and digital transitions, in addition to those needed to the financing of the EU economy. To meet these priorities, in addition to relaunching the securitization market, there is a need to remove the barriers that currently limit access to the equity markets for European companies, in particular for the technology sector, and the free flow of capital in the Union.

In conclusion, Europe needs a radical departure in the policy agenda to regain its global economic competitiveness and that of its financial system to promote economic growth and meet the immense challenges ahead.

1. *IMF datamapper: $14.77 vs $16.29 TR for the EU in 2008 compared to $27.36 for the US vs $18.35 TR for the EU) at the end of 2023)*
2. *Source: Official Monetary and Financial Institutions Forum / Luxembourg for Finance Report*
3. *Source: European Commission 2023 Strategic Foresight Report*
4. *ECB data portal*
5. *Oliver Wyman / EBF: The EU Banking Regulatory Framework and its Impact on Banks and the Economy January 2023*

FERNANDO VICARIO
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Policy choices are key for the future of the European banking system

Over the past decade, European banks have struggled to keep pace with the financial performance of their global peers, especially in Corporate and Investment Banking. While this situation stems from both cyclical and structural reasons, policy choices can significantly help the sector and the EU economies.

First, European economies have been hit by successive crises from the pandemic to the war in Ukraine, which resulted in the energy crisis. Consequently, growth for European banks has also been negatively affected. The sudden and sharp increase in ECB rates didn't help either, leading to anaemic growth.

Second, more structurally, the majority of European banks lack global scale. The European banking system is centred on regional banks and national champions. Few of these are pan-European and even fewer are global. This makes it difficult to compete against larger global players. In addition, European banks' profitability relies more on traditional lending activities that are usually kept on the balance sheet, while their international peers are often more active in investment banking and trading.

Fixing the scale issue could prove difficult; M&A is often cited as the solution. Some consolidation has occurred but mostly domestically, in highly fragmented banking markets. Some vertical M&A across the value chain has also picked up in products such as insurance or asset management. However, neither approach has been enough to build large players and close the gap with global peers.

Cross-border M&A has the potential to be transformational. However, the absence of a common European framework, starting with the Capital Market Union (CMU) and the Banking Union (BU), is a hinderance, as two merging banks would not be able to fully crystallise revenues and extract cost synergies.

Larger banks could arguably better withstand periods of economic stress and volatility, decrease the risk of financial disruption, and better support European corporates in their expansions. Finally, stronger banks with scale could also better contribute to the mobilisation of private resources needed for the EU green transition.

Europe has nonetheless come a long way since the Global Financial Crisis (GFC) in 2008. Policymakers, regulators and banks took significant measures to strengthen banks' business models, cut costs and clean up balance sheets. Yet profitability and valuations have been trailing behind their US and international peers since the GFC.

The lack of progress in CMU and BU remains a key hurdle for EU banks to crystallise synergies and achieve scale across markets. The completion of the BU, in particular the establishment of a European Deposit Insurance Scheme and the removal of barriers to cross-border consolidation would help to address the chronic fragmentation in the European banking sector.

Further harmonisation in the national legal and tax frameworks can also improve the economic rationale for EU retail banking integration. A more effective resolution framework for small and middle-sized banks may also facilitate market exits and reduce overcapacity. Greater integration, with a permanent borrowing facility backed by a common fiscal capacity would also be needed to reduce protectionist tendencies.

Finally, SSM banks are currently involved in transformational projects such as DORA, CSRD and the AI Act, among others, which require substantial investments in human and technology resources. Smaller banks will struggle to change at the same pace as large institutions, and this may lead to unintended consequences. Efforts to make regulation more proportionate are welcome.

More generally, the EU needs deeper European capital markets, with more private capital financing and greater banking disintermediation, combined with a larger use of securitisation and other forms of risk transfers.

The lack of progress in CMU and BU remains a key hurdle for EU banks.

The EU securitisation market is not performing to its full potential and is not contributing sufficiently to the development of the EU capital markets. Securitisation can offer: risk transfer out of banks' balance sheets through investments with different risk profile; more lending without the need for increasingly more expensive bank capital; smooth transformation of bank balance sheets from 'brown' to 'green'; simultaneous financing for a large number of EU SMEs; and support for the ECB monetary policy, corporates and sovereigns in times of economic duress.

Therefore, strengthening the CMU should be one of the key policy priorities for the next European Commission. Also in this context, a common safe asset, which could serve as the ultimate risk-free benchmark, would be instrumental in the development of a truly integrated European financial market.

ALBAN AUCOIN
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European banks need a level playing field to regain their competitiveness

Despite a resilient and highly regulated financial system, the EU banking sector has globally shrunk. Between 2009 and 2022, EU banks' share of global market capitalisation fell from 34% to 17.5%. The market share of US corporate and investment banks (CIBs) in Europe is close to 50%, while the market share of European CIBs in their own market is only 35%.

This decline is mainly due to a number of structural causes at both national and European level. These include market fragmentation, the burden of over-regulation and strict supervision, excessive capital requirements, over-taxation and other practices that hinder competitiveness, such as fee caps and regulated pricing.

The EBA estimates that the finalisation of Basel III will increase the RWAs of EU banks by 16% but with a capital shortfall of a mere EUR 600 million. This has the air of a bad joke, since it means that management buffers will be absorbed by new capital requirements. It is like telling somebody that we are going to increase your income tax by 16%, but you will not be affected because you have enough savings to cover the extra burden!

EU banks have a hefty management buffer of 500 bps above capital requirements. This buffer is necessary since two things really matter to the markets: the distance to Maximal Distributable Amount and the distance to the resolution threshold (SREP requirement). For investors, these are key to receiving dividends, and the major threat facing them is losing their capital. According to *The EU banking regulatory framework and its impact on banks and the economy* report produced by Oliver Wyman, EU banks had a management buffer of 440 bps in 2022 vs 190 bps for US banks. This difference is explained by supervisory pressure, both through formal restrictions and informal requirements, uncertainty regarding capital requirements, supervisor discretion, and less transparency and predictability in the EU.

Usually, supervisors play down the consequence of capital requirements on the economy, saying that banks will adapt. However, they often do so by constraining their lending capacity. The ECB figures clearly show that, after Basel III, loans to corporates significantly fell in the Eurozone, only recently returning, in nominal terms, to their 2007 levels. And since there is no Capital Markets Union, no viable alternative yet exists. Another incorrect theory is that the better capitalised a bank is, the more it lends. If that were correct, the capital requirement should be set at 100%! In fact, there is a balance to be struck between financial stability and growth. According to the *EU implementation of the final Basel III framework* report by Copenhagen Economics, the optimum point is around 12-13% of CET1, with any further broad-brush increase in capitalisation resulting in a net cost to society. No risk means no reward.

The rules of the game now need to be changed to give European financial and non-financial companies the room for manoeuvre they need to reduce the competitiveness gap.

In concrete terms, the official mandate of all regulatory and supervisory bodies should be altered to include objectives in relation to competitiveness and long-term growth, as is the case in the US and in the UK. Credible independent competitiveness tests should be carried out ahead of any new regulatory proposals, and gold-plating should be discouraged via the European Commission more frequently exercising its existing powers on level 2 or 3 initiatives that are inconsistent with level 1.

In implementing CRR3/CRD6, EU regulators and supervisors should uphold their objective of "avoiding a significant increase in overall capital requirements for the EU banking system", by recalibrating buffer requirements to avoid double counting (eg. P2), as envisaged in the UK.

The macroprudential framework should also be reviewed to avoid any future possible increases in capital requirements (including via the countercyclical buffer or the systemic risk buffer) on top of the already significant increases brought about by CRR3, as such increases would further harm the position of EU banks.

The European banking sector is resilient and well capitalised, the priority is now competitiveness.

The impact of the output floor on the MREL, already significantly above international TLAC requirements, should also be neutralised.

Over the next parliamentary term, the European Union will have to deal with unprecedented geopolitical, environmental, digital and demographic challenges. These multifaceted issues will force the European authorities to take urgent stock of the situation and come up with bold responses. The European banking sector is resilient and well capitalised, the priority is now competitiveness. This does not contradict the objective of financial stability - quite the reverse.

HIDEO KAWAFUNE

Chief Executive Officer, SMBC Bank International plc and Managing Executive Officer & Head of EMEA Division, SMBC Group and Chair, Supervisory Board, SMBC Bank EU AG

The case for greater international alignment: a perspective on CRR III

This upcoming EuroFi conference in Budapest is timely because it not only follows important elections in the EU and its Member States, but comes after the much anticipated publication of the CRR III/CRD VI Banking Package into the Official Journal in June this year, confirming the EU's progress towards implementing Basel III. This marks an important milestone in the post-GFC reforms to banking regulation and will significantly strengthen the prudential framework in the EU.

Recent events such as the 2023 Banking Turmoil, have reminded us of the importance of a sound regulatory framework that accounts for the interconnected nature of the banking system. As a Japanese headquartered G-SIB operating across 135 offices in 38 countries and regions, at Sumitomo Mitsui Banking Corporation (SMBC) we are aware of the impact we have across many different markets globally and the importance of consistent high regulatory standards.

The Basel Committee on Banking Supervision (BCBS) includes within its mandate a commitment for member countries to promote financial stability across the globe and work together to fulfil its mandate. The Basel III standards released in 2017 were originally intended to be implemented by January 2023; the delay in adoption and implementation across many major jurisdictions creates a misalignment of application dates presenting challenges for global banks operating and competing across different markets.

Japan has been leading major jurisdictions with implementation from March of this year; other jurisdictions including Australia and Canada have likewise implemented. However, in the EU, CRR III will not come in to force until January 2025 and in the UK, the implementation date is still to be confirmed but it will be July 2025 at the earliest. The whole sector will of course be watching developments in the US closely, where timely and full implementation of Basel III is important to ensure a level-playing field. Different timelines not only bring complications for banking groups operating across different jurisdictions, but will have implications for capital allocation through the misalignment of the phased introduction of the output floor requirement. Although the decision to delay FRTB implementation in the EU seeks to address competition implications, it is important that other aspects of the package are not delayed, which may further exacerbate these concerns.

The strength of the Basel framework is that it is largely implemented consistently, which helps to minimise fragmentation and ensure fair competition along with high standards. It is understandable that jurisdictions will want to take into account the specificities of their markets when applying the rules; however, this has created several areas of misalignment. Different rules have emerged across major jurisdictions under the Standardised Approach for Credit Risk, where different Risk Weights (RW) are applied to unrated corporates, which may have an impact on the financing of large corporate customers and knock-on effects for the real economy.

Another example of divergence is the attitude towards the use of private ratings, which is an important risk management tool for banks, but implementation is not universally aligned with Basel in this area. Furthermore, recognising the importance of derivatives in allowing parties to hedge specific risks, some jurisdictions have chosen to apply a lower alpha factor for Counterparty Risk (SA-CCR) than the original Basel proposals for certain exposures, which may in turn provide a competitive disadvantage to some derivatives business in other markets.

The focus must now be on the timely implementation by banks and effective supervision by regulators.

As EU regulators have pointed out, the finalisation of CRR III is only the first step of implementing these important regulations. The focus must now be on the timely implementation by banks and effective supervision by regulators. It is vital that the regulatory community continues to look for ways to minimise divergences in the implementation of the Basel framework and where gaps are identified by the BCBS, these are tackled appropriately. Furthermore, as regulators and policymakers examine future changes to the framework, for example, possible revisions to the rules on Interest Rate Risk in the Banking Book and the Liquidity Coverage Ratio following the events of 2023, it will be important to learn from the experience of Basel III and work to ensure that any future changes to the framework are introduced in close partnership across the banking sector.

CHRISTIAN CASTRO
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Banking regulation and banks' competitiveness

The beginning of the new legislative term in the EU marks an appropriate time to reflect on the roadmap for the upcoming political cycle.

Looking back, we certainly come from a period of intense regulatory activity, involving prudential policy, ESG, digital issues, AML/FT, and horizontal legislation such as due diligence in corporate sustainability and eIDAS, among several others. Looking ahead, while precise policy initiatives have yet to be defined, some broad themes can already be observed. The list is not that short. But looking at the Commission's Strategic Agenda for 2024-2029 and related speeches, there is one salient overarching theme, which is also central to financial activity and regulation: the quest to bolster competitiveness.

Though the relationship between competitiveness and regulation is not straightforward, the following three questions may be useful to reflect on it.

First question: following the premise "First do no harm", what type of regulation would be better to avoid?

The EU banking sector competes on international markets on a broad range of financial products and services, as well as on funding. Banks also compete with a broad range of players, including non-bank financial intermediaries, bigtechs and a growing variety of companies. In this scenario, it is already challenging to ensure minimum regulatory consistency across players with the usual 'standard tools' – such as capital and liquidity requirements, reporting/disclosures standards, and rules, guidelines and restrictions on conduct, AML/FT and corporate governance, to name just a few. Yet, doing so would be even much more challenging and potentially hazardous if price-based regulatory tools are used instead.

Regulation should aim to ensure that prices work efficiently, rather than acting on prices themselves. Depending on markets' characteristics, direct (eg: binding caps) or indirect price regulation (overly intricate approaches on Value for Money) can seriously lessen EU banks' competitiveness. Also, it can hinder innovation and may end up limiting the provision of financial services to different types of clients.

Second question: How can regulation support the digital and sustainable transition in the EU?

European authorities are committed to deliver the digital and sustainable transformation. This will need vast resources and substantial efforts. The banking sector, in turn, is fundamental to the financing of the real economy in Europe, particularly to SMEs and households. As such, more efficient, stable and predictable regulation will help EU banks to do their part in supporting the twin digital and sustainable transition. Predictability also means to allow a time to develop new regulation and a time to implement it. On ESG, it seems now the time to focus on implementation, reduce undue burden and keep assessing the international landscape on this field.

Formal regulatory frameworks for new risks usually evolve from best practices and interactions between entities and regulators/supervisors. Given the novel and dynamic features of those risks associated to ESG and digital technology, a continuous and transparent supervisory dialogue can be the seed of future regulatory frameworks. In the meantime, more flexible and qualitative approaches – less 'capital centric' for instance – are likely to work more efficiently. Cyber-risk, cyber-resilience and AI are clear examples.

Third question: What other policies (close to regulation) may also affect EU banks' competitiveness?

There are several, but taxation policy is surely a major one. Since 2022, nine EU Member States have introduced windfall taxes on the banking sector. This is in addition to existing specific levies on the sector in eight members. The motivation, design and duration of all these levies vary significantly. They go from levies targeting 'extraordinary' profits, to purpose-specific contributions. In addition, their design (eg: the tax base; temporary or permanent), scope (eg: all banks, some banks) and discretions (eg: deductibility regimes) are significantly heterogeneous. This is a key source of financial fragmentation and potential stigmatisation, thus affecting competitiveness of EU banks.

This is time to help bolster the competitiveness of the EU banking sector.

Spain is one of the countries where a windfall tax was introduced. The IMF has commented in its Art IV on the levy, indicating that the current design has several important limitations. The ECB has also warned about its effects on banks' resilience, capital and credit provision as well as on market competition and level playing field. It is worth noting that a less competitive EU banking sector is also less able to work as a driver of full economic growth.

BANKING UNION CHALLENGES

GIUSEPPE SIANI
Director General for Financial Supervision and Regulation – Banca d'Italia

Financial integration: state of the art and the way forward

Where do we stand?

It is widely recognized that fragmentation in the EU banking market imposes significant costs on banks, hampering the efficient allocation of resources across the EU and limiting the geographical portfolio diversification. Barriers to cross-border banking activities also discourage competition, hence limiting the pressure on banks to innovate and improve their services. Ultimately, fragmentation hinders the banking sector potential to support the real economy and effectively address the current global challenges.

Financial and technological trends are promoting new channels of integration among different markets and across countries: in particular, the traditional banking business has been increasingly complemented by other activities such as asset management, custodian services, payment systems, bancassurance, etc. Moreover, banks and NBFI do not necessarily need to establish subsidiaries, nor enter in M&A, to provide services across borders, given that EU regulation allows authorised institutions to operate throughout the EU, for instance by providing services via digital platforms. Non-EU banks may also establish branches in individual Member States, subject to national laws. Relationships among financial and not-financial entities are increasing to exploit synergies in a technology-oriented environment. This trend indeed boosts the level of integration in the financial system, even though according to a less traditional business model.

EU legislators and competent authorities have made considerable efforts to increase the level of integration in the banking sector, but there are still margins for improvements, for example regarding regulatory divergences on several topics and the incomplete Banking Union (BU) and Capital Markets Union (CMU). Against this backdrop, ring-fencing measures confirm concerns by host Member States that the potential cross-border crises might impact on their domestic depositors and economies, given that home parent companies might fail to support domestic subsidiaries, where needed.

Progress so far...

I would like to remind three of our main achievements at EU level:

1. the creation of the SSM has been a pivotal turning point to enhance a cohesive and consistent business environment across Member States, thus reducing regulatory arbitrage and strengthening banking practices, which in turn built greater confidence among investors, institutions and authorities.
2. The SSM itself has actively promoted integration in the EU banking market through several ad hoc initiatives that can contribute to cross-border operations, such as the supervisory guidelines for cross-border liquidity waivers. Moreover, the SSM published in 2021 its Guide on the prudential treatment of mergers and acquisitions, that clarifies how the SSM assesses merger transactions and the relevant applicable supervisory treatment, in particular for the calibration of the Pillar 2 add-ons post-merger, if any. However, such clarification has not determined the desired fuelling effect.
3. The creation of the Single Resolution Mechanism and the harmonization of banks crisis management arrangements, which have mitigated the risks associated with having a wide range of national crisis management mechanisms, thus providing for an EU more consistent framework for managing the resolution of failing banks.

... and challenges ahead

While recognizing our success on the first two pillars of the BU, it is now time to complete the third pillar through the establishment of EDIS, which would ensure risk sharing across the EU, thus both mitigating concerns of host Member States and reducing the incentives to adopt ring-fencing practices.

The second key issue concerns the current review of the crisis management framework. The ongoing legislative proposal does not seem to go in the direction of significantly expanding the access to the Single Resolution Fund. However, the Council recent compromise broadens the adoption of preventive and alternative measures by DGSs and can therefore be considered positively, albeit sub-optimal, given that it reduces the disorderly piecemeal liquidation scenarios.

> **The reduction of the banking market fragmentation is intertwined with the creation of the CMU.**

Lastly, the reduction of the banking market fragmentation is closely intertwined with the creation of the CMU. While a deeper integration of capital markets would facilitate the provision of cross-border financial services, leading to better access to host jurisdictions by banks, it is also true that the BU is a prerequisite for the CMU as, in the words of Governor Fabio Panetta, "it is difficult to envisage a genuine CMU without the key players being able to operate throughout the euro area". An effective step ahead along the trajectory of fully integrating the EU capital markets is therefore a unique opportunity to trigger a virtuous circle, which would ultimately contribute to decisively addressing the issue of financial fragmentation in the EU, thus reaching a genuine Banking Union.

KERSTIN
AF JOCHNICK
Member of the Supervisory Board – European Central Bank (ECB)

The Banking Union's unfinished business

In a previous contribution, I outlined how better regulation, more efficient supervision, well-capitalised banks and strong institutions had led to a more resilient banking sector during the first ten years of European banking supervision.[1] However, in the context of a monetary union and a single supervisor, one area which has fallen short of expectations is bank integration. While we have seen a fair amount of banking consolidation within national borders over the past decade, cross-border mergers have been more the exception than the rule.

As a result, despite the progress made in several areas, the European banking system remains closer to being a collection of national banking sectors than a truly integrated market. This is problematic because overcoming the fragmentation of the financial system along national lines was one of the main objectives political leaders had in mind when establishing a banking union.

In the following, I will discuss the reasons behind this lack of cross-border integration and what could be done to remedy it in the future.

The importance of the (missing) third pillar

Banks looking to expand beyond national borders have to deal with an array of different regulations across European countries, including in tax, accounting and insolvency regimes as well as in securities markets. Fostering bank integration would therefore require increased harmonisation on these fronts.

While such convergence could take years, perhaps the single largest deterrent to cross-border bank mergers is European rather than national legislation. This is because cross-border capital waivers are not an option under current EU law, so banking groups cannot freely move capital between their subsidiaries in multiple jurisdictions. EU law does provide for cross-border liquidity waivers, however, and the ECB has tried to create an environment in which banks can use this limited leeway in the legislation to this end.[2] But the take-up of this initiative has been lukewarm as some host country authorities still fear that local subsidiaries could be put at a disadvantage compared with their parent entities if the latter experience financial distress. This is where the lack of progress on the third pillar of the banking union – a common insurance scheme for bank deposits – appears to be a major obstacle.

It is therefore safe to say that if such a common deposit insurance scheme were in place, some national authorities would be more likely to allow the free movement of capital and liquidity across borders, which would in turn increase banks' appetite for cross-border mergers.

Harmonising the macroprudential stance

Beyond legal convergence across countries and the creation of a true safety net for bank deposits, prospects of a unified banking market in Europe would also benefit from a more harmonised macroprudential stance in the banking union as a whole. The pandemic brought the question of the usability of banks' buffers to the forefront of the policy agenda. The lessons from that episode appear to have been partly heeded, as national macroprudential authorities have tended to take a more proactive stance towards building banks' buffers in recent years so that they could be released in a countercyclical manner.

However, this increased policy activity has brought about some new challenges. First, there are the level playing field issues, as banks of a similar size and footprint for the banking union as a whole may be subjected to different buffer requirements by their home macroprudential authorities. And second, there is the growing complexity of the framework, because some countries have opted to activate systemic risk buffers (whether across the country or just for specific sectors), while others have not. This has raised some difficult questions about the degree to which macroprudential measures taken in one country should be "reciprocated" by third countries for cross-border banking exposures or exposures through bank branches.

The European banking system remains closer to being a collection of national sectors than a truly integrated market.

Therefore, a union-wide perspective is needed in the macroprudential framework to ensure that this approach is consistent across Member States and potential overlaps are minimised. This can be done without altering the existing balance of competencies between national authorities and the ECB, for example by updating the commonly agreed methodologies for determining banks' macroprudential buffer requirements.

Conclusion

Taken together, the absence of a common insurance scheme for bank deposits and the lack of a union-wide perspective in macroprudential policy have significantly contributed to strengthening the national character of banking systems in recent years. A more concerted policy effort by the different stakeholders will be required if the promise of a truly unified banking market is to be fulfilled.

1. *Af Jochnick, K. (2024), "Financial stability under European banking supervision", contribution for Eurofi magazine, 20 February.*
2. *Enria, A. and Fernandez-Bollo, E. (2020), "Fostering the cross-border integration of banking groups in the banking union", The Supervision Blog, 9 October.*

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How to cut the Gordian knot of the Banking Union

Most discussions on the home-host issue are currently focused on the fair burden sharing in the event of a bank failure. This is a legitimate and politically sensitive topic, which was made evident in a number of cases, providing important lessons for the future. Still, insufficient attention has been paid to an equally important issue - the role of banks in financing economies, supporting economic growth, and providing macro-stabilization function in host countries, primarily of the Central and Eastern Europe (CEE) region.

There is a growing need to urgently mobilize private resources to achieve our goals linked to green and digital transitions, strengthening Europe's defence and security, as well as to catch up with the USA and China in economic growth. The role of the banking sector during crises was highlighted in recent episodes, especially during the COVID-19 pandemic, where a well-capitalized banking sector played a crucial role in stabilizing the economy, thus fulfilling an important macro-stabilization role. In addition, bank infrastructure was essential in the distribution and implementation of support for businesses and households.

The banking sector in host countries of the CEE region experienced dynamic development after its transformation in the 1990s. Its dominant position, coupled with early negative experiences with quasi-alternative investment opportunities, have not contributed to the creation of the necessary ecosystem for the proper development of the capital market. In Slovakia, for example, the privatization process has had a negative impact, as its implementation preceded the establishment of properly functioning institutions, coupled with a number of scandals with the so-called "non-banks" that took the form of Ponzi schemes. To tackle these early complications, various measures to boost the domestic capital markets have been taken with different success rate among the CEE countries. Yet, a common feature remains - the banks play a key role in the economies, while the banking markets remain concentrated with a significant share held by large European banking groups. We are now faced with a situation where strong and trustworthy banks compete with undeveloped capital markets. As a result, the strategic role of banks in national economies is further increasing, while the variety of financing and investment opportunities for companies and households remains reduced.

Banking union could significantly benefit from greater focus of the CMU on less developed markets.

The current focus on completing the Capital Markets Union (CMU) could be the answer to overcome bank dependence and may also present a unique opportunity to expand the range of financing opportunities. Assuming, of course, that this initiative will also lead to development of smaller, regional capital markets and simultaneously connecting them with the existing infrastructure in the EU. It is important to note, that while the key issue in developed capital markets is scale-up, in less developed markets it is the initial start-up phase. Less developed capital markets would benefit from tools that increase or equalize their attractiveness, such as the harmonization of insolvency frameworks or measures that improve visibility of companies, whereas developed markets would benefit more from measures that bring additional resources, such as securitization relaunch. Of course, there are also many common objectives, especially in terms of reducing bureaucracy, cutting the red tape and simplifying procedures. Importantly however, wider acknowledgement is warranted by the home countries that the Banking union could significantly benefit from greater focus of the CMU on less developed capital markets.

The CMU is certainly not a panacea. The well-known and extensively discussed aspects such as the common understanding of financial stability in the banking sector, amendments to bank recovery and resolution framework, the European Deposit Insurance Scheme, as well as state aid rules and the Regulatory Treatment of Sovereign Exposures are equally important. Nonetheless, a fully-fledged CMU would significantly contribute to reducing dependence on the banking sector. By doing so, the CMU can be the mythical sword that cuts the Gordian knot of the Banking union.

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Banking Union and primary concerns of host countries

The Banking Union brings numerous benefits but also challenges for host countries of banks with parent companies in other EU member states. Properly addressing these concerns will contribute to a more balanced financial environment, strengthen confidence in the banking system, and ensure sustainable economic development for all member states.

Host countries play a crucial role in the Banking Union, as our concern for capital adequacy, liquidity, macro-prudential supervision, competitiveness, and effective bank resolution significantly contributes to the financial stability of the entire EU. The risks of deteriorating the so-called home-host balance not only affect financial stability but also the feasibility of resolution plans, level playing fields, the economy, employment, and access to international institutions. Through the credit rating agencies, these risks also impact funding sources.

In host countries such as Slovenia, foreign-owned banks are essential for financing the economy and providing employment. However, they are not necessarily crucial to the banking groups they belong to. This, in turn, may reduce their willingness to pursue various objectives that are vital for host countries. In this context, it is important to highlight the readiness for adequate recapitalization, sufficient liquidity, and compliance with other prudential requirements, which will, through the supervisory mechanisms of the Banking Union, appropriately prevent the transfer of risks from home countries and enable effective action in times of crisis. Based on various EU-level initiatives, we are also concerned that centralized supervision and resolution mechanisms could negatively impact smaller banks and, consequently, the local economy. We highlight potential insufficient liquidity as a possible negative consequence, which could lead to the insolvency of banks.

Based on the above, host countries aim to ensure sufficient capital and liquidity reserves as well as effective capital and liquidity support in the event of a crisis.

In the area of capital and liquidity requirements, the Commission has previously proposed their waiver at the level of individual banks in the case of cross-border groups. According to the Commission, the introduction of waivers would allow the reallocation of financial resources (capital, liquidity) among member states within the EU at their discretion, enabling operations in individual countries with little or no liquidity and capital while the system of contractual commitments of the group's remaining entities would act as a safeguard to assist a group member in trouble. However, host countries insist on legal safeguards ('level 1 safeguards'). Waivers could increase the likelihood of transferring group problems to subsidiaries and vice versa. Additionally, liquidity and capital waivers would create an unequal competitive position for subsidiary banks compared to local banks, which must fully comply with all requirements.

Host member states insist on the fulfillment of individual, not just consolidated, prudential requirements.

Furthermore, the question arises regarding the rationale for reducing capital requirements for the group and doubts about the efficiency of the banking market. Waivers, such as for additional lending in an overheated real estate market, could have negative consequences for European banking.

Meeting all prudential requirements at the individual bank level is crucial for a healthy and stable banking system in each member state and forms the basis for effective supervision. Consolidated supervision significantly complements individual supervision but does not replace it.

In 2021, the Commission prepared a legislative proposal related to the implementation of Basel III requirements. In this context, it proposed the introduction of an Output Floor for setting capital requirements, where the Output Floor would be applied only on a consolidated basis. Most host countries, including Slovenia, which was then holding the EU Council presidency, strongly opposed this proposal. Subsequently, an agreement was reached to apply the Output Floor at all levels: individual, sub-consolidated, and consolidated.

In the adoption of the so-called Daisy Chain Directive within the CMDI legislative reform, it was important for host countries to maintain the discretion of the national resolution authority to determine the internal MREL (Minimum Requirement for Own Funds and Eligible Liabilities) requirement on a consolidated basis.

In negotiations, host countries also strive for greater influence of national resolution authorities in the management of the Single Resolution Board.

We believe that it is essential to continue advocating for the interests of host countries, which may not always align with the interests of the countries where banking groups are headquartered. This approach is essential for the Banking Union to deliver stability and resilience to the financial system for all its members, which was, in fact, the primary objective of establishing the Banking Union.

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A well-functioning internal market needs a macroprudential reform

The EU is heading into the new Commission's term with a significantly revised microprudential framework for banks. The changed prudential rules imply higher capital requirements for many banks using internal models due to decreased risk sensitivity of the prudential framework, which may be further amplified in banks' overall capital requirements due to macroprudential buffers.

Macroprudential requirements is an area of banking regulation where the EU and its member states have gold-plated international standards. Many EU banks have ended up in a situation where significant decisions impacting their capital and business planning are published suddenly, inconsistently, and without including a full analysis of overlaps with other requirements. This unpredictability may make banks more conservative in their lending, constraining the lending capacity to the real economy. It also disincentivises cross-border business models given that each member state has their own macroprudential approach, which can be changed at short notice, adding a degree of uncertainty. Furthermore, there is currently no authority in charge of assessing whether the aggregate capital requirements for a banking group are proportionate to its overall risk picture. All of these elements hamper the development of a true single market with free movement of services.

The EU needs an overhaul of the macroprudential framework. This should be a top priority for the new Commission in order to boost competitiveness for both banks and their customers, to improve on the risk sensitiveness the of banks' capital requirements, and to level the playing field within the EU.

How should this be done? First, The EU should take a hard look at the complexity of the existing framework, especially when compared with global peers. Bringing the rules, and the tools, closer to those set in Basel standards would bring along a more level and predictable playing field. There should also be a more clear pecking order of microprudential and macroprudential measures. The ideal starting point for this would be that risks are covered using microprudential measures as a priority, with macroprudential tools to be used where this is not possible or practical.

Second, for the simplified toolbox, EU level standardisation and decision making should be significantly strengthened. This would mean common metrics and methodologies with clearly prescribed tools available to decision makers, with clear rules on how to map metrics, such as G/O-SII scores, to buffer requirements.

The EU needs an overhaul of the macroprudential framework.

Third, to the extent possible, the actual decision making should be consolidated within the EU/EEA. The current framework prescribes roles for several EU authorities, but the scattered analysis and oversight roles have not led to sufficient convergence of macroprudential decision across the EU/EEA. In particular, there should be more close cooperation between microprudential and macroprudential decision making, since experience shows that same or similar risks can be covered by microprudential and macroprudential measures. The group level supervisor typically has the best information and analysis of the risks faced by a banking group and should have a say in the correct combined buffer level for that group.

There has been much discussion on the need to add releasability to the macroprudential framework. Conceptually, this makes sense. Releasable buffers make the framework more adaptable to changes in business cycles and, in theory, enable banks to adjust their lending capacity to dampen economic cyclicality. But in practice, the positive neutral countercyclical buffer has often come on top of already high structural buffers, adding excessive conservatism to the combined buffer requirements of banks. At the same time, experience from Covid-19 showed that releasing buffers without clear communication on eventual build-up made the use of these buffers undesirable for banks. Thus releasability in itself does not solve anything as long as there isn't sufficient clarity and incentives for banks to make use of it. An eventual reform of the framework should include further releasability, coupled with commensurate downward adjustments of other tools, such as the capital conservation buffer and clear guidance to banks on future build-up.

Novel or evolving risks, such as climate and cyber risks, have also been mentioned in discussions around the macroprudential review. While it is important that all authorities are aware of these risks, it should be noted that the microprudential setup is currently being reformed especially for climate risks. Setting further macroprudential capital requirements based on these risks at this stage would run a high risk of overlaps with Pillar 1 and Pillar 2 requirements. Furthermore, the current framework of national decision making is particularly ill-suited for climate risks, which are cross-border by nature.

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Why Pan-European banks are now a necessity

Europe faces an array of economic challenges, from the energy and digital transitions to remilitarization. Governments are increasingly constrained by fiscal limits, so private sector financing will be crucial to these efforts.

That would be much more straightforward in the United States, where capital markets cover roughly 70% of all corporate financing needs. But in Europe, the figure is just 30%.

A true Capital Markets Union across Europe would help greatly, but it won't happen overnight. Private credit remains materially less developed than in the United States, and has historically focused more on providing debt financing for buyouts.

That leaves banks. Unfortunately, European banks aren't sized for the task. While their balance sheets have been stable over the past decade, tougher capital requirements have drastically reduced their risk appetite. The balance sheets of the top five US banks are 2.8 times larger than those of their European peers, allowing for more diversification, larger exposures, and greater investment budgets with which to jump to the forefront of technological developments.

Moreover, despite the ever-larger need for pan-European financing, European banks still operate largely within national borders. The top five banks in Europe by assets account for just 34% of the overall market, compared with 75% in the United States.

Europe's failure to foster large banks operating across a pan-European market creates risks. The first: reduced resilience to economic shocks. By restricting capital flows and liquidity across borders, ring fencing practices limit banks' ability to diversify risks and funding.

The second: impaired financial stability. By protecting the borders of national banking systems, ring fencing can create pockets of vulnerability. In crises, insufficient coordination among national authorities can hinder resolution and exacerbate systemic risk.

The third risk: diminished financial strategic autonomy. By operating mainly within national borders, European banks struggle to compete with large non-European firms, particularly in global businesses such as capital markets. History has also shown that during times of crisis these global firms retrench to their home markets.

Many challenges are deeply ingrained in national customs and will be difficult to change overnight. But five are technical in nature and can and should be addressed urgently:

The European Deposit Insurance Scheme. Ongoing proposals to develop a uniform EDIS have been stalled due to concerns of dissimilar risk levels across EU members, hampering integration of balance sheets. A reinsurance-based solution might revive talks.

> **Authorities must shift from a sole focus on stability, to also considering growth & competitiveness.**

Common backstop approach. Work toward this goal must continue. A single resolution mechanism is not yet equipped with an operational backstop fund to supplement the existing Single Resolution Fund in case of contemporaneous resolution of multiple large institutions.

Cross-border liquidity. The GSIB scoring methodology (which includes surcharges depending on the home country) keeps capital ratios higher for cross-border mergers than domestic ones. Impediments also remain to cross-border liquidity transfers within banking groups.

National regulation. The EU regulatory framework allows for variations in domestic regulation of tax, mortgages, customer protection, insolvency, and other areas. For the next EU Commission there might be a few quick wins achievable, such as in corporate or dividend taxation.

Accounting. Unfavourable accounting treatment (such as the implications of recognition of fair value adjustments of loans and bonds portfolios) makes M&A less appealing.

In addition to these technical fixes, a more fundamental change in mindset is required. Authorities and regulators need to shift from prioritizing stability at all costs to also considering growth and competitiveness. We need the strategic will to create truly European banks, accompanied by proper incentives. What if, for example, capital implications were lower for cross-border mergers than for domestic? Imagine if banks operating on a to-be-defined European perimeter (such as providing financing to corporates and sovereigns in more than x markets, with a certain minimum volume level to ensure relevance) could receive capital relief commensurate with their more diversified business model. Likewise, what if a separate backstop for these European banks were created?

Granted, larger banks come with their own risks. Despite the regulatory overhauls since the global financial crisis, none of the victims of last year's banking crises has gone through the resolution process foreseen by the Basel regulations. Hence, this framework remains to be tested in a real case. Nevertheless, if Europe wants to succeed in an increasingly polarized world, radical "top down" action is required.

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Banking Union is a growth engine we cannot afford to ignore

Europe wants to improve its resilience, boost its competitiveness, and navigate the climate and digital transitions. For all these goals, Europe needs to maximise local sources of funding.

As we consider how to do this using private finance, capital markets rightly take centre stage as it is an underused funding source. However, better allocation of bank funding is also an important part of the puzzle. This allocation issue can only be solved by completing Banking Union.

The potential gains of completing Banking Union have been estimated at 0.3%-0.8% of Eurozone GDP by the European Parliament's Research Service (EPRS). [1] The EPRS rightly framed their research as an exercise in "mapping the costs of non-Europe". Missed opportunity, as opposed to direct losses, are too often disregarded in policy debates. To put this into perspective, the EPRS estimation would mean an additional yearly income of €250 and €750 for every Eurozone household, each year. Banking Union is a growth engine that cannot be ignored.

The full promise of Banking Union is that it is both a financial stability and a financial integration project. It provides a stepping stone towards a single market for banking services. This would allow more efficient allocation of capital to support the real economy, break down financial barriers between countries that hold back growth, and boost competitiveness.

It should be noted that non-EU banks, often focused on corporate and investment banking, currently benefit more from the EU internal market, especially post-Brexit. They set up centralised holdings for their operations in the EU from which they grow cross-border provision of services through branches, with fewer local constraints. EU-headquartered banks, typically with large retail operations, remain stuck in a more segmented setup. They tend to be more rooted and systemically relevant for domestic, national, markets.

How do we make progress?

Whereas the capital markets agenda is complex and entails a lot of hard-to-tackle fundamental problems, the road to completing Banking Union is relatively straightforward. In our view, there are both **missing** and **imperfect** pieces of the puzzle that lead to a Banking Union stuck halfway.

On the one hand, there are the infamous and often repeated **missing** pieces of Banking Union:

Creating an EDIS – this will be beneficial for the European saver by promoting cross-border competition for deposits. It will also help alleviate concerns over how losses are allocated between DGSs in a cross-border bank failure.

Liquidity in resolution – a credible EU-level provider of liquidity in resolution would resolve host Member States' concerns and greatly increase the credibility of the Banking Union resolution framework.

On the other hand, Banking Union is also hampered by problems with **imperfect** Banking Union-related legislative framework.

The macro-prudential framework is not fit for Banking Union – the persistent different application of macro-prudential tools, notably buffer requirements, at national level, creates an unlevel playing field between banks in the Banking Union. The regime needs urgent reform with a focus on harmonisation and predictability.

Significant barriers to transferability of funds and instruments – in an imperfect banking union, bank contributions to national DGS cannot be transferred to another Banking Union DGS in case of M&A or changing corporate structures. This is a source of paralysis for cross-border activity. Similarly, there are questions about the transferability of MREL instruments in cross-border mergers.

The focus can and should now shift to boosting competition and competitiveness.

Difficult application of liquidity waivers and capital upstreaming – The CRR allows for liquidity waivers, but in practice this has never happened. Cross-border banks also face challenges when upstreaming capital from fully owned subsidiaries to the group level. In a functioning Banking Union, banks should be able to manage their balance sheets much more centrally, avoiding trapped liquidity and capital within the group.

Boosting the EU's strategic autonomy requires a complete Banking Union, as part of the financing goals behind a Savings & Investment Union. The current framework is sufficiently robust from a prudential perspective. The supervisory setup works very well, as events, or rather lack thereof in the Banking Union, over the past years have demonstrated. The focus can and should now shift to boosting competition and competitiveness by destroying the walls standing between the EU's national banking markets.

1. *[1] EPRS, Increasing European added value in an age of global challenges, Mapping the cost of non-Europe*

   (2022-2032), March 2023, https://www.europarl.europa.eu/RegData/etudes/STUD/2023/734690/EPRS_STU(2023)734690_EN.pdf

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EU BANK CRISIS MANAGEMENT FRAMEWORK

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A level-playing-field view of the funding mix for resolution

The fragmentation of the crisis management framework, mostly with regard to mid-sized and smaller banks, is a well-worn theme the European Union is facing. As such, reaching a fully integrated Banking Union could not be achieved if many banking crises are still handled through non-harmonized national methods that requires a strong reliance on industry funds, or even public funds. Yet, harmonization in the European Union is not out-of-reach and the last discussions on the crisis management and deposit insurance (CMDI) legislative proposal invites us to move forward.

On the positive side, it is important to keep in mind that we already did the hardest part by establishing such a European crisis management framework for the largest banks. The resources built up by the banks under the Single Resolution Board's remit to fulfil the Minimum Requirement for Own Funds and Eligible Liabilities (MREL), to absorb losses and restore capital in resolution, have reached EUR 2 500 bn in 2023 (or 34% of the total risk exposure amount). The Single Resolution Fund has now received almost EUR 80 bn in contributions from banks. Year after year, resolution plans are being complemented and tested with more and more granularity.

What has already been achieved for the largest banks should give us confidence that a broader harmonization is both feasible and legitimate. It would ensure that banks of different size and established in various Member States operate under similar rules, not only under normal circumstances but also when they face a crisis situation.

Stringent safeguards for external funding are key to hit the right balance with internal funding.

Extending the scope of resolution to more banks, while ensuring that national tools such as deposit guarantee schemes (DGS) preventive interventions are not used as a substitute to resolution to support failed banks, seems to be the best way to reach that goal. It was a key objective of the CMDI package proposed by the Commission in April 2023. As shown by the vivid discussions surrounding of the CMDI proposal, the main challenge to achieve a meaningful and workable extension of the resolution framework is to reconcile different views on the funding mix that should support the resolution of a mid-sized or smaller bank.

On the one hand, "internal funding" supported by investors is without doubt the best way to avoid moral hazard and costs for taxpayers, ensured by a sufficient level of MREL requirements. For the largest banks, MREL is the first and main line of defence and the same principle should apply for banks that would be newly included in a larger scope of resolution. However, where the use of transfer tools – used on a standalone basis or combined with other tools, such as bail-in – would decrease the need for recapitalisation, a proportionate downward adjustment of the MREL would be legitimate, irrespective of the size of the bank.

On the other hand, external funding in resolution, through resolution funds and DGS, was designed as a very restricted and last-resort option for the largest banks. These principles should be preserved to avoid the risk of ending up with two coexisting approaches for resolution: mostly based on MREL and bail-in for the largest banks; contrasting with strategies mostly based on external funding from resolution funds and DGS, akin to a form of industry-funded bail-out, for mid-sized banks and smaller banks. The latter would be a source of moral hazard and the extension of resolution would actually be a setback in terms of harmonization.

Stringent safeguards to external funding in resolution are key to hit the right balance with internal funding, and ensure that the CMDI proposal does not fall short of the initial ambition. Sensible safeguards should ensure that the use of external funding in resolution remains a last resort option where internal resources are insufficient at the time of crisis, in extreme scenarios, and would be restricted to banks that, prior to the crisis situation, were thoroughly applying the resolution planning framework.

That last consideration, in particular, would create the right incentives both for banks and for authorities to converge toward a higher level-playing-field for resolution planning. Once a bank has reached a sufficiently high level of ex ante compliance with the harmonized framework (including MREL requirements), it could then be envisioned to allow ex post a potential resolution scheme to include, as a last resort, an extended access to mutualized funding at the level of the Banking Union.

A solid governance must underpin such an ambition. In this respect, the established dynamics of the Single Resolution Mechanism should be preserved to ensure a level-playing field and take decisions in the interest of the whole Banking Union, moving beyond national banking sectors interests.

DOMINIQUE LABOUREIX
Chair – Single Resolution Board (SRB)

CMDI will enhance the EU crisis management framework if its tools are effective

In 2022, the Eurogroup agreed on a number of elements to strengthen our crisis management framework. One of these elements was a "broadened application of resolution tools in crisis management at European and national level, including for smaller and medium-sized banks, where the funding needed for effective use of resolution tools is available, notably through MREL and industry-funded safety nets."[1] The rationale was to spare taxpayers from having to shoulder the consequences of these smaller banks' crises, as it has happened in the past.

The 2023 Commission's Crisis Management and Deposit Insurance proposal (CMDI) pointed exactly in that direction. More small banks would be earmarked for resolution. Resolution authorities, in turn, would have additional easy-to-use tools to deal with the potential failure of those banks.

Resolution has a number of advantages over liquidation. First, in resolution, the use of taxpayers' money is explicitly ruled out. Also, when a failing bank reopens after the resolution weekend, customers keep access to its full range of services. This is not necessarily the case in liquidation.

This does not mean that all banks running into trouble should be resolved. Even after CMDI, liquidation will stay relevant for most banks. The Banking Union is home to around 2 000 small banks and, even after CMDI, for the most part, liquidation will remain the preferred approach in case of crisis. So, resolution will not be the general solution.

With CMDI, banks entering in the scope of resolution, even the smaller ones, would have to respect the same standards as their larger peers, in a proportionate way - ensuring a level playing field. This means, among other things, that these banks would have to build and maintain their minimum requirement for own funds and eligible liabilities (MREL), like their larger peers.

At the same time, resolution authorities would need a more flexible toolset to deal with the resolution of these smaller banks. This is why the Commission introduced an alternative way of funding a market exit for the bank in crisis, if it is in the public interest and after the depletion of the MREL resources of the bank. To do so, CMDI makes the use of Deposit Guarantee Scheme funds more realistic (through the so-called "DGS bridge"), and facilitates the use of the Single Resolution Fund. This funding would help the sale of the ailing bank to a solid acquirer. By doing so, CMDI enhances flexibility, preventing the risk of unsuccessful resolution decisions.

Nevertheless, MREL will remain the first line of defence. In that sense, after the introduction of CMDI, shareholders and (MREL) creditors will clearly shoulder the burden of resolution in all banks earmarked for resolution, big or small. If anything, by enlarging the scope of resolution and leaving the MREL requirements unchanged, CMDI would increase the aggregate amount of MREL in the system.

At the same time, through the DGS bridge, CMDI would give resolution authorities the flexibility to deal with smaller banks at a limited cost for the industry[2].

Some stakeholders worry that this proposal could create bad incentives for smaller banks by simplifying the use of DGS funds or the SRF for their resolution. This is not the case. CMDI doesn't change neither the resolvability expectations, nor the loss order: shareholders are first to bear losses, then MREL-eligible instrument holders, and only then, when and where necessary, DGS and the SRF - to finalise the sale of business.

After the reviews of Council and Parliament, the CMDI proposal now seems less ambitious. In particular, the Council's text introduces 19 new safeguards restricting access to the new funding – a key element for a successful resolution. Whatever compromise legislators may find in trilogue on the sensitive issues around the DGS bridge, they should make sure it delivers in terms of funding available for a resolution decision. Without proper funding, liquidation and bailouts may become the only option.

If the CMDI's funding is too small or its safeguards too complex, the reform's impact may be limited.

The SRB will implement the final package agreed by the colegislators, whatever its content. Nevertheless, it should be clear that, if the funding provided is too limited or its safeguards too complex to satisfy during a resolution weekend, the reform's impact on financial stability and taxpayer protection may be limited. Everyone, including banks, will benefit from a more effective crisis management framework. CMDI, in the path charted by the Eurogroup, is crucial for delivering on this objective and will have a positive impact for achieving a fully-fledged Banking Union.

1. *Eurogroup statement on the future of the Banking Union of 16 June 2022*
2. *Single Resolution Board, "The Commission proposal to reform the EU Bank Crisis Management Framework: A selected Analysis", December 2023*

JACEK JASTRZĘBSKI
Chair of the Board – Polish Financial Supervision Authority

Let us not overlook the small banks

According to the European Central Bank's data as of the end of the fourth quarter of 2023, in the countries participating in the Single Supervisory Mechanism, there were almost 2 000 less- significant institutions (LSIs)[1]. In Poland, there is also a great variety of small, non-complex institutions (SNCIs) in the legal form of cooperative banks (403 SNCIs among 492 cooperative banks). They support many local development initiatives and local self-governments, provide credit to local entrepreneurs and help to stimulate economic growth.

However, the current shape of the EU framework for bank crisis management and national deposit guarantee schemes (Crisis Management and Deposit Insurance – CMDI) is designed for significant, 'too big or too complex to fail' financial institutions. Such an approach is based on the (and to be honest, quite questionable) assumption that only those entities can pose systemic risk. In this situation an important question arises: should the resolution process apply only to large and medium-sized banks whose liquidation would cause significant issues in a country, or should it also include a broader range of smaller banks?

As practice shows, to date, the resolution proceedings have been applied rarely, while many failing small banks have been liquidated under national liquidation regimes, in certain cases with the involvement of taxpayer funds (bailouts), instead of industry-funded mechanisms, such as the Single Resolution Fund (SRF). A notable examples of this were Banca Popolare di Vicenza S.p.A. and Veneto Banca S.p.A., liquidated in 2017 under national insolvency proceedings with the use of public funds. As a result, the harmonised resolution framework was bypassed and superseded by non-harmonised national arrangements which involved public support. As these cases clearly show, narrowing the application of the resolution procedure only to large banks can result in resorting to the use of state aid, which is not in line with the whole post-crisis CMDI philosophy.

While assessing whether the public interest premise is fulfilled, which is a trigger for resolution, it is necessary to take into consideration not only the impact of a bank's failure on an entire country's financial system and on national or transnational financial stability (which usually is not the case for small banks), but also to perceive the bank as an element of a complex ecosystem, performing critical functions for the local economy. Apart from that, for example in the case of a cooperative bank, also the potential impact of its insolvency on the cooperative banking sector as a whole must be considered.

The current CMDI framework is designed for 'too big or too complex to fail' financial institutions.

Previous episodes of cooperative bank failures in Poland have shown that in this part of the banking sector, the risk of contagion is relatively high. Additionally, the resolution procedure proved to be key for preserving financial stability at a regional level. The least-cost test conducted by the resolution authority in Poland has shown that the cost connected with resolution was lower than the cost related to the pay-out of covered deposits in regular insolvency proceedings.

The European Commission has acknowledged the existence of the problem of marginalising small banks in the context of resolution proceedings and on 18 April 2023 proposed a reform of the CMDI framework to widen understanding of public interest, i.e. to broaden the scope of resolution also to small entities. The aim of the proposal is to facilitate application of the resolution procedure to the LSIs. The general direction of the proposed reform is desirable, however, there are still areas that need to be improved to make resolution a strategy feasible for small banks. In particular, such entities have their business models based mainly on funding via retail deposits, thus issuing liabilities in order to comply with MREL requirements may be challenging and costly for them. In this way, they may also face difficulties with meeting the requirement of bail-in of at least 8 per cent of total liabilities including own funds (8% of Total Liabilities and Own Funds (TLOF)), which is the condition necessary to access national resolution financing mechanisms or the Single Resolution Fund. As a consequence, in the case of small banks with the traditional funding model, the bail-in of uninsured deposits in order to meet the 8% TLOF requirement may be necessary, however it could in turn undermine depositors' trust in the banking system.

In conclusion, the resolution process should apply to a broader range of smaller banks. However, all the considerations raised above point to the need for a further reform of the resolution framework (including the MREL requirements) to make it more adjusted for small institutions, including those operating within Institutional Protection Schemes.

1. *https://data.ecb.europa.eu/data/datasets/SUP/SUP.Q.B01._Z._Z.R0104._T.LSI._Z._Z._Z.Z.C*

BARNABAS DEZSERI
Hungarian Member of the Financial Services Committee – Ministry for National Economy, Hungary

The next step for a more efficient crisis management

The EU banking resolution framework is relatively new. Still, after 10 years we are currently working on its second review, which shows of its importance. Clearly the move that the framework was setup by the EU, including the infrastructure of resolution authorities and funds, the crises preparedness by the resolution plans and build-up of bail-in eligible liabilities (MREL) has made EU banking system very stable, which has also increased the confidence in the sector. This was clearly tested last year for example. We all see its benefit and it seems to be a logical move to use it to broader range of smaller banks. Clearly with the enlarged scope we shall have a more holistic view considering various tools of crisis management. We can say the resolution framework has matured and now we shall see how it fits in well with older tools of banking crises management.

This is the current challenge to make sure that the bail-in can play with tandem with other crises management strategies while we build on the benefits of the new framework. Also we should defend taxpayer money and save the still viable part of the bank. Clearly financing burden is firstly borne by shareholders and creditors, we base the preparation on this principle. Still, it is the nature of the crises that one could never be 100% ready for it, and that is where other financing sources should come into play. Furthermore, I believe in several cases we need only liquidity support, so the replenishment of safety nets is expected.

Another challenge with the enlarged scope is that we should take care of the diversity of banks, which can be even more complex in the strongly integrated Banking Union framework, here I shall also refer to the mutualised system of Single Resolution Mechanism. The credibility of the financing of is a crucial issue. The build-up of loss-absorbing capacity, typically through successful issuance of eligible instruments, and the conditionality of accessing the safety nets, like resolution funds a deposit guarantee schemes, are all elements for this credibility. Also the transfer tools should be taken more into account as we broaden the scope and strengthen the framework.

We shall have an efficient system with the flexible use of toolbox fit for different banks.

In fact I would go further, we should also treat the diversity of the situation of different Member States. The structure of the banking markets are different inside and outside of Banking Union, and there are also different tools of crisis management which have worked well in the past. However I would like to underline that we should avoid free-riders of the system, as the moral hazard can endanger financial stability as well. We should have a balanced system that takes care of more fragile domestic banks, which may be in an even more difficult situation because of their country of origin. In a flexible system we should be clear that in some cases the goal is orderly market exit of the nonviable bank. Contemplating on this balance, on the issue of level playing field between large and small banks we shall not make hasty assumptions, but look into the details. For example MREL is not a fee, but a factor that shows the resilience to consumers and investors. Clearly a larger bank can build up MREL more efficiently, and the bank gets stronger by it. Also a smaller bank who enters into a difficult situation is clearly not doing that intentionally. We can all agree that MREL is the first line of defence, but we should pay greater attention to the type of clients, who invest in these types of instruments, as these may affect the financial stability of a Member State, if the clients are unaware of the associated risks. Therefore MREL eligible instruments should only be available to retail clients with strict safeguards, or market them to professional investors.

In summary the resolution framework is clearly beneficial, so the logical next step is to enlarge the scope, see how different crisis management tools can work together and even identify synergies. We shall have an efficient system with the flexible use of toolbox fit for different banks. Taking into account the long standing experience of crisis management gained through resolution and insolvency procedures we can have a holistic review of the framework, so we can provide solutions to the unaddressed problems, strengthening further the resilience of the EU banking sector. I believe that the work of the Hungarian Presidency is to move forward toward a more effective crisis management framework, but also taking care of the diverse nature of banking systems and the Member State specificities.

FERNANDO RESTOY

Chair – Financial Stability Institute (FSI)

The need for a liquidity facility for banks in resolution

Liquidity has been a hot topic since the 2023 banking turmoil, but the central role of liquidity in resolution is not a new insight. Without liquidity, continuity of critical functions is not plausible. Even though resolution action will have restored capital levels, a firm may not have access to market sources in the weeks or months following a resolution.

Recognising this, the FSB specified in 2016 that jurisdictions should have credible arrangements for public backstop funding with capacity to meet the needs of systemic firms in resolution and promote market confidence.

The failure of Credit Suisse (CS) highlighted the consequences of shortcomings in this regard. In March 2023, Switzerland did not have arrangements for resolution funding or a public liquidity backstop.

Prior to reaching the point of non-viability, CS received CHF 50bn of emergency liquidity assistance (ELA) from the Swiss National Bank (SNB). This significantly depleted its available collateral, so when the SNB had to provide up to CHF 200bn in additional liquidity in the run-up to and following the merger with UBS, that lending was uncollateralised. To protect the SNB for part of that lending, emergency legislation was adopted to put in place a public sector backstop – a guarantee by taxpayers against any losses it might occur.

The CS case has lessons for the EU. Here, the current picture is complex: different public sources of liquidity apply, depending on whether it is needed before or during resolution, or to support post-resolution restructuring. And, crucially, there is currently no adequate public backstop mechanism.

The ECB's liquidity facilities are part of its monetary policy operations, although they may serve to provide liquidity to individual solvent banks that have the required collateral. During crises, the ECB has occasionally temporarily extended the maturity of its lending or widened its eligible collateral.

ELA for individual banks that are liquidity stressed but solvent falls to national central banks. NCBs have considerable discretion as to the terms on which it is provided, including the collateral.

Once a bank is in resolution, the Single Resolution Fund (SRF) may provide loans, provided the conditions for access have been met. Notoriously, those conditions require the prior bail-in of at least 8% of the bank's total liabilities, including own funds (TLOF). The amounts that may be used in a single resolution are capped at 5% of the bank's TLOF.

Time to consider a new facility for the ECB to lend in resolution with a mutualised public indemnity.

The SRF currently stands at its target level of approximately €75 billion. This is a considerable sum. However, looking at the amounts of liquidity required by CS in the run-up to and following the merger transaction, the SRF's prefunded resources clearly fall short.

Potentially, there is a backstop that almost doubles its firepower. In 2018, it was agreed that the European Stability Mechanism (ESM) could lend the SRF up to €68 billion. The ESM would introduce mutualised financial backing by MS into the framework. However, that public backstop is not yet in force, since ratification of the ESM Treaty is currently blocked at the political level.

A bank that has been subject to bail-in or a resolution transfer should meet the solvency requirements for ELA or access to ECB facilities. In theory, these may be an additional source of liquidity until the resolved bank commands enough counterparty confidence to return to market-based funding. However, there are potential obstacles. It may require lending for a longer term than those sources are designed to provide. A bank that has emerged from resolution is unlikely to have sufficient eligible collateral to fully secure the amounts needed.

Therefore, a euro area liquidity facility with a mutualised backstop is essential for the credibility of the resolution framework in the banking union. Activation of the ESM backstop is the necessary first step. But beyond that, it is questionable whether the current resources of the SRF, even with the ESM backstop, would be sufficient to meet the liquidity needs of a large bank in resolution.

Experience in other jurisdictions show that it is difficult to envisage a sufficiently robust liquidity facility without the involvement of the central bank. To provide funds in resolution, the ECB would however need a public indemnity as it might have to lend without full collateral coverage, as happened in the case of SNB funding of the CS failure management. In order to preserve the principles of the banking union, that indemnity could only be provided by fully mutualised guarantees.

It needs to be stressed that the risk of loss for the fund providers in resolution is, by definition, quite low. No losses were incurred by the SNB, or the Swiss state under its indemnity, in relation to CS. If resolution is effective, the bank will be solvent. Effectiveness should be guaranteed by developing a sound resolution strategy and business reorganisation plan. Rigorous resolution planning is key.

by Fernando Restoy and Ruth Walters

DENISE BAUER-WEILER
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Crisis cycle: the key components for crisis prevention and management

Now more than one year after 2023's banking turmoil, Swiss authorities and international bodies have set out lessons to be learnt. They conclude that the existing regulatory framework worked and demonstrated that the reforms which followed the Global Financial Crisis increased the resilience of the financial sector globally. Nevertheless, in the crisis continuum, carefully calibrated adjustments will be necessary to further reinforce the regulatory framework.

While the focus of the public discussion in the EU is on the need for a liquidity facility in resolution, successful crisis prevention and management needs to be embedded in a broader setting which covers each phase in the evolution of a crisis. This starts with a strong risk culture and a solid capital base, includes early intervention measures as a crisis begins to unfold, and flexible resolution tools when it has crystallized.

A strong **risk culture** can help prevent a crisis in the first place. This includes governance arrangements with clear assignment of responsibilities and decision-making processes, and strong tone from the top on risk and compliance to foster good behaviours. There needs to be a culture of constructive challenge for all risk types, in the first line and in control functions, including clear escalation mechanisms. Long-term incentives in the remuneration and promotion framework are also a key part of a sustainable long-term business model. In Switzerland, the introduction of a senior managers regime is being discussed to ensure clarity on individual accountability.

Meeting **capital requirements** that are set by the law, including those that are set at individual firm level by the regulators, helps provide the financial strength and resilience to weather a crisis, and remains the backbone of risk management. In accordance with the Basel framework, AT1 should remain part of banks' capital structure.

The accelerated speed of bank runs in the digital age and related **liquidity** crises highlight the need for further diversification of market-based funding sources. Securitisation, for example, can provide more stable funding than short-term deposits.

If a bank's own efforts to address the causes of distress are insufficiently determined, authorities need to be able to exercise **early intervention powers** to prevent further deterioration. Regulators across jurisdictions should, where needed, strengthen their early intervention frameworks, ensuring that supervisory measures are based on clearly defined objective criteria. To the extent that an advanced framework already exists as in the case of the EU, supervisors need to be able to use their powers effectively, even where reported prudential ratios are compliant with regulatory requirements.

In the crisis continuum, adjustments will be necessary to further reinforce the regulatory framework.

Improvements in access to central bank liquidity during market stress are crucial: commercial and central banks need to collaborate to ensure they have well planned operational and legal arrangements for pledging and receiving a wide range of less liquid assets as collateral against central bank funds.

As a crisis deepens, as shown by the Credit Suisse events, the role of loss absorbing AT1 instruments for the recovery of an institution can be crucial. However, their loss absorbing function in going-concern should be reinforced: further work at supranational level may be needed to provide additional clarity on the features of these instruments and enhanced standardization may help provide clarity to investors.

At the end of the crisis cycle, **flexible resolution tools** are key. In March 2023, the rescue of Credit Suisse was deemed the most suitable course of action, ensuring prompt stabilisation and minimising impact on financial stability. Nevertheless, recovery and resolution planning proved to be good preparation. Going forward, the degree of optionality in resolution strategies needs to be enhanced to address a range of crisis scenarios. The greater the optionality of resolution tools available to authorities, the greater the chances that resolution of a failing bank can effectively be implemented. Effective planning for the operationalization of variant strategies, including via regular testing of resolution capabilities, is therefore central.

Finally, the availability of a **public liquidity backstop** tool is fundamental to maintaining market confidence and ensuring the success of a resolution action or, as with Credit Suisse, of a rescue transaction. In the Banking Union context, political collaboration across Member States is needed to ensure a liquidity backstop that enables the SRB and ECB to fulfil their roles and mandates in preventing one or more bank crisis from causing wider, unnecessary losses and systemic instability.

While liquidity in resolution is an important part of the crisis prevention and management framework, additional targeted actions should be considered to reinforce management accountability, enhance supervisory effectiveness and ultimately ensure credible resolution planning is in place for a variety of scenarios.

MARIJA KOLAK
President – National Association of German Cooperative Banks (BVR)

Resolution of medium and small banks: a response to the CMDI review proposals

In April 2023, the European Commission's proposals for the CMDI review suggested that the resolution mechanism should become the standard for medium-sized and small credit institutions. This proposal faced criticism from the start and both the Council and Parliament have since suggested changes in their respective positions. Our network, the German Cooperative Financial Network, which comprises around 700 small institutions, supports many of the changes requested by the Council as they take into account the specificities of the national banking sectors and the needs of smaller credit institutions.

Already for reasons of market discipline, insolvency should remain the default exit strategy.

Moreover, resolution tools are primarily designed for institutions of systemic importance. Their complex nature is not suitable for small and medium-sized credit institutions, whose failure has minimal impact, if any, on the overall financial stability of a country or region. The resolution mechanism should remain applicable only to institutions for which it was originally designed: banks which are systemically important and highly interconnected. For good reasons several jurisdictions apply a prudential approach that differentiates between larger banks and smaller retail institutions. In the same vein a single set of resolution-rules for banks of all sizes seems inappropriate from a conceptual perspective as it is not reflecting quantitative and commercial realities. Such differentiation needs to be reflected when enhancing European competitivity in a Savings- and Investment Union.

Another aspect, where we do not see the consequences adequately reflected, is the Commission's and Parliament' suggestion of an unlimited financial participation of deposit guarantee schemes in resolution financing, coupled with a deterioration of their position within the creditor hierarchy. Not only does this approach bear significant risks. The far-reaching use of deposit guarantee schemes for resolution measures could seriously weaken existing well-functioning deposit protection schemes and undermine depositors' trust. Therefore, the super preference of deposit guarantee schemes in the insolvency ranking has to remain intact, as suggested in the Council's position.

Also, from a wider perspective the additional financial burden for banks by the extension of the resolution tools and the changes to the creditor hierarchy raise concern. It would reduce the capacity of banks to support the digital and sustainable transition. The focus should rather be on enhancing banks' lending capacity in the context of a "Savings- and Investment-Union", a priority of the new Commission to enhance Europe's competitivity.

A single set of resolution-rules for banks of all sizes seems inappropriate.

Moreover, unresolved aspects of the too-big-to-fail problem persist, as highlighted by the turmoil surrounding Swiss and US-American banks in 2023. Even though these institutions are not part of Europe' Single Resolution Mechanism, the problems with resolving systemically important banks, such as size, interconnectedness, consequences of bank runs, and bail-in implementation, are similar. Additionally, the issue of breaking the "vicious circle" between banks and state through government bonds remains unaddressed. While there is much talk about completing the banking union, this crucial aspect has been neglected. Finally, the proposals do little to defuse the complexities of the home-host debate and to pave the way for a better allocation of capital and liquidity by banks operating cross-border.

Given this backdrop, focusing on the alleged problems with the failure of small institutions and proposing resolution measures that would weaken deposit guarantee and institutional protection schemes seems counterproductive.

Another debate in the context of the CMDI package focused on the appropriate approach to deposit protection. The DGSD from 2014 rightly focused on harmonization and avoided the sensitive issue of mutualizing national deposit guarantee schemes. It also effectively reflected the mode of action and effectiveness of IPSs.

The CMDI review proposal includes several welcome technical suggestions for the DGSD. However, we believe that it also has to ensure the functionality of institutional protection schemes (IPS) as those systems add a further layer of security for their members. Unfortunately, both the Commission proposal and the Parliament's negotiating position make preventive measures by IPS, and thereby their entire mission, virtually impossible through numerous impractical rules. The Council position, although it brings more complexity and more changes seem necessary, certainly is a step in the right direction.

JUAN POSWICK
Head of Recovery and Resolution – BNP Paribas

Crisis Management and Deposit Insurance (CMDI) review: where to land?

Going back to the Eurogroup statement of June 2022, the four objectives of the CMDI review were to (1) clarify and harmonise the Public Interest Assessment (PIA), (2) broaden the application of resolution tools in crisis management at European and national level, including for smaller and medium-sized banks, (3) further harmonise the use of national Deposit Guarantee Scheme (DGS) funds to facilitate market exit of failing banks, under a harmonised least cost test (LCT) and (4) harmonise targeted features of national bank insolvency laws to ensure consistency with the CMDI framework. Note that "harmonisation" comes back explicitly in three of these four objectives and that a clear link is made between the use of DGS funds in resolution and market exit.

Behind this Eurogroup call to review the CMDI and stated objectives lay the observations that resolution-like solutions were still applied at national level outside the framework, at the expense of DGSs or taxpayers, with limited burden-sharing by shareholders and creditors, and that several smaller or medium-sized banks that were not earmarked for resolution could threaten financial stability in case of failure.

Looking at the Commission proposal and the respective positions of the Parliament and the Council, it is not obvious to see whether the Eurogroup objectives will be met. Unfortunately, indeed, it seems that a genuine political will to drop national habits in favour of a harmonised EU framework is still missing among several Member States.

In a constructive mood though, let us suggest some ideas that may help achieving reasonable progresses, leaving the fourth objective open for the moment.

Starting with the PIA, assessing it at regional level should allow capturing more banks that could generate financial stability risks if failing. It is important though to define "regional level" in a way that covers truly significant geographical and economic areas and avoids further fragmentation of the EU market; the Parliament position appears somewhat misguided in that respect. More importantly, any change from a negative to a positive PIA should only be allowed under specific conditions. In particular, changing the PIA of Liquidation Entities and entities under simplified obligations at the point of quasi failure should not be allowed. Leaving such possibility of last-minute change would indeed undermine the basic principles on which the framework was built.

A genuine political will to drop national habits in favour of true EU harmonisation is still missing.

Broadening the application scope of resolution tools to smaller and medium-sized banks is generally welcome. The extent of the enlargement should not be an issue if adequate funding can be ensured, coming first from shareholders and creditors of the failing bank through appropriate MREL, as well as proper preparatory measures by both the resolution authorities and the concerned banks. Without being prescriptive, the Commission proposed guidelines to that effect, which the Parliament further detailed, and the Council did not retain at all. Could the Member States reconsider their views and so, start to gradually harmonise practices is a key question. Next to it, if funding means are available, authorities should intervene early enough upon deterioration of the situation to avoid that such means are already gone when resolution is declared. Positions appear more convergent here, particularly concerning preventive measures. Rapid handover to resolution authorities could be further prescribed for barely viable entities and maximum delays between situation assessments once preventive measures have been launched could be defined.

Facilitating the use of DGS funds and harmonising the LCT has been approached in various ways. The Commission went quite far in its proposal with a general preference for deposits, all at the same level. The Parliament was less radical with two tiers within deposits and the Council went for a more complex four-tier proposal. A mid-way approach close to the Parliament position could be reasonable. So, the LCT could more easily be satisfied for banks that are mainly funded by retail and SME deposits. Though, the link between the use of DGS funds in resolution and market exit of the failing bank should not be left aside. Furthermore, the purpose was to harmonise the use of DGS in crisis management, i.e., in resolution, and not to facilitate use of DGS funds in various alternative ways as allowed under diverse national rules. The Council position may have missed the goal in that respect. Counter-balancing that diversion, it enhanced the safeguards preventing easy access to the Single Resolution Fund (SRF). In order to evolve towards more harmonised rules and easier access to funds at European level, SRF today or EDIS tomorrow, all Member States should accept to gradually close the door to national specificities and backdoors. And, of course, to accept the principle of building adequate levels of MREL for their PIA-positive candidates and of preparing them for resolution, as per the existing framework.

DIVERSITY IN THE EU BANKING SYSTEM

HELMUT ETTL
Executive Director – Austrian Financial Market Authority

Proportional and risk-based supervision's contribution to diversity

One objective of any financial system in Europe, regardless of its structure, is to support the (real) economy effectively and efficiently. Therefore, the banking system must meet the needs of different stakeholders and population groups within the EU, which differ both in terms of their characteristics and their associated risks. For example, European banks have to offer business models tailored to the needs of private individuals, small and medium sized enterprises (SMEs), large corporations and start-ups. They must offer business models both for young, tech-savvy customers as well as older technology-averse customers. Diversity of banks' business models across the European Union is key in achieving this.

As digitalisation progresses, many new players such as digital banks and BigTechs have entered the market. Such players drive innovation, leading to changes throughout the whole banking landscape, as they increase competitive pressure on incumbent banks. In addition, traditional banks must embrace new technologies (and the accompanying implications that come with them) and modernise themselves on an ongoing basis. Such a digital transformation and permanent modernisation are necessary to ensure the sustainability of banking business models.

In this context, it is necessary to highlight the continuing economic importance of the co-operative sector and regionally-offered services. They include guaranteeing the security of supply for older customers especially in rural areas. Additionally, this sector also plays an essential role in Austria, for example in SME financing. However, the different business models (traditional vs challenger) can also learn from each other and utilise their respective strengths.

A look behind the scenes reveals an enormous battle for value chains, particularly in the digital sector. New market entrants with new business models have collected a significant share of the value chain of traditional banks. There is a particular focus on outsourcing and, with the advent of DORA, third-party service providers are now also subject to greater supervisory scrutiny.

Banks and supervisors alike need to keep abreast of digital developments and emerging new business models. The regulatory framework must therefore allow a rapid response to the dynamic developments, while ensuring a level playing field and common standards in application of the principle of proportionality. It is essential that supervisors find the right balance between consistency (same risk, same rules) while also affording due consideration to the respective business model and its inherent risk. Furthermore, this distinction and different rules that accompany it should not become too complicated and the risk of unnecessary over-complication should be minimized.

Supervision is already conducted proportionally, in accordance with a business model's inherent risk. The principle of proportionality inherently states that there is no "one size fits all" approach – different risks and different business models require different supervision.

The SSM has also intensified examining the areas where the main risks exist. The SSM is moving towards a risk tolerance framework, in which supervisory resources should be explicitly deployed where risk is most inherent, while also, on the other hand, consciously tolerating risk in other areas. Such an approach makes even more focused and risk-based supervision possible.

The ECB's ongoing SREP Review is also intended to further empower supervisors and enable them to fulfil their essential tasks more efficiently and effectively. It is important to move away from a "box ticking exercise" approach and instead to explicitly focus on the main risks identified. In addition, supervisors need to anchor proportionality and risk-based supervision even more firmly in their thinking and daily duties. These two principles will also be further strengthened as part of the revision of the EBA SREP guidelines. Their consistent implementation in Austria will further strengthen proportional and risk-based supervision of LSIs.

One size doesn't fit all: different supervisory approaches for different risks and business models.

Consequently, this discussion reiterates that effective supervision cannot be carried out using a series of "box ticking" procedures. Effective supervision requires highly specialised employees who engage with individual business models and make appropriate decisions accordingly. Regulatory provisions must be complied with by all players – regardless of whether they involve new or traditional business models. New innovative business models must also fulfil the high regulatory expectations, not only in the prudential area, but also in the AML area, for example. Ultimately, the competitive battle over technology will determine success and failure in the future.

ELIZABETH MCCAUL

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Adapting to technological shifts: supervision in the evolving financial landscape

A major strength of the European banking system is the diverse business models and governance structures that in turn enhance resilience and ability to meet the needs of customers. As supervisors, it is our duty to ensure each bank's soundness and safety by assessing the effectiveness of their risk management, the appropriateness of their technology investments and the sustainability of their business models, among other things. At the same time, it is not our task to defend supervised entity market shares. Neither do we favour specific business models or technologies. This role requires careful calibration amid technology and societal shifts that are continually reshaping the business of banking. Banks and supervisors must both adapt, especially in the face of the unprecedented speed of technological progress that is driving customer demand for digital solutions from banks and the entry of new competitors.

So what does this mean for the role we need to play in the sector's digital transformation?

Simply put, we look to answer at least two questions:

1. How do we ascertain whether banks are managing the long-term sustainability of their business model effectively as well as risks from digitalisation and non-bank partnerships, and provide appropriate supervisory responses to any weaknesses?
2. How can we maintain an effective regulatory and supervisory framework amid constantly reshaping financial value chains, un- and re-bundling of financial services and decentralised financial services provision?

Our focus is on how banks formulate, execute and monitor their digital strategies, emphasising timely identification and adequate mitigation of risk. We are incorporating digitalisation into our supervisory priorities so we can answer these questions, and are publishing criteria and best practices for banks' digital activities as we continue to learn.[1]

Going forward, we will expand our supervisory work and review the use of specific technologies such as artificial intelligence, constantly striving to better understand how banks' efforts to devise digitalisation strategies, investment decisions and ecosystem interactions are linked, especially in terms of impact on business models and operational resiliency risks.

The financial landscape is shifting, and so should regulation and supervision. To evolve properly, collectively we need a holistic understanding of the new contours of the financial system. We need robust risk assessment capabilities to apply a proportionate and fair approach while enabling innovation. Calibrating supervisory actions properly should be based on the economic and societal impact of services, not the technology or licences used.

A major restructuring is under way in financial services: integrating financial services into non-financial ecosystems, changing the risk landscape, blurring traditional industry lines and challenging conventional regulatory boundaries. Against this rapidly evolving backdrop, we also must continuously reassess the effectiveness of our supervisory framework.

Bigtechs and fintechs are reshaping customer experiences using technology and data not only to compete with traditional banks, but increasingly to collaborate with them by delivering their products as customer interfaces. Mobile apps and platforms are the new norm for providing financial services. Licensing-as-a-service delivering these apps and platforms via partnerships extends the reach of banks by leveraging fintech innovation. There is much that is good about this.

But partnerships with non-bank intermediaries pose new challenges when they act as the primary consumer interface while banks bear legal responsibility. Sound practices about reliance on third-party providers should be applied to these partnerships, even if they must be framed differently in the world of partnerships.

And here's why: fintech providers tend to prioritise customer convenience, efficiency and growth, without demonstrating knowledge of what robust bank risk management practices entail. Banks need to exercise control over customer onboarding, operational resilience, liquidity and legal risks. They must consider the interaction between their own innovative business models and their partners' risk profiles, prepare for intermediary and vendor failures and oversee the soundness of partners who may take excessive risks or become sources of concentration or interdependency risks.

There is another, not inconsequential twist. Bigtech conglomerates where the primary business is technology rather than banking are entering the financial sector through e-commerce and payment platforms, and subsequently expanding into retail credit, mortgage lending or crypto services. These actors may also explore alternative, less-regulated lending forms like crypto lending using peer-to-peer platforms, ultimately mimicking the economic functions of banks without being subject to the same comprehensive oversight.

We need to expand our tools and surveillance to prevent gaps in oversight. They need to be robust and yet versatile enough to oversee disintermediated, interdependent and possibly distributed-ledger-based business models. We must adapt regulation and oversight of bigtech conglomerates, for entities mainly active in non-financial services. This necessitates a thorough understanding of the financial activities of large non-bank groups across jurisdictions and sectors.

Our preferred response to such challenges involves creating global standards for supervising non-banks, fostering cross-border cooperation and promoting information sharing among supervisory authorities. We should avoid the kind of regulatory "race to the bottom" that is often driven by a myopic vision of prioritising innovation and attracting large firms which may not contribute to the good of society. This may require the EU to continue leading the regulatory evolution in the oversight of bigtechs, conglomerates and crypto-asset services.

1. *https://www.bankingsupervision.europa.eu/ecb/pub/html/ssm.reportondigitalisation_202407~3f4de7a771.en.html*

EVA SLUKOVÁ

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Diversity in the EU banking system

The EU banking system has undergone significant changes in recent years, with the presence of two main types of banks contributing to the diversity of the European financial market. Traditional credit unions, mutual, or cooperative banks prioritize personalized services and member ownership, serving as community-focused institutions. On the other hand, emerging players such as fintech companies, challenger banks and various digital platforms offer innovative solutions like peer-to-peer lending and mobile payments, contributing to a more competitive landscape.

Both traditional credit unions, mutual, or cooperative banks and emerging banks in some cases provide alternative sources of funding for those who may have been underserved by traditional banks for a variety of reasons ranging from a specific line of business of some SMEs to geographical remoteness of some customers. The contributions of emerging players have already had a positive impact on the bank industry, but challenges remain that must be addressed in order to ensure their long-term and ongoing success. Representatives of both groups often struggle with regulatory compliance, as smaller institutions have problems with the amount of increasing regulatory and reporting burden and at the same time new players must navigate complex regulations and licensing requirements in order to operate in the banking sector. In particular, the current issues of cybersecurity and data protection are crucial and burdensome for all these entities as they need to protect sensitive customer information and maintain confidence in their services to ensure the stability and growth of the banking sector.

Another perspective on continuing complexity of the diverse banking environment in the Member States is provided by the ongoing debate on a level playing field and the drive to complete the Banking Union. The introduction of the third pillar of the Banking Union, the European Deposit Insurance Scheme (EDIS), which is intended to strengthen financial stability by providing a common safety net for depositors across the EU, is currently blocked. Together with persistent concerns about risk sharing and moral hazard, notwithstanding the legislative measures already taken in this area, the impossibility of finding a compromise is partially due to heterogeneous system of deposit guarantee schemes and private institutional protection schemes in place in the Member States. The only way forward may be an appropriate level of supervision and integration of these diverse entities into the regulatory framework of the Banking Union, particularly in the context of EDIS, with careful consideration of their unique characteristics and risk profiles.

Diversity in the EU banking system is necessary to promote innovation and competition.

The heterogeneity of banks and the differences in approach to resolution between Member States have proven to be a challenge that needs to be addressed in the current revision of the EU framework for bank resolution and deposit insurance (CMDI). One of the objectives of the current revision of crisis management is to adapt and further strengthen the existing framework to enable authorities to organise an orderly exit of failing banks of any size and business model from the market, and to allow more use of the resources of deposit guarantee schemes in the resolution process, not just to preserve them for the pay-out function. Nevertheless, as the Council's negotiation has made absolutely clear there are significant differences in current use of resolution framework and lessons learned so far or different motivation and experience with the use of the national deposit guarantee schemes in crisis situations. The agreement on the negotiating mandate reached during the Belgian presidency is being loudly criticised by representatives of the European Commission for failing to meet the objectives of the reform, which is based on the Eurogroup's statement on the future of the Banking Union of June 2022, and for renationalising and fragmenting the application of the crisis management framework for banks. The Council's position is also criticised for the significant difference between the efficiency and credibility of resolution in banking union Member States and in non-banking union Member States, which may lead to differences in the treatment of failing banks. It then remains to be seen how fragile this compromise will be in the trilogues with the European Parliament.

In conclusion, while both good and bad examples of banking diversity can be found within Member States' banking systems, diversity in the EU banking system is not only necessary to promote innovation, competition and widen access to finance for individuals and businesses but must also be maintained for underserved customers and SMEs in the rural periphery of Europe. Striking a balance between national interests and a harmonised approach will be essential to address the regulatory challenges of the complexities of the EU's diverse banking environment.

LÁSZLÓ VASTAG
Executive Director for Prudential and Consumer Protection Supervision of Money Market Institutions – The Central Bank of Hungary

Proportionality: focusing on the micro- and small enterprises

Micro- and small enterprises (companies having less than 50 employees) account for 99% of the total non-financial businesses in the EU and these companies employ close to 50% of the persons employed by the private sector, whilst they contribute roughly one third to the total value added generated in the EU.

The above statistical data are strong indicators that the success of the European economy lies in the fate of small- and micro enterprises. However, these businesses even if they are successful in their respective fields, are hardly on the radar screen of capital market investors, and though there could be a chance to involve angel investors in some cases or obtain certain government/EU support, these are available only to a number of companies with specific business models (e.g. agricultural sector, those who have an appealing business plan). Therefore, they are and most probably will continue to be predominantly served by the banking sector.

Policy makers in the EU and in the EU member states are encouraging the banking sector to continuously meet the financing needs of this sector and the access of the SMEs to bank financing has become easier and cheaper during the last decade. Nonetheless the different financial institutions have different approaches to serving small enterprises ranging from boxed-up products to tailor-made solutions.

In our experience the bigger the financial institution is the more likely its general approach towards small businesses is to create a few relatively simple products with a corresponding scoring system (often very much reliant on the collateral background) and automatize the client service model to the maximum possible extent. On the contrary smaller institutions are more likely to engage in complex client interactions, use a broader set of information for the credit decision and as a result offer more demand driven solutions to small businesses.

Two tangible examples of that latter approach are (i) cooperative or mutual banks, which are deeply rooted in their respective business community and therefore might have the advantage to "see beyond the figures"; and (ii) fintech or more broadly speaking financial institutions that are keen to use more the support of advanced IT solutions, like big data, social scoring or potentially AI might as well be able to take a more detailed view about the needs and possibilities of their small business clients.

Uniformization of banks could negatively affect the inclusivity of the EU financial system.

On that basis it is safe to say that uniformization of the EU banking system towards traditional commercial banks with savings cooperatives and innovative financial intermediaries losing ground could potentially negatively affect the inclusivity of the EU financial system, when it comes to the service of small businesses.

However, the complexity and sheer size of the single rule book and the ever-increasing costs of regulatory and supervisory compliance make it more and more difficult for smaller institutions to stay on the market in a sustainable fashion. Henceforth, it has been an important topic for regulators and supervisors for almost a decade how the principle of proportionality should be applied to preserve the diversity of the EU banking sector.

Although there are elements of proportionality in the EU banking regulation it is more the supervisory practice and judgment so far where the concept is supposed to be filled with content and that is why in our view no breakthrough has been achieved in this field. What is expected from supervisors and regulators is to apply proportionality, and though some angles are provided, the exact content and practice are not detailed, consequently, it remains as a broadly interpreted concept in all jurisdictions, creating the opportunity for setting back the level-playing field for the institutions, which is also a justifiable expectation just as the proportionality.

The gut feeling which is associated with proportionality is that it means something like compromising on risk and that is against the nature of supervisors, whom always had the sneaking suspicion – that grew into a conviction after the 2023 banking turmoil – that the demise of an institution, which is not considered systematically important, might have a negative impact at system level. Therefore, the challenge is a balancing exercise i.e. to implement proportionality without compromising on the prudential position of the institutions, where the issue of simpler, but stricter rules recurringly comes up.

Moreover, proportionality is a sword that cuts both ways in the sense that regulators and supervisors shall ensure that by applying proportionality, traditional banks are not put into disadvantage vis-a-vis small banks.

NATHALIE AUFAUVRE

Secretary General – Autorité de Contrôle Prudentiel et de Résolution (ACPR)

Cultivating banking diversity in the age of digital finance

The diversity of the EU banking system is an asset as it contributes to financing economy and preserving financial stability. The EU banking system is well diversified in terms of size, geographic footprint (global and domestic) and business model (bank-insurers, commercial banks, investment banks, cooperative institutions, finance companies, digital banks, fintechs). Such diversity, by fostering competition and innovation, is key to enabling various financing needs to be met – from households to businesses – especially in the EU where banking intermediation is predominant. Diversity is also achieved through large universal banking groups, which show internal diversification in terms of activity, risks, income, liquidity and funding. It participates to resilience by limiting procyclicality and contagion risk and proved to be helpful during recent stress episodes including the pandemic, war in Ukraine and 2023 banking turmoil. This diversity should be cultivated for the benefits of the EU economy and customers especially in the context of the twin transitions (ecological and digital).

The full benefits from diversity can only accrue if it is supported by strong regulatory and supervisory frameworks. Regulation, as is the case with CRR2 and now CRR3, must preserve diversity without questioning the full application of standards to all EU banks and by providing necessary adjustments to requirements (notably disclosure and reporting) for smaller banks to ensure proportionate treatment and ease the market entry and growth of emerging players. It is also of critical importance to preserve the competitiveness of EU large internationally active banks, and so to pursue the development of the Banking Union while ensuring that non-EU groups providing financial services in EU are effectively subject to equivalent requirements. Diversity must be also supported by keeping supervision risk-based and "business model-neutral", that is without interference in business model choices. This requests a deep understanding of institutions' activities and environment and a good capacity to address adequately each institution's specificity and risk profile. Finally and beyond banking, diversity and innovation should continue being supported through the variety of EU sectoral regimes (investment services, payments, e-money, cryptoassets) which have been introduced over time to address the risks and challenges raised by innovative practices in a proportionate manner.

It is key to preserving banking diversity while addressing challenges of digitalisation.

The challenges raised by the ongoing digitalisation of finance and emerging players or business models should be further addressed. New actors in financial services such as fintechs and bigtechs can bring further competition, efficiency and cost reduction for the ultimate benefits of customers and the entire financial system, but they can also raise risks. Therefore, it is key to preserving banking diversity while addressing challenges of digitalisation. The EU legislation has been evolving to embrace digital transformation and balance the related opportunities and risks: critical acts as DORA (operational resilience), DMA (markets), AIA (artificial intelligence) and the financial data access and payments package under discussion are the building blocks of a safe and virtuous innovation by addressing the most imminent risks while bringing legal certainty. However, the potential financial stability risk that may result from a further increase of such actors' activities in financial services should be addressed. The existing supervisory and regulatory framework, whereby various regimes apply to financial service activities other than banking, is typically activity-based (e.g. payments and e-money) rather than entity-based, that limits supervisory visibility over the aggregated risks that may arise from all the financial activities carried out by these actors. This is all the more the case as bigtechs in particular could increase their provision of financial services including the provision of credit while there is no harmonised EU regime for non-bank lending. Against this backdrop, policy actions may be warranted: first, to closely monitor the development (type and scale) of financial service activities by non-banking groups; second, to enhance the regulation and supervision of such groups, for instance by requiring them to group all their financial service and ancillary activities, when significant, in a dedicated structure (e.g. an Intermediate Parent Undertaking) to which relevant prudential requirements (e.g. banking rules in case of banking or banking-like activities) could apply and that would be subject to consolidated supervision at EU level; third, to consider back-stop supervisory powers to deal with specific scenarios (e.g. the distribution of services through platforms reaching a critical level with a change in power balance); and fourth, to develop an harmonised regime for non-bank lending.

JOE HENEGHAN
Chief Executive Officer,
Europe – Revolut

Making the Banking Union more inclusive for digital pan-European banks

Digital banking models have emerged only recently compared to the long-established European banking regulatory frameworks. No one expected such rapid adoption of digital bank solutions, which have evolved from offering purely payment services to providing core banking services such as loans, deposits and mortgages. While some time ago we could say that digital banks were not there to fully compete with traditional banks, this is no longer the case. For example, Revolut's revenues surged from EUR 190 million in 2019 to EUR 2.1 billion in 2023, and its customer base expanded from 7.8 million in 2019 to 38 million in 2023.

Such growth can be attributed to a model prioritising user convenience, cost-efficiency, and innovative financial solutions, challenging conventional banking paradigms. A good example is Revolut's recently launched instant access savings accounts. With these accounts, Revolut users can have daily interest payouts and instant access to funds with rates as high as 3.5% for EUR per annum. In this way we are making it simpler than ever for our customers to grow their savings.

European regulation and supervision needs to evolve with these models as well. Digital banks require pan-European frameworks because, unlike traditional banks, they are European from the outset and do not follow the model of growing in one European market before expanding to the pan-European level.

This can be done by enhancing the Digital Single Market for financial services, building more consumer trust in the banking system and promoting interoperable pan-European payment solutions.

Enhancing the Digital Single Market for financial services

One major obstacle to the Digital Single Market is IBAN discrimination, an issue that is detrimental not only to digital banks but also to businesses that want to expand across Europe and to customers who live cross-border. Revolut launched a project to establish branches across Europe in order to provide local IBANs to serve its clients locally, and the results are striking. In one country, the number of direct debits increased by over 200% just in 5 months since launch of the branch, signifying the significant impact local IBANs have. While a lot of work has been done recently by national competent authorities and European stakeholders to fight against IBAN discrimination, the issue remains. As Commissioner Mairead McGuinness rightfully mentioned, it's "a stone in our shoes," and it's time to put an end to this practice. The only viable solution we see is to move to a European IBAN number, confirming the unity of the Single Market and allowing everyone, from consumers to businesses, to enjoy the benefits of the free movement of goods and services.

Regulation must evolve with digital banking to ensure competition and better choice.

More consumer trust in the system

Another issue that digital banks are facing is the absence of the third banking pillar, an European Deposit Insurance Scheme (EDIS). An incomplete banking union results in pan-European digital banks struggling to gain confidence from EU depositors not based in the home state of the digital bank and consequently failing to attract more deposits from users from their host states. For example, in the recent report the Dutch Consumer & Markets Authority (ACM) observed that 'There is also a lack of trust among consumers in foreign products banks. This lack of confidence is partly due to doubts about whether savings are safe in such banks.' Revolut strongly believes that this lack of trust can and should be taken away if Member States want more competitive offerings in their markets. This can be done by completing the EDIS project.

Solving European payments fragmentation

As we expand across Europe and become the primary bank for our customers, we are witnessing how fragmented the European banking and payments regulatory landscapes are. Some Member States have developed their own A2A or card payment solutions tailored to specific markets. While these solutions offer more user convenience and create competition with international card schemes, their benefits diminish when a payment is cross-border. We anticipate and look forward to the possibility of a single access point to such solutions, similar to the European Digital Identity Wallet. Whether it be the EPI, Digital Euro, or any other interoperability initiative, ambitious timelines and non-discriminatory access rights are essential for success.

Conclusion

We believe that these reforms are needed not only for digital banking business models but also for customers being served. Making the Banking Union more inclusive for digital pan-European banks ensures competition and better choice for consumers and businesses and allows them to enjoy the benefits of the free movement of goods and services.

KAROLIN SCHRIEVER

Executive Member of the Board – Deutscher Sparkassen- und Giroverband (DSGV)

Smart regulation aiming for a stable, competitive and diversified banking sector

The EU is home to a wide variety of banking models, reflecting the diversity of Europe with its numerous regions and their different social and economic needs. A regulatory framework that allows all banking business models to thrive will promote tailored financial solutions for citizens and the real economy. On the other hand, a blind pursuit of consolidation could weaken competition and innovation, increase costs for clients, and negatively impact financial stability through too-big-to-fail risks.

We need them all: Start-ups and FinTechs that bring innovative solutions, international champions that take higher risks or carry out complex mergers, and smaller, locally rooted institutions with decentralized structures that allow for quick decision-making and close customer proximity that minimizes asymmetric information.

EU decision-makers face the challenge of considering the entire banking sector when shaping the policy framework. The good news is that the efforts by regulators and the banking industry since the financial crisis have paid off. We have a comprehensive regulatory framework in place to prevent undesirable developments, and the EU banking sector has demonstrated its resilience multiple times in recent years. However, there is room to improve efficiency, which would ultimately strengthen Europe's competitiveness. Ensuring a real level playing field is essential!

There is no doubt that financial stability will remain the corner stone of future regulation. Now, however, more attention has to be paid to the performance of the banking sector. Against the backdrop of the twin transition of the economy, financial resources will be required on an unprecedented scale. A large proportion of this will have to be raised via private financing channels so that it will be paramount for all of the EU's financial institutions to be able to efficiently allocate capital.

In recent years, we have seen a steadily increasing number of – in part bureaucratic – regulatory requirements with particularly negative consequences for smaller institutions. Now, a break is needed, as is a reflection on possible improvements and redundancies:

- With the Single Rulebook, the EU's prudential framework still largely follows a one-size-fits-all approach. The resulting fixed costs and complexity affect smaller players and new entrants disproportionately. While the principle of proportionality is getting traction, it has to be filled with life by truly differentiating regulation and supervisory intensity along the lines of size and systemic relevance.
- Regarding efforts to improve the Banking Union, specificities of a large share of the banking sector are ignored. Often, decentralized banking networks are organized in networks and around an Institutional Protection Scheme (IPS). This is a proven and cost-efficient means of preventing financial crises by protecting depositors and regional economic cycles. It is essential that the functionality of the European IPSs is maintained in the course of the further development of the banking union, especially when looking at the negotiations on CMDI and EDIS.
- The introduction of a digital euro has great potential to spur innovation in payment systems and financial services. For this to materialize we will need a fair remuneration model incentivizing banks and payment service providers. At the same time, it has to be avoided that the digital euro favors big tech companies to monopolize their market control.
- In the area of open banking, the German Savings Banks want to play a vital role: as data holders, enabling third-party providers, and as users of external data in order to further improve customers services. Yet, with regard to the numerous data categories in scope of FIDA we see the risk of a dysfunctional imbalance: a sprawling scope of application which triggers a severe implementation effort on one side that is not being matched by economic customer benefits. It must be borne in mind that the costs of implementing the technical and organizational requirements for data access can be considerable.

The EU banking sector directly reflects the diversity of the EU's economic and social needs.

Given the important role of the diversified banking sector for the economy, but also during any type of crisis, the EU will need to find a proper regulatory environment. It has to aim at striking the right balance for all whilst providing the right incentives, enabling innovation and allowing for a well-functioning financial services sector. This is not about weakening banking regulation, but about making it smarter.

MIKE VELTHAAK
Advisor to the Management Board – Rabobank

Preserve EU autonomy and diversity by applying a holistic approach

Recent legislative proposals related to the Retail Investment Strategy, the digital euro and the Financial Data Access Act (FIDA), along with the finalised Regulation on European Digital Identity (EUDIW), will altogether have a significant impact on the European bank diversity and the way retail banks operate. These proposals were composed with good intentions to increase the EU's strategic autonomy in geopolitical competition, as well as promoting financial inclusion, innovation and a European data economy. But when combined with increased competition and costs that banks have to bear to facilitate these EU digital initiatives, it will erode the banks' revenues and increase their expenses, creating an unintentional risk of a decrease in the diversified European financial landscape. Though it's clear that Europe needs to make progress on these topics, these proposals will not meet the intended objectives due to several omissions.

For banks with a large retail clients base, the digital euro entails a risk in the case of a large surge in digital euro usage. A study by the European Commission's Joint Research Centre shows this will create substantial challenges for the European banks balance sheets and profitability, especially for the small ones without access to capital market funding. In addition, the current digital euro legislative proposal forces banks to facilitate the distribution of this central bank digital currency, while it is currently unclear if banks would receive a fair compensation. European retail banks are expected to face significant funding and implementation costs and mandatory responsibilities such as KYC, AML and fraud management. On the other hand, Big Techs and other innovative companies with targeted business models on specific low cost and profitable elements in the payments value chain, can provide the digital euro wallets without having to bear these costs. And once this situation arises, there will be no way to reverse it. Furthermore, the digital euro could potentially crowd out existing and new European payment solutions, which would run against the EU strategic autonomy objective.

Besides the digital euro, legal proposals like FIDA, and the finalised EUDIW Regulation also have the potential to exacerbate unfair competition between banks and Big Techs. For instance, FIDA could grant Big Tech firms access to precious financial data held by banks, while banks do not have reciprocal access to the significant amount of data collected by Big Techs. Also the EUDIW aims to open up the EU market for digital services, enabling individuals to proof fully digitally their identify, for example to open bank accounts. But also the EUDIW may impose banks with disproportionate expenses when they will have to make significant changes to their existing infrastructure and networks as the final legal text lacks clarity and builds on different existing national systems.

EU digital regulations should prevent a decrease in bank diversity.

Not having to bear the cost for the implementation and operationalisation of the European digital initiatives and not being required to provide reciprocal access to the data collected by Big Techs, will create a situation where Apple, Google, and Amazon further consolidate power, as we are already seeing in the payment area.

Though the digital initiatives are aimed at innovation and strengthening Europe's strategic autonomy and monetary sovereignty, these pieces of legislation may weaken the European banking and payment sector in favour of non-European companies of scale. To prevent this, it is essential to adopt a holistic approach based on well-designed impact studies that considers the combined impact of the individual proposals for the EU financial sector, including bank diversity and whether they could place a break on new credit creation by the European banking system. Instead of positioning retail banks as utility providers, it is crucial to offer them a proper compensation for the tasks EU banks are required to mandatorily perform as (semi-) public services and that allows them to develop innovative products and services that meet market needs. The proposals should also provide them with a clear legal text and time frame to facilitate a smooth implementation and include a requirement that opens up the data collected by non-banks. In addition, European digital regulations should include safeguards that prevent a development of a one size fits all movement and that ensure that all digital players embrace social inclusion, to ultimately safeguard that the more vulnerable and less digital literate Europeans will not be excluded. Banks welcome competition as this will trigger innovation, but please facilitate this in a careful way.

BENOÎT DE LA CHAPELLE BIZOT

Head of Public Affairs and Advisor to the Chief Executive Officer – Groupe BPCE

The relational and cooperative banking model is the way forward

As we are celebrating the SSM's 10th anniversary, which also coincides with European elections, it is a rare opportunity for the financial services sector to step back and assess the progress made on financial regulation. In our view, many reforms have been successful: European banks are now much more solid, with significant improvements in capital, liquidity,, asset quality, and crisis management.

However, it is time to raise an important question: beyond stability, have these new regulations delivered better financing of the economy and allowed banks to onboard more customers, SMEs, and local communities in order to enable them to face the real challenges linked to the environmental, digital, and societal transitions?

The short answer is not enough. This is why our common work is not over but starting. Europe is faced with numerous challenges: a context of great geopolitical uncertainty, worsening economic disparities between Europe and some of our partners like the US, and the financing of three key transitions I mentioned above —digital, environmental, and social.

With their limited budgetary and fiscal capacities, both Member States and the European Union cannot finance all these investment needs, which the European Commission estimates to be around 1000 billion euros per year (600 billion for the green transition, 200 billion for the digital, and 200 billion for defense).

Private sector financing is, therefore, indispensable, but the conditions for such private financing to meet expectations are not currently in place. In fact, European integration in financial services has been slow for many years: there still is no freedom of capital and liquidity movement within banking groups, nor any cross-border mergers. Regarding the Capital Markets Union, there still isn't any harmonization on savings products' taxation, nor on supervisory practices. Additionally, building a credible European savings product remains challenging at best.

We stand ready to work with regulators and supervisors to deliver real change, on the ground.

This lack of consensus prevents us from defining a common trajectory for the European financial sector and prevents banks from fully fulfilling their mission: being useful and providing financial solutions to our customers, whether it is every day, in times of crises, and for their long-term projects.

This is the essence of cooperative banks, which are the best placed to deliver real change: our banks are based on loyal advisory services, and maintain long-term and comprehensive relationship with clients, which enables us to truly support them. Moreover, we serve all types of clients, at every stage of their lives. We do not select our clients based on the profitability of a transaction and act as a real shock absorber: for example, 96% of loans for individuals in France are at fixed rates, which means that we absorb part of the risk for both our clients and the overall economy.

Nonetheless, this model, which the is dominant one in France (cooperative banks finance 60% of the economy), is challenged by European regulation and supervision. Too often, European regulation and supervision push towards the transactional banking model.

This is in direct opposition with cooperative banks' relational banking model, which is based on long-term client support and profitability, and not on transactions. This is a defining feature, which allows us to offer services to all our clients, across all territories, and ultimately change and shape our territories, even in times of crisis.

In order to uphold this model, I have a conviction: the Commission, and the European system in general, when establishing regulations and supervisory systems, must conduct a test on the specific impact of each new regulation on the financing of the economy, the long-term relational banking model, and the governance of cooperative companies.

In Europe, we are walking on one leg: that of stability. This leg is fundamental, but we do not sufficiently incorporate the other one: financing capacity. This is the essence of what banks do. For example, we will implement Basel IV before the British and in a stricter manner than the Americans, which will result in additional capital charges. A capital charge is not a penalty on banks, but on our clients, which means fewer loans for the French and European economy. The test on the financing of the economy would, for example, show the impact that the adoption of Basel IV would have on financing capacity, and allow us to make more informed decisions.

We stand ready to work with regulators and supervisors to deliver real change, on the ground, where no other banks could deliver it. I am convinced that the cooperative relational banking model will allow Europe to reposition the financial sector as a strategic and long-term sector, which is capable of engaging in ambitious investments. It is the way forward.

We should work collectively and rigorously. There is a change of Commission and a new chair at the SSM, and it is time to put forward our ideas.

GUY CORMIER

President and Chief Executive Officer – Desjardins Group

Balancing strength and mission in a competitive financial landscape

In the evolving landscape of the global financial industry, cooperative institutions are redefining how they balance robust financial stability with their core mission. They navigate the complexities of modern finance and global economic issues while adapting from traditional cooperative models to sophisticated financial entities.

What are the positives and negatives of the different business banking models in jurisdictions where banks play a decisive role in the financing of the economy, particularly in the face of challenges such as digitalization, financial inclusion, and the ESG transition?

In Canada, business banking models are mainly cooperative financial institutions, such as credit unions, and traditional banks. They are regulated either by federal or provincial laws.

Cooperative financial institutions are born from the needs of the members. Their views and priorities have great influence on the conduct of the business. To reconcile those needs and priorities in a large cooperative organization like Desjardins Group is not an easy task. Governance challenges, such as balancing democratic decision-making with efficient management, and the risk of a mission drift as they grow, pose significant challenges. Moreover, the reliance on member-based capital structures limits the access to capital markets, making it more difficult to raise funds quickly compared to banks, particularly during financial stress.

On the other hand, the membership structure and cooperative values create an attachment to the organization, a delicate collective loyalty that needs to be nurtured. Cooperatives must navigate these difficulties while striving to maintain their commitment to member engagement, community support and long-term sustainability, all of which are integral to their identity and success.

What are the main features of Desjardins' business model within this context?

Founded 125 years ago and designated as a Systemically Important Financial Institution (SIFI) by the Autorité des marchés financiers (AMF) in 2013, Desjardins Group is the leading cooperative financial group in Canada and the Americas, and the 6th largest in the world, with assets of C$444 billion. Today, more than 58,000 employees and elected directors are always working in the interests of 7,7 million members and clients.

As a cooperative, we give our members the support they need to be financially empowered.

Desjardins is an integrated financial services provider offering a comprehensive range of products and services and a variety of insurance products and brokerage which allows it to compete with traditional banks.

Financial inclusion has been a core principle of Desjardins Group. Since Alphonse Desjardins founded the first caisse populaire in 1900 in Lévis, Quebec, the organization continues to prioritize serving the financial needs of all members, particularly those who may be underserved by traditional financial institutions... Desjardins also invests heavily in local economies, particularly in Quebec and Ontario, by supporting small businesses, local projects and community initiatives.

In terms of innovation, Desjardins Group has been a pioneer in the digital transformation of financial services. It offers cutting-edge online and mobile banking solutions, rivaling those of the major banks, while maintaining a strong physical presence with its 204 caisses across Quebec.

Do regulation and supervision sufficiently address this diversity need in Canada and in Europe in particular?

As a SIFI, Desjardins Group is subject to stringent regulatory oversight similar to that of Canadian banks. With a robust Common Equity Tier 1 capital ratio of 21,2 %, Desjardins is among the best-capitalized financial institution in Canada. The AMF, the financial regulator in Quebec, is actively involved in several key national and international committees which allows it to stay aligned with global regulatory standards, contribute to the development of international financial regulations and ensure that Quebec's financial institutions, including Desjardins Group, operate within a stable and sound regulatory environment. It should also be noted that the International Monetary Fund's (IMF) support for provincial regulators, such as the AMF, improves coordination between provincial and federal regulators, thereby contributing to the overall stability and integrity of the Canadian financial system.

Desjardins Group's strong position in the industry highlights the resilience and relevance of the cooperative model and its capacity to build a sustainable and equitable financing model in an increasingly competitive financial landscape and global world.

PRIORITIES FOR THE INSURANCE SECTOR

ALBERTO CORINTI
Member of the Board of Directors – Italian Insurance Supervisory Authority (IVASS)

Evolving risk context calls for evolving supervisory practices

If we want to find one underlying feature that reflects the current risk context, I think we could say that it is characterized by a number of very dynamic, emerging trends that, in various ways, influence the materialization of more traditional, specific risks, both in terms of frequency and intensity of possible losses.

Current geopolitical trends could affect many types of market risks, for example in terms of increase in interest rates, pushed up by inflation, or credit and real estate risks, due to reduced growth or detrimental effects on trades or activities; but geopolitical trends could also have a number of other, less predictable effects on risks, such as cyber risk, that could significantly influence the business.

Also, climate change and, more generally, the transition to a more sustainable world, could -in many ways - affect the value of assets and liabilities of insurance companies and, at the same time, increase more qualitative risks, such as reputational or legal risks.

Again, the increasing use of IT innovations leads to the exacerbation of operational and cyber risks, but also to repercussions on business risks, in case of non-alignment with technological developments, and on legal and conduct risks, in relation to the way the relationship with policyholders is managed.

Overall, this landscape entails at least two main challenges for companies and supervisors. First of all, it reduces risk predictability, as it limits the capability of historic data to anticipate the future and increases the variety of ways in which certain risk factors could materialize. Secondly, due to the very nature of these risk trends and the consequent high correlation between the exposures in different firms and regions, it increases the probability of widespread, and therefore potentially systemic, impacts.

One could wonder if the current regulatory and supervisory framework in the EU is sufficiently equipped to face these challenges.

Without having the ambition to answer this question, in my view there are at least three areas to consider if one aims to reduce, in the current context, the probability of insolvencies as well as of systemic externalities, while reinforcing the social role of insurance in the economy.

Obviously, the first focus is on the approach of the prudential regulation. It should be sufficiently risk based and flexible to adapt to new risks; it should significantly rely on good and wide-ranging enterprise risk governance; and it should provide supervisors with tools and information that effectively help focussing on the real threats, early enough. I think that all these aspects are fundamental features of Solvency II. One could certainly question some elements of this framework, like its complexity, the volatility of its indicators or the calibration of some financial requirements, but I think it is apparent that its structure and forward looking approach constitute the preconditions to properly deal with an evolving and unpredictable risk context. It obviously remains to be seen how the framework is implemented in practice across jurisdictions.

Secondly, the ability of supervisors to promptly detect systemic threats at global, regional and national level and to intervene timely and effectively. Also in this case, I think that the insurance sector can rely on a framework that allows successfully achieving these objectives. The IAIS Holistic Framework, which also inspired the European macro-prudential framework, is indeed based on three key elements: on measures, to be applied on a proportional basis, that are aimed at mitigating the probability and intensity of the materialization of risks with systemic potential; on thorough monitoring of the main potential sources of systemic impacts, both at individual and market wide level; and finally on a toolkit of supervisory powers to be used as necessary. In this case too, however, the framework needs to be properly implemented in practice by national supervisors in order to be effective. The IAIS is committed to pursue this objective with its implementation assessment plan.

> **We need good supervisory practices applied consistently and effectively across jurisdictions.**

Finally, and I think this is maybe the area with the most room for improvement, we need good supervisory practices applied consistently and effectively across jurisdictions. The ability of supervisors to understand new and complex risk sources and their potential transmission channels, to be timely, effective and balanced in their interventions, to concretely cooperate on common challenges, is certainly key. In this regard, the role of supranational institutions, like IAIS and EIOPA, is of utmost importance. It is essential, however, that in each jurisdiction, supervisors have sufficient resources, knowledge and powers to reinforce their supervisory approach and keep up with the evolution of the context.

PETRA HIELKEMA

Chairperson – European Insurance and Occupational Pensions Authority (EIOPA)

Priorities for the next political cycle

Ten years ago the focus was very much on preparing for the introduction of a new regulatory framework for the insurance sector in response to a global financial crisis. The result – Solvency II – better aligned capital to risk, introduced a risk-based approach to assess and mitigate risks, strengthened governance models and introduced forward-looking risk management.

The framework has proved its robustness with the insurance sector weathering a series of crisis: a global pandemic, Russia's unlawful invasion of Ukraine, an energy crisis and inflation. It is not surprising that outside of Europe, many countries are mirroring Solvency II in their own regulatory frameworks.

Fast forward to today and Solvency II is one of a myriad of regulations affecting the insurance sector. Technological developments, climate change, and the interconnectedness of financial services – these are all factors that have contributed to new legislation in particular, horizontal legislation, that cuts across sectors. Indeed, following the extensive legislative activity, the European Insurance and Occupational Pensions Authority (EIOPA) believes that a first priority for the new Commission and co-legislators is to focus on implementation so that both industry and supervisors have sufficient time to ensure frameworks operate effectively.

Beyond implementation, however, there are other more specific areas requiring attention.

First and foremost are protection gaps. Whether talking about climate or cyber, success will stem from increasing knowledge of the source of gaps at policy maker and industry level, and raising awareness at consumer level. Access to good data on losses and exposures underpins both, and EIOPA sees a role in collecting data, ensuring open access to data, as well as supporting any future data-exchange, for example of cyber incidents, under different frameworks.

There is also a need to make sure that insurance is available, affordable and is also taken up. Again, awareness is important here. EIOPA would recommend the development of a tool to increase consumer awareness of their risk exposure and facilitate the adoption of risk prevention measures.

Pension gaps also require attention, with a growing number of people at risk of poverty in older age. In addition to further work on pensions tracking systems and dashboards, EIOPA also recommends taking a second look at the pan-European personal pension product (PEPP). While PEPP uptake has not been as high as hoped, EIOPA firmly believes that there is still demand for a simple, transparent, portable, digital-first savings product to help close savings gaps. More broadly, increasing pension savings will contribute to the development of the Capital Markets Union (CMU) through retail investment. However, the shift from defined benefit to defined contributions requires proper oversight of products, which could be achieved through a convergent EU approach to conduct supervision of personal pensions products. This will help ensure that products offer value to consumers.

In this regard, EIOPA has already made advances in the area of value for money and will continue to place consumer protection at the heart of its work, furthering work on the development of supervisory benchmarks and continuing to engage on the Retail Investment Strategy.

Improvements to the supervision of insurers operating across borders will also help to safeguard consumer protection and ensure trust in the Single Market. EIOPA has long argued that when home national competent authorities fail to act and policyholder protection is at risk, there should be effective last-resort measures in place to protect policyholders. The EU supervisory community via EIOPA's Board of Supervisors should be able to take a directly binding decision to stop consumer detriment immediately. A minimum harmonisation of IGSs would also help ensure adequate and consistent consumer protection across the Single Market.

While there has been much progress in the areas of sustainable finance and digitalisation, now is not the time for complacency. Regarding sustainable finance, further incorporating sustainability risks into both the prudential and conduct frameworks can ensure a more resilient and sustainable financial system. With digitalisation, it is important to continue to support innovation, but not at the expense of good consumer outcomes.

The next political cycle should build aim to strengthen competitiveness, deepen the Capital Markets.

Data is at the heart of the insurance and pensions sectors, for industry, consumers, and for supervisors. For this reason, EIOPA supports standardized, high-quality, and available data, as well as the smarter use of data and technology for supervision to improve products and services for consumers, and the ethical use of data to combat financial exclusion and safeguard privacy.

Much has been accomplished under the last political cycle to build robust and resilient insurance and pensions sectors. The next political cycle should build on this to strengthen competitiveness, deepen the CMU and foster good consumer outcomes.

UGO BASSI

Director - Banking, Insurance and Financial Crime – DG for Financial Stability, Financial Services and Capital Markets Union, European Commission

Solvency II – Navigating through rough waters with a robust regulatory framework

One of insurers' key competencies consists in calculating and managing risks. Nevertheless, recent years have been extremely challenging for the insurance sector in Europe and globally, as uncertainty has increased and risks have become more interconnected. It is time to take stock of the most recent global crisis events and to assess to what extent the European insurance sector has been affected.

Overall, the European insurance sector managed well to withstand shocks, which is largely due to the robust regulatory framework of Solvency II. Yet, some lessons were drawn and targeted adjustments to the framework proved necessary to keep the framework fit for purpose. It is important to highlight therefore some of the modifications that are currently implemented under the Solvency II review on the back of recent and future challenges for the sector.

During the last years, financial markets and financial institutions have been repeatedly shocked by different crisis events. In early 2020, the global Covid-19 pandemic triggered an unprecedent economic crisis including a massive plunge of stock prices and a surge of risk premia on bond markets. Nevertheless, solvency ratios of European insurers remained overall fairly high because of the sound capital regulation in place. In February 2022, while the hangover of Covid-19 was still nagging, Russia started its invasion of Ukraine. The Russian invasion came along with increasing geopolitical tensions, a globally reduced economic outlook and an increase in commodity prices, which further fuelled the rise of inflation in Europe and beyond. As a result, central banks increased their policy rates to counter inflationary effects. While the massive hike in interest rates caused financial distress for some of the financial institutions in the US, Switzerland and to some extent for the pension fund sector in the UK, the European insurance sector overall fared well during the period of rising interest rates.

Against the backdrop of these events, Solvency II has worked well as a prudential regulatory framework. As a consequence, the review of Solvency II was not intended to constitute a revolution but rather a refinement of the regulation in light of current and future challenges.

Thus, for instance, in view of excessive market volatility, which repeatedly occurred over the last years, the new volatility adjustment method is expected to shield insurers more efficiently in periods of market turmoil while taking the insurers' risk profile better into account. As regards insurers' ability to pay policyholder claims, in particular for life insurers, the new extrapolation method for long term guarantees involves a new procedure that increases the amount of market information, which is considered to ensure an adequate level of stability. As discussed before, risks for insurers have become increasingly interconnected and require a macroprudential dimension for a comprehensive regulation. To that end, the review introduces for the first time a macroprudential toolkit into Solvency II. Specifically, insurers will need to consider systemic effects into their investment decisions and prepare forward looking liquidity risk management plans. Even beyond those risks that materialised during past crises, there are future risks to be considered. We are living in a world of constant change and climate related risks and perils are on the rise. Pertaining to sustainability risks, the review ensures that climate risks will be better taken into account. Insurance undertakings will be required to develop prudential transition plans. The review will furthermore support the Capital Markets Union in Europe, as it contains, for instance, a preferential treatment on long-term equity investments subject to lighter criteria. In addition to these regulatory modifications, the Solvency II review comprises, inter alia, improvements for cross-border supervision and reporting and contributes to a more proportionate way in applying the regulatory requirements.

Yet, the review is not yet fully completed, as the Solvency II framework is made up of two instruments, the directive and a delegated regulation. The latter one, is currently under preparation and will implement the political decisions agreed in the directive.

Solvency II – a robust regulatory framework for current and future challenges.

Following the events over the last years, one might ask: What will be the next crisis, when will it occur and to what extent will it affect the insurance sector? A precise answer to these questions we certainly cannot give. Though, we certainly cannot exclude that there will be again periods of rough waters ahead of us. The Commission will regularly monitor market developments and the adequacy of the regulatory framework in light of new challenges. The implementation of the new framework will be a priority, as the insurance sector is not only managing risks but also instrumental in contributing to growth and to the green and digital transitions.

MARTIN LANDAIS

Director, Insurance division, French Treasury – Ministry of the Economy, Finance and Industrial and Digital Sovereignty, France

Insurance sector's resilience amid supervision, climate, and cyber challenges

Over the past decade, the insurance sector has demonstrated remarkable resilience despite the challenges of a low or even negative interest rate environment and the disruptions caused by the COVID-19 pandemic. The robustness of the prudential framework has been a cornerstone of this resilience, ensuring that insurers remain solvent and capable of fulfilling their commitments to policyholders. This period underscored the sector's ability to withstand economic shocks and highlighted the effectiveness of regulatory measures in safeguarding financial stability.

Over the past years, the financing of the economy, the ecological transition and the protection of policyholders have been our three main goals. In this regard, the agreements found on Solvency 2 and IRRD are welcomed. The new prudential rules are an incentive for insurers to invest in the European economy, and in particular in the ecological transition. Prudential requirements will be better suited to different interest rate environments while avoiding excessive volatility through a dedicated prudential treatment for long-term equity investment. Those rules also pave the way for the adaptation of the prudential treatment of securitization, which is a cornerstone for the CMU to be completed.

As regulators, our next step is to work hand in hand with the Commission on the delegated act of Solvency 2, which is pivotal for the long-term equity and securitisation to scale up. Then, it will be in the hands of insurers to demonstrate their ability to reap the benefits of this favourable framework, as Solvency 2 was often described as deterring insurers to invest in equity. Regarding policyholder protection, the implementation of the IRRD will encourage insurers to be fully prepared for potential financial difficulties.

When supervision measures are not enough to avoid insolvency, a range of resolution tools, which we wanted to keep sufficiently broad and effective, will enable the authorities to avoid cases of disorderly bankruptcy, and therefore to better protect policyholders and financial stability while protecting public funds and ensuring the continuity of critical functions.

Over the past decade, the insurance sector has demonstrated remarkable resilience.

Regarding the green agenda, we welcome the introduction of "prudential" transition plans in Solvency 2, in addition to those provided for in CSRD. Now it is important to pay attention to their implementation, framed by EIOPA guidelines, which should be well articulated with CSRD's and ensure a level playing field with the banking sector. We also acknowledge the work of EIOPA to better tackle climate-related risks, notably their propositions of prudential treatment of sustainability risks and their work to address climate protection gaps. Alongside national authorities, we believe their work is crucial to be at the edge of climate-related concerns. At national level, the insurance stress-test recently conducted by the ACPR will help insurers to better anticipate the impact of climate change on their solvency position in the short and long term. However, this exercise is only a part of a long-term process, in conjunction with the long-term climate scenarios introduced into the ORSA by Solvency 2.
We also have to deal with a busy digital agenda.

First, the AI Act has just entered into force, and frames a risk-based approach where high risk AI systems will have to respect strengthened obligations. The insurance sector is concerned since AI systems designed for risk assessment and pricing in relation to natural persons in the case of life and health insurance are considered high risks. In this regard, we support EIOPA's work on AI which aim at assessing the impacts of the AI Act in the Member States and at defining guidance on how to use and supervise AI in the insurance sector.

Second, cybersecurity is at the core of our concerns, and we welcome the provisions introduced by the DORA regulation which aims at reinforcing the governance of cyber risks in European financial services.

Finally, the negotiations on FIDA have been ongoing for more than a year now. This new regulation aims at establishing new rules regarding the sharing, access and use of the European customers data by third parties for them to provide more innovative and personalized financial services. France is committed to several fundamental principles: customer protection, level-playing field among all stakeholders in the EU and preservation of the European sovereignty. In particular we have asked for the most sensitive data to be excluded from the scope of FIDA, for setting limits to the possibility for the gatekeepers to access the customer data and for prohibiting the non-European entities to become FISPs. In any case, this regulation will have significant consequences on competitiveness but more broadly on the economic model of the European financial sector, hence the need to be particularly cautious regarding the framework we are currently shaping for the future.

FRÉDÉRIC DE COURTOIS
Group Deputy Chief Executive Officer – AXA Group

Insurers are an important piece of the answer to the main challenges ahead

Over the past decades, the European insurance sector has demonstrated its ability to cope and adapt to a changing environment impacted by multiple crisis while remaining extremely robust. The regulatory environment, through the adoption of the Solvency II Directive in Europe accompanied the financial resilience of the sector. However today, the current insurance business model is sometimes questioned in the light of insurability issues arising from for example more frequent extreme climate events or aging population, all of this coupled with more stringent national budget constraints. In front of these challenges, insurers want to act proactively to reaffirm their societal role while recognizing that the society transformation requires more cooperation between private and public stakeholders to find the right solutions to the challenges.

Firstly, insurers can contribute to enhancing societal resilience by both promoting a more prevention mindset but also by managing a large number of insurance claims. In 2023, the global insurance industry paid out 100 billion euros for Nat Cat claims, aiding communities in post-disaster reconstruction. Insurers hold unique risk knowledge through risk modeling and precise data on geo-coded risks and perils, empowering them to promote individual and collective resilience through public authorities' action towards more prevention measures. Furthermore, insurers can also incentivize good practices through justified premium reductions. Additionally, in the event of major events, insurers can provide effective support to citizens by managing massive claims through the mobilization of expert networks and repairers. Nevertheless, all this requires more and more partnerships with public stakeholders on topics such as risk management plans, prevention measures and disaster indemnifications.

Secondly, demographic changes are impacting societies, economies, and pension systems. The insurance industry can provide protection for old age peace of mind as the number of people aged 80 years or older is expected to triple between 2020 and 2050, while one third of people are not saving for their old age. The ongoing discussions on the Capital Market Union (CMU) present an opportunity to address the challenges of an aging Europe and incentivizing investment in capital markets. By creating the right conditions favoring long-term investment saving products, the CMU can channel investment flows into the European economy and orient these towards the financing of the transition. The insurance industry is willing to play a pivotal role in raising awareness and offering solutions to encourage long-term savings and protection for old age dependency.

Improved dialogue with all stakeholders will empower insurers to tackle future challenges.

Thirdly, as digitalization revolutionizes our society, our industry has historically been a responsible user of digital solutions and data. The insurance sector is fully committed to develop and use Artificial Intelligence (AI) responsibly and also investing in the digital transition. This contributes to a better understanding of risks and enables insurers to enhance prevention to the benefit of our consumers, for example, in the case of floodings. In the path to increased digitalization of our society, achieving a well-balanced legislation is crucial. This requires notably to reflect on private-public partnerships for large cyber risks presenting systemic features that could challenge the economy's ability to absorb massive shocks in the event of an extreme cyber event.

To benefit citizens and society at large, addressing climate and digital risks challenges will require collective action involving private actors and public authorities to establish strong partnerships. Embracing cross-sectoral approaches to major risks will create synergies for the entire society. The rapidly evolving landscape presents an opportunity for insurers to be even more proactive than before in addressing current and future societal needs. Moreover, by enhancing prevention solutions based on new technologies, deploying ambitious risk transfer solutions (including Insurance Linked Securities for not only Natural catastrophes but also newer risks such as cyber), or providing more automatic risk coverage through parametric insurance policies, insurers have a range of solutions to explore and develop further.

These innovations, combined with increased cooperation with various relevant stakeholders including consumers as well as public authorities, will enable insurers to tackle current and future challenges and fulfill their societal role effectively.

THIERRY FRANCQ

General Director for Regulatory and Economic Affairs – Covéa

Minimize regulatory cost and reduce insurance gap

The European insurance agenda has for years focused on financial stability, management of the risks weighing on the sector (such as cyber risk) and the protection of customers/policyholders. Many directives or delegated regulations are still to be finalized or implemented in these areas, and we can safely say that the legal and prudential corpus, combined with the European supervisory system, constitute a very solid... and costly framework. Added to this is the expected contribution of insurers to sustainable development, the contours of which are gradually becoming clearer in an abundance of text whose consistency is not always assured.

There is therefore no need to strengthen this regulatory arsenal, quite the contrary. It is now time to focus on the concerns of our fellow citizens and the needs of our economies, in view of the challenges they face and in which insurance plays a role. In other words, to focus on the ultimate objective, namely broader insurance coverage, at an affordable cost for all European citizens and businesses.

It is not a question here of proposing a list of new regulations, but of analyzing the challenges and questioning what the European level can (or cannot) provide, through its multiple tools: regulation of course, but also attention paid to the proportionate and coherent implementation of the rules, vigilance of competition authorities, legal framework for access to data, purpose and conditionality of European aid, etc.

What are the challenges we face, if we focus on non-life insurance:

- Increasing climate risks. These risks are clearly growing rapidly. However, the comparison with the United States shows that Europe still suffers from a substantial “Insurance Gap” for these risks. There is also a risk of seeing certain areas neglected by insurers. This situation is harmful for our citizens and for our economies.
- A strong inflationary trend in the costs incurred by insurers and therefore in insurance prices, while many citizens are experiencing purchasing power difficulties. Phenomenon linked to climatic and social risks, but also to inflationary trends due to adaptation to global warming (electric vehicles, renovation of buildings, etc.) or the behavior of automobile manufacturers. The regulatory avalanche has also significantly increased management costs for insurers.
- Insufficient risk prevention action, both concerning climate risks and health risks for example, which harms the insurability of economic agents.

It’s time to focus on the final objective, i.e a broader insurance coverage, at an affordable cost.

Facing these challenges, what kind of actions we should consider:

Reduction of the Insurance gap on climate risks:

- Member States undoubtedly have the largest share of responsibility on this subject, given the disparity of situations between Member States.
- But the European level can also make its contribution: for example, by ensuring that the regulatory environment favors the intervention of reinsurers under optimal conditions in Europe, or by encouraging collaboration and sharing of experience within the EU. Reduction or limitation of costs incurred by insurance: - It is necessary to continue the examination of the regulations weighing on insurers to optimize their cost, in capital and in operational terms, in the light of experience, like the modification of the S2 prudential rules which has just been adopted. This must go as far as removing disproportionate regulation: FIDA is a clear example of ineffective regulation at exorbitant cost, as its application to banks shows. In any case, it is imperative not to burden the regulations with future delegated regulations and recommendations (guidelines) issued by the authorities.
- We must encourage - and not inhibit - innovation, for example through the use of AI which constitutes a real lever of productivity in insurance: the implementation of the AI Act must pursue this objective, the legitimate safeguards must be strictly proportionate.
- The inflation of automobile repair costs and in particular spare parts, perhaps linked to the transition to electric vehicles, deserves careful examination by the competition authorities.- Access to automobile data by insurers is also a key area for understanding risk more precisely and optimizing prices, especially as insurers will face a substantial change with the transition to electric.
- Finally, prevention is key to reducing the cost of climate and health risks (see below).

Amplification of prevention actions:- Limiting the costs of climate disasters requires prevention above all. Europe could contribute to this through regional aid and funding research on this theme.- Prevention is also key in terms of health. Europe should promote access to individual health data to allow insurers to fully play their role in this area.

HIDEHIKO SOGANO

Director, Managing Executive Officer, Chief Sustainability Officer – Dai-ichi Life Holdings, Inc.

Global challenges call for greater public-private sector collaboration

Reflecting on the past decade, the financial sector has maintained stability despite geopolitical risks, supply chain disruptions, pandemics, and inward-looking political shifts. This resilience can be attributed to proactive measures and emergency collaborations by both private and public sectors, leveraging past lessons effectively.

In the insurance sector, we are introducing the ICS, an economic value-based framework for assets and liabilities, and a holistic framework based on an activities-based approach to capture systemic risks. This framework, linking macro and micro perspectives, is proving effective.

However, insurance affordability has decreased among low-income groups in some countries, especially the younger generation, partly due to ineffective income distribution policies. Moreover, there is insufficient understanding of insurance in both emerging and developed economies, leading to a lack of awareness and coverage. Consequently, even in times of increased uncertainty, people are not necessarily turning to insurance for their anxieties.

On the supply side, the insurance sector faces challenges from increased risks due to environmental degradation, such as natural catastrophes (NAT-CAT). The focus is on absorbing risk transfers from municipalities, businesses, and individuals (e.g., infrastructure, fire, flood, and agricultural insurance). As uncertainties rise, the sector struggles to manage risks, leading to increased reliance on reinsurance and, in some cases, a reduction in insurance services.

While the sector has strengthened risk management and maintained sound management, it is not a perfect solution. As economic, political, and social uncertainties are expected to increase over the next decade, public-private cooperation is crucial to broaden the understanding of insurance. The protection gap is not merely about penetration rates; it represents a loss of opportunities when neither sector takes on risks, hollowing out the meaning of insurance.

A few years ago, there were concerns about non-insurance industries like GAFA entering the insurance market. Today, enhancing the attractiveness of the insurance industry itself is perhaps more important. The industry is also accelerating its expansion into peripheral businesses, prompting a re-evaluation of the fundamental meaning of insurance.

Public-private sector cooperation is further needed amid uncertainties in the next 10 years.

Considering the next 10 years, with the retreat of globalization, building consensus becomes significantly more difficult compared to ten years ago. Amidst this, both insurance authorities and the industry should boldly tackle global challenges like the introduction of ICS, climate change issues, and cyber risks.

Regarding climate change, it is necessary to design policies and financial supervision that incentivize the expansion of decarbonization finance to reduce climate change risks and enhance resilience across the economy in the long term. Cyber risks, often intertwined with geopolitical risks like hybrid attacks by specific nations, require technological cooperation and risk information sharing between the public and private sectors, although complete prevention remains elusive. In Japan, cross-industry cybersecurity exercises, such as Delta Wall, are effective.

The use of AI in insurance, particularly in underwriting decisions, raises consumer concerns about transparency, necessitating discussions on ethical utilization rules. Additionally, companies committing fraud and harming consumer interests by focusing too much on sales performance need cultural change. Strengthening penalties through regulations is not a fundamental solution; fostering a healthy insurance company culture, including a DE&I perspective, is essential. The industry needs to focus on indicators beyond short-term profitability, and public-private discussions are needed to determine effective insurance regulation and industry efforts.

Given potential new regulations and supervisory enhancements, regulatory frameworks should adopt a principle-based approach, considering varying circumstances across countries. Application should be tailored to fit each insurance market. Private insurance companies must prioritize benefiting policyholders and recognize that ensuring the long-term sustainability of services generates social value.

The growing awareness among authorities to keenly detect private sector movements is positive. However, unintended consequences are emerging due to varied actions of different authorities. For instance, recent US bank failures have heightened interest in liquidity risks. While this is a critical risk in the banking sector, opinions diverge on its significance in the insurance sector. Careful consideration is needed to avoid introducing unnecessary regulations that could hinder the role of insurance companies and reduce societal utility. Moreover, excessive intervention can significantly increase compliance costs for the private sector and this situation is widely recognized, yet often overlooked.

NEXT EUROFI EVENTS

THE EUROFI HIGH LEVEL SEMINAR

9, 10 & 11 April 2025

WARSAW - POLAND

THE EUROFI FINANCIAL FORUM

17, 18 & 19 September 2025

COPENHAGEN - DENMARK

INSURANCE PROTECTION GAPS

JONATHAN DIXON

Secretary General – International Association of Insurance Supervisors (IAIS)

The role of insurance supervisors in building societal resilience

Some stark figures underpin the global challenge of addressing insurance protection gaps.

The damage and economic losses caused by natural catastrophe (NatCat) events are increasing, partly driven by growing exposures in high-risk areas. As the impacts of climate change intensify, it is expected that this will result in even greater damages, leading to increased protection gaps that can affect households, businesses as well as other sectors such as agriculture. The Sigma resilience report stated in 2022 that only 45% of global economic NatCat losses of US$ 275 billion were insured – meaning a NatCat protection gap of US$ 150 billion.

While the IAIS has focused on NatCat protection gaps to date, we are acutely aware that protection gaps exist across a spectrum of risks, also including cyber, health, pandemics and pensions. Across these lines, the figures are also rather alarming. The Global Federation of Insurance Associations (GFIA) published a study on global protection gaps and recommendations for bridging them last year and cited the (annual) pension protection gaps at US$1 trillion, cyber at US$0.9 trillion and health at $0.8 trillion.

Protection gaps manifest differently across markets, countries and regions, but disproportionately affect more vulnerable segments of society and are felt more severely by emerging market and developing economies. For example, the Centre for Financial Regulation and Inclusion in Africa, CENFRI, estimate that 94% or $9.4bn of economic losses in 2023 were uninsured, and that insurance penetration across Africa was just 2.5%. These differences are likely to be compounded by climate change.

Beyond physical risk, insurance protection gaps can create spill-over effects to the rest of the financial system and/or real economy. If damages are not covered by insurance, the costs of reconstruction can fall to governments to provide financial support, with budgetary implications. There can also be spill over into the banking sector if uninsured households or businesses are unable to pay back loans or mortgages due to financial pressure from a disaster.

It is against this backdrop that the IAIS published its "Call to action" in November 2023, outlining why addressing NatCat protection gaps is vital to insurance supervisors and presenting a range of supervisory actions to address challenges related to affordability, availability and take-up of insurance coverage against NatCat events.

A key message of the call to action is that addressing protection gaps is relevant to all supervisors, regardless of mandate. In particular the call to action identified five major areas of supervisory action:

- **Assessing insurance protection gaps** – including collecting data and promoting the development of NatCat models, stress testing and scenario analysis as public goods – to better understand the magnitude and drivers of protection gaps. At the global level, the IAIS will be undertaking a deep dive into the potential impact of NatCat protection gaps on financial stability, for publication in 2025.
- **Improving consumer financial literacy and risk awareness** – there is scope for supervisors to collaborate with industry and other elements of government responsible for consumer protection, to emphasis the value of insurance.
- **Incentivising risk prevention and reduction of insured losses** – for example, supervisors can incentivise or require insurers to integrate incentives for risk prevention in their product design as well as underwriting and pricing practices to achieve a positive impact on the level of losses.
- **Creating an enabling regulatory and supervisory environment** to support availability of insurance and uptake of coverage; and
- **Advising government and industry, including on the design and implementation of public-private partnerships or insurance schemes.** This year the IAIS alongside the OECD provided a contribution to the G7 High-Level Framework for Public-Private Insurance Programmes against Natural Hazards", developed under the Italian Presidency. It sets out considerations for developing a high-level framework for PPIPs against natural hazards for countries, particularly targeting policymakers and insurance supervisors who are considering the development of PPIPs.

Addressing protection gaps is relevant to all supervisors, regardless of mandate.

Overall, the imperative to narrow the protection gap for NatCat events requires a collaborative multistakeholder effort, including governments, insurers and supervisors. The combination of their insights, convening power and authority can lead to the development of comprehensive strategies that bolster societies to withstand and recover from these events.

FAUSTO PARENTE

Executive Director – European Insurance and Occupational Pensions Authority (EIOPA)

Insurance natural catastrophe protection gaps – A multidimensional approach

Europe has been warming at about twice the global rate since 1980, making it the continent with the fastest warming trajectory[1]. In recent years, there have been several extreme climate events with severe societal consequences: The 2021 floods in Germany and Belgium caused 44 billion € in damage and resulted in more than 200 deaths. Similarly, the 2023 floods in Slovenia caused damages around 16% of the country's GDP.

However, EIOPA's Dashboard on insurance protection gaps for natural catastrophes[2] shows that historically only a quarter of the total losses caused by extreme weather and climate-related events across Europe were insured, indicating a large insurance protection gap. The dashboard aims to represent the drivers contributing to this gap, as to enable the identification of measures that will enhance society's resilience to natural catastrophes, and to raise awareness and promote a science-based approach. Improved projections provide further evidence that, if no measures are taken, future climate change will escalate extremes such as heavy precipitation, droughts, and floods, thereby widening the gap.

The insurance protection gap for natural catastrophes in the EU poses a risk to economic growth, competitiveness, and potentially national budgets. From a systemic perspective, climate risks threaten to Europe's energy and food security, infrastructure, financial stability and public health.

A lack of insurance to cover losses caused by natural catastrophes lowers the financial resilience of economies, making it more difficult for businesses and people to recover from disasters. This gap also adds pressure on national budgets, which typically assume a substantial portion of the recovery and reconstruction costs for infrastructure, while suffering a loss of revenue due to disruption of economic activities. The absence of insurance can thus have a significant adverse fiscal impact, potentially prolonging recovery.[3] The risk can spread across the financial sector, as the lack of insurance can impact the value of collateral for mortgage lending.

The regulatory framework can facilitate the insurance industry's ability to offer coverage and increase uptake by households and businesses. Regulators and supervisors can incentivise insurers to embed risk reduction and adaptation measures in their product design, recognizing that protection gaps cannot be addressed by increasing insurance penetration alone. Pro-active measures on the vulnerability of buildings, localisation of exposure and optimised insurance coverage will be important for societal resilience. (Re)insurers, as society's risk managers, can contribute to reducing climate change risks. Some insurers are already doing so, by providing advice on adaptation measures to policyholders. EIOPA has introduced the concept of impact underwriting, aiming to incorporate climate change adaptation and mitigation options into pricing and underwriting.

Supervisors can further contribute to addressing natural catastrophe protection gaps by assessing them and supporting initiatives for improving financial literacy and risk awareness, and by advising governments and industry on the design and implementation of public-private partnerships or insurance schemes.

EIOPA performed significant work in identifying and addressing barriers to the demand for nat cat insurance products. One challenge is that consumers may not fully grasp the coverage they purchase, leading to expectation gaps that can undermine consumer trust in the insurance sector. It is therefore important that supervisors, insurers, and society as a whole to collaborate in building trust and developing solutions that increase resilience to nat cat risks.

A deeper understanding of consumer behaviour can help bridge the protection gap. Studies conducted by EIOPA have identified that consumers often perceive the process of taking out insurance as complex and time-consuming. This, combined with a lack of clarity about the conditions, may further disincentivise insurance uptake.

Addressing EU insurance protection gaps requires decisive and coordinated action by all stakeholders.

EIOPA assessed options for reducing the climate insurance protection gap[4], highlighting the role of private insurance markets, while advocating for a multi-ladder approach for sharing losses from natural disasters among various parties at different loss layers. This is deemed necessary due to the expected increase in frequency and severity of extreme events.

Tackling insurance protection gaps and fostering long-term societal resilience to nat cat risks requires decisive and coordinated action from all stakeholders. There is no time for complacency. Insurance supervisors stand ready to further contribute to overcoming the challenges ahead.

1. *European Climate Risk Assessment (EEA)*
2. *Dashboard on insurance protection gap for natural catastrophes - European Union (europa.eu)*
3. *See the ECB FSR Special Feature "Climate change and sovereign risk", May 2023.*
4. *Joint Staff paper with ECB: Policy options to reduce the climate insurance protection gap*

JOSÉ ANTONIO FERNÁNDEZ DE PINTO

Director General, Insurance and Pension Funds – Ministry of Economy, Commerce and Business, Spain

Challenges for insurability and insurance approaches

Climate change is increasingly affecting our societies and their various processes, including insurance. Mean temperatures are steadily rising, while sudden, drastic changes can occur overnight. Precipitation extremes are becoming more intense, resulting in both excessive rainfall and severe droughts. Additionally, secondary perils such as hail, tornadoes, and wildfires are on the rise. The overwhelming evidence of these changes is compounded by another significant factor: the rise in global population and the increase in exposed assets. More people and properties are now vulnerable to extreme weather conditions, driving the surge in losses.

This has made prevention and protection measures increasingly necessary. Insurance plays a crucial role not only in indemnifying losses from these events but also in reducing risk by enhancing society's capacity to respond. Unfortunately, estimates indicate that only one-third of catastrophic losses are insured globally and in Europe. This insurance protection gap is concerning given the growing potential for catastrophic events to impact societies. Increasing losses also create affordability problems for the insured, leading to a vicious cycle that further widens the protection gap.

There are no magic solutions to this problem, but certain approaches could bring positive changes. These approaches need to be embraced by insurance regulators, the market, public stakeholders, the insured, and ideally, government agencies with competencies in risk reduction.

Broadening Mutualization

A common starting point is to broaden mutualization. This is essential not only to gather resources to indemnify losses but also to prevent adverse selection issues from impacting insurance viability. Countries with high income, a high degree of insurance culture, and proper risk awareness—usually driven by experience—can achieve high insurance penetration rates and thus broad mutualization almost naturally. However, this scenario is uncommon, necessitating the application of market and regulatory measures.

Creation of Pools or (Re)insurance Companies

One option is to create a pool or a (re)insurance company to cope with losses from specific exposures created by certain perils, such as floods, earthquakes, or cyclones. These pools or companies can be private with some degree of public control or funding, or a public (re)insurer can be created to partner with the private sector in covering a list of predetermined hazards.

Climate change and population grow challenge insurance. Solutions to consider.

Compulsory Insurance

Another way to expand mutualization is to make the uptake of insurance compulsory. This can be implemented by legally mandating insurance, by binding extensions of voluntary insurance to cover common property policies for certain hazards, or in their weakest form, by automatically including some covers with the option for insureds to opt out at their own risk. Making insurance compulsory is always controversial, and its adoption often depends on the shared moral values of a given society and the perceived usefulness. Nevertheless, data indicate that in countries with some degree of compulsory insurance, especially where there is a specific program in place to cover certain catastrophic hazards, the protection gap is clearly smaller.

The Consorcio de Compensación de Seguros (CCS) model.

The Consorcio de Compensación de Seguros (CCS) in Spain exemplifies a successful public-private partnership model aimed at providing catastrophic risk coverage—low frequency and high severity—which the private sector alone could hardly offer without significant exclusions and coverage gaps. The uniqueness of the CCS lies in combining geographical compensation and risk compensation. Geographical compensation mutualizes risks manifesting at different severities across Spain, while risk compensation mutualizes various types of events that rarely occur simultaneously.

This, combined with mandatory catastrophic risk coverage when purchasing a damage insurance policy from a private insurer, results in Spain having a 75% insurance rate for extraordinary risks in homes and 100% in motor vehicles. The premium is low—0.07‰ of the insured capital for homes, 0.12‰ for offices, and 0.18‰ for commercial and industrial risks, among others—and affordable for any insured party regardless of risk characteristics; in fact, there are no risk selection criteria.

As a result, about 60% of catastrophic losses in Spain are covered by insurance.

In summary, in a context of growing losses, insurance is more relevant than ever for creating sustainability and resilience in societies. To achieve this, insurance itself must be sustainable and resilient.

The example of the CCS in Spain shows that with the right approach, it is possible to achieve high levels of insurance penetration and protection against catastrophic events, thereby enhancing societal resilience.

KURT MOELLER
Member of the Executive Board of Zurich Insurance Austria, Country Chief Underwriting Officer – Zurich Insurance Company

The next European Commission must champion climate resilience

Gaps in insurance protection are at the core of several societal challenges. Climate change is upon us. So is social and political change, reinforced by global trends, from demographics to digitalization. If not addressed, the consequences of those challenges for our communities and society will be significant. Thus, the time to act is now.

Climate-related extreme events and other natural disasters already cause significant economic disruption and hardship for populations experiencing them. Europe is the fastest warming continent in the world, and direct aggregate catastrophe losses in the EU already amounted to approximately €500 billion in the period between 1980 and 2020 (EIOPA, 2023).

From a global perspective, market penetration of natural catastrophe insurance in Europe is comparatively high in aggregate. However, it differs significantly from country to country – from as low as 3% in Italy to as high as 97% in Switzerland. This results nonetheless in high gaps of natural disaster protection, inevitably causing consequences to countries' public finances.

Risk prevention and adaptation are essential to tackle these gaps. As an insurance company we know the distress that comes with the damage caused to homes and businesses by natural catastrophes. Protection against those damages is always better than just providing support in the wake of a severe weather event. Nevertheless, to deliver the changes required to protect Europe from the impact of increasing frequent natural catastrophes in the future, action needs to be taken by governments, companies, and households.

Governments will have a key role in creating the appropriate framework for risk prevention and insurance penetration. Both will need to be prioritized, alongside developing additional financial risk capacity to cover extreme losses and to keep risk pricing at socially acceptable levels. Austria is therefore evaluating the possibility of integrating natural disasters into compulsory fire insurances, following the example of Belgium.

Insurance companies, on the other hand, will have a critical role to play as risk managers, modelling perils, and resilience services providers. Thus, the insurance sector is already expanding its business, providing respective expertise to firms within the European Union. This includes risk assessment and advice on adaptation solutions. At Zurich Insurance, specialized risk engineers support various customers, from companies to cities, to manage a wide range of risks through prevention and mitigation services, going beyond traditional insurance.

Europe needs to explore new measures and bold policy thinking.

The international shipping company Maersk, for example, relies on Zurich Resilience Solutions teams to strengthen the climate resilience of their most critical ports including Rotterdam over the next 30 years, taking advantage of on-site climate assessments, simulating data-driven and science-based climate change scenarios, their impacts (such as sea level rise) as well as risk mitigation recommendations and solutions tailored to each port to protect them from physical damage and business interruption.

The car manufacturer AUDI AG (Volkswagen Group) also partnered up with Zurich Resilience Solutions as a response to various extreme weather scenarios: together, they developed innovative flood resilience measures at a plant in Neckarsulm, Germany, that help keep production afloat.

Initiatives addressing the climate protection gap at EU level can also be a catalyst for Member State action. Increased interest in capacity building and integrated risk management is to be expected, in particular when it comes to prevention measures. We believe that combined efforts, at national and European level, towards establishing a timely and relevant database on natural disaster risk is vital. Most EU Member States currently do not have a mechanism in place to collect, assess or report economic losses due to extreme weather and other natural hazards. The dashboard on insurance protection gaps for natural catastrophes launched by EIOPA in 2023 should be leveraged, supporting a forward view of protection gaps to inform how national and EU-wide public-private partnerships could be designed and evolved. Furthermore, an EU-wide equivalent of the French Barnier fund – dedicated to risk mitigation and property buybacks – could be explored, with the backing of strong and liquid capital markets.

Invigorated European financial markets could also open new opportunities for risk sharing at a European level. Only by exploring new measures and with bold policy thinking, will Europe be able to effectively combine the capabilities and expertise of the private and the public sectors to deliver the resilience that societies require.

CRISTINA MIHAI
Head of Regulatory Risk Management EMEA – Swiss Re Management Ltd

Global protection gaps at record high

In the context of our dedicated macroeconomic and insurance resilience research, Swiss Re models estimates of the global insurance protection gap by projecting expected economic and insurance losses for four key perils: crop, natural catastrophe, health and mortality.

According to our latest sigma Resilience Index research, the global protection gap reached a new record high of USD 1.83 trillion in premium equivalent terms in 2023, with more than 40% of risks remaining unprotected or uninsured across the crop, health, mortality and natural catastrophe perils. This corresponds to a 3.6% annual increase in nominal terms since 2013, slightly above that of global GDP growth. In terms of the geographic distribution of these results, emerging economies are still much less resilient than advanced ones, with protection gaps being significantly higher in those regions.

Zooming in on the global natural catastrophe protection gap, this rose 5.2% yoy to USD 385 billion in premium equivalent in 2023, reflecting economic growth and inflation. Global protection available against natural catastrophes (i.e. exposure covered by insurance) increased by 10.1% yoy in 2023. At the same time, global protection needed (i.e. total exposure) increased by 6.3% yoy. This can be seen as improved resilience and an encouraging underlying trend in risk protection which should ideally continue in the long term.

Effectively reducing protection gaps requires two fundamental strategies. The first consists in structurally narrowing gaps through loss prevention measures that reduce the risk of damage to crops, property or infrastructure. At the limit of loss prevention, the second strategy comes into play: expanding insurance coverage.

Re/insurers have an important role to play on both accounts. They can incentivize loss prevention through pricing signals, client engagement or advice to relevant stakeholders, such as public authorities. And they can expand the scope of insurance to new and under-served risk pools through ongoing innovation around data, analytics, and distribution. Progress has been encouraging, as re/insurers are now able to design covers for risks that used to be viewed as uninsurable.

The ability of re/insurers to incentivize loss prevention and expand the availability of risk transfer solutions also depends on governments and regulators taking appropriate action. Authorities have numerous tools at their disposal, across the spectrum of protection gap areas. Mandatory health and workers' compensation insurance, support for crop insurance through public insurance programs or subsidies, granting tax benefits to encourage life and health insurance and reducing taxes on property insurance premiums are just a few examples. In addition to creating incentives for risk transfer, public measures are of central importance when it comes to promoting behavior to limit damage, for example through fiscal rules, zoning laws or building codes.

Sustainably reducing protection gaps requires a joint effort by public and private stakeholders.

While the re/insurance industry has for a long time investigated and discussed the issue of protection gaps and the link to economic and societal resilience, the topic has understandably also attracted increasing public and regulatory attention in recent years. One such very recent example is the European Commission-convened Climate Resilience Dialogue, which brought together key public and private stakeholders in order to discuss ways to narrow the climate protection gap and increase resilience to the effects of climate change. The resulting report addresses aspects related to both loss prevention and risk transfer, and nicely illustrates that no single actor can do it alone. Rather, joint efforts by public authorities, regulators, supervisors, businesses, citizens and re/insurers are needed. One suggestion put forward in the report, the idea of exploring the potential of public-private partnerships, seems particularly compelling, for example in view of covering hard-to-insure risks that exceed the capacity of private markets (such as future pandemics or cyber catastrophe risks for large, coordinated attacks). We look forward to further engagement with European regulators on this topic and on other proposals made in the CRD report.

One key message which we will continue conveying in this context is that re/insurers' ability to help reduce protection gaps greatly depends on their ability to diversify risks across jurisdictions. By promoting open markets and removing trade barriers, such as the mandatory holding of collateral or the localization of assets, regulators will be able to unlock the full potential of re/insurers on the path to effectively and sustainably reducing protection gaps.

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Q&A

MARK JOPLING

Head of Global Financial Services for EMEA & APJ – Amazon Web Services (AWS)

AWS helps financial services customers innovate and optimise their operations; and we are still in the early days of the digital transformation journey

How is AWS helping its financial services customers innovate and optimise their operations? What are the future prospects?

By 2028, according to Gartner, cloud computing will shift from being a technology disruptor to becoming a necessary component for maintaining business competitiveness1. However, for many financial services customers the imperative to use cloud is already here due to cost, flexibility and resilience advantages. The benefits of cloud are well-established; and include efficiency gains, reduced costs, scalability, faster innovation, better customer outcomes, as well as improved operational resilience.

Talking to our customers, they highlight the following: cost savings are realised by avoiding on-premises infrastructure, with large fixed spend, and reducing the ongoing variable spend; staff productivity is improved, with increased output by the same size team, because much of their previous tactical work is no longer needed; sustainability is improved by reducing the environmental impact of IT operations; better operational resilience is achieved by enhanced availability, security and less downtime; and business agility means new products, new geo location expansions, or more features of existing products can be delivered.

When we add the potential applications of Generative Artificial Intelligence (GenAI) made possible by cloud computing, there is so much potential for further enhancements for customers and consumers in the financial services space. But more on that below...

Can cloud services be seen as a central element of an evolving digital infrastructure? Does DORA provide an appropriate framework to support this development or should a broader approach be developed?

Cloud services are already a central element of an evolving digital infrastructure and AWS keeps that in mind as we develop our offering. Our core infrastructure is the most flexible and secure cloud computing environment available today and it is designed to meet the most stringent security requirements in the world and satisfies the security requirements for financial, health, military, global banks, governments, and other highly sensitive organisations.

Many third-party services, such as cloud computing, are provided on an industry- and location- agnostic basis. Delivering harmonization between jurisdictions and industries in regulations will be crucial to ensure that the goals of policymakers, customers and the industry can be met while financial institutions continue to benefit from the advantages of third-party services and outsourcing.

DORA can support and speed up the digitalization of the EU financial system by delivering on these objectives, but it is important that regulators, financial entities and providers work together as it is implemented to ensure that the EU financial services sector can continue to choose what is best for them and benefit from technological innovations. This is especially important in light of an increasingly complex cybersecurity landscape where threats continue to proliferate and new preventative measures are constantly being developed.

AWS is committed to working with the financial services community on the implementation of DORA, while enabling financial entities in the EU to increase agility, enhance their resilience and above all, to innovate.

Are AI and ML likely to have a truly transformative impact on the financial sector in the coming years Does the EU AI Act provide an adequate framework for the development of AI in the financial sector?

The unprecedented pace of digitalization requires financial institutions of all sizes to increase agility and accelerate innovation; artificial intelligence and machine learning (AI/ML) are at the heart of this innovation. From a technology provider perspective, what we see is that the adoption of AI/ML has accelerated in recent years - due to the availability of virtually unlimited capacity in data storage and compute power (and cost-effective) from cloud services.

AI/ML tools are powering devices and software used across financial services (FS) to solve problems and create opportunities both in the private and public sectors in a number of areas, including: product personalization, automation of legacy processes and manual document processing, improving customer experience, compliance and market surveillance and fraud detection.

Improving customer experience has been a key focus for FS institutions over the last few years and includes areas such as a seamless account opening process, a more efficient loan or claims processing workflow, and interacting with customers using their preferred communication channel: web, mobile, chat, voice, email. This continues to be a competitive area where businesses are racing to provide their customers with the best possible experience while ensuring that the appropriate security and regulatory measures are implemented. And in insurance, we also see firms using AI/ML for claims processing, benefiting from automation and generating an overall better customer experience.

On the EU AI Act we support efforts to put in place effective risk-based regulatory frameworks and guardrails for AI that protect civil rights, while also allowing for continued innovation and practical application. As one of the world's leading developers and deployers of AI tools and services, trust in our products is one of our core tenets and we welcome the overarching goal of the regulation. We encourage policymakers to continue pursuing an innovation-friendly and internationally coordinated approach, and we are committed to collaborating with the EU and industry to support the safe, secure, and responsible development of AI technology.

What are the priorities for the next European political cycle in the area of digital finance? Should we focus on implementing the measures that have already been adopted or are additional measures needed?

The focus of this political cycle for digital finance should be getting implementation right and taking stock around the key files delivered during the previous mandate, such as DORA and the EU AI Act. DORA will not only be a change for the industry, but also for the regulators who will need to understand and engage with entities, such as cloud service providers, that were previously outside their direct scope. Ensuring a proportionate and pragmatic approach will be key to delivering operational resilience for the financial services ecosystem.

The EU also needs to keep in mind that many third-party services, such as cloud computing, are provided on an industry- and location- agnostic basis. Engagement to deliver an internationally consistent, proportionate and risk-based approach for third- party risk management and outsourcing will support the continued digital transformation of the sector. It means the EU can ensure regulations meet their needs, but are also interoperable with other jurisdictions to ensure firms can utilize services on a cross-border basis consistently. With the rapid level of technological innovation in financial services, flexibility to ensure any measures can handle increasingly dynamic complexities in the financial and technology spaces is also crucial. Therefore, it is important that the harmonization between jurisdictions and industries is front of mind as regulations are finalized.

1. *https://www.gartner.com/en/newsroom/press-releases/2023-11-29-gartner-says-cloud-will-become-a-business-necessity-by-2028*

DIGITAL FINANCE: KEY PRIORITIES

ALEXANDRA JOUR-SCHROEDER
Deputy Director-General – DG for Financial Stability, Financial Services and Capital Markets Union, European Commission

An outlook for the next legislative cycle in Digital Finance

During the von der Leyen I Commission term between 2019 and 2024, we proposed a comprehensive set of new legislation on digital finance.

We were the first jurisdiction with a comprehensive regulatory framework for Crypto Assets. MiCA (the Markets in Crypto Assets Regulation) provides rules for stablecoins which entered into application in June 2023, its other parts are going to become applicable in December 2024. We are monitoring that this set of rules for crypto assets will be correctly implemented. At the same time, we will analyse new trends and assess whether those need a regulatory framework. I am thinking for example on “asset tokenization”. Financial institutions are already issuing bonds, funds or other securities in tokenized form.

Digitalisation brings massive speed and efficiency gains, but it makes markets also more vulnerable for cyber-attacks. Financial firms are working in an ever more symbiotic relationship with technology firms. We see an increasing dependence on third party providers of ICT services (such as cloud or data analytics), as we could witness with the quasi-world-wide outage due to a programming error in July this year. This is why we proposed DORA (Digital Operational Resilience Act), which will start applying in January 2025. DORA requires companies to make sure that they can hold up all sorts of cyber-related disruptions or threats.

The new EU Artificial Intelligence Act opens a truly new chapter. It is worldwide the only regulation on AI. It sets out two so-called high-risk use cases in finance: for creditworthiness assessments and for insurance underwritings. It is crucial to understand where exactly in the value chain of a financial service or product AI systems intervene. AI systems that automate invoicing processes would cause less damage than those that decide who would get a credit and under which conditions. We are in a lively exchange with stakeholders to assess if and how existing financial regulations would benefit from adaptations or at least clarifications through guidance. For this purpose, we launched a series of AI in finance workshops, together with the European Supervisory Authorities. We also launched a targeted consultation, together with DG CNECT.

We have also made efforts to modernise and digitalise payments in the EU. The implementation of the Retail Payments Strategy involves two major legislative proposals. Firstly, a Proposal on Instant Payments in Euro adopted in 2024, which will make Euro credit transfers completed within 10 seconds the norm in Europe. The second proposal, which was adopted in June 2023, was a revision of the second Payment Services Directive. It includes measures to combat and mitigate payment fraud, improve consumer rights, further level the playing field between banks and non-banks, improve the functioning of open banking, improve the availability of cash, and to strengthen harmonisation and enforcement. We hope that the co-legislators will reach agreement on this proposal in the course of 2025. Following the significant legislative activity associated with the Retail Payments Strategy, there will be substantial implementation and enforcement work during the 2025-2029 mandate. The deadlines for banks and other payment services providers to roll out euro instant payments will fall during the early years of the new mandate and must be strictly imposed.

Digital finance remains on the top list of EU deliverables to strengthen our competitiveness, to protect our financial stability and our values.

We would also like to highlight the importance of data-sharing and European financial data spaces, which are part of our broader European Data Strategy. How innovative our companies are will depend on the availability of reliable and high-quality data. We proposed PSD3/PSR and FIDA (Framework on Financial Data Access) to make it easier for customers to share their financial data beyond payment accounts in a protected manner. This opens new opportunities for customers and can also stimulate innovation. We are also making additional efforts for better access to data pools from the public sector, for example with the Data Hub of the Digital Finance Platform. We consider developing a comprehensive financial data strategy to guide this.

Overall, we have achieved a lot in the European Union to create favourable conditions for innovative and responsible digital finance to thrive in the EU. With the von der Leyen Commission II we will continue this path to further promote innovative and secure solutions to retail and business customers.

ANIKÓ SZOMBATI
Executive Director for Digitalization and Fintech –
The Central Bank of Hungary

Financial innovation shifting to higher gears – policymakers have to follow

The MNB, the Central Bank of Hungary wishes to be at the forefront of financial innovation – we were among the first central banks in Europe to dedicate an executive directorate to financial innovation and FinTech support. The central bank published the FinTech and Digitalization report for the fifth time this year, which identifies key international trends, and provides a comprehensive analysis of the Hungarian FinTech sector, and the digitalization level of the domestic banking, insurance and capital markets.

We base our activity on our FinTech and digitalisation strategy, whereby we put the customers' economic welfare, safety and convenience in the centre, without favouring any form of affiliation of the service provider. Along these lines we see the FinTech sector in Hungary as a rapidly increasing ecosystem, with 212 Hungarian-based fintech companies operating there in 2022. The majority of the firms are serving mostly the B2B market with data analysis and business intelligence services.

Based on our our 7-pillar categorisation of internal and external factors, the digital maturity of the Hungarian banking sector further improved in 2023, starting to emerge from the medium level. The insurance sector has seen progress in the digital accessibility of some functions, but the sector as a whole has been slower to digitalize. The digital maturity of investment service providers shows a heterogeneous picture, which can be improved by developing digital strategies.

The early findings of the abovementioned report led MNB to issue a recommendation on the digital transformation of credit institutions in 2021. The Recommendation, that requires commercial banks to develop a digitalization strategy, aims at setting a minimum level of digitalisation standard for the banking ecosystem so that to remain relevant for the customers even in the age of digital challenger banks. However, the central bank initiative, consisting of recommendations and good practices covers not only front-end developments, but governance, education and cybersecurity as well. As the realisation of these strategies is evaluated since then on a yearly basis, we see that this flexible, consultation-based form of soft law can really be productive, especially amid the fast pace of technological advancement.

In terms of digital finance policy, I believe that the latest adopted frameworks like MiCA, the DLT Pilot Regime and the AI Act are on the right track in grasping emerging trends and enabling new technologies, while also maintaining financial stability. Therefore, focusing on their implementation but also constantly monitoring market developments, potential regulatory shortcomings and acting accordingly will be of key importance.

However, there is always room for improvement. For instance, the substantial client number increase of neobanks highlights some consequences of the current passporting regime that would need to be addressed and fine-tuned in order to provide a truly level playing field for all market players and proper consumer protection for clients. Most neobanks, licensed in one member state provide cross-border services, including savings accounts, to an order of magnitude more clients throughout Europe than those of their home countries. Though some of these entities are already under the direct supervision of the ECB due to significance, should a bank failure occur, home country deposit insurance scheme funds might be insufficient to indemnify all harmed clients EU-wide. In a cross-border service provision setup, host supervisory authorities also have limited information or consumer protection tools available in helping clients with their legal disputes. These issues could be mitigated e.g. by mandating entities to join host country deposit insurance schemes proportional to host country user base size – at least for as long as the European deposit insurance scheme becomes a reality. Along these lines, examining the feasibility of obligatory submission of local consumer disputes arising to host country financial arbitration or dispute resolution bodies would also be beneficial, thereby getting neobanks incentivised to resolve consumer complaints swiftly and effectively on time.

The current passporting regime needs fine tuning amid the spread of cross-border neobanks.

Regarding the next era of open banking and open finance, fostering the development of high-quality, standardized, easily implementable, secure and fast APIs for real-time data sharing, while preserving data privacy and customer choice must be a top priority for the following years. For this to happen, incentives, such as API call compensations or the opportunity to provide so-called "premium APIs" for value-added services would have to be available for financial institutions.

MÄRTEN ROSS
Advisor, ECOFIN & EFC –
Ministry of Finance, Estonia

Digital finance needs help from non-digital agenda

How is digitalisation progressing in the Baltic region's financial sector and is it expected to lead to a significant transformation of the sector in the medium term?

The Baltic financial system is in many respects already in post-digitalisation phase. Supported by reasonable infrastructure and supportive legal environment, much of the payment activity and retail interaction with financial institutions are near fully digitalised. Digitalisation in wider sense has also shown up inside the market participants themselves, including in provision of regtech or digital identity services.

Therefore, it is actually not easy to see major further transformation coming from digitalisation from that angle. Obviously, digitalised services as such is a diverse concept and fundamental changes in the market shares are certainly expected from new technologies and applications, but are difficult to foresee.

However, on the other hand, reaping fully the potential efficiency gains from digitalisation have been also constrained by non-technical limitations such as legal complications with data sharing and cross-border usage, for example for AML procedures or fighting payment fraud. Similarly, constraints to provide cross-border services due to fragmented depositary services is also quite a limitation for further usage of financial services that digitalisation otherwise promises. Limited size of the single Baltic domestic markets have also lead sometimes to temporarily lagging uptake of some digital services and advances, including in payment services.

This means that further digitalisation with more thorough cross-border financial integration in Europe could indeed lead to further structural changes in the market. Even in such highly digitalised markets as Baltic countries. Whether it leads simply to somewhat more competitive market and wider choice for consumers, or would it lead to reshaping incumbent regional banking and payment market shares, remains however to be seen.

What should be the priorities for the next European political cycle in terms of digital finance policy: focusing on the implementation of the frameworks already adopted, addressing emerging trends or new technologies, developing more specific rules for finance, lifting obstacles to digitalisation?

First priority should be the implementation of already enacted or forthcoming regulations. Particularly, as with DORA we have been already quite advanced and with FIDA there are still more questions about implementation than needed. Furthermore, while RIS might be based on good intentions, its ability to handle some of the MiFID/MIFiR overregulation is quite doubtful.

But then - based on this experience - continue working on lifting obstacles and constraints that unnecessarily limit reaping the benefits of digitalised single market and cross-border services. One should not underestimate the ample potential that further digitalisation still provides, particularly for cross-border service providing.

While not willing to downplay the importance of directly digital regulations (e.g. linked to cyber security or data sharing rules), probably more important constraints to digital finance still come from those single-market regulations, or lack of them, that are not so much in the narrow digital agenda sphere. Easier and doable cross-border service penetration, either in everyday banking and investment services (eg opening an account), or how depositories are set up and function, matter still more for digitalised financial services than narrower technical constraints.

> **The agenda for capital market union is in many respects also a digital finance agenda.**

One could even go further – the way how our pension systems still are national in most respects, limits consumers and savers more from getting better returns via digitalisation than any direct digital finance regulation. Or the way how investment accounts are tax-treated, including between the markets, might matter quite a lot. Therefore, the agenda for pushing through the capital market union is in many respects also a digital finance agenda.

Further note of caution here. While in many cases the seemingly obvious answer to those problems tend to bring up proposals for central services, the cure to many of these constraints is not necessarily the centralization or centralized public services. While it is a legitimate option, there is a real threat that instead of benefiting the market, central services could add unnecessarily to the costs of intermediation. Therefore, the quality of impact analyses is of utmost importance.

ONDŘEJ KOVAŘÍK
MEP – Committee on Economic and Monetary Affairs, European Parliament

Time to take stock - Analysis of current legislation before new legislative proposal

During the most recent political cycle, we have passed a number of new pieces of legislation related to the digital transition which are either horizontal or specific to the financial sector. From the Data and AI Acts, as well as the DMA and DSA on a horizontal level, we're also now just beginning to see the implementation of the new crypto framework - MiCA, as well as digital resilience (DORA), with secondary legislation (including Delegated Acts -DAs - Implementing Acts - IAs - and Regulatory technical standards - RTS) and expect that we will negotiate the remaining acts as we go forward with the Council - most likely beginning in 2025, concerning Financial Data Access.

Last mandate we agreed many new pieces of legislation. I hope we do not rush to bring in more for this new mandate. Regulatory certainty is key for market players and stakeholders in the digital finance sector.[1] I opine that our priorities should be in following up on the implementation of legislation, particularly the secondary legislation, discussing with not only regulators but also understanding the stakeholder experience. We can already see examples of regulators and stakeholders having different interpretations of the final rules, for example most obviously with DMA and DSA, and it's important for all of us to draw lessons from the outcomes there.

For the use of new technologies to become normalised within the financial sector, I am of the view that we already have a good set of legislative pieces of the puzzle completed, and I have concerns that any more could stifle innovation and the uptake of new technologies, ultimately harming the competitiveness of the EU globally. This also applies to the work done by the European supervisory authorities to bring DAs, IAs and RTS to the Commission, but also the co-legislators for adoption of these crucial pieces of legislation which will ultimately shape how MiCA works in practice following its implementation.

Of course we can never rule out new events which may necessitate a legislative reaction, but as we discovered during the MiCA negotiations, market turbulence events should not necessarily lead to a change in approach. First it's important to clarify the effect on the European economy, and then whether any other pieces of legislation should be used first in addressing the issues. Only in the case where we find there is not a sufficient response tool available to regulators and supervisors, should we then consider bringing that as an additional element to the negotiation of pieces of legislation on the table.

I do believe that we need further evolution in terms of the regulatory and supervisory approaches. I have been a consistent proponent of regulatory and supervisory technologies, which can reduce the burden on regulators and supervisors. There are good examples out there of industry-led self regulation based on regtech and suptech, and I hope that national and EU authorities consider engaging with industry further on this, and consider whether some elements could be suitable for supervision on a national or EU level for financial services. This is particularly relevant for those sectors where we see a high crossover between financial and technological players, such as digital assets, tokenisation etc. But it can go further than that. It offers opportunities to regulators and supervisors to harness technology to streamline, reduce administrative burden and cut down on red tape.

As we go forward in the digitalisation of the economy, it's clear that for end-users having simple and understandable data and APIs is very important. It's something that I am convinced that companies should be working towards when it comes to their customer-facing interfaces. The role of legislators here is to ensure that legislation is principles-based rather than the approach we often tend to have in EU legislation, which is more prescriptive. The benefits would be having legislation which can be aimed towards the same ends, namely competitiveness, consumer-friendly, setting clear outcomes-based objectives within the legal texts. Secondary legislation will be crucial across the board, and also while ensuring the core financial stability mandates they have, they should allow companies to innovate in different ways, in competition with each other, but also in collaboration with partners, including regulators and supervisors at different levels of the value chain or across the whole process. It's an approach which we discussed in depth for example with regards to FIDA, which is currently being negotiated in Council and Parliament.

Overall, for the incoming Commission, the most important thing will be to have a clear overview of legislation currently having an impact on digitalisation in finance. Before future legislation in this area is proposed, aside from ensuring level 2 legislation matches the objectives set by the co-legislators, the Commission needs to examine the current policy toolbox available to itself as well as EU and national regulators and supervisors, and this is also something that Parliament and Council should be doing as well before pushing for new legislation in the area. Now is the moment to take stock of the many pieces of legislation we have implemented in recent years, and analyse how effective they are in the financial services sector and specifically the digital finance sphere.

MARIA TSANI

Head of Financial Services Public Policy and Regulatory Affairs EMEA – Amazon Web Services (AWS)

Financial supervision in the digital age

Digitalization is impacting all aspects of our lives and the financial services sector is not immune to this. A modern financial system thrives on digital infrastructure and the opportunities brought by digitalization. Banks, investment firms and payment companies all leverage digital technologies such as cloud to deliver core day-to-day services in a secure, resilient and efficient way. From instant payments to running secure banking platforms, tech has come to underpin the smooth functioning of the financial ecosystem. The uptake of innovative technologies such as GenAI can further yield tremendous opportunities for the financial sector – and cloud is helping financial entities of all sizes reap the full benefits of the digitalization process.

At the same time, the ubiquitous presence and use of digital technologies in the financial sector has rightly brought increasing regulatory attention to digital resilience. The EU has been leading efforts to address this with the Digital Operational Resilience Act (DORA). Since the proposal was first presented, we have seen other jurisdictions moving forward with initiatives to address operational resilience in the financial sector. At AWS we are committed to raising the bar on security and resilience so we are pleased to see cyber resilience increasingly getting the attention it deserves, with the EU at the forefront in this space globally.

As we look towards the new legislative term, all eyes will be on the implementation of the framework and ensuring DORA is a success.

One of the key objectives of DORA has been to increase convergence and efficiency in supervisory approaches when addressing ICT third-party risk. In the past, Member States exercised their own discretion when it came to cybersecurity and operational resilience in the financial sector, leading to a patchwork of regulatory requirements and expectations. This effectively meant a significant administrative and compliance burden for financial entities, as well as regulatory uncertainty, especially for those firms operating on a cross-border basis.

The DORA framework sets a single, EU-wide high-bar for security and resiliency, while remaining proportionate and risk-based. It is imperative we don't undermine of its raisons d'être by introducing parallel or even conflicting supervisory expectations. On the contrary, if implementation is to be effective, we need to prioritize harmonization to ensure a smooth transition to and consistent application of DORA standards, while reducing the risk of fragmented interpretations across the supervisory chain.

This need also extends to adjacent regulatory frameworks. The EU has grown its cybersecurity rulebook significantly over this past mandate, with much legislation addressing the issue of resilience, and different sets of requirements cropping up across sectors. In this context, it is crucial we minimize the overlap between DORA and parallel frameworks such as NIS2, to reduce regulatory uncertainty and potential for clashing expectations (for instance when it comes to incident reporting requirements). This is particularly important for technology providers, who offer their services to entities that operate outside the financial services sector.

Further, the DORA framework recognizes that it must remain future-proof to accommodate evolving technological developments. It is vital that supervisory expectations also incorporate this principle by not sticking to approaches that are outdated and will not deliver the much-needed level of resiliency and security required in a modern financial system. In this sense, as the financial system evolves, supervisory practices need to evolve themselves.

Merely relying on traditional approaches applicable to financial entities might not be effective.

The specific nature and position of cloud and technology providers in the ecosystem should be taken into account by financial regulators and supervisors by developing a tailored approach that it is fit for purpose. As we are treading uncharted territory, merely relying on traditional approaches applicable to financial entities might not be effective. On the other hand, a tailored approach would mean more efficiency and better risk management.

The journey towards getting cyber resilience right will require robust regulatory and supervisory harmonization as well as new supervisory approaches that are fit for the digital age. Dealing with evolving cyberthreats and delivering digital resilience requires a collective effort and broad collaboration of the industry and all relevant stakeholders. At AWS, we remain ready to play our part and be an active partner to the financial community in this regard.

BARBARA NAVARRO
Head of Research, Public Policy and Institutional Relations – Santander

Navigating the digital wave in financial services: a difficult regulatory balance

Global Financial Services Industry has been under a steady but relentless digital revolution for more than a decade already. The promise of increased efficiency and convenience along this process have been partially jeopardized by the implementation of a huge amount of regulatory packages. This hasn't been an exception in the EU. Onwards and under this new political cycle that opens now, EU Regulators should revamp competitiveness and safety as the two flipsides of a coin – a delicate act that will imply a right balance of several themes at interplay:

Users needs at the forefront of the regulation

At the heart of this challenge lie evolving user new user's expectations and consumer habits. Today's consumers demand bespoke financial experiences, seamless access, and reinforced transparency. The solution to promote may be enabling the use of Big Data and Artificial Intelligence for the manufacturing of tailored financial products and the performance of risk assessments. Open Banking initiatives, where customers control their data, can further enhance competition and client choice even provide the opportunity to monetize data under certain circumstances.

AI is a double-edged sword

New regulations must be clear to avoid hindering innovation, but also address risks as data protection and cybersecurity threats. Existing regulations already cover many areas, so new rules shouldn't overlap, creating increased complexity. This is crucial for Europe to be competitive in AI. It has the potential to revolutionize financial services, from fraud detection to personalized investment advice. The EU needs to develop Ethical Frameworks where regulations should address potential biases in AI algorithms and ensure fair treatment of clients. Clear guidelines are needed for responsible AI development and deployment, mitigating risks like algorithmic errors. Regulatory frameworks must ensure these technologies serve, not exploit, clients. All this to be done permitting that AI developers can provide a top-notch capable AI to be delivered and implemented in the Block.

The financial industry sees opportunities and challenges

Regulations are overwhelming and costly. We advocate for simpler, phased-in approaches and a playing field where all providers, including FinTechs, are subject to the same rules. Regulations should also be "future-proof" and adaptable to new technologies.

The current regulatory landscape in the EU is still fragmented. This patchwork of national rules creates uncertainty for businesses operating across borders, hampering the development of a truly pan-European digital finance market. Moreover, one could argue that existing regulations were not designed for the digital age, more on the contrary are somehow endangering its development.

The EU's approach must prioritize user needs to create a thriving digital finance ecosystem that empowers citizens and strengthens the EU's global position. This requires continuous adaptation. The focus should be on enforcing existing regulations, eliminating overlaps, and clarifying supervision. This will benefit businesses, consumers, and the overall EU economy.

New Policy Priorities: Addressing the Gaps

The EU has recognized these challenges. Recent policy priorities aim to strengthen the cybersecurity of financial institutions establishing a proper and adjusted regulatory framework. These are positive steps and are recognized internationally as the landmark of regulatory avantgarde, but a critical view is necessary. Failure to address these issues could have significant downsides. European champions might struggle to compete with global players operating under more flexible regulatory regimes. At the same time, and we have witnessed signs of this already, Europeans could enjoy less "clever" AI artifacts than other geographies citizens, something unaffordable in a globalized world. Furthermore, a lack of clear regulations compromises the development of potentially transformative technology as a lever of growth, employment and wealth.

Harnessing our tech potential requires a shift in our regulatory approach. One that places competitiveness in the center.

Conclusion: A competitive Digital Financial Market is at stake

The EU's regulatory approach for digital finance requires a delicate balance over the cycle. By prioritizing citizen's needs, embracing technological advancements while mitigating risks, and ensuring regulatory frameworks are adaptable, the EU can foster a thriving digital finance ecosystem to empower its population and strengthens its competitive position in the global financial landscape. However, achieving this balance will demand continuous vigilance and a willingness to adapt as the landscape continues to evolve.

MARC ROBERTS
General Council – Raisin GmbH

Navigating the future: a positive outlook on FinTech

In the past few years, financial companies have faced significant challenges. Geopolitical unrest has led to economic distress, high inflation, and the highest interest rates in a decade. However, as global crises continue, markets have rebounded, inflation has stabilised, and funding conditions are improving again. The decrease in interest rates indicates that the world has somewhat adapted to the circumstances, and there is now more normality in interest rates than in the last 15 years. As for FinTech companies, after experiencing rapid growth, they have adjusted their focus to achieve sustainable and profitable growth.

Despite the increasingly challenging conditions, FinTech remains one of the most prominent industries globally. Independent research indicates that revenues in the fintech industry are expected to grow nearly three times faster than those in the traditional banking sector between 2023 and 2028.

Looking ahead, the fintech industry will encounter not only challenges but also numerous opportunities. The next five years present a variety of possibilities for the fintech industry, driven by advancements in technology, evolving consumer expectations, and an increasingly digital global economy. These are poised to redefine financial services, creating new avenues for growth and innovation.

Of course, technology is necessary where it's sensible, but it needs to benefit all market participants, including banks and retail customers. Real change for many European citizens comes with access to simple, economically sensible products and the prosperity of a strong European financial system.

The last few years have shown that we are heading in the right direction. In light of harmonisation, we are looking forward to the following steps on several regulatory implementations: the retail investment strategy (RIS), harmonised rules in regards to anti-money-laundering (AML), new approaches and progress on different areas concerning the capital market union, and, as part of it, renewed progress with the ECON vote on EDIS, let us hope for completion of the banking union at last. Those are only a few examples of progress on legislation moving forward to ensure improved unification across the EU. More unification and harmonisation will benefit all market participants and the EU as a relevant global financial market itself.

However, it is not only the regulatory environment that enables positive change. Technological innovation will allow companies to leverage existing technologies, such as remote onboarding and machine learning, making customer due diligence more effective and efficient. Fintech companies can reach a larger audience with the use of mobile apps. Mobile and digital banking apps offer convenience, speed, and lower costs than traditional banking, attracting a new generation of tech-savvy consumers.

Sustainability and ethical finance are emerging trends on which fintech can capitalise on. Consumers and investors are increasingly prioritising ESG criteria in their financial decisions. Fintech firms that develop products aligned with these values, such as green investments and ethical banking options, will attract a growing market segment.

The promising future of fintech is marked by rapid innovation, increased accessibility to financial services, and enhanced user experiences, driven by advancements in technology, transforming the global financial landscape and fostering financial inclusion.

The last few years have shown that we are heading in the right direction.

Also, there are opportunities for partnerships between traditional financial institutions and FinTech that are likely to increase. These collaborations can combine the agility and innovation of fintech with the scale and experience of established banks, creating hybrid models that offer the best of both worlds. Already today, there are a bunch of successful examples to find.

In summary, the next five years will be transformative for the financial industry, characterised by technological advancements, new business models, and evolving consumer demands. Companies that can harness these opportunities will be well-positioned to thrive in this dynamic and rapidly changing industry. With prudent regulation, ambitious objectives, partnerships, and a competitive market, FinTech will continue to thrive and remain one of the fastest-growing industries.

We thank **the Hungarian EU Council Presidency** and **our partner institutions** for their support in organizing the Eurofi Budapest Forum

NAVIGATING AI AND THE CLOUD

PETRA HIELKEMA

Chairperson – European Insurance and Occupational Pensions Authority (EIOPA)

The future of cloud computing and AI in the EU insurance sector

The importance of data analytics in insurance makes cloud computing and artificial intelligence (AI) key strategic technologies for the sector. Integrated platforms from cloud computing service providers simplify and therefore accelerate the deployment of AI by insurance undertakings across the insurance value chain.

Most European insurance undertakings already use cloud computing, with the services commonly outsourced from large technology companies (commonly referred to as "BigTechs"). According to EIOPA's 2024 report on the digitalisation of the European insurance sector (hereinafter EIOPA's Report), 80% of respondents already outsource cloud computing storage services from BigTechs.

Cloud computing service providers often cross-sell different services alongside data storage or basic compute capacity. As shown in EIOPA's Report, Software as a Service (SaaS) is the most common service purchased from cloud providers by insurance undertakings. In addition to data storage services, SaaS packages typically include services such as IT security programs, marketing platforms, anti-money laundering (AML) screening tools, Customer Relationship Management (CRM) solutions and other data analytics services, including AI.

EIOPA's Report shows that 50% of the respondents already use AI in non-life insurance and 24% in life insurance. An additional 30% and 39% of respondents expect to use AI in the next three years in non-life and life insurance, respectively. Furthermore, 66% of the reported AI use cases were developed in-house by insurance undertakings themselves, while the remaining 34% were outsourced from third-party service providers.

The expectation is that the use of both cloud computing and AI will considerably increase in the years to come in view of their significant benefits, including enabling the development of more efficient and automated processes or helping insurance undertakings to generate value for their customers.

But the adoption of modern technologies also entails risks, with cyber security and data privacy issues being the most material risks perceived by insurance undertakings that participated in EIOPA's Report. The concentration of cloud computing within a reduced number of service providers can also raise relevant operational resilience issues.

The introduction of Large Language Models and Generative AI solutions, which are also typically developed by large technology firms and research institutions, introduces further complexities. These models bring new or amplified risks and opportunities and can make it more difficult for downstream users such as insurance undertakings and intermediaries to address these risks, while also requiring the up-skilling of staff and new governance approaches.

Insurers need to keep pace with these developments to remain competitive, yet the adoption of these technologies can pose organisational challenges. According to the insurers that participated in EIOPA's Report, issues related to acquiring adequate talent and skills and the transition from old legacy systems to new platforms represent the most relevant constraints.

Regulatory frameworks also play a key role in this process. They should facilitate innovative data ecosystems, for instance by enabling access to relevant datasets as it is done under the Data Act, the Data Governance Act, or the proposal for a Regulation on a Framework for Financial Data Access (FiDA). Regulatory sandboxes and other innovation facilitators, such as those promoted in the AI Act, and which already exist in the financial sector for several years in line with the principle of proportionality recognised in Solvency II, can also be seen as a positive development.

In addition, while insurance legislation such as Solvency II or the Insurance Distribution Directive already regulate operational risks as well as the use of AI by insurance undertakings, new regulations such as the Digital Operational Resilience Act (DORA) and the AI Act aim to update the legislative framework for the digital age: by ensuring robust operational resilience frameworks against cyber-attacks and promoting the responsible use of AI systems that deliver fair outcomes to consumers. For example, the AI Act recognises the shared responsibility of the different actors throughout the AI value chain (developers, deployers, importers etc.), while insurers remain ultimately responsible for the critical activities they outsource under Solvency II.

Cloud computing and AI in the European insurance sector present opportunities and challenges.

Navigating different regulations and their potential overlaps can be challenging. EIOPA is committed to supporting the consistent and proportionate implementation of existing and new provisions as the regulatory landscape evolves, including by training supervisors in modern technologies through initiatives such as the EU Digital Finance Supervisory Academy. The aim is to ensure that stakeholders harness the benefits of digitalisation while safeguarding customer protection and financial stability in the markets.

ANDREW VENNEKOTTER
Head of Security Regulatory Engagement, Europe – Amazon Web Services (AWS)

AI is already helping the financial sector create new value streams, securely

Amazon Web Services (AWS) has been working on artificial intelligence and machine learning (AI/ML) for more than 20 years, but we are now at an inflection point in technology driven by the availability through the cloud of secure, cost effective, scalable compute, and the concurrent rapid advancements in the areas of algorithms and mathematics. Consumers as well have grown more comfortable with using AI in their daily lives. As technology is advancing, we are also seeing an increasing sophistication on the part of end users, who now expect more intelligent, automated, and personalized experiences.

To understand where the industry is going with AI/ML, we need to differentiate between traditional statistics, AI/ML, and generative AI (GenAI). The financial industry has long been using traditional statistics and AI/ML to explore data, perform inference and classification tasks, find patterns, and learn from data in order to make more informed decisions. By contrast, GenAI can create new content and ideas, including conversations, stories, images, videos, and music. Like all AI, generative AI is powered by ML models—very large models that are pre-trained on vast amounts of data and commonly referred to as foundation models (FMs). Recent advancements in ML (specifically the invention of the transformer-based neural network architecture) have led to the rise of models that contain billions of parameters or variables.

The opportunities for value creation in the financial sector when using AI are wide-ranging. Currently, customers are telling us about four key benefits. First, AI helps them fight financial fraud by identifying potential threats faster and streamlining regulatory compliance processes. Second, AI helps customers generate personalized marketing content, which allows them to meet brand guidelines consistently as well as accelerate new account acquisitions. Third, customers have registered an increase in productivity as the tools support accelerated analysis and decision making. Finally, financial sector customers report an improved customer service and call center experience.

Let me illustrate with a few use cases. Mastercard uses AWS's AI/ML services to improve fraud detection capabilities globally. This has enabled Mastercard to detect three times the number of fraudulent transactions and reduce false positives tenfold, leading to billions of dollars in merchant savings and providing a better experience for customers. In the United States, one hedge fund has built an AI-powered investment analyst assistant that can generate charts, compute financial indicators, and create summaries of the results. This flexible solution enables analysts to spend more time understanding markets and economies. In early April, we announced a partnership with AXA, a global commercial insurance and reinsurance company, to co-develop the AXA Digital Commercial Platform (DCP), a risk management solution. This new solution will integrate industry, business and environmental data with geospatial analytics and GenAI technologies to help clients monitor their assets and navigate complex and interconnected risks including supply chain disruption, natural disasters and cyber threats.

Financial services organizations are also using AI to improve their own security. For example, NatWest data scientists and engineers are leveraging the latest GenAI models in a secure and scalable platform to build new services to combat the next generation of threats from financial crime.

One of our leadership principles states: "Success and Scale Bring Broad Responsibility." So as customers grow in their adoption of AI/ML and GenAI, we need to help them do so in the right way. We emphasize responsible AI dimensions like accuracy, fairness, security, and privacy in developing GenAI.

We also help customers on this journey with tools like Guardrails for Amazon Bedrock, which allow customers to block as much as 85% more harmful content, filter out over 75% hallucinated responses for retrieval augmented generation (RAG) and summarization workloads, and apply safety, privacy and truthfulness protections within a single solution. Builders can use SageMaker Clarify to bolster explainability and mitigate bias. In addition, AWS collaborates with industry and participates in AI governance initiatives for developing standards and best practices.

The financial sector is using AI to achieve intelligent, automated, and personalized experiences.

As VP for Generative AI Vasi Philomin said in July 2024, we are "committed to working with companies, governments, academia, and researchers alike to deliver groundbreaking generative AI innovation with trust at the forefront."

This is an area where regulators can play a constructive role. We encourage them to collaborate with the industry to develop and promote assurances and best practices that are consistent with existing risk-based legislation and aligned with international initiatives and standards. This would help ensure the financial services industry can innovate by leveraging AI responsibly while maintaining global competitiveness.

EMILY PRINCE

Group Head of Analytics – London Stock Exchange Group (LSEG)

'Reframing financial services' future with AI: making better and faster decision

Generative AI is creating new possibilities for the financial services industry, especially in the form of enhanced productivity and data discoverability. It brings a universe of opportunities for people to interact differently with vast amounts of data and to empower their decision-making.

While more data suggests more automation, decision-making and accountability will still lie with humans. However, the focus of human input is shifting to controlling where data comes from, how it is managed and treated, and ensuring that outputs are accurate, auditable and unbiased.

As part of this, risk and data management literacy will continue to grow as a fundamental requirement for financial services professionals across various roles. Regulations such as the GDPR, the EU AI Act, and the Digital Operational Resilience Act (DORA) are already bringing this to the forefront through new requirements and clear accountability.

Flexibility and Interoperability are Key When Innovating with AI

To gather and analyse the volumes of data now available to them, financial services organisations need a modern and resilient data architecture. Companies are strategically augmenting their existing tech stacks to create a flexible, yet unified data architecture capable of supporting AI projects at scale.

At the same time, companies integrating third-party data or technology for AI purposes face increased scrutiny from policymakers regarding supplier concentration, data privacy, or audit risks. However, with the right controls in place, flexibility, and human oversight, a safe and effective environment for AI innovation can be achieved.

At LSEG, our ability to successfully deliver critical operations and timely data, regardless of circumstances, is key to our business as a financial market infrastructure and data provider. Developing an AI framework for finance is more than just using technology. It's about building trust, ensuring robust governance, and instilling a culture of ethical AI usage.

Importance of Guardrails and a Responsible Approach

The financial services industry relies on pinpoint accuracy, and for most of the existing AI use cases, risks tend to be centred around data. Generative AI is only as good as the quality of the data it is trained on, making it particularly important to actively mitigate risks associated with AI hallucinations, data bias, and privacy.

Governance frameworks should be 'responsible by design'. This includes setting policies, standards, and procedures and integrating risk management into all stages of the AI development lifecycle. Responsibility also lies in how companies decide to embed AI within their existing processes. This means choosing the right AI tools that best solve specific tasks and deploying them in the most appropriate use cases, maximising benefits while reducing and effectively mitigating risks.

Looking Ahead on Policy

The private sector has a key role to play by clearly implementing and demonstrating a responsible usage of AI. Doing so will enable businesses to scale their governance and work closely with policymakers on developing practical AI regulations that ensure the safety and privacy of users and consumers. Many businesses are proactively seeking to integrate AI governance into their operations, but this process requires time and legal certainty when investing in resources for AI implementation.

The EU AI Act stands as an important marker in AI governance, reshaping the way companies approach AI deployment and development. As financial regulators take stock of existing use cases and examine the implications of AI in financial services, guidance is beneficial. However, such guidance should be principle-based and focused on risks rather than specific technologies or types of AI models.

Developing an AI framework for finance is more than just using technology. It's about building trust.

Finally, facilitating multistakeholder collaboration and international consensus will help to clear the path towards a global approach to responsible AI and mitigate the risk of policy fragmentation. The work of policymakers and new AI agencies such as the EU AI Office should now focus on helping firms subject to the EU AI Act to implement these requirements, including via guidance and industry engagement.

In addition, supporting international efforts will ensure the interoperability of different AI governance frameworks. As AI technology develops and other initiatives emerge, policymakers should ensure that the existing legislative framework is flexible enough to be implemented alongside other jurisdictions' frameworks and remain relevant for upcoming AI use cases.

MATTHIAS PETER

Partner, Financial Services – KPMG

AI in the financial services - Managing risk and fostering innovation

Information gathering and processing are fundamental to financial services. This is evident from historical innovations: Lloyd's of London, initially a coffee house in the 17th and 18th centuries, served as an information exchange for sailors and ship owners. Moreover, the 'ticker' from the ticker tape machine, a late 19th-century innovation, enabled real-time stock price updates. The internet and cloud computing, recent innovations, have enabled fast banking apps that are transforming customer interactions with banks globally.

Banks have long worked on automated information processing, as shown by the prevalence of legacy IT systems built inhouse. These systems predate current AI methods, which are now crucial for banks in knowledge derivation, decision support, and automation to reduce costs, to optimize processes, or to even improve customer experience. Like this, AI addresses broader industry challenges like skilled worker shortages and cost pressure from intense competition in banking markets.

The initial introduction of AI, particularly machine learning, saw a muted response in risk management due to existing robust frameworks. Established regression models like probit and logit for credit default predictions meant that many in industry and regulation, saw no need for significant changes in model risk management, affirming that existing regulations sufficiently cover AI models.

The release of ChatGPT in late 2022 marked a shift. Unlike traditional machine learning, GenAI applications like ChatGPT allow user interaction without coding knowledge, producing outputs like text, images, and videos in user-friendly formats. This easy accessibility offers both opportunities and risks.

GenAI models pose specific challenges.

The EU AI Act is the first comprehensive legislation in the EU to address AI-related challenges through a risk-based approach. It categorizes applications into banned, low-risk, and high-risk categories, with stringent requirements for high-risk scenarios on transparency and fairness.

The EU AI Act identifies credit scoring and life and health insurance pricing as high-risk. Due to its broad AI definition, the act affects existing models. At the same time, the Act's risk-based approach struggles with GenAI's versatility, as one model can serve numerous use cases, imposing extensive requirements, especially on third-party providers. Outputs from GenAI models must be meticulously scrutinized to manage risks effectively.

AI Risk Management is key to leverage the benefits of the new technologies.

GenAI presents unique challenges in bias identification and mitigation, as direct data access is often unavailable. Evaluation methods for these models include:

- Automated Evaluation: Uses statistical models to assess and compare responses.
- Model-Based Evaluation: Another trained model evaluates the model.
- Human Evaluation: A human assesses and validates GenAI outputs.

Additional challenges and regulatory intricacies include but are not limited to data protection and the necessity for cloud-based data hosting of GenAI solutions.

AI Model Risk Management is key to leverage the benefits of new technologies.

Initially, the financial services industry increased awareness of GenAI risks by blocking direct access to OpenAI's ChatGPT and advising against using GenAI chatbots with bank data on personal devices. This was a reactive measure. Now, the industry is proactively identifying GenAI use cases, defining AI governance and strategies, and providing employees with secure GenAI solutions and training to enhance their output.

In the long run, banks need to evolve their model risk management frameworks to include AI models. Traditional ML methods like supervised learning can be integrated into existing frameworks with relative ease. Integrating GenAI models is harder. For instance, a sharpened focus on model use is required, considering the broad capabilities of GenAI and the use-case-based nature of AI regulation. Also, adhering to industry and regulatory standards (e.g., NIST standards) ensures the necessity that validation processes go beyond statistical accuracy.

Traditional ML methods typically run on-premise, giving banks full control over data and models. In contrast, banks lack the data to train their own GenAI. To leverage managed open-source and proprietary models hosted by external providers a cloud application strategy for GenAI is required.

Banks' Model Risk Management frameworks are a good base for managing AI model risk.

GenAI represents a significant innovation in financial markets. To replicate the success of past innovations, the industry must grasp GenAI's benefits and manage its risks effectively.

Fortunately, there is no need to reinvent the wheel. Existing bank model risk management frameworks provide a strong base. It is crucial to enhance these frameworks to fully leverage GenAI while controlling its risks. Augmenting these frameworks by accounting for AI regulatory guidelines and implementing industry standards will be the next steps to be taken.

UNLEASHING DATA-DRIVEN INNOVATION

GIUSEPPE SIANI
Director General for Financial Supervision and Regulation – Banca d'Italia

The role of data in the financial sector: a supervisory perspective

The EU AI Act represents a landmark regulatory attempt to ensure that AI technologies are deployed safely, transparently, and in alignment with European values. By categorizing AI applications based on their risk levels and imposing corresponding regulatory requirements, the AI Act seeks to mitigate potential harms while fostering innovation. In the financial sector, this is crucial as we increasingly rely on AI for tasks ranging from fraud detection to algorithmic trading.

Moreover, the EU's data frameworks, such as the General Data Protection Regulation (GDPR) and the Data Governance Act (DGA), have set high standards for data protection and established mechanisms for data sharing and governance. These regulations are designed to ensure that data flows within the EU are secure, ethical, and beneficial to all stakeholders. Last but not least, the proposal on a framework for Financial Data Access (FiDA) aims to further streamline data access and reuse, enhancing the sector's operational efficiency and innovative capacity.

Looking ahead, the next European policy cycle should prioritize several key areas to facilitate the effective use of data. For example, the swift finalization of FiDA, followed by a clear and practical implementation roadmap, should represent one of the top priority in this regard, provided, however, that adequate collaboration with industry stakeholders is ensured to keep the framework both ambitious and feasible.

Against this backdrop, I would highlight three main areas of commitment, both for authorities and business entities.

The EU should promote the overarching policy objectives of data quality, governance and fairness. In particular, the EU should promote proper initiatives that promote common standards and best practices for data collection, processing, and sharing. This can be achieved through consistent incentive structures such as public-private partnerships that encourage financial institutions to share data safely and responsibly. Policies should also be designed to prevent data monopolies and ensure level playing field for all players, which will facilitate interoperability and trust among stakeholders. To unlock the full potential of data thus limiting possible negative impacts for the public and the financial stability, we need to strengthen the necessary risk culture underpinning proper data governance.

Strong data governance drives effective risk management and decision-making. Given the increasing operational complexity, the ability to effectively analyse both structured and unstructured data from various sources, aggregate it, and ensure its integrity is key to ensure business model sustainability: Comprehensive and accurate information allows business entities to make informed decisions regarding risk management. This should be complemented by proper data governance arrangements that would ensure the relevant risk data aggregation capabilities, which has been one of the main focus of prudential supervision over the past years.

Moreover, artificial intelligence significantly enhances business opportunities by improving data analysis. However, continuous oversight is key to ensure proper allocation of roles and responsibilities together with the necessary check-and-balances mechanisms. Last, but not least, the "human-in-the-loop" concept ensures human judgment and oversight remain fully embedded in AI-driven processes, thus preserving overall accountability and full compliance with ethical standards.

Strengthening ICT risk management through strategic controls and digital resilience is essential to address new challenges. Informed business decisions related to digital transformation must also include proper consideration to firm-wide management of ICT/cyber risk, given also its increasing cross-cutting nature across the financial system and beyond.

Supervisors are fully aware of the significant effort required to intermediaries to the relevant regulation on operational resilience. However, we also acknowledge the need to preserve the wealth of good market practices developed through existing regulations and supervisory actions related to operational continuity.

Strong data governance drives effective risk management and informed business decisions.

Technological innovation impacts supervision too. SupTech tools facilitate massive data analyses beyond traditional reporting. For example, we currently consider together with the ECB potential operational synergies associated with their relevant use for on-site reports, shareholders' structures, extensive information related to the professional qualifications and integrity of individuals. We share similar challenges: the need to avoid unconscious biases and keep human judgement as well as significant implementation costs.

The journey ahead requires collective efforts to implement these frameworks properly, enhance data quality, promote data sharing, and ensure ethical and secure data practices. By prioritizing these areas, we can unlock the full potential of data-driven innovation.

NIKHIL RATHI
Chief Executive Officer – Financial Conduct Authority (FCA)

Data, AI, Open Finance – The foundations for a revolution

Technology is playing an increasingly central role in financial services. Recent advances in Artificial Intelligence (AI) and growth in open finance technology have the potential to revolutionise the financial services industry. As a regulator with innovation at the heart of its work, our approach seeks to create an environment that facilitates safe and beneficial adoption of new technologies.

Our existing technology-agnostic, principles and outcomes-based approach to regulation places clear responsibilities on deployers of AI systems to act with accountability and in the interest of consumers. This provides a strong and proportionate baseline to effectively supervise firms while giving them the flexibility to innovate.

Given the transformational, cross-sector nature of AI, the FCA cannot – and is not – tackling this topic alone. We are collaborating closely with a wide range of international partners and are following important international developments like the EU's AI Act with interest. We will also be engaging with the UK Government as it develops its proposals for binding regulation for developers of the most powerful AI models.

The FCA has experience of supporting innovators through our regulatory and digital sandboxes. Since the launch of our Regulatory Sandbox and Innovation Pathways services in 2014, we have received over 370 applications. By creating an environment where new technological propositions can be tested safely and responsibly, including providing access to high-quality synthetic data (artificially generated data designed to mimic real-world data), we can empower firms to foster technology exploration. We are also launching an AI-specific sandbox which will further enhance the data available for users and regulators.

Through our AI TechSprints, we have been exploring solutions to address industry challenges. Most recently, we explored AI-powered solutions to help detect evolving forms of market abuse, and in particular more complex types of market abuse that are currently difficult to detect, such as cross-market manipulation.

In addition to supporting firms, such initiatives also help regulators decide how they might consider deploying AI to assist in their own responsibilities. AI is not just changing markets, but also the way we regulate.

Access to quality data is a pre-requisite for development of both AI and open finance. Synthetic data is an area of particular focus. Our Synthetic Data Expert Group aims to provide unique insights into use cases, opportunities and challenges this technology poses. It also assesses the ability of AI to generate synthetic data. It can enable responsible innovation, including solutions to issues affecting regulators such as financial crime and fraud.

The parallel development and support for open finance and a smart data economy will increase the possible data sets that firms can use. This will help create new or improve existing services. We welcome the announcement of the UK's Digital Information and Smart Data Bill and support a regulatory framework for smart data to be in place as soon as possible. This Bill should facilitate the scalable and sustainable growth and development of open banking. Developing open banking will set the foundations for the growth of open finance.

We encourage and support innovation by firms, for example, through new products in open banking payments and the development of APIs to share open banking data. The right regulatory environment will enable us to explore appropriate regulations to promote open finance as both legislation and use cases progress. We are encouraging stakeholders to experiment and test use cases within open finance.

Regulators have a unique position when it comes to not only utilising data, but also ensuring that firms can access the data they need to innovate. One area of consideration is the competition implications of Big Tech and accompanying data asymmetries, explored in our feedback statement published in April. Data asymmetries in financial services could reduce competition, reduce innovation, and lead to worse outcomes for consumers. For this reason, we will continue to monitor Big Tech's activities in financial services and take proactive steps towards developing a regulatory approach.

Access to quality data is a pre-requisite for development of both AI and open finance.

The intersection of AI, Big Tech, and open finance while representing a new frontier should not represent an unwieldy challenge for regulators. By encouraging innovation and promoting safe competition, the FCA aims to foster an effective and proportionate regulatory regime in the interests of consumers and market integrity.

PETRA HIELKEMA

Chairperson – European Insurance and Occupational Pensions Authority (EIOPA)

The EU's data and AI landscape for insurance: a work in progress

The insurance sector is approaching a data-driven evolution. Artificial Intelligence (AI) and advanced analytics have the potential to reshape business models, enhance customer experiences, and optimise risk management. From its inception, the industry has relied on record-keeping and statistical analysis to assess risk, price policies, and manage claims. The advent of digitalisation has exponentially expanded the volume, variety, and speed at which data is available. Solvency II has already established a framework to supervise data use and IT risk management by insurers. The recent AI Act reinforces this existing practice, adding further requirements for high-risk AI applications.

EU regulations such as the GDPR and the Data Governance Act establish a foundational framework for data sharing, while FiDA specifically targets the financial sector, aiming to ease consumer access to and control over their data. The proposal aims to put consumers in the driver's seat over what financial data to share, with whom, and for what purpose.

While the concept of data sharing is not new, FiDA is proposing to formalise and streamline this process. By establishing standardised protocols, FiDA could enable granular control and easy retrieval of consent by consumers of their data. This freedom to transfer data between different platforms and services will potentially break down data silos and empower consumers. Meanwhile, leveraging richer datasets, insurers could develop more accurate risk assessments, which could lead to more tailored products and competitive pricing. Furthermore, the sector could gain deeper insights into consumer behaviour, preferences, and financial health through data-driven insights, thereby enhancing consumer experiences and streamlining operations.

However, across the board challenges and risks remain. Data security and quality are paramount, as the aggregation of vast amounts of financial data could lead to breaches that undermine consumer trust. There is also a risk that products and services resulting from data shared and reused by third parties, such as insurance dashboards, may be incomplete and provide consumers with misleading information.

Consumers are increasingly conscious of their data. Thus, safeguarding sensitive information, while demonstrating transparency and accountability, will be vital. Not all data that insurers have can be disclosed and EIOPA is ready to help identify the insurance data that can be shared securely. This clarity will ensure that FiDA fosters innovation without compromising consumer trust.

Cyber risk is another critical issue, given the increased potential for attacks targeting sensitive financial information. Additionally, there is a risk of financial and digital exclusion, particularly for individuals without access to the necessary digital infrastructure or skills to participate fully. The increased data access granted to BigTechs under the proposal might stifle competition and raise privacy concerns, as these entities could potentially exploit their market dominance.

Finally, while the availability of more data allows for more precise risk assessments and individual pricing, it could contradict the principle of mutualisation, which is based on the pooling of risks. Mutualisation plays an important role in bolstering societal resilience as it spreads the risk of potential losses across a large group, making insurance more accessible and affordable, especially for those with higher risks or limited means. Mutualisation stabilises the insurance market while protecting individuals from the full impact of insured events. The more that data is used to differentiate, the less the risk is shared, and this could result in discriminatory pricing practices, disproportionately affecting vulnerable consumers. And although these challenges are not unique to FiDA, they could be accelerated if they are not tackled effectively.

It is important to embed the right consumer protection measures and supervision. While immediate priorities should be on the implementation of the AI Act and finalising FiDA, further consideration should be given to robust consumer protection measures and supervision to safeguard consumers' best interests. To address potential risks, supervisory efforts could prioritise digital ethics and the prevention of dark patterns and biases.

Advantages for consumers extend to placing data control and ownership firmly in their hands.

Therefore, while collectively the EU's data and AI landscape provides a solid foundation for enabling data use and sharing in the insurance sector, the success of these initiatives will depend on their effective implementation and the prioritisation of key areas. Further considerations, including consumer protection, privacy, and security, will be essential to ensure that the operational conditions for data-driven innovation are in place. By addressing these priorities, the European insurance sector can harness the full potential of open finance and AI, driving innovation and delivering better outcomes for consumers and businesses alike.

ALEX IVANČO

Financial Counsellor, Head of Financial and Cohesion Policy Unit – Permanent Representation of the Czech Republic to the EU

International standard setting is the norm for global industries

You might have experienced trying to explain to your parents or relatives how a smartphone works, what are the benefits over a classic one. With kids, it might be the exact opposite, you just try to limit their time and access, hoping that they don't override your password. Sometimes it feels the same trying to establish future-proof rules for digital finance without the benefit of the crystal ball, hoping that common sense, decency would be enough.

Financial sector is regulated, for reasons that vary from protecting stability of the system to the protection of its weakest part. Some would argue that with bank secrecy laws in place there is no need for GDPR or any other extra protection of your personal data in your banking account. Or that with licensing and supervision paramount in the financial sector you don't expect practices that constitute a breach of the fundamental rights to be tolerated. So why do we need to introduce new rules or technology specific ones?

Most of the non-regulated economy sectors witnessed changes, that are yet to be seen fully in their pace and impact in the financial sector. Part of the reasons for the delay might be that the old rules are prohibitive, unfit for digital era. That the system is calibrated to always warrant compliance first rather than account for the benefits of the new technology. While others might argue that the existing rules protect incumbents from the competition rather than clients from malevolent actors. Either way it seems that the regulator indeed has to revisit the rules.

Globally, jurisdictions approach open finance framework differently: putting digital ID in the center as in the case of Australia, mandating financial institutions to start exchanging data in a fixed time period as in Brazil or inviting the financial sector to come up with a data exchange standard as in Switzerland. One would expect international coordination in the private sector to be taking place for a long time, as these initiatives are nothing new or unexpected, and international standard setting is otherwise the norm for globally interacting industries.

One would expect international coordination in the private sector to be taking place for a long time, as these initiatives are nothing new or unexpected, and international standard setting is otherwise the norm for globally interacting industries.

Taking the example of trade or trade finance, such a coordination is taking place there for a long time. Industry-led ICC proposals are submitted to the UN bodies. UNCITRAL Model Law on Electronic Transferable Records (MLETR) that introduced a global legal framework for DLT based digital assets in 2017 was recently adopted by the UK and France. Similar development can be expected in technical standards. What ISO TC are you part of? And your competitors? EU Data Act might be the basis for sectoral frameworks such as FIDA, so why not expect the data standards from other industries to do the same, especially in the case of nonappearance of significant industry proprietary activity. ESAs might be good partners, but it is the industry that should lead the way.

It is good to remember the ambitions of the EU strategy for digital finance, that is to bring to the consumers, SMEs and CMU the benefits of the digitalization. New geopolitical risks require new approaches for the protection of data and its processing, but the new rules should not block neither delay access to the benefits of the new technologies.

We need to focus on digital literacy and financial literacy. This is not completely new. While customers have the right to switch to a different TelCo operator with their existing telephone number, they might face difficulties when trying to share their data or roaming consumption information with a competitor for the purpose of a better offer. Technical solutions should allow clients full control over their data, ensuring privacy and security, in order to build trust first. Only then there can be a free decision of these customers to engage, share data fully or partially, with the view to benefit from their processing.

PATRICE AMANN

EMEA Regional Business Lead - Worldwide Financial Services – Microsoft

Unlocking innovation in financial services: leveraging Data and AI for superior customer value and operational efficiency

The financial sector stands to benefit immensely from the effective use and sharing of data, unlocking numerous opportunities for innovation, efficiency, and improved client services. Access to comprehensive and high-quality data empowers financial institutions (Fis) to make more informed decisions by extracting patterns and insights. This capability enhances business strategies, optimizes client offerings, and improves risk management. Data-driven automation significantly streamlines financial processes, reducing operational costs and minimising errors. For example, robotic process automation (RPA) can handle repetitive tasks like transaction processing and compliance reporting, allowing human resources to focus on strategic activities. Additionally, a consolidated view of client assets enables institutions to offer highly personalised services, tailoring recommendations, investment strategies, and risk management plans to individual profiles. Data analytics also plays a crucial role in identifying potential risks early and managing them proactively, enhancing the overall stability and resilience of financial institutions.

AI is a powerful tool that can enhance data utilisation in the financial sector, contributing to improved decision-making, efficiency, and client services. AI algorithms excel in predictive analytics, forecasting market trends, customer behaviour, and investment opportunities by analysing vast amounts of historical data. Machine learning models can help to identify potential credit defaults, and detect investment risks, enabling data-driven decisions. AI-powered natural language processing (NLP) can process and analyze unstructured data from various sources like news articles and social media, helping institutions stay informed and adjust strategies accordingly. RPA leverages AI to automate repetitive and mundane tasks, freeing up human resources for more complex roles. AI algorithms can also detect anomalies and patterns indicative of fraudulent activities, providing robust protection for clients and institutions by analysing transaction data in real-time to identify suspicious behaviour.

The European Union (EU) has implemented several frameworks to promote the effective use of data in finance, including the EU AI Act and various data governance initiatives. These frameworks aim to balance innovation with regulatory oversight, ensuring the responsible use of data and AI in the financial sector. The EU Financial Data Access (FIDA) framework, proposed by the European Commission, grants consumers and small and medium-sized enterprises (SMEs) the right to authorize third parties to access their financial data. This initiative expands open finance beyond payment account data, fostering innovation by enabling third-party service providers to offer new and enhanced financial services while ensuring consumer protection and data privacy. The EU AI Act provides guidelines for the development and deployment of AI technologies, emphasizing transparency, accountability, and risk assessment. While encouraging innovation, the Act sets clear boundaries to ensure AI is used ethically and responsibly. Financial institutions can leverage AI within these guidelines to enhance their operations, provided they adhere to principles of transparency and accountability.

The EU Data Act and other frameworks facilitate data sharing and re-use across sectors, aiming to create a single market for data. These initiatives ensure data availability and accessibility while maintaining high standards of data protection. However, challenges remain, such as establishing effective Financial Data Sharing Schemes and ensuring consistent implementation of these frameworks across member states. To fully realize the potential of data-driven innovation in the financial sector, additional measures are needed to address challenges related to data access, quality, and standardization, and to foster a collaborative environment for data sharing. Ensuring data accuracy, completeness, and consistency is crucial for reliable data analytics, and institutions should invest in robust data quality management practices. Common data standards are essential for interoperability and seamless data exchange between systems and institutions. Harmonising data formats, definitions, and taxonomies can facilitate efficient data sharing and integration, requiring collaboration between regulatory bodies, industry associations, and financial institutions. Encouraging data sharing through incentives can promote innovation and collaboration within the financial sector. Regulatory support and industry collaboration are vital to creating a conducive environment for data sharing, and incentives could include tax benefits, funding for joint research initiatives, or recognition programs for institutions that actively participate in data-sharing efforts.

Effective data use and AI drive innovation, efficiency, and personalized services.

In conclusion, the effective use and sharing of data in the financial sector presents significant opportunities for improved decision-making, operational efficiency, personalised services, and enhanced risk management. AI technologies amplify these benefits through predictive analytics, NLP, RPA, and fraud detection capabilities. The EU AI Act and data governance frameworks provide a foundational basis for data-driven innovation, promoting responsible and ethical use of data and AI. However, additional measures, such as ensuring data quality, standardisation, and fostering collaboration through incentives, are necessary to fully leverage the potential of data in finance. By addressing these challenges, the financial sector can unlock the full value of data, driving innovation and delivering superior services to clients.

ÁLVARO MARTÍN ENRÍQUEZ
Head of Data (CDAO) – BBVA Spain

AI and Data Sharing for a competitive european financial sector

Information has always been at the core of the banking business. Yet, digitization has enormously increased the availability and value of data, thanks to advances in cloud computing and AI. Consequently, data from existing or prospective customers has become an increasingly valuable asset for nearly any business. It can be leveraged for customer acquisition, cross-selling, personalization, or advice, both within the sector where the data was generated and across different sectors. For example, data from e-commerce marketplaces can be used to provide credit or insurance products to either side of the marketplace.

Against this background, facilitating the sharing of customer data (with the users' consent) through data sharing regulations can promote innovation and competition. However, it can also introduce competitive advantages or disadvantages between players if the regulations impose asymmetric obligations. This is often the case with sectoral regulations such as PSD2 or FIDA, which impose data sharing obligations only on players from one sector but allow third-parties to access such data without bearing similar obligations for their own (non-financial) customer data.

This is why we have long been calling for a horizontal, cross-sectoral approach to data sharing. Yet, the EU has so far only taken some steps in that direction, introducing data sharing obligations for just a few more sectors (large digital platforms, IoT products, electricity meters) and setting very general conditions for data sharing in the horizontal Data Act. As the new regulation on "open finance" (FIDA) is now being negotiated by the co-legislators, and the forthcoming EU Commission will define new political priorities in the coming months, it is crucial to stress the importance of avoiding asymmetries in sectoral regulations and moving towards a more horizontal, cross-sectoral approach to data sharing. Introducing reciprocity requirements in FIDA —requiring third-parties from other sectors to also make their own customer data available if they want to access data under FIDA— would be a step in the right direction, if coupled with a market-driven, step-by-step approach to the implementation of data sharing.

Facilitating data sharing in a consistent and horizontal manner is all the more important amidst the exponential growth in AI, including Generative AI, which is further increasing the potential to extract value from data. Otherwise, the already existent competitive asymmetries due to sector-specific data sharing regulations would be exacerbated. On the other hand, to harness the potential of AI, which is essential for the competitiveness of the EU financial sector, we need a regulatory and supervisory environment that supports the development and adoption of this technology.

Amidst AI surge, consistent data sharing is crucial for EU financial sector competitiveness.

The recently adopted AI Act is very relevant for the financial sector, as some specific use cases, such as the credit scoring of natural persons, are designated as high-risk. The AI Act also regulates providers of General Purpose AI models, which many financial institutions will increasingly rely on for the adoption of this technology. Since the AI Act is the first of its kind internationally, its implementation should be flexible enough to deal with unexpected issues in a way that does not harm the adoption of AI in Europe. Additionally, as the financial sector is already highly regulated, it is essential that the AI Act is implemented in a way that is consistent with the overall financial regulation and supervision. To that end, financial authorities should have a leading role in the interpretation and supervision of the AI Act regarding financial activities, avoiding overlaps or inconsistencies coming from multiple authorities.

For its part, the AI Office should focus on promoting experimentation with AI through sandboxes and testing in real-world conditions, ensuring that providers of General Purpose AI systems collaborate with financial entities willing to adopt their technology, including potentially for high-risk use cases. Additionally, new competition challenges related to AI providers should be monitored, particularly as generative AI becomes more prevalent and a few large players dominate this space. Adjustments to regulations like the Digital Markets Act (DMA) may be needed in the future to address the emergence of gatekeepers in generative AI applications. Although the DMA currently does not explicitly cover standalone generative AI services, it does regulate how AI systems are integrated into core platform services. Nevertheless, it should be explored whether it may be necessary to extend the scope of the DMA in the future.

JACQUES BEYSSADE

Secretary General – Groupe BPCE

The EU AI and data framework should not put our competitiveness at risk

According to the European Commission, Artificial Intelligence (AI) is one of the most important applications of the data economy, with data serving as the fuel for training and improving AI algorithms. Both AI and data are priorities of the *digital Finance strategy*, with the ambition to play a leading role globally in data driven innovation. The choice to establish a strong regulatory framework around AI and Data is underpinned by political and economic objectives, resulting in a double bet: First, giving confidence to users to embrace AI-based solutions so that businesses are allowed to develop them, by defining the world's first comprehensive AI law based on EU values and fundamental rights. Secondly, creating a solid data-driven economy, by being the first jurisdiction in the world to impose access and sharing of a wide scope of financial data within the financial sector.

We fully share the view expressed by the Belgian Presidency of the Council in its *conclusions on the Future of EU Digital Policy*, that it is imperative to prioritise the effective and efficient implementation of the numerous EU legislative acts adopted in recent years to strengthen the Digital Single Market.

One crucial aspect of implementing the AI Act revolves around standardisation efforts led by the European Committee for Standardisation (CEN) and the European Committee for Electrotechnical Standardisation (CENELEC). These bodies are tasked with delivering European standards by April 2025, including standards on risk management systems for AI systems. For entities like banks, this will necessitate an articulation with current procedures and practices, requiring additional effort to ensure compliance with the new regulations. Equally imperative is ensuring that standards and guidance account for the financial sector's specificities and requirements, aligning with existing, robust risk management and supervisory processes for a seamless integration with established practices. Ensuring that horizontal workstreams arising from the AI Act are functional for the banking sector is vital.

The ESAs' role in monitoring financial innovation may also lead them to issue guidelines. This additional layer of soft regulation will complicate an already complex ecosystem. Therefore, effective coordination among DG CONNECT, DG FISMA, and the ESAs is crucial to avoid overlapping guidelines with different approaches and concepts. Such overlaps could increase administrative burden, reducing resources for businesses, and hinder innovation.

Banks and other Financial actors are fully aware that Open Finance and AI hold significant potential for innovation: in an increasingly competitive and evolving market, the financial sector is developing voluntary ecosystems with diverse stakeholders to create value through new models of collaboration and innovation.

The Financial Data Access framework (FIDA), currently under discussion, should reach its initial goal of supporting the emergence of strong European market players without unbalancing existing data-sharing ecosystems. It also crucial to not facilitate unfair competition from non-EU data-advanced players. In the same conclusions cited above, the Belgian Presidency underlined the need to thoroughly assess the impact of any new legislative initiative to prevent the risk of hampering an agile and innovation-friendly European Digital Single Market.

With these risks in mind, we are concerned about the deep weaknesses of FIDA's impact assessment, in which the Commission acknowledged that "*it is difficult to make quantitative predictions about its benefits at the whole economy level*". Imposing a regulation of such a wide span without having the necessary proper assessment of its impacts does not provide all the guarantees needed by the market, customers and citizens. We therefore welcome the Council's cautious approach reaffirmed in its June progress report. It should be noted that some concepts are inconsistent from one piece of legislation to the other.

Regarding the global competitive landscape and the already strong position of non-EU players on data and AI, Europe cannot afford to miss its double bet.

Priorising the implementation of the numerous EU legislative acts is key.

We are concerned by the recent findings of the European Court of Auditors that EU AI investment is not keeping pace with global leaders. Additionally, with FIDA, as proposed by the European Commission, Europe would be the only jurisdiction in the world to foresee the big bang opening of such a wide perimeter of financial data at once. This represents a major risk both for economic players and for customers.

As AI and data continue to reshape industries worldwide, the EU must ensure that its regulatory framework does not unexpectedly disrupt natural market balances and put EU competitiveness at risk.

The targeted consultation on artificial intelligence in the financial sector should help the Commission to prepare adequate guidelines in close coordination with EU players.

Jacques de Larosière's latest book

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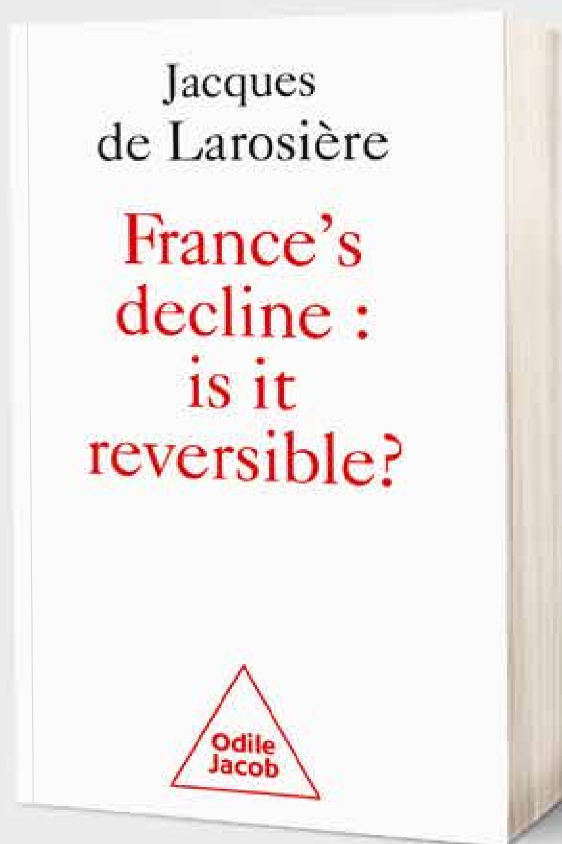

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CYBERSECURITY AND DIGITAL OPERATIONAL RESILIENCE

GERRY CROSS
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DORA – The final countdown to implementation

The details of the DORA framework – the so-called "Level 2" regulation – are currently being finalised ready for implementation on January 17 2025. The European Supervisory Authorities, together with more than 50 competent authorities and others, completed this work taking into account the close to 900 comments received during public consultations.

A key theme from the received comments is the need for proportionality given the wide range of firms, across all financial sectors that are subject to DORA and the consequential need for the DORA framework to be fit for application to firms of all types, sizes, shapes, and levels of complexity.

Proportionality therefore has been a guiding principle of the work to develop the DORA framework and has been built into the foundational architecture of DORA as key concepts. For example a strong emphasis on proportionality can be seen in DORA's ICT risk management framework that should be consistent with the size and nature of a firms' activities and which is further supported in the RTS on ICT Risk Management, where Article 1 requires financial entities and their supervisors to take into account elements of increased or reduced complexity and risk.

Furthermore, DORA frequently uses concepts such as "criticality", "major", and "systemic" throughout the framework when setting requirements and contains specific proportionate requirements such as the simplified risk management framework for non-complex firms. Similar examples of strong proportionality can be seen in DORA's RTS on incident reporting, where values have been set purposely high to reduce the burden on smaller entities and in DORA RTS on TLPT where selection criteria have been tested to ensure only the biggest and most appropriate financial entities will become subject to TLPT requirements. As regards the monitoring of outsourced activities, while financial firms remain responsible for their activities, regardless of whether or not they have been outsourced, the level 2 regulations should embed a fully proportionate approach.

The practical implementation of the DORA requirements is of course centre stage, both from financial entities' perspectives but also from that of competent authorities. Financial firms should by now be advancing well in their implementation work, including completing gap analyses between their existing controls, policies and procedures and the requirements of DORA, towards a timely and high quality implementation of those requirements.

Financial firms should by now be advancing well in their implementation work.

With regard to critical third-party providers of ICT services to financial entities, the new oversight regime reflects the important role that these technology firms have in the functioning of the financial system. At the same time it recognises that these technology firms are not providers of financial services but rather the providers of outsourced activities.

Over recent months, the ESAs and national competent authorities have established a High-Level Group on Oversight that is helping oversee the establishment of the operational aspects of the new oversight regime. One key aspect will be the designation of those third party ICT service providers which should be considered critical in accordance with the delegated published in the Official Journal of the Commission end of May. The designation of these "CTPPs" is dependent on the collection and analysis of the registers of information on ICT outsourced services based on the ITS on the Register of Information. Work is ongoing to have the new registers of outsourcing arrangements up and running in good time and the ESAs and competent authorities have been collaborating in a dry run exercise to assist financial entities to become familiar with the operation of the new templates.

FRANÇOIS-LOUIS MICHAUD

Executive Director – European Banking Authority (EBA)

EBA-EIOPA-ESMA joint preparations for the fast-approaching application of DORA

Policy

The Digital Operational Resilience Act (DORA) was adopted to enhance the digital operational resilience of the EU financial sector. It addresses the key vulnerabilities, like cyber risk, and dependencies of the financial sector towards technology, with a view to fostering a smooth, continuous, and safe provision of financial services to customers.

As requested by DORA, the EBA, EIOPA and ESMA (the ESAs) published in 2024 a series of standards and guidelines in the areas of ICT risk management, ICT incident classification and reporting, testing of ICT systems, management of ICT third party risks and oversight. A guiding principle was to devise requirements which are proportionate, pragmatic, harmonised for all entities across the financial sector, while also consistent with existing legal acts.

With the legal framework now almost completed, financial entities can accelerate their preparations for DORA's application in January 2025. Adjustments are in particular expected in the areas of ICT risk management, incident reporting processes, and contractual arrangements with third party providers, including the related registers of information.

One of the priorities the EBA just set for EU banking supervisors in 2025 (as part of its European Supervisory Examination Programme) relates precisely to checking on the adequacy of institutions' risk management frameworks, of their classification and timely reporting of major incidents, threat-lead penetration testing and reporting of the registers of information.

To help financial entities prepare to submit their DORA registers of information in 2025, the ESAs are also carrying out a voluntary "dry-run" exercise. More than 1 000 firms plan to participate. They would thus receive specific feedback in the autumn, in addition to the wider take-aways which will be shared with the entire industry.

Oversight

To address third-party and concentration risk, DORA entrusts the EBA, EIOPA and ESMA with the responsibility of ensuring an oversight of Critical Third-Party Providers (CTPPs) providing ICT services to EU financial entities. Four aspects deserve particular attention.

Firstly, the oversight of CTPPs will rely on an intrinsic cooperation between the the ESAs and competent authorities. In particular, Joint Examination Teams will be assembled bringing skills, experience, and competences on ICT risk supervision and operational resilience from the ESAs and other sectoral supervisory authorities. These authorities will also take part in an Oversight Forum, which is tasked to promote a consistent approach in monitoring ICT risks, to coordinate measures to increase digital operational resilience and to play a role in the designation of CTPPs. In addition, national supervisors and the ESAs will coordinate their actions and share information to ensure effective management of risks posed by CTPPs to financial entities. The ESAs will be able to issue recommendations to address issues at CTPPs, which national authorities can follow-up through supervisory actions to their financial entities. On the other hand, the supervisory findings related to the services of CTPPs will also feed into the ongoing oversight activities.

Secondly, to ensure an efficient oversight maximising limited resources and building an oversight culture, the ESAs have decided to create a truly joint function, pooling the oversight resources envisaged for them by DORA, to carry out the day-to-day oversight tasks. This "joint oversight venture" will maximise synergies and ensure a fully consistent cross-sector approach when overseeing CTPPs. This joint function will be headed by a director placed under the direct responsibility of senior managers from the three ESAs gathered in a Joint Oversight Network.

Thirdly, the ESAs, working closely with a dedicated high-level group on DORA oversight, are currently developing the methodologies, arrangements and processes for the DORA oversight. This includes risk assessment methodologies, processes for onsite and off-site activities, but also processes for issuing recommendations. potential penalties, and for collecting oversight fees.

> **EBA, EIOPA and ESMA make good progress on their joint setting-up of the DORA oversight framework.**

Finally, a lot of attention is currently paid on preparing for the CTPP identification and designation in 2025. Here, financial entities' registers of information about their contractual arrangements with third-party provides will play a key role. Data will need to be available timely in a good quality, so that it can be provided by financial entities to their direct supervisors and then to the ESAs' joint oversight function so that they could designate CTPPs in 2025 on the basis of the criticality criteria set out in DORA and the related Delegated Regulation.

All in all, preparation for DORA are progressing well. DORA is a game changer which will benefit both ICT users and providers and should result in a safer environment for all. The global ICT disruption experienced at the end of July was yet another reminder of the criticality of the ICT chain in our economies.

FRANCESCO MAZZAFERRO

Director General of Secretariat – European Systemic Risk Board (ESRB)

Systemic cyber risk is a continuously moving target

The ESRB has been working on the systemic nature of cyber risk and its threat to financial stability for a significant portion of its existence. Growing digitalisation, the financial sector's heavy reliance on ICT (information and communication technology) services and cyberattacks on financial entities have sparked concerns over its potentially systemic nature. Cyber risk has also continuously been cited as top priority by financial entities, regulators and supervisors alike.

Systemic cyber risk is a cross cutting risk that transcends sectors and therefore often requires staff from vastly different backgrounds to work together and assess its potential impact. When a threat crystalises, it is called an event and if the event is severe enough to cause negative effects, it is called an incident. It is therefore critical to assess if an incident is an isolated event or may escalate from an operational level to the financial and confidence realms. For the latter to happen, either critical functions that underlie the real economy must be incapacitated or financial losses need to reach levels that the ensuing shock cannot be absorbed by the system. For this purpose, the ESRB developed conceptual frameworks to assess at which points or thresholds cyber incidents can become systemic and pose risk to financial stability. We call them Systemic Impact Tolerance Objectives. These SITOs are conservative measures and should help authorities inform their policy response.

It is also important to understand which ICT services the financial sector most heavily relies on and in the event of a severe incident, how the economy would be affected by an outage of these services. These critical functions are often provided by entities (known as critical third party service providers) that are seldomly known outside the world of IT. Certain services are only provided by few companies and concentration risk and non-substitutability of services can have detrimental knock-on effects. Though without systemic consequences, this can be seen in recent incidents affecting large financial entities. Albeit having invested considerably in cybersecurity they are not immune to exploits and cyberattacks. Significant investment in cybersecurity is therefore a necessary but not sufficient condition for cyber resilience.

One characteristic of systemic cyber risk is its inherent level of uncertainty. It is impossible to predict when an incident will occur, but it is certain that incidents will occur. Businesses and authorities across the system need to employ an assume breach mentality and integrate it into corporate culture and business strategy. This will help employ sound business continuity, disaster and recovery, and crisis management plans to prepare for worst-case scenarios. Here we move from assessment and prevention to mitigation for increased resilience.

It is impossible to predict when an incident will occur, but it is certain that incidents will occur.

A technique that can help macroprudential authorities prepare for worst case scenarios is Cyber Resilience Scenario Testing in which system-wide operational stress tests are conducted. One difference between microprudential and macroprudential operational stress tests is that in a macroprudential setting, all dependencies should be tested, not just the firm's individual response. Therefore, a financial entity's response to stress needs to be considered in another financial entity's response and vice versa. This is a highly complex task but does not only inform the individual firm on their own cyber resilience, but it also helps authorities in their role to respond to and mitigate a systemic incident in the future.

Systemic cyber risk is a continuously moving target for which financial entities and macroprudential authorities alike need to embrace change. When a cyber crisis evolves into a full-scale financial crisis, traditional tools such as capital buffers may be effective. However, they may be largely ineffective if the system's operability itself is incapacitated. Thus, macroprudential authorities should consider tools outside of their traditional realm or develop new tools that meet the requirements of effectively responding to an evolving threat.

System-wide contingency options and backup solutions can help to ensure the sustained provision of critical economic functions. There may be systemic cyber incidents that cannot be solved by business continuity measures employed by individual financial entities alone. System-wide tools and backup systems are developed, tested and put in place in advance and can take effect immediately after an incident occurred. These can temporarily ensure the continued provision of vital services to the economy and maintain confidence in the financial system. Such tools can foster overall and system-wide resilience and safeguard financial stability in the long term.

DAVID BAILEY

Executive Director for Prudential Policy – Bank of England

An ecosystem approach to cyber and digital operational resilience

Introduction

1. The Prudential Regulation Authority (PRA), working with the Bank of England (BoE) and Financial Conduct Authority (FCA) define operational resilience as the ability of financial institutions (FIs) and the financial sector to prevent, adapt to, respond to, recover from, and learn from operational disruptions. Our operational resilience and third party risk management (TPRM) policies are technology-neutral, but with cyber resilience and digital operational resilience as key elements. Respondents to our Systemic Risk Survey repeatedly identify a cyber-attack as a key risk to the financial system. These concerns are backed by recent attacks which often involved third party service providers to FIs (TPSPs) (Capita and ION) and, in some cases impacted FIs' delivery of vital services (ICBC). The BoE Financial Policy Committee's 'Macroprudential approach to operational resilience' sets out how operational (including cyber) disruption could impact financial stability.

2. Compliance with regulations on operational resilience, TPRM and proposed regimes for Critical Third Parties (CTPs) is necessary to strengthen the financial sector's digital operational resilience. While FIs and CTPs are/will be individually responsible for complying with relevant regulations, in doing so, it is crucial that they take into account the financial ecosystem in which they operate and how they may impact it. A key theme is that, to strengthen the financial sector's digital operational resilience, we need to treat it as an ecosystem all parts of which must work individually and collaboratively towards shared goals.

Financial institutions

3. UK FIs collaborate to improve the resilience of the financial sector through collective action and sector response initiatives, including via the:

- Cross Market Operational Resilience Group (CMORG), co-chaired by the BoE and UK Finance, which aims to strengthen the resilience of the financial sector and its ability to respond to operational incidents through collective action. This allows FIs and regulators to collaborate outside of formal regulation and supervision;
- Sector Response Framework (SRF) which coordinates FIs' response to incidents affecting the financial sector; and
- sector exercises, such as SIMEX (the next of which will take place later this year).

Regulators

4. The role of regulators includes regulating and supervising the cyber resilience of FIs and the wider financial system. In the UK, we do so by:

- developing outcomes-focused, proportionate regulation on operational resilience, TPRM and CTPs;
- CBEST, which has been our flagship intelligence-led penetration testing programme since 2014. While CBEST focuses on systemic FIs, we publish thematic findings and have launched a similar programme for smaller FIs (STAR-FS); and
- FPC cyber stress tests, which we also follow up with thematic findings

5. Regulatory cooperation during incidents is key. In the UK, we have the Authorities' Response Framework for the regulators and HM Treasury to co-ordinate with each other, FIs and other authorities during incidents that could majorly disrupt financial services.

Critical third parties and other TPSPs

6. As we saw with events involving CrowdStrike, FIs' reliance on TPSPs is increasingly important due to digitalisation and technologies such as cloud and artificial intelligence. TPSPs that support FIs' delivery of important business services must understand and facilitate their compliance with regulatory obligations.

7. A small number of TPSPs, known as 'CTPs' in the UK, could cause risks to financial stability if their services to FIs fail or experience disruption. To address this systemic risk, we are introducing a CTP Regime whereby HM Treasury will designate CTPs. We will directly oversee the resilience of CTP's services to FIs. Among other requirements CTPs, will have to document and validate their processes for coordinating with the regulators and their FI customers during incidents.

All parts of the financial services ecosystem need to collaborate to strengthen digital Op-Res.

Standard-setting bodies (SSBs) and international fora

8. As cyber-attacks do not respect national borders, SSBs are seeking to address regulatory fragmentation through global standards. For instance, the Financial Stability Board (FSB) has published guidance on cyber-incident response & recovery, third-party risk management, cyber-incident reporting and a cyber lexicon. The G7 has sought to facilitate cross-border cooperation through cross-border exercises.

9. However, cross-border regulatory and supervisory cooperation in this area could be enhanced. Regulators and FIs would benefit from exploring how existing or new bilateral and multilateral cooperation structures, such as colleges and crisis management groups, can improve coordination in areas such the management of cross-border incidents; oversight of CTPs; and exercises and tests.

TULSI NARAYAN

Senior Vice President, Security Solutions and Processing, APEMEA – Mastercard

Cybersecurity across the supply chain

In an increasingly digital world, cybersecurity is climbing the priority list for business leaders. While the excitement around evolving technologies is palpable, the boardroom is becoming increasingly aware of the risks that come with it. The impact of a cybercrime can be debilitating. Globally, the average data breach cost victims $4.45 million in 2023.

In response to this growing threat, cybersecurity has quickly developed from an IT challenge to a C-Suite priority; it's now the top digital risk businesses face today.

The best way to fight cybercrime is to understand the risk. What does it look like? Why does it happen? How can it be stopped? These are vital questions that both cyber leaders and their vendors need to know if they are going to address the risks effectively. Cybersecurity and operational resilience are now an integral part of any organisational strategy. The ability to identify vulnerabilities, detect threats and mitigate risks can be the difference between success and failure.

While enhancing consumer convenience, the increased reliance on third parties has led to greater complexity in payments acceptance and processing. An explosion of digital players, applications and devices is continually infused into the payments ecosystem, creating infinitely more undefined, and often inadequately protected web of connections between networks.

The ecosystem is under perpetual threat of widespread attack as a lack of proper third-party or supply chain risk management leave networks vulnerable. Criminal groups and indeed nation states are exploiting the weak links in that supply chain, targeting applications and providers that neglect to utilize network, regulatory and security standards and protocols.

Over the last few years alone, attacks such as SolarWinds Orion, Apache Log4J and MoveIT have all highlighted the entities' vulnerability to supply chain cyber-attacks. As a result, stakeholders are at risk of attack—even those with strong individual cyber and fraud protections in place.

Yet, it is important to underline how some players have tended to lack either the understanding about how these disruptions are impacting them – or the capabilities to mitigate the risks.

Organizations are not always able to look across third-party business relationships because of the lack of systems and processes available. Of course, the entity you're doing direct business with is important – but what about who these entities are doing business with? For example, if a business that you're heavily reliant on is working with a sanctioned organization or suffers a major cyber breach due to one of their own suppliers – that's a risk that you might not have visibility into.

In addition, risk monitoring practices are outdated if they involve fragmented teams of people, antiquated manual surveys and a large dependency on other organizations' inputs/disclosures.

To keep pace with the threat requires automation. It's imperative to proactively identify risk before disruption can occur.

At Mastercard, we continually invest in cyber security and network protection to address evolving widespread threats to the ecosystem. In fact, we have invested more than $7 billion over the past five years.

Our cybersecurity solutions such as our third-party and supply chain risk management platform RiskRecon (https://www.riskrecon.com/solutions/riskrecon-by-mastercard) demonstrate Mastercard's commitment to investing and providing much needed capabilities to our customers and partners to drive operational resilience.

RiskRecon uses Mastercard's unique network view to protect customers by continuously monitoring 19 million entities to identify fraudulent trends. This data is then used to inform risk assessments against transactions, connections to third-parties, 4th parties and beyond, building trust across the ecosystem.

As the world changes Mastercard is evolving too, enhancing collaboration with partners, through our fusion centers, and, in Europe, through our recently inaugurated European Cyber Resilience Centre that allows us to bring together law enforcement, private and public sector and cyber security experts from across the region.

This collective approach sharpens our response and strengthens our ability to share intelligence about potential future threats. Strong alignment with policy makers, too, as illustrated in recently adopted legislation, such as DORA, and cross-sector legislation such as the NIS2 Directive and the Cyber Resilience Act are important steps in helping avoiding fragmentation.

Analysing the threats, sharpening intelligence, influencing the right regulatory approach and mitigating cyber risk all help us anticipate what the future may hold – and sharpen our collective defence.

THIÉBAUT MEYER
Director, Office of the CISO – Google Cloud

Navigating DORA compliance: a collaborative journey towards financial resilience

The Digital Operational Resilience Act (DORA) aims to bolster the European financial sector against ICT disruptions. While larger entities are generally ahead due to their existing risk management frameworks, the path to achieving compliance by January 2025 may be challenging for smaller entities, who may be grappling with resource constraints and the complexity of integrating DORA requirements into their operations.

One major pillar of the regulation is the effort towards robust Threat-Led Penetration Testing (TLPT). In this area, Google Cloud is providing thought leadership on approach and implementation of pooled testing. In November 2023, Google Cloud published a non-paper outlining a technical testing approach to address the "end to end" testing whilst accommodating the nuances of the Shared Responsibility Model. Google Cloud followed this with a further non-paper in June 2024 which provides our perspectives on principles that should underpin the creation of a customer pool to facilitate pooled testing. These proposals are supported by our experience as a leader in the security field to facilitate discussion amongst regulators and customers alike. We welcome the opportunity to continue shaping the development of guidance to address this key requirement.

While thinking about enhancing the resilience and the cybersecurity level of European financial entities, it is important to consider the impact of the coming AI revolution. First, AI will rapidly modify the threat landscape, enabling attackers to act faster, with sophisticated modus operandi that will be more challenging to detect. AI can be used by bad actors to gather intelligence, find and analyze vulnerabilities, and spread malicious software across organizations.

On the other hand, AI is also a highly valuable tool for the defenders. It enables the automation of repetitive and time-consuming tasks, allowing teams to focus on more complex activities. AI also offers the possibility to scale and analyze data more quickly to react more effectively to incidents and limit their impact. It is these types of features that we offer at Google Cloud in our tools.

Other regulations are currently being put in place in Europe with the aim to enhance the collective capacity of the European Union to detect, prepare for, and respond to large-scale cybersecurity incidents and attacks: the NIS2 directive, the AI Act, the Cyber Resilience Act, the Cyber Solidarity Act, PSD3 etc. Regulators need to maintain a focus on consistency between texts and avoid inconsistencies, particularly in more technical implementation acts.

To ensure a resilient financial ecosystem, DORA's implementation demands a collaborative effort to navigate evolving risks, compliance challenges and diverse interpretations.

In addition, one of DORA's significant challenges lies in the potential for divergent interpretations of DORA's requirements between supervisors and the industry. For instance, supervisors' interpretations of certain provisions may differ from how financial institutions understand them. This discrepancy can lead to confusion and delays in implementation, as organizations struggle with aligning their practices with evolving interpretations. We believe a better approach is to focus on the desired outcome rather than prescribing the methodology for achieving it. It is paramount to avoid overly prescriptive texts and guidance that may become outdated due to technological advances. A continuous cooperation between the European Supervisory Authorities and the financial national competent authorities will reinforce the harmonization and consistency of interpretation.

Google Cloud will play its role in this collective effort to strengthen the resilience of the European financial sector and has put in place a robust compliance readiness program. It focuses on key initiatives to prepare for the new direct oversight for critical ICT third-party providers under the Regulation and supports customer compliance. These initiatives span across DORA's five pillars - Digital Operational Resilience; Third Party Risk Management; Incident Reporting and Management; Risk Management and Governance; and Information and Intelligence Sharing. We have already announced updates to Google Cloud contracts to support our customers in ensuring their DORA compliance readiness and we will continue to support our customers with new resources that address the applicable DORA requirements.

DORA's implementation journey necessitates a collaborative effort between regulators, financial institutions, and CSPs. Clear communication, consistent interpretation, and ongoing dialogue are essential to ensure smooth implementation and foster a resilient financial ecosystem. By embracing industry best practices, leveraging AI's potential, and proactively addressing emerging challenges, the financial sector can navigate the complexities of DORA and achieve its goal of robust operational resilience.

DIANA PAREDES
Chief Executive Officer & Co-founder – Suade Labs

Balancing compliance and innovation: operational resilience challenges for SMEs

The global IT outage in July this year, described as one of the largest in history, highlighted vulnerabilities in our increasingly interconnected world. This incident saw 8.5 million systems affected by the faulty CrowdStrike update, causing widespread disruptions, including the infamous "blue screen of death" on Windows PCs. The disruption underscored the importance of operational resilience, demonstrating how a single point of failure can have far-reaching consequences for businesses and their stakeholders.

In an era of rising cyber threats and technological dependencies, strengthening operational stability and minimising systemic risks is a key priority for many, including the European Union. On 16 January 2023, The Digital Operational Resilience Act (DORA), approved by the European Union, came into force. DORA's primary aim is to bolster the operational resilience of financial entities by setting uniform requirements for managing information and communication technology (ICT) risks.

DORA is different from previous regulations because it is a regulation, not a directive, meaning it applies directly and consistently across all EU member states. This uniformity aims to ensure the security and confidentiality of IT systems and data across all financial entities. Before DORA, various guidelines existed but did not achieve full harmonisation. Now, the management body of each financial entity bears the ultimate responsibility for managing ICT risk, including setting policies for data availability, integrity, and confidentiality, and approving digital operational resilience strategies.

The implementation of DORA presents both opportunities and challenges. One of the critical considerations of DORA is its impact on innovation and third-party vendor management. While the regulation sets stringent requirements, it also seeks to encourage a more robust and transparent financial sector. The additional compliance measures are designed to enhance overall market stability and resilience, though they may also impose additional burdens on SMEs.

Small and medium-sized enterprises (SMEs) might encounter increased expenses related to compliance, as they may need to invest more in technology, train their staff, and possibly hire external consultants to meet the requirements of DORA. These expenditures can impact their limited financial resources, requiring careful budgeting and prioritisation. However, investing in these areas can also strengthen their overall resilience and competitiveness in the long term.

The detailed regulatory demands of DORA can be challenging for SMEs, which might not have the necessary expertise and experience in handling ICT risks. This can make it difficult for them to fully grasp and implement the regulations, increasing the risk of non-compliance and potential penalties. On the other hand, adhering to these regulations can enhance their risk management capabilities and prepare them for future disruptions.

DORA also aims to create a level playing field, ensuring that all market participants adhere to consistent standards. This could foster greater trust and stability within the financial ecosystem, potentially benefiting SMEs by providing a more secure operating environment. However, the uniform approach might not fully account for the unique challenges faced by smaller entities, which could impact their ability to innovate and compete effectively.

The proportionality principle within DORA, which scales requirements according to the size and complexity of the institution, aims to mitigate some of the burden on smaller entities. By enforcing a standardised approach to ICT risk management, DORA seeks to enhance overall market stability. However, it is important to monitor whether this approach sufficiently balances the need for security with the flexibility required for innovation.

In conclusion, DORA represents a significant step in safeguarding the operational resilience of the EU's financial sector, addressing current vulnerabilities and aiming to create a more secure financial ecosystem. While SMEs may face particular challenges in meeting DORA's requirements, the regulation's proportionality principle and its focus on consistent standards offer both potential benefits and drawbacks.

The regulatory demands may post challenges to SMEs, potentially impacting their ability to innovate.

The CrowdStrike incident exemplifies the critical need for robust operational risk management, underscoring that, despite the challenges, it remains imperative for organisations to strengthen their resilience against unexpected disruptions. As financial institutions work towards the January 2025 compliance deadline, the collective efforts to enhance operational resilience will be essential to fortify the sector against future disruptions and cyber threats, balancing security and innovation.

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CRYPTO PERSPECTIVES AND REGULATORY OUTLOOK

CARLO COMPORTI
Commissioner – Commissione Nazionale per le Società e la Borsa (CONSOB)

Crypto-assets regulation – What's next?

MiCAR represents a major advancement in bringing clarity of applicable common rules, legal certainty and accountability to the crypto-asset markets. As we approach its implementation, ESMA has nearly finalized its policy mandates and is shifting efforts towards supervisory convergence. The EBA's experience in establishing common approaches for the already applicable requirements on ARTs and EMTs is a good starting point and the collaboration between ESMA and EBA will continue to strengthen with a view to deliver consistency of approaches, for instance with the publication of Q&As

As we progress in implementing the MiCAR framework we discover areas where further clarity and alignment with existing rules on traditional finance would be needed (one example being transaction reporting to supervisors). The review of MiCAR will offer the opportunity to fill gaps.

ESMA and EBA are also working closely to provide inputs for the MiCAR-mandated report on the latest developments in crypto-assets, including decentralized finance (DeFi) and the appropriate regulatory treatment of decentralized crypto systems.

As known, MiCAR does not contain specific requirements for decentralized autonomous organizations (DAOs) or the deployment of smart contracts in decentralized settings, nor does it address the concept of full decentralization. This could lead to regulatory fragmentation or, even worse, loopholes. While supervisory convergence through soft law is important, it may not be sufficient to ensure legal certainty and enforceability in all instances. There is a need to clarify the scope of MiCAR and other existing financial sector rules to address gaps that could pose significant or systemic risks through spillover effects (as the digital centralised ecosystem is interconnected with the decentralised ecosystem as well as with the traditional financial system).

Although the approach on whether and how to regulate DeFi is still being developed, several issues deserve close attention. A fundamental challenge is that the dynamics of open-source software and infrastructures collectively managed by participants can differ significantly from those of traditional financial actors and their IT systems. At the same time, similar or even additional risks may arise depending on the use of the software, infrastructures, and the activities performed on top of them.

To address these challenges, several initiatives could be considered. First, common approaches could be established to monitor developments in DeFi and related risks, particularly regarding the size of DeFi activities, leverage, and interconnections with supervised entities. One way to reduce data gaps is for the EBA and ESMA to collaborate on developing standard templates for harmonized supervisory data collection, which is already set under MiCAR.

If DeFi is to be regulated, new approaches (combining hard and soft law) will need to be developed, focusing on activities and outcomes to address smart contracts with financial applications. A harmonized framework for DAOs and financial asset tokenization could be considered, although challenges remain due to the lack of harmonization in civil, securities, and corporate laws across the Union.

Overall, any new framework should encourage compliance by design for DeFi protocols, focusing on risk mitigation and consumer protection. For instance, the framework could include rules for smart contract testing and audits, as well as transparent governance structures that allow for accountability and timely human intervention. Users should be made aware of the risks they face. Additionally, it would be useful to consider how and under what conditions smart contracts and DAOs could be classified as compliant with agreed standards and to define liabilities and ownership rights to benefit users.

Another important topic is interoperability. There is a risk of "balkanization" of DLT platforms, especially with proprietary infrastructures. The EU framework should support open systems. Standardization could be incentivized without stifling competition, market diversity, or innovation.

Any new framework should encourage compliance by design for DeFi protocols.

Calibrating regulation for decentralized ecosystems is indeed complex. Provided that the size and use of DeFi protocols do not pose systemic risks, a *step-by-step experimental approach* at the Union level *could be preferable to foster learning by doing*. For instance, an EU regulatory sandbox coordinated by the ESAs could be introduced to test how to adapt current rules to decentralized settings and promote the development of protocols that meet desired outcomes. Experience from the DLT Pilot regime could be leveraged.

Appropriate (hard or soft) regulatory initiatives could encourage broader and more responsible participation of institutions and individuals in DeFi ecosystems. We should seize the opportunity to fully exploit and incentivize the benefits of transparency, verifiability, and traceability of on-chain information.

URSZULA MIZIOŁOWSKA
Head of the Payment System Unit – Ministry of Finance, Poland

Consumer protection solutions as a trigger for the crypto market development

For years, we have been observing the growth of global crypto market and the number of its investors, including retail ones. We have also witnessed the increasing interconnection of this market with the structures and entities of the traditional financial market.

Information about significant drops in cryptocurrency prices and, unfortunately, various types of abuses often appear in the public space. There is no doubt that a regulatory framework for the crypto market is essential.

The regulations proposed at the EU level regarding crypto-assets are a breakthrough in many aspects. We are dealing with a matter that, in principle, was created in order not to be "limited" by restrictive regulatory frameworks. MiCAR is unique because it is the first attempt to propose a regulatory and supervisory framework for this market in a comprehensive way. Due to MiCAR, but also taking into account the existing EU acquis in the field of financial markets regulations (in particular MIFID), the EU will become the largest single market with a stable legal framework for crypto-assets in the world. Entities offering or providing crypto-assets services will have access to 440 million people, ensuring equal operating conditions.

First of all, it seems that the scope of MiCAR is adequate to the threats that may potentially be associated with this market. The EU legislator decided to supervise and introduce clear rules for stablecoins, as they are of key importance for the cryptocurrency sector and constitute a key connection between cryptocurrency markets, traditional financial institutions and retail market participants, including due to activities as close to the customer as payment services. Stablecoins therefore require appropriate regulatory and disclosure standards if the cryptocurrency ecosystem is to develop in a sustainable and secure manner.

MiCAR has several main goals, including supporting innovation and ensuring market integrity, but it is increasing consumer confidence and reducing risk that receives the most attention in the text. In every area of the financial market, access to reliable information about the product and entities whose services you intend to use is a key issue. It is no different, or perhaps more important, in the case of the crypto-asset market. Taking into account that MiCAR introduces solutions that protect clients against excessive risk, encouraging them to invest safely, entities offering crypto-assets and providing services will have the opportunity to enter the mainstream of the financial market and develop their activity in conditions of equal competition.

It is essential to introduce mechanisms thanks to which the client will have a full picture of the crypto-assets he intends to buy, including their specificity and functions, as well as the risk associated with a given offer. The client should also have comprehensive information about the entity with which he or she intends to enter into a business relationship, which is obliged to have appropriate competences and reputation. It is important for the development of a stable and more predictable market that MiCAR also eliminates many uncertainties on the part of crypto-asset holders, introducing, among others, a permanent right of redemption at any time.

Taking into account the specific nature of the crypto-assets market and its functioning in the digital space, it is also important for holders and potential holders to provide them with reliable, clear and non-misleading marketing materials. Furthermore, easy access to information on which crypto-asset provider has been authorised to provide such services across the Union, is important here.

MiCAR also emphasises mechanisms to warn customers about fraudulent entities, but also obliges crypto-assets service providers to warn customers that particular crypto-assets or crypto-asset services may be inappropriate for them.

MiCAR introduces solutions that protect customers, encouraging them to invest safely.

Taking into account MiCA's comprehensive approach to consumer protection and counteracting market abuse, often based on solutions that have been present on the traditional financial market for years, the regulation in this scope seems to have no gaps.

MiCAR is a pioneering legislative text in terms of regulating crypto market and it undoubtedly places the European Union as a global pace setter it provides regulatory certainty and stronger protections for consumers.

As the crypto market dynamically evolves and matures, MiCAR's impact on the EU cryptoasset landscape and its global implications will need to be closely monitored by interested parties. The results of these observations should provide an answer as to whether and to what extent further regulatory measures should be considered in relation to activities related to cryptoassets that currently fall outside the scope of MiCAR.

FERNANDO RESTOY

Chair – Financial Stability Institute (FSI)

Emerging regulatory responses to financial stability risks posed by stablecoins

Although cryptoassets are not yet part of the core of the global financial system, their potential to pose risks to financial stability cannot be overlooked, particularly if they gain widespread traction for payments. In the evolving cryptoasset market, some categories of stablecoins hold greater potential to be used as a payment medium than others. This is particularly true for centrally issued stablecoins which aim to maintain a stable value relative to a fiat currency by relying on traditional financial instruments as reserve assets – a category referred to as an "e-money token" in the EU Markets in Crypto-Assets Regulation (MiCA).

While this type of stablecoin is currently used mainly to settle transactions and store value in cryptoasset markets, traditional financial institutions have started using them as digital settlement assets, and leading payment service providers are exploring their integration into their networks. In this context, financial stability risks could materialise, especially if certain business models achieve rapid scalability and wider retail payment use.

A scenario involving widespread usage could give rise to a variety of risks with potential implications for financial stability. These include the possibility of currency substitution in emerging market and developing economies; substantial impacts on economic activity and the functioning of the financial system in the event of operational disruptions; negative confidence effects on money and payments in the event of an issuer's failure; and increased market, credit and operational risks for financial institutions that play multiple roles within a stablecoin arrangement.

With these considerations in mind, policymakers are taking action to address the potential financial stability risks that stablecoins may pose. Internationally, the Financial Stability Board and standard-setting bodies are working towards a consistent policy response. Concurrently, at the national level, some jurisdictions are modifying their regulatory frameworks.

A recent paper[1] by the Financial Stability Institute compares established or proposed regulatory frameworks for stablecoin issuers in 11 jurisdictions. Emerging regulatory strategies at the national level share common requirements: issuers are typically required to maintain reserves equivalent to the value of their circulating stablecoins, ensure segregation and custody of assets, and establish clear redemption procedures. Regulations also contain prudential, governance, risk management, anti-money laundering and countering the financing of terrorism requirements as well disclosure obligations. Most frameworks follow two authorisation regimes for issuing stablecoins: (i) banks and certain non-bank financial institutions under existing regimes, and/or (ii) a newly established crypto-specific licence.

Disparities in regulatory regimes could contribute to inconsistencies and policy ineffectiveness.

However, national regulatory regimes show discrepancies and inconsistencies that can prevent effective coordination across jurisdictions. For instance, the terminology used to classify stablecoins varies significantly across regulations. Notable differences also exist in restrictions on reserve assets, the nature of stablecoin holders' claims and the treatment of redemption fees.

In addressing stablecoins that present substantial financial stability risks, two primary approaches can be identified: the first involves the creation of a distinct category for "significant" or "systemic" stablecoins, as exemplified by MiCA and the proposed regime in the United Kingdom (UK), respectively. This approach is accompanied by increased prudential requirements that typically encompass stricter reserve asset requirements, mandatory audits, and supervisory oversight. The second approach empowers authorities to enforce additional requirements or impose restrictions when they deem that stablecoins pose a risk to monetary and financial stability.

Within the current landscape, MiCA emerges as one of the world's first comprehensive regulatory frameworks for cryptoassets. While it provides a robust stablecoin regime, aspects such as reserve assets' requirements for significant stablecoins might eventually need a reassessment. Following the example of other jurisdictions, like the UK, it is worth considering requiring systemic stablecoins to be fully backed by central bank deposits with the aim of enhancing holders' confidence and mitigating run risk. Moreover, defining requirements for entities operating the support infrastructure for significant e-money tokens, coupled with more explicit guidelines on the use of permissionless ledgers for their transfer mechanisms, could prove beneficial.

As stablecoin markets evolve, authorities need to monitor developments, collaborate internationally and implement global standards to ensure a consistent approach to the financial stability risks posed by stablecoins.[2]

1. *FSI Insights No 57, April 2024 (bis.org)*
2. *By Fernando Restoy and Denise García*

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DIGITAL TRANSFORMATION OF SECURITIES MARKETS

JULIAN REISCHLE
Director General Payments and Settlement Systems – Deutsche Bundesbank

How to foster new technologies in EU securities markets

The rise of new technologies will change securities markets in the EU profoundly. It will affect the entire value chain in securities markets, from pre-trading to trading all the way to post-trading. Technological innovations have the potential to reshape European post-trading infrastructure significantly. Tokenisation can play a special role in this regard.

Tokenisation can be defined as the digitalised representation of an asset, including the rights and obligations attached to the asset. To function as a security, transferability and tradability must also be possible. The use of tokenisation could lead to significant efficiency increases in post-trading. It is conceivable that the long custody chains that currently exist between issuers and investors could be significantly shortened in the future through tokenisation. In addition, smart contracts could be used to execute corporate actions more efficiently. By using distributed ledger technology (DLT), investors and issuers would have a common data repository, which would reduce the need for reconciliation in general and lower the error rates that occur during reconciliation. The tokenisation of securities through DLT therefore has the potential to reduce some of the costs and complexities in post-trading and minimise risks at the same time.

However, the specific solutions on the financial market have not yet exhausted the enormous potential promised and are often still at an early stage. To foster the development and adoption of promising new technologies in securities markets, such as tokenisation, it is crucial that policymakers, regulators, central banks, and the financial industry cooperate closely. In the EU, both European and national policymakers are responsible for drafting the necessary laws and regulations to create a secure and trustworthy space in which financial firms can develop and launch services based on new technologies such as tokenisation.

Jointly developing new technologies in EU securities markets is key to their adoption.

The EU DLT Pilot Regime, for instance, allows operators of market infrastructure to test distributed ledger technology in the issuance, trading and settlement of tokenised financial instruments. As part of the DLT pilot regime, shares, bonds and other debt instruments can be traded and settled directly using DLT.

The EU and Germany are among the leaders concerning the tokenisation of financial assets. In many European countries it is now possible to issue securities in purely digital form without the need for physical documents, potentially also via DLT infrastructures. In 2021, the Electronic Securities Act (*Gesetz zur Einführung elektronischer Wertpapiere – eWpG*) came into force in Germany. This new legal framework regulates the issuance and the transfer of certain securities in dematerialised electronic form including DLT-based assets and will therefore significantly facilitate innovation. This is important because it is not technology alone that determines the success of an innovation but also the legal framework and the overall ecosystem's ability to absorb new technology.

The German development bank KfW and large German corporations have already used this new legal framework to issue DLT-based digital bonds. In addition, cooperation between Deutsche Börse, the Deutsche Bundesbank and the German Finance Agency has enabled the issuance of a German government bond entirely in digital form.

The Eurosystem and the Bundesbank are aware of market participants' keen interest in trying and testing tokenisation for securities issuance and settlement. One major pillar in this respect is the Eurosystem exploratory work on new technologies for wholesale central bank money settlement. From a financial stability perspective, it is of particular importance for central banks that wholesale transactions can be settled in risk-free central bank money. Therefore, the Eurosystem has a strong interest in exploring how DLT-based financial market transactions could be settled in central bank money. Through practical work with interested market participants, the Eurosystem is expanding its exploratory work in this area, which has thus far mainly been restricted to conceptual activities. The Bundesbank actively supports the Eurosystem's exploratory work by providing its DLT-based Trigger Solution, which links market DLT platforms to the Eurosystem's traditional TARGET payment system. Using this set-up, three market participants have jointly issued two tokenised bonds using DLT settled in central bank money. In a longer-term perspective, the Eurosystem has to assess the opportunities and challenges related to the unified ledger approach proposed by the Bank for International Settlements.

The Eurosystem's exploratory work shows that when market participants, central banks and policymakers cooperate in a constructive fashion, important innovations can be achieved. Jointly developing new technologies in EU securities markets is key to their adoption.

TOBIAS THYGESEN
Director, FinTech, Payment Services and Governance Department – Danish Financial Supervisory Authority

Harvesting the full potential of tokenisation in tomorrow's capital markets

It has been a long-standing goal of European policy makers to move towards the capital markets union – with all the benefits that would entail. Most agree that progress has been painstakingly slow – and regular attendees at Eurofi would have noticed a certain fatigue creeping into CMU discussions. However, all is not lost – and on the infrastructure-side not the least, we see light ahead.

One such light is the use of distributed ledger technology (DLT). DLT brings the promise of increased efficiency, transparency and accessibility for investors. However, so far, progress has been slow – perhaps not surprising in an infrastructure market characterized by strong network effects.

Enter the *DLT Regulation* (DLTR), the aim of which is to facilitate the testing of DLT in capital markets without compromising investor protection, market integrity, financial stability, or transparency. This visionary pilot regime exempts DLT market infrastructures from certain regulatory requirements, looking to foster the development of innovative solutions for trading and settling securities on DLT. By doing so, the DLTR provides a sandbox environment where these technologies can be tested and refined.

The DLTR enables DLT-based systems to integrate trading and settlement activities within a single legal entity. This is significant because current regulations prevent investment firms offering a Multilateral Trading Facility (MTF) from engaging in securities settlement and, similarly, Central Securities Depositories (CSDs) are restricted from providing trading activities. In Denmark, for instance, securities settlement involves a collaboration between Danmarks Nationalbank and the Danish CSD, Euronext Securities Copenhagen (ES-CPH). The securities leg is settled through ES-CPH while the cash-leg settles on accounts with Danmarks Nationalbank.

The clearing of net positions in securities settlement systems significantly impacts the need for liquidity. In 2022, Denmark's securities trades averaged DKK 255 billion daily, resulting in a net cash settlement of DKK 19.2 billion. This net settlement approach drastically reduces liquidity requirements compared to gross settlement. This highlights the efficiency of current systems, yet also sets the stage for understanding whether DLT could further optimize these processes.

The Danish FSA carried out a test of a system developed by Deon Digital, which allows securities trades to be entered into and settled simultaneously and in real times, using so-called smart financial instruments (SFI) to enable increased automation and transparency in the lifecycle of financial contracts.

The conclusion of the test was very clear! DLT systems that support simultaneous trading and settlement with direct investor participation can streamline many "back-office" tasks that arise out of the step-by-step design of the securities settlement systems currently in use. For instance, if the ledger serves as the definitive record of ownership and specifications of securities, it can mitigate the need for ongoing reconciliation and reduce the risk of settlement suspensions due to discrepancies. This enhanced transparency benefits investors and minimizes the need for extensive monitoring systems for settlement fails, as simultaneous settlement eliminates the possibility of non-delivery affecting subsequent trades. The reduction in these tasks can lead to significant cost savings and operational efficiency.

However, transitioning to real-time gross settlement poses challenges for investment firms. While real-time settlement eliminates the need for clearing net positions, it demands scalable and swift settlement systems.

The use of DLT brings the promise of efficiency gains in the capital markets.

The full potential of DLT in capital markets can only be realized if either credit institutions or central banks make themselves available to support DLT-based capital markets. The DLTR gives credit institutions exclusive rights to offer e-money in such systems, while central banks can issue Central Bank Digital Currencies (CBDCs). This currently creates barriers, and a liberalization of the provisions allowing e-money institutions to also issue e-money tokens for settlement on DLT-based systems would further unlock the transformative capabilities of DLT. The DLTR also gives rise to other issues. The requirement to develop an exit strategy for example basically means that new actors would need to enter into agreements with existing infrastructures they compete with.

Despite such challenges, the test showed that adoption of DLT in capital markets infrastructure offers substantial efficiency gains in back-office processes through the potential for DLT to eliminate settlement fails and automate numerous operational tasks, significantly reducing costs and manual interventions. The potential for such automation and error reduction can transform how capital markets operate. But to succeed, it is still necessary to iron out the obstacles standing in the path of further progress down this road.

JON FINK ISAKSEN

Head of Policy, EMEA – Uniswap Labs

Tokenisation - Solving the EU's capital markets puzzle

As part of its 'tokenisation' agenda, the European Commission is making efforts to further promote the integration of distributed ledger technology (DLT) in market infrastructures. The Commission should take advantage of the full possibilities offered by the underlying technology, such as Decentralised Finance (DeFi) enabled by smart contracts as this will be instrumental in supporting further digitalisation of the securities market and the much broader market of real world assets. This is one route to enabling the EU's Capital Markets Union objective.

The DLT pilot regime was a forward-thinking initiative aimed at evaluating the technical obstacles to utilising DLT in securities markets. However, more than one year into its application, the DLT pilot faces significant challenges. The volume caps and high entry requirements have deterred both large incumbents and new players, stalling progress on tokenisation within the EU. While the idea was commendable, the approach has proven too slow as the market moves on. As a result, the crypto-asset markets and trading platforms under the MiCA framework have the possibility to advance rapidly, while innovation in traditional markets run the risk of lagging behind.

Meanwhile, other jurisdictions are quickly catching up and, in some cases, moving beyond the EU's initial crypto-asset framework, having had more time to observe and adapt. To ensure global competitiveness, the EU must continue to innovate. The regulatory framework needs to support this. So it is crucial that incumbents do not work in silos to meet existing and sometimes anachronistic requirements, keeping proprietary information to themselves. Indeed the opposite – open collaboration and shared standards – will drive the entire industry forward.

At Uniswap Labs, we have long believed the integration of DeFi technologies, such as Automated Market Makers (AMMs), into traditional markets offers a path to greater efficiency and innovation. As the Commission prepares the next regulatory cycle, it is vital to improve on the DLT pilot by lowering entry barriers, increasing volumes, adjusting the time frame, increasing the availability of tokenised cash and rethinking the transitional measures. In fact, perhaps it is time to leave the DLT pilot behind and focus on promoting innovation in capital markets in more permanent ways building on the principle of technological neutrality.

Tokenisation must be a core component of the EU's digitalisation and Capital Markets Union (CMU) agendas. By creating a legal framework that encourages the use of blockchain for securities markets, the EU can address the limitations of the DLT pilot and foster a more dynamic and integrated capital market.

Tokenisation has the ability to move financial markets entirely onchain, increasing liquidity by maximizing the number of potential counterparties. Especially as onchain markets are global and unrestricted by geographical boundaries. Relatedly, AMMs naturally support better liquidity by separating the tasks of liquidity provision and pricing compared to Central Limit Order Books (CLOB). This division of labor simplifies the process and typically results in more stable and consistent liquidity. This mechanism is particularly beneficial for less liquid markets, providing a continuous source of liquidity and thus enhancing overall market efficiency.

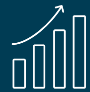
This technology creates new possibilities, and any regulatory attention should take that into account. Any overhaul of the DLT pilot or a revamped push for tokenisation to promote a deeper and unified capital market in the EU must also build on real industry practice, for example by allowing the use of public permissionless systems and open protocols as the infrastructure.

Intermediaries will still play a crucial role, especially in protecting retail investors. While DLT and DeFi can streamline and automate many processes, both traditional and new intermediaries are necessary to ensure compliance, perform due diligence, and safeguard investor interests. The challenge lies in integrating these new technologies with existing structures to enhance, rather than replace, the roles of intermediaries.

The future of the EU's capital markets depends on its ability to adapt and innovate. By making tokenisation and automation cornerstones of not only the digitalisation but also the CMU agenda, the EU can lead the way in creating a more efficient, inclusive, and competitive financial system.

Visit the **«Current Topics»** section of the Eurofi website for the latest Eurofi policy notes and contributions from public and private sector representatives on key economic and financial policy issues.

Economic and stability challenges



Capital market regulation

Banking and insurance regulation

Digitalisation and new technologies

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Payments and AML

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RETAIL PAYMENT PRIORITIES

ULRICH BINDSEIL

Director General, DG Market Infrastructure & Payments – European Central Bank (ECB)

Retail payment priorities for the Eurosystem

Strengthening the European payments market through the creation of pan-European solutions for retail payments at the point of interaction (POI) and the enhancement of the "classic" SEPA payment instruments are at the heart of the Eurosystem's retail payments strategy. Pan-European solutions for retail payments at the POI should be governed at the European level to counterbalance the growing reliance on international card schemes and – for e-commerce – on global big tech providers. The Eurosystem welcomes market initiatives that are working towards pan-European retail payment solutions for the POI, provided they respect the Eurosystem's key objectives regarding reach and customer experience, convenience and low cost, safety and efficiency, European brand and governance, and, in the long run, global acceptance.

The second major goal of the Eurosystem's retail payments strategy is to strengthen the "classic" SEPA, primarily through the full deployment of instant payments. On the operational side, the ECB ensures that instant payments have a pan-European reach via its TARGET Instant Payment Settlement Service (TIPS). The TIPS-based interoperability solution for euro area SEPA instant credit transfer clearing houses implemented in 2022, the growth in the number of participants in TIPS and the go-live of the multicurrency functionality in February 2024 with the migration of the Swedish Krona instant payments to TIPS led to a substantial rise in transaction volumes. In conjunction with the European Commission's instant payments regulation and the industry's rollout of instant payment products and services, it will be ensured that citizens holding a payment account can make instant payments in euro, and that person-to-person and POI payment solutions can rely on them.

Another important objective is the improvement of cross-border payments. The ECB and the national central banks of the euro area support the G20 roadmap to enhance cross-border payments. In its operational role, the Eurosystem is exploring how TIPS could support cross-currency payment transactions within Europe. The ECB is also in discussion with central banks outside Europe and the BIS Innovation Hub platform Nexus to identify interlinking opportunities.

External developments of the last years have underlined the importance of the resilience of retail payments. This could be enhanced by ensuring a fallback option which is at least sufficient for a minimum service and does not rely completely on the same technology. Moreover, the resilience of each payment solution needs to be addressed. This would ideally include offline capabilities, in case of network disruptions, problems at processor level or problems at individual payment service providers.

The Eurosystem contributes to the goal of a competitive European market for retail payment services.

As the volume of digital retail payments in the euro area continues to increase the introduction of a digital euro would not need to crowd out private solutions. The Eurosystem's retail payments strategy and the digital euro project are complementary. Both aim to achieve a higher level of efficiency, strategic autonomy and resilience, as well as supporting digitalisation and innovation in retail payments. Moreover, the digital euro aims at using existing industry standards, components and technology. This would implement a digital euro efficiently and contains the investments of the European retail payments industry. The implementation of a digital euro could also help private retail payment solutions to achieve a pan-European reach and expand their use cases.

In parallel to promoting its retail payments strategy, the Eurosystem supports work on developing innovative payment services at the level of the Euro Retail Payments Board (ERPB). Notably, the ERPB has been promoting progress in open banking, which enables third-party providers to access payment account-related data with the consent of banks' customers, and to initiate payments via open application programming interfaces. This in turn allows third-party providers to offer convenient and attractive payment solutions. At the invitation of the ERPB, the European Payments Council provided a SEPA Payment Account Access scheme setting out rules, practices and standards that allows the exchange of payment accounts related data and facilitates the initiation of payment transactions of value-added services provided by banks to third-party providers.

ANIKÓ TÚRI
State Secretary – Ministry for National Economy, Hungary

Retail payments – Best protection is prevention

The ever-increasing trend towards digitalisation is also affecting the field of payment services that is why it is important to introduce a legislative pause into the system, to slow down the changes in order to create a safe legal environment for payments. We need to take control of the payment fraud trends, for example in Hungary the volume of payment fraud has been increasing by 238% compared to the previous year, which means more than HUF 23 billion (according to the data of the Hungarian Central Bank).

Hungarian Presidency puts fraud prevention at the forefront, as the most effective protection is prevention. On the Council working party meetings the Hungarian Presidency is trying to focus on fraud prevention and risk mitigation, even at the cost of reducing customer satisfaction, as it is much easier to prevent a transaction from taking place than to trace the route of the fraudulent amount.

Instant credit transfer was introduced in Hungary in 2020 and has since become a popular payment service in Hungary. In 2024, the share of instant credit transfers has been increased by 5.9% and the total value by 19.8% compared to the first quarter of 2023. The regulation on instant credit transfers in euro has been accepted and published within the EU in 2024. Based on the Hungarian practices we can underline that the instant payment service is important in terms of competitiveness, as it is a good alternative to international card schemes.

The instant credit transfer is adopted as a payment solution, since the amount will be credited to the payee's payment account within 5 seconds after the transaction is initiated, in the EU it is regulated to 10 seconds. The speed of the transfer raises some security issues, as it is almost impossible to verify that the IBAN and the payee's name match, creating a security risk. Not to mention the fact that fraudsters may be able to keep transferring the amounts continuously, until the original transaction will end up being untraceable. This is why transfers shall be made more secure in the near future.

In Hungary, the use of electronic payment solutions has intensified in recent years. Last year, the total value of electronic payment transactions amounted to HUF 1 billion, an increase of 20.8 per cent compared to 2022. It cannot be emphasized enough that the speed of growth is too fast for some consumers to adapt. It is crucial to leave a certain time period for consumers to pick up the space and learn how to safely use the new electronic payment services.

It is essential to recognise that financial literacy is key, as fraudsters' methods are becoming increasingly sophisticated and the skills of the average consumer are relatively low in comparison. Financial literacy is a shared interest and responsibility of governments and payment service providers (PSPs). The age group of 20-60 is the most targeted by fraudsters due to their active presence in social media and their data made available by online registration, so it is important to inform them about the known trends of payment fraud, and if the incident has already happened, it is important to inform them where they can report incidents.

Even during the digitalisation era it is important to consider the needs of consumers with low digital skills. That is why we are supportive towards the Payment package initiative, namely that the proposal would like to provide the benefits of safe payment services efficient against fraud (as SCA) for people who do not have access to digital devices, eg. smart phones.

Hungarian Presidency puts fraud prevention at the forefront, as the most effective protection is prevention.

As previously mentioned, prevention is a key issue, therefore a new official procedure has been introduced in Hungary, modelled on the procedure for the prevention of money laundering. The system is based off a chain of communication between the payment service user (PSU), the PSP and the Financial Intelligence Unit (FIU) of the Hungarian Tax Authority. The first step would be for the PSU to report the suspicion of a fraudulent transaction to the PSP holding its bank account. The second step would be for his PSP to inform the payee's PSP, which would report the suspected fraud to the FIU, thus starting the chain of tracing where the funds might be and then finally deciding what their reactions should be (the PSP in question has the right to block the amount for a maximum of 4 days).

One of the overarching priorities of the Hungarian Presidency is competitiveness. Thus we believe that innovation is crucial in the payment sector but it should go hand in hand with consumer protection, furthermore due diligence and financial literacy shall be part of the effective fraud prevention.

KUBA KIWIOR

Regional Managing Director,
Central Eastern Europe – Visa Europe

Visa – A network bringing innovations to everyone, everywhere

Visa enables the global movement of money and is working to provide payment solutions and services for everyone, everywhere. We facilitate secure, reliable and efficient money movement among consumers, financial institutions and merchants. We continuously strive to identify and invest in new capabilities, work with clients to help secure the payments environment and take action to improve the security, integrity and resiliency of our network. Our network can handle up to 65,000 transactions a second; allowing 27 different ways to route each transaction across over 10 million miles of network cables – that is enough to circulate the Earth four hundred times – at an unrivalled 99.999% network availability. Over the past five years, Visa has invested over $10 billion in technology, including to reduce fraud and enhance cybersecurity resilience, helping to keep the share of our transactions with fraud present down to historic lows of 0.1%. To put that in perspective, Visa prevented over EUR 40 billion in fraud on our network last year alone.

Visa has been at the vanguard of innovation in payments since its founding in the 1950s with the first consumer credit cards, and we are constantly thinking about the next big payment innovations, and how we ensure they are accessible to all in line with regulations around the globe. Visa runs an open network enabling our members to take advantage of our technology and security to constantly innovate and access best-in-class innovation. Technology has already improved many aspects of how people and communities interact with each other, but the best services are those that are personalised and tailored to the specific needs of each person.

If you think about contactless, it has been one of the most defining trends in how consumers shop over the past few years. But it didn't start off that way. Visa started working on contactless technology over 15 years ago and today 9 out of 10 face-to-face transactions in Europe are made using contactless. This also drove a huge appetite for other more seamless payment experience, such as simpler payments on the metro and out on the high streets. Over the last 10 years, Visa has also further enhanced security across the payment ecosystem through tokenisation – a technology that replaces sensitive payment data with a cryptographic key that conceals sensitive payment data. We believe that tokenisation is the next step on that journey - whilst this technology is already making payments more seamless and secure in use cases such as mobile payments, it is a powerful tool for facilitating experiences of the future.

Policy and regulation can be an important catalyst for fostering innovation and competition in payments taking into account privacy and strategic autonomy. The European Commission's 2020 Retail Payments Strategy set an ambitious precedent for what the European Union (EU) could achieve for the development of retail payments. Going into the next European Commission mandate, we observe that Europe's payment landscape continues to be well-functioning, dynamic and competitive – with new domestic and cross-border options emerging across a range of networks; card, SEPA instant credit transfers and new forms of digital currencies.

At the same time, whilst the policy frameworks themselves achieve many of the right objectives, we observe that the implementation of EU regulation remains a pain point for industry – particularly smaller players. Given the wealth of regulation currently in force, or soon to be adopted, Visa recommendation is to focus on these implementation challenges before any additional regulatory requirements are introduced with a view to promote competitiveness across a level-playing field.

We believe tokenisation is the next step to deliver seamless payment experience.

Much of the recent policy framework includes significant regulatory and implementing technical standards or regulatory guidance, and many of these additional measures will need to align. We observe that this additional implementation work may require further trade-offs and clarifications which make industry implementation difficult, and the uptake of EU rules complex and potentially disruptive.

The holistic and ambitious range of incoming regulatory requirements mean that industry will require significant support to shape necessary investment decisions required over many years to give effect to regulatory changes. These investment decisions vary by market participant, and cycle for industry upgrades – noting that peak retail periods do not permit major technology investments to be made. We look forward to working with the European Commission on this journey into the future of payments.

JUAN ORTI

Country Manager Spain, Vice President & General Manager Spain & Benelux International Card Services – American Express

Shaping Europe's payment future: getting PSD3 and PSR right

As Europe's payment ecosystem continues rapidly to evolve, the proposed Third Payment Services Directive (PSD3) and Payment Services Regulation (PSR) offer a unique opportunity to redefine the continent's financial landscape. These regulations must strike a delicate balance: fostering innovation while ensuring security, and promoting competition while maintaining stability.

Recent data underscores the necessity of this regulatory evolution. The Deutsche Bundesbank, for instance, reports in its 2023 study on payment behaviour in Germany, that while cash still accounts for 51% of point-of-sale transactions in Germany, its use is declining rapidly. Since the previous study in 2021, cash use has dropped 7 percentage points. Meanwhile, mobile payments have tripled since 2017, and 80% of Germans now have access to real-time transfers. The European Central Bank's SPACE report reveals a surge in contactless payments across the Euro area, from 41% in 2019 to 62% in 2022. These trends highlight a clear shift towards digital and innovative payment methods.

To harness this momentum and create a truly competitive European market, PSD3 and PSR must address several key areas:

Harmonisation of Surcharging Rules: The current patchwork of surcharging regulations across Member States has inadvertently hindered innovation and limited consumer choice. Already adopted in the majority of Member States, a comprehensive EU-wide ban on surcharging for all payment instruments would protect consumers, improve user experience, and create equal opportunities for all providers. This could particularly benefit smaller businesses expanding across borders, reducing complexity and costs.

Enhanced Passporting Rights: To truly foster a pan-European market, payment institutions need the ability to operate seamlessly across the EU. Eliminating the 12-month credit term limitation would level the playing field between banks and non-bank providers. This could lead to more diverse credit offerings, particularly benefiting consumers and SMEs in smaller Member States.

Risk-Based Approach to Strong Customer Authentication (SCA): While security is paramount, overly rigid authentication requirements can hamper user experience. The proposed PSR's revised approach to SCA is a step in the right direction. Explicitly allowing behavioural biometrics as part of the 'inherence' factor could significantly improve ease of use, especially for less tech-savvy customers, without compromising security.

Addressing Social Engineering Fraud: As digital transactions increase, so does the risk of sophisticated fraud. A holistic approach, including telecommunications providers and online platforms, is essential. Implementing a carefully balanced shared liability regime would incentivise all actors to prevent fraud, creating a safer ecosystem for consumers and businesses alike.

Fair Access to Payment Infrastructure: The cornerstone of an open market is ensuring all licensed payment service providers have non-discriminatory access to essential infrastructure. While progress has already been made on access to the interbank payment system, the same needs to be replicated in all other areas, including the Digital Euro.

These policy recommendations aim to create an environment where innovation thrives, and consumers benefit from enhanced choice and security.

The success of PSD3 and PSR will ultimately be measured by their ability to foster a payments landscape that is not just technologically advanced, but also inclusive, secure, and responsive to the needs of all market participants. By prioritising open competition, cross-border operability, and robust security measures, these regulations can set a new global standard.

PSD3 and PSR offer a unique opportunity to redefine the continent's financial landscape.

As Europe navigates this important moment, the stakes are high. Get it right, and the EU could become a global hub for payment innovation, attracting talent and investment while providing consumers with unparalleled choice and security. Get it wrong, and Europe risks falling behind in the rapidly evolving digital economy.

The path forward requires careful consideration and ongoing dialogue between regulators, industry players, and consumers. Only through this collaborative approach can Europe hope to create a payment ecosystem that truly serves the needs of its diverse population while maintaining its competitive edge on the global stage.

PERRINE KALTWASSER

General Manager of Risk, Compliance and General Counsel, of the Conglomerate & Member of the management board – La Banque Postale

The digital wallet is fully part of the future of payments in Europe

Banks have been playing a leading role in the development of SEPA payment instruments in Europe, the last being Instant Payment (IP), with increasing transactions following the entry into force of the IP regulation. The launch of the single currency in 2002 was also an important milestone.

However, cards were left out, while they account for a large part of the EU transactions. Popular with customers and based on both national and international networks, the card has failed so far to find a European way. Technological developments, particularly the rise of digital wallets, could constitute a response to this European gap.

The rise of wallets is linked to a simple, fluid and efficient payment experience

The world of payments is experiencing major changes in uses due to technological innovations such as mobile, contactless or instant payments, and digital wallets. The latter are booming all around the world. According to the Global Payment Report 2024, cards remain globally the preferred payment method in physical points of sale (52% of expenses, versus 30% for wallets) while in e-commerce, wallets and cards account respectively for 50% and 35%. The report predicts that by 2027, the relative weight of cards will drop by around 10 points in favor of wallets.

Mobile phones are now at the heart of all citizens' uses. Paying with a smartphone is widely accepted and adopted, especially among young people. Besides, the volume of new users is set to increase over the coming years, depending on the intention of use.

Customers' expectations are converging towards increasingly fluid and easy shopping journeys: mobile payment undoubtedly makes the act of payment fast and seamless. In Europe, Apple's recent decision to allow the use of all wallets on its iPhones, to avoid antitrust sanctions from the European Commission, may fuel an additional incentive for individuals and merchants to turn to digital wallets.

As payments go more digital, maintaining confidence in the payment system is a challenge for key stakeholders. Regarding security matters, the digital wallet happens to bring a relevant solution to reduce the risk of fraud.

Indeed, mobile payments are secured by authentication methods that are difficult to reproduce (fingerprint, face shape, voice recognition, etc.), making it almost impossible to pay with someone else's smartphone. Connecting to a phone designated as a trusted device and using biometrics or secret code to validate a payment via the application meets the requirements of strong customer authentication required by the European Commission to secure payments.

La Banque Postale supports Wero, the digital wallet for 450 million European citizens

La Banque Postale pays attention to changes in the uses and needs of its 10 million active retail customers and provides them with the best innovations combining practicality, fluidity, and security.Given the strong growth in contactless payment volumes and customers' appetite for existing wallets, La Banque Postale supports the development in Europe of a digital wallet for the benefit of all European customers and merchants. This development is even more necessary given the absence of a European card scheme.The EPI wallet will respond to all traditional uses of payments, be it peer to peer, between individuals and professionals, in-store or online, and will offer consumers and merchants a pan-European payment option for most of their payment transactions. These different services will be implemented step by step until 2026. For example, in France, Wero will replace the transfer service between individuals called "Paylib entre amis", which benefits from good brand awareness (nearly 50%) and has around thirty million registered users (compared to 15 million in 2020).

> **The European digital wallet meets customer expectations and new uses.**

Payments are a strategic area for Europe, and the wide distribution and use of a European wallet is a major issue in which La Banque Postale, shareholder of EPI and distributor of Wero, intends to fully participate.

To achieve the EU single payment market, a pan-European solution for both face to face and remote payment is necessary. As far as it can reach the critical size quickly (banks, countries, merchants), with the support of European authorities, EPI and its wallet Wero will be able to achieve this ambition.

Nevertheless, such a target also requires focusing on the development of this innovative and disruptive solution, and on its adoption by European consumers. That implies giving visibility to all stakeholders (distributors and consumers) and identifying initiatives likely to directly compete with it. In this perspective, the digital euro project should be considered with caution.

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THE EUROFI FINANCIAL FORUM **2025**

COPENHAGEN - DENMARK

17, 18 & 19 SEPTEMBER 2025

GLOBAL AND EU CROSS-BORDER PAYMENTS

THOMAS LAMMER
Deputy Head of Secretariat – Committee on Payments and Market Infrastructures (CPMI)

EMILIE FITZGERALD
Visiting Member of Secretariat – Committee on Payments and Market Infrastructures (CPMI)

The G20 cross-border payments programme is proceeding at pace

Enhancing cross-border payments can offer benefits to all, through lower costs, faster speed, greater transparency and improved access. The Bank for International Settlements' Committee on Payments and Market Infrastructures (CPMI), in coordination with the Financial Stability Board (FSB), the International Monetary Fund, the World Bank and other relevant international organisations and standard-setting bodies, has conducted a variety of stocktakes and analysis in the first two years of the G20 cross-border payments roadmap. The cross-border payments programme in 2024 is advancing at pace towards its target destination.

To monitor progress the implementation of measures of the prioritised G20 roadmap, the CPMI launched in 2023 a monitoring survey among central banks on the updated roadmap's three priority themes. These priority themes are (i) payment system interoperability and extension; (ii) cross-border data exchange and message standards; and (iii) legal, regulatory and supervisory frameworks.

The results, based on the feedback of 71 central banks, suggest that the journey of enhancing cross-border payments has successfully started: 71% of real-time gross settlement (RTGS) systems and 91% of fast payment systems have completed or are planning to complete at least two of the priority actions. All fast payment systems already operate 24/7, and many are now focused on implementing the ISO 20022 messaging standard and are planning interlinking initiatives with other fast payment systems for cross-border payments. Most RTGS systems are also planning to implement the ISO 20022 messaging standard.

In recent decades, domestic payment landscapes have benefited from some transformative improvements such as the introduction of fast payment systems, migration to the ISO 20022 messaging standard and the renewal of RTGS systems. Fast payments have become a viable alternative to cash or card payments in many jurisdictions and have supported financial inclusion, lower transaction costs and increased competition for retail payments. Even where initiatives have a domestic focus, they have the potential to improve the first and the last mile of cross-border payments.

One promising solution in the near to medium term to extend the domestic fast payments experience across borders is interlinking. Linking fast payment systems between jurisdictions, combined with strong governance and oversight, can enable such functionality across borders without compromising on safety and efficiency. The CPMI recognises the promise that fast payment systems interlinking shows for cross-border payments and is committed to its implementation across a large number of jurisdictions.

Agreeing on robust governance and oversight arrangements can be especially challenging due to the multi-jurisdictional, cross-border and potentially cross-currency nature of these arrangements. To support this, the CPMI is finalising a framework for the governance and oversight of these arrangements that will be delivered to the G20 in October.

Improvements in messaging standards and data exchange can also assist in the initiatives of interlinking fast payment systems. The CPMI has two initiatives in this area that aim to address current frictions. The first initiative is the harmonisation of the ISO 20022 messaging standard. Last year, the CPMI published its harmonised data requirements for enhancing cross-border payments to overcome differences in implementation across jurisdictions. The second initiative is the harmonisation of application programming interfaces, or APIs, which are increasingly relevant for data exchange between providers. In October 2024, CPMI will publish a report to the G20 around facilitating greater harmonisation of APIs in cross-border payments.

The cross-border payments programme requires collective public and private sector commitment. Cooperation is essential. As many jurisdictions and stakeholders as possible, including emerging markets and developing economies, must come on board. To assist this, the CPMI convenes G20 and non-G20 central banks in a community of practice, and private sector stakeholders in the payments interoperability and extension industry taskforce, as platforms for cooperation, coordination and discussion.

Enhancing cross-border payments also requires sustained action by individual jurisdictions and payment systems, with continued public-private sector collaboration. The CPMI will continue monitoring the progress across the priority themes and stands ready to facilitate the discussion and provide guidance as needed.

DISCLAIMER: The views expressed in this article are those of the authors and not necessarily the views of the Bank for International Settlements, the CPMI or its member central banks.

EMMANUELLE ASSOUAN
General Director Financial Stability and Operations – Banque de France

DLT applied to cross-border: what potential for more efficient infrastructures?

Achieving faster, cheaper, more accessible and more transparent cross-border payments is the aim of the roadmap set by the G20. Tokenisation, defined as "*the process of recording claims on real or financial assets that exist on a traditional ledger onto a programmable platform*"[1], is one promising way to achieve these policy objectives.

There are three reasons why the use of a Distributed Ledger Technology (DLT), which is the main vector for tokenisation, could be beneficial in cross-border payments. First, DLT can improve transparency and ease data reconciliation. Second, DLT reduces costs and inefficiencies by optimising processing thanks to smart contracts. Third, DLT functions on a 24/7/365 basis, which could significantly shorten transaction time, in particular for cross-border transactions over different time zones.

However, several features of tokenisation carry financial stability implications such as fragmentation resulting from multiple competing DLT, and other legal or cybersecurity risks.

In this context, central banks and the BIS Innovation Hub (BIS IH) are undertaking experiments to explore the potential of tokenisation to enhance cross-border payments. Since 2020, the Banque de France has been conducting experiments, with a view to issuing a wholesale Central Bank Digital Currency (CBDC) and developing interoperability with other DLT platforms to limit market fragmentation. The Banque de France has been a pioneer along two key dimensions.

First, to further strengthen the role of the euro as an international currency, the Banque de France successfully experimented the use of an automated market maker (AMM) solution for the cross-currency exchange of wholesale CBDCs. An AMM solution would be a unique counterpart for all currency buyers. Furthermore, an AMM would operate 24/7 and set a currency price according to the proportion of CBDC in the liquidity pool.

Project **Mariana** (2022-2023) achieved a better understanding of AMM, and its ability to trade, price and settle in a single operation. Project **Rialto** (2024-2025), in the wake of Mariana, aims to further improve instant cross-border payments using also interlinked instant retail payment systems.

Second, the Banque de France also focuses on the concept of unified ledger, a new kind of financial market infrastructure, which could combine tokenised central bank money, tokenised commercial bank money, and tokenised financial assets on a common seamless programmable platform.

This is the aim of Project **Agorá**, a public-private partnership between the BIS IH and seven leading central banks, plus several commercial banks, payment providers and financial market infrastructures (FMIs). It focuses on wholesale payments and it will test the feasibility of a multi-currency ledger for cross-border payments and the possibility of bringing together wholesale central bank money and commercial bank money in the form of tokens as the basis for a new type of FMI.

The Banque de France's participation in Agorá as the representative of the Eurosystem is of particular interest for the enhancement of the Capital Markets Union (CMU). A European unified ledger would be an infrastructure operated by European governance standards, on which tokenised financial instruments and tokenised settlement assets including CBDC, currently being explored by the Eurosystem, would coexist. This new infrastructure should initially target less efficient market segments that currently rely largely on manual processes, such as registrars and transfer agents for funds, but could then gradually extend to other asset categories.

Tokenisation is an ever-changing but promising process that authorities must continue to explore.

A European unified ledger could thus contribute to deepening the CMU. It has indeed the potential to improve the efficiency of post-trade in Europe through increased interoperability for market participants. It could also encourage the development of products issued directly on DLT, such as securities for innovative companies and green bonds, thus facilitating the allocation of European household savings to finance the green and digital transitions. Also, a unified ledger may overcome the constraints due to regulatory diversity in Europe, thanks to the programmability features offered by DLT.

These projects reflect the broad range of use cases that DLT provides for cross-border payments and its potential to address key frictions in this domain. Its implementation within the Eurosystem may also be particularly relevant to the objectives of the CMU. Tokenisation is an ever-changing but promising process that authorities must continue to explore.

1. *Bank for International Settlements, 2023, The tokenisation continuum*

SHRIYANKA HORE
Managing Director , Global Head of Industry Engagement – Swift

Harmonising standards and data sharing drives global payments interoperability

Harmonisation of financial messaging standards is critical for achieving improved straight-through processing, reducing cost and risk, and improving customer experience. But, to achieve faster, cheaper, more accessible and transparent global payments, this is not enough.

Harnessing ISO 20022

The industry's move to the data-rich ISO 20022 standard is a significant leap forward. The High Value Payment market infrastructures (MI) and the global banking community are on an adoption journey, and 68% of low-value payment MIs have also adopted ISO 20022.

In Europe, all ECB payment schemes are now ISO 20022 native – Target2, SEPA, SEPA Inst and OCT Inst – along with regional private rails like EBA Clearing's EURO1 and RT1.

But the alignment of market practice across these Payment Market Infrastructures (PMIs) is critical if we're to achieve seamless interoperability. A number of working groups have been collaborating in this space:

The Payments Market Practice Group (PMPG), a global industry forum, has created the Cross-border Payments & Reporting Plus (CBPR+) usage guidelines

The High Value Payments Systems Plus working group, an industry-led initiative to harmonise ISO 20022 usage guidelines for high-value payment PMIs, has created the HVPS+ usage guidelines

The Committee of Payments and MIs (CPMI) published a set of harmonised ISO 20022 data requirements for the industry.

Gearing up for the G20 goals

The G20's drive to enhance the speed, cost, access and transparency of cross-border payments has provided motivation for collective efforts for harmonisation across borders.

Swift, in collaboration with our global community, has delivered a number of building blocks, addressing friction in the payment chain and helping to drive the industry towards the G20's goals.

> Harmonising standards and data sharing frameworks is critical for achieving global interoperability.

Now, 90% of transactions over Swift reach the beneficiary's bank within an hour. But there's work to do at the industry level to ensure end-customers can access these funds as quickly as possible. Delays in money reaching the account often occur because of friction on the beneficiary leg – caused by currency controls, batch processing systems and limited MI operating hours. Local infrastructure and policy therefore have an important role to play in achieving the G20 goals.

Empowering instant PMIs for cross-border payments

The proliferation of Instant Payment Systems (IPS) has transformed domestic retail payments, but very few are cross-border enabled. The G20 roadmap is looking to enable domestic IPSs for the last-mile delivery of international payments and is exploring IPS-interlinking.

The BIS' Project Nexus is focused on connecting multiple domestic IPSs to enhance cross-border payments. The project is leading the way in demonstrating the need for harmonisation beyond messaging, covering shared technical standards, rulebooks and governance.

There are other established models in this space, such as the One-Leg-Out (OLO) model that has been adopted by Europe with the introduction of the OCT Inst scheme in November 2023.

This work highlights the need for shared standards between IPS MIs, but differences remain between disparate domestic low-value payment standards and industry-wide cross-border standards. As such, the Instant Payments Plus (IP+) working group, a collaboration between Swift and the industry, developed an ISO 20022 market practice aligned with the guidelines developed for CBPR+ and HVPS+, to enable instant payment systems for cross-border payments.

Swift continues working with the PMPG to ensure that CBPR+, HVPS+, IP+ and the CPMI data model are fully interoperable.

Facilitating interoperability through harmonisation

Taking a holistic view of harmonisation is vital, recognising that it's not just about messaging standards. Enabling seamless interoperability requires alignment of market practice, sharing of reference and regulatory reporting data to enable pre-validation, and the adoption of common technical standards (e.g. Unique End-to-End Transaction Reference).

Europe's policymakers are working towards this wider harmonisation in developing regulation for cross-border and instant payments. An excellent example is the European Commission's Verification of Payee (VoP) security measure – soon to be compulsory for all instant payments across the EU & EEA. This helps prevent accidental misdirected funds and fraud, important since instant payments are irreversible.

Some European countries have already implemented domestic VoP systems. While these work domestically, some have limitations in cross-border scenarios. Swift is helping to facilitate interoperability between solutions and aiding FIs to meet the requirements through our Payment Pre-validation service. We're committed to developing a community-driven interoperability model. Through this work we can realise the vision we share with the G20 to deliver instant, frictionless and interoperable cross-border transactions that are faster, cheaper, more accessible and transparent.

TIM KEANE
Head of Regional Operations, EU CIS – Western Union Payment Services Ireland

Harmonization to enhance the cross-border payments

The financial services sector, with its relentless focus on new technologies, is at the very top of the industries that haven't just embraced innovation, but can claim that their use of innovation has changed the way people live and work, and companies operate across the world – a world where geographical borders now matter less, and global markets are interconnected more than ever before.

The payments sector has been at the forefront of this digital transformation, not least to also respond to evolving consumer expectations. Customers today benefit from faster, cheaper, more secure, and convenient cross-border payment solutions. For companies operating at a global level, such as Western Union, ensuring that consumers can benefit from similar payment experiences across jurisdictions is a priority at the core of our operations.

These developments have been made possible both because of technological evolution and due to the important collaborative work that has been taking place internationally. The G20 is now entering the implementation phase of its Cross-Border Payments Roadmap, with a final push to achieve the highest degree possible of regulatory framework harmonization and ensure that payments benefit from increasingly interoperable systems. The Financial Action Task Force is, amongst others, prioritizing the alignment of the information collected associated with global payment value chains. This is essential to ensure that loopholes are closed, and that money can flow across jurisdictions in a transparent and safe way.

With all these significant steps taken at a global level, it is equally important to guarantee that the European Union remains integrated in the global payments landscape, as a major player fostering both innovation and consumer protection. To that effect, important efforts are underway: For companies like Western Union operating across the entire Single Market, the paradigm shift towards a more Regulation-based approach is truly welcome. The new AML Regulation, and soon-to-be established centralized Authority, will also contribute to a more harmonized approach that will help prevent financial crime, closing existing loopholes and facilitating the exchange of information between obliged entities and supervisors.

However, to contribute to a better functioning of Payments market, further emphasis on interoperability and harmonization across Member States is still needed, including on consistent rule enforcement. Despite progress made, friction on the cross-border provision of payment services persist, hurting consumers and preventing businesses from achieving efficiency gains and scaling up their operations.

To harmonize and align the rules internationally will allow to encourage further innovation.

Ongoing efforts on the Payment Services Package and the implementation of the various payments and AML frameworks provide a unique opportunity to enhance both payment system harmonization and interoperability and addresses Cross Border Payments Roadmap's building block 5 challenges. Amongst others, Western Union believes that the Cross Border Payments framework could benefit from:

- Addressing persisting competition challenges between bank and non-bank PSPs, notably by ensuring that unwarranted de-risking practices are fully eliminated. These practices lead to significant challenges for business continuity, ultimately affecting consumers who struggle to access products and services with their PSP;
- Ensure that regulatory requirements are proportionate, fit-for-purpose and technically feasible. The new PSR as well as aims to enhance consumer fairness and information through enhanced transparency on the information associated with money transfers. Western Union strongly supports these efforts but the proposals to display FX margin may not improve consumers' ability to make an informed choice and could even be confusing. For providers, independent benchmarks would be more technical appropriate as central bank reference rates may not consistently provide reference rates for all global currencies that are accessible to market participants; and
- Minimize inconsistencies between the various requirements across legislative frameworks, including the rules on payment services, AML/CTF and data privacy. Duplicative and contradicting requirements lead to decreasing efficiencies and significant legal uncertainty, penalizing the competitiveness.

The current momentum to harmonize and align the rules, within the EU and internationally, needs to be leveraged to improve the way existing cross-border payments are conducted and encourage further innovation in the sector. Western Union, with its unique global perspective, will continue to support policy makers and the industry on these efforts, contributing to better cross-border payments, better risk-mitigation techniques, fairer competition and offer consumers safer, cheaper and more convenient cross-border money transfers.

DEBORAH HRVATIN
Chief Risk Officer – CLS Bank International

The importance of PvP in an everchanging FX ecosystem

CLS was established in 2002 as a response to the public sector's call for the private sector to mitigate foreign exchange (FX) settlement risk. This is the risk that one party delivers the currency it sold but does not receive the currency it bought, resulting in a loss of principal. CLS's payment-versus-payment (PvP) solution has grown to be the de facto market standard for tackling FX settlement risk, settling payment instructions in 18 of the world's most traded currencies.

The proportion of FX trades not settled on a PvP basis has increased in recent years, driven by the growth in emerging market (EM) currency trading. According to the Bank for International Settlements 2022 Triennial Survey,[1] the share of non-CLS eligible currencies grew from USD0.2 trillion average daily turnover in 2010 (ca. 5.5% of trades) to USD0.7 trillion in 2022 (ca. 8.5% of trades). This has led the FX market to renew its efforts in reducing FX settlement risk. One way to mitigate the outstanding settlement risk is to make PvP and other practices for risk mitigation, including netting, available to a broader range of currencies – particularly heavily traded EM currencies.

Extending PvP solutions in EM currencies comes with challenges, ranging from operational to legal and regulatory aspects, that must be carefully managed in the current geopolitical context. There are several public / private sector initiatives around the globe exploring ways to further facilitate the mitigation of the FX settlement risk.

In October 2020, the Financial Stability Board published the G20 Roadmap for Enhancing Cross-Border Payments, an initiative addressing the challenges of cost, speed, transparency, and access in cross-border payments. Building Block 9 of the G20 roadmap focuses on mitigating FX settlement risk for cross-border payments – a key challenge for the wholesale market – by encouraging the use of PvP arrangements. The G20 initiative acknowledges that while existing PvP systems like CLSSettlement have made significant progress in reducing settlement risk, there are still obstacles to broader PvP adoption.[2]

During its first two years, the G20 roadmap initiative focused on stock-takes and analysis. On this basis, and in an effort to deliver tangible enhancements to cross-border payments by the end of the 2027, the project established a three-year prioritization plan and a public-private sector engagement model.[3] As a member of the CPMI-led Payments Interoperability and Extension task force, CLS is working with a diverse group of public and private sector stakeholders to help achieve the G20 cross-border payments targets.

Several public/private initiatives are exploring further mitigating FX settlement risk.

CLS is also contributing to the three-year review of the FX Global Code, a set of global principles of good practice for the FX market. The FX Global Code inter alia encourages FX market participants to explore ways to further mitigate risk and reduce operational costs by adopting a best practice approach to FX settlement risk management and netting (principles 35 and 50).

There is a spectrum of settlement practices starting ideally with PvP settlement, which fully mitigates FX settlement risk, to different kinds of netting solutions which are encouraged to at least help decrease FX settlement risk exposure.[4] One could picture this as a "waterfall" of potentially cascading mechanisms.

At the top of the waterfall, CLSSettlement provides the wholesale settlement backbone for the global FX market, settling on average over USD6.6 trillion a day. CLS estimates that it has captured 90% of the CLSSettlement-addressable market, with volumes continuing to grow. In June this year CLS settled a record value of USD19.1 trillion.

Further down the waterfall and where PvP is not available, CLS provides an automated bilateral payment netting calculation service, CLSNet. This service helps market participants benefit from greater operational efficiency and enhanced risk mitigation for over 120 currencies, including currencies not supported by CLSSettlement. This service continues to grow, and its average daily netted value[5] is now USD148 billion, up 40% year-on-year. In June this year CLSNet saw a record daily netted value of USD593 billion.

CLS will continue to engage with the community of regulators, central banks and the industry to work on solutions to mitigate settlement risk, particularly for EM currencies.

1. *BIS Triennial Central Bank Survey; bis.org/statistics/rpfx22.htm*
2. *CPMI (2023) Final Report – Facilitating Increased Adoption of PvP*
3. *See cls-fx-policy-01-navigating-the-fx-lane-shaping-fx-series-september-2023.pdf (cls-group.com)*
4. *See cls_shapingfx02_pvp_or_not_to_pvp_may2023.pdf (cls-group.com)*
5. *Netted value refers to bilateral net payment amounts calculated by CLSNet*

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MACROECONOMIC AND MONETARY SCOREBOARDS

DIGITAL EURO: FEATURES AND CHALLENGES

BURKHARD BALZ
Member of the Executive Board – Deutsche Bundesbank

The digital euro: paving the way for the digital age

In October of last year, the European Central Bank and the other central banks in the Euro area including the Bundesbank successfully completed a two-year investigation phase of the digital euro project. Now, the Eurosystem is preparing for the possible issuance of the digital euro as a digital means of payment to meet the changing payment preferences and trends of European citizens. Many central banks around the globe are currently engaged in some form of central bank digital currency (CBDC) work with a view to adapting central bank money to the digital age. The Eurosystem is certainly among the pioneers regarding retail CBDC with respect to the progress of its work on the digital euro.

In a nutshell, the digital euro would be European digital cash. European because payments would be possible throughout the entire euro area and the digital euro would also be made and managed in Europe. Digital because payments would be possible using a smartphone and in online trade. It would also be open to upcoming, new forms of payment and services. And cash because the digital euro would be publicly provided money, i.e., secure, intended for transfer among individuals, and with a high level of privacy protection. However, it would not replace cash. The digital euro would complement physical cash, offering individual users more freedom of choice by providing a secure and accessible payment solution. And that would be the case in almost all everyday payment situations – be it at the checkout in retail stores, among friends and relatives, when making purchases online, or even when making payments to or receiving payments from public authorities. A digital euro would be free of charge for private individuals for its basic functions and could be used both online and offline, that is to say without a connection to the internet, as well as for person-to-person (P2P) payments. No other digital means of payment in Europe currently offers all these functions. The digital euro would be an all-in-one solution for retail payment transactions.

Furthermore, a digital euro would make a significant contribution towards strengthening the European payment infrastructure and supporting the strategic autonomy of Europe's payment ecosystem. The European payments landscape is highly fragmented. 13 out of 20 countries in the euro area do not have their own national card scheme and therefore rely solely on internationally operating providers. Despite a number of initiatives over the years, 25 years after the introduction of the single European currency, the euro, there is still no European payment solution that can be used across the entire euro area and that runs on a European infrastructure. Furthermore, there has been a growing trend towards cashless payments in Europe for many years now. According to the SPACE study conducted by the ECB, cash payments in the euro area fell from 72% in 2019 to 59% in 2022. At the same time, e-commerce is booming. However, the payment solutions for the digital world are typically run on non-European payment infrastructures.

This raises the legitimate question as to whether Europe can afford to be heavily, or even solely, dependent on a hand full of international players when it comes to an infrastructure as critical as its payment system. The rising geopolitical tensions in recent years have ultimately highlighted the risks that such a dependency can entail. With a digital euro, Europe would have a payment solution in the form of public money for retail payments across the entire euro area – and that under European governance. Accordingly, the digital euro would strengthen the strategic autonomy of Europe and increase our resilience.

The digital euro would be an all-in-one solution for retail payment transactions.

However, for the digital ecosystem of the future, Europe needs more than just a digital euro for retail transactions. There would also be benefits in a new form of digital central bank money for banks and other financial institutions: wholesale CBDC. Experiments with distributed ledger technology (DLT) can be observed across the entire economy. And when it comes to wholesale DLT-based financial market transactions, central bank money is the safest and most liquid settlement asset. Here, too, the payment and settlement systems need to adapt to changing needs. The Eurosystem, together with market participants, is therefore examining a number of so-called interoperability solutions that connect the DLT world with the payment system infrastructure. One of these solutions is the "trigger solution" developed by the Bundesbank which is quick and easy to implement and almost risk free. It is based on a bridge device that connects the DLT world with conventional payment systems. It is remarkable to see how the private and public sectors are joining forces to harness the benefits of new technologies for capital market transactions.

STEFANO CAPPIELLO

Director General of Regulation and Supervision – Ministry of Economy and Finance, Italy

Digital euro: the role of public money in the digital age

Money is an everchanging tool and the central bank digital currencies are only the latest milestone in a long journey, which covers a wide range of very different legal and technological means, from spices to metals, to eventually land onto paper and digital. In this evolutionary process, the CBDC is the natural response to the fact that, in an increasingly digitalised world, everyday life and transactions take place increasingly through (or even in) a digital environment. Physical central bank money, such as banknotes and coins, represents a decreasing percentage of retail payments. CBDCs are therefore needed to ensure that fiat money holds its role as a public good and as the anchor of the payment and monetary system, also to safeguard financial stability and strategic autonomy.

The digital euro project is the Euro area answer to the challenges posed by this scenario and will safeguard the role of public money as the cornerstone of our payment system. However, the digital euro will not develop from a blank sheet of paper: it will need to find its own space in an already advanced and competitive payment ecosystem. Thus, to be successful, it should be built on the same formula that has made the success of physical public money: leveraging on the expertise of financial intermediaries in distribution and customer relationship while ensuring high levels of security, affordability and ease of use. The current technical and legal activities – undergoing in a coordinated way at both the Eurosystem and the co-legislators' level – are aiming at striking the right distribution of roles and responsibilities in this new public-private partnership. The distribution of the digital euro should be carried out by payment service providers, who are best positioned to do so, but will be regulated so to guarantee that both consumers and businesses enjoy high levels of safety and affordable costs. Digital euro accounts should be large enough to allow the most common payment transactions but, at the same time, will be designed in order not to impact negatively on banks' liquidity requirements nor their role in the financing of the economy.

A balanced allocation of tasks between public and private actors will be key for the digital euro.

With respect to the costs associated to the digital euro, the use of the digital currency should be affordable to all users (with free basic services offered to natural persons) while ensuring that payment service providers recover the costs associated with the distribution of the new instrument. Also, the digital euro shall provide for a high degree of privacy while always securing the need of authorities to access data to comply with relevant tax and AML/CFT requirements. With respect to the latter, while recognizing the need for (as long as possible) a neutral approach between physical currency and CBDC, one should also keep in mind the specific challenges that the digital support raises, and the need to address them with adequate regulatory safeguards. From a functional point of view, the digital euro is in fact much more than a simple digital version of banknotes and coins: it can accommodate an increasing number of use cases, from P2P proximity payments to credit transfers to government and businesses.

Thanks to its flexibility, security and ease of use, the digital euro could play a pivotal role in the European strategy for financial inclusion, an issue that has not received adequate attention in the current debate. In a world where cash access and usability is diminishing and electronic devices are ubiquitous in every social class and geographical area, the combination of a digital euro account with a payment instrument incorporated on widely distributed and easy-to-use physical medium (e.g., smartphone, physical card, etc.) could create a universal and low-cost financial mean for financial inclusion, thus overcoming the difficulties that other solutions have experienced in the past (such as the PAD's basic account). The G7 under the Italian presidency is examining the role played by CBDCs' projects in promoting financial inclusion to better understand their potential as an entry point to the formal financial system in both advanced and developing economies. It is worth mentioning that the know-how acquired with a digital euro could also spill-over to other important areas where CBDCs can make the difference, such as cross-border payments and the lack of innovative means for settling financial transactions recorded on DLTs.

In sum, the benefits of the introduction of a digital euro seem to largely exceed its cost. The ECB and co-legislators are working, together will all relevant stakeholders, to ensure that all risks are taken care of and to provide for the smooth roll-out of this new payment instrument. If public and private sector join forces, and the roles and responsibilities of the different parties are clear, the digital euro will guarantee the innovativeness, competitiveness, inclusiveness and strategic autonomy of the Euro area also in the digital age.

KATHARINA PAUST-BOKREZION

Head of Payments & Digital Policy, Government & Public Affairs – Deutsche Bank AG

European sovereignty: the power of a synergistic path for EU retail payments

Europe is at a pivotal juncture for the sovereignty of its retail payments. The integration of the digital euro and private sector payment initiatives, such as the European Payments Initiative (EPI), is not just a strategic move but a necessity to achieve European independence in digital payment solutions. Understanding and utilising the symbiotic relationship between the public and private sectors and their potential to reshape the European financial ecosystem is key to long-term success and competitiveness.

The Digital Euro: A Pillar of Stability

The digital euro for retail payments aims to provide a secure and efficient digital form of central bank money that complements cash and existing electronic forms of money. The focus of its design should be on the long-term resilience of the European payment system by providing a central bank payment infrastructure that efficiently interoperates with the private sector infrastructures for retail instant payments in the Eurozone.

Like the existing Eurosystem infrastructure for instant payments, TARGET Instant Payment System (TIPS), the digital euro platform will be important for innovative digital payment solutions for citizens and businesses in the Eurozone and beyond. The seamless convertibility of private forms of regulated digital money with the digital euro will facilitate public trust in the accessibility of central bank money in the digital era.

In the context of stability, it must be further underscored: the digital euro for wholesale payments in capital markets, interbank and cross-border payments is equally essential for stability, and arguably, assumes an even greater role in strengthening the international role of the Euro. Consequently, it becomes an absolute necessity for the Eurosystem to devise a well-defined, tangible roadmap for a wholesale digital euro to address these strategic objectives.

EPI, Bizum & Co: Payment Solutions for the EU by the EU

The European Payments Initiative (EPI), Bizum, Bancomat, and MB Way are examples of collaborative efforts of EU banks and payment service providers to create payment solutions that work consistently across the EU. They aim to increase competition in the EU payment landscape and complement well-functioning national solutions.

> **A strong public-private symbiosis is the key success factor for our sovereignty strategy.**

The private sector is in the middle of further advancing and rolling out the payment solutions of the future. Time to market is key to be successful considering the fierce competition. The fast-changing payment needs and habits of citizens and businesses center around future technology on devices and in apps changing the payment preferences of citizens and constantly challenging the readiness of businesses.

In market segments where competition is currently inefficient, these strategic initiatives are expected to drive down costs for businesses when accepting payments. The overarching objective is to provide state-of-the-art and multifunctional payment solutions that can be used across the European continent for all EU currencies.

Synergy for Sovereignty

With the introduction of open banking under the revised Payment Services Directive (PSD2), the EU kicked off a transformation towards a vibrant payment market. The ECB, together with the private sector, can build on that foundation. The integration of the digital euro with private sector payment solutions and initiatives brings significant benefits towards achieving European sovereignty in digital payments.

At the same time, existing and well-established payment solutions continue to play an important role in facilitating financial and digital inclusion across all Member States, acknowledging the diversity of payment cultures.

By bringing these respective strengths together, the ECB and the private sector can develop a joint roadmap towards a shared vision of EU retail payments.

It is the combination of these different elements of the payment landscape that will unleash the full benefits of the digital euro. As the Bank for International Settlements proclaims in its vision for a future monetary system: improving the old, enabling the new.

A Joint Vision for the Future

In conclusion, a European retail payments strategy centered around pan-European private sector initiatives and the digital euro is a critical step towards strengthening the EU's strategic autonomy, sovereignty, and competitiveness in the digital economy based on a strong and resilient payments sector.

As Europe navigates the intricacies of the digital age and the challenges posed by the recalibration of the geopolitical landscape, understanding the necessity of efficiently integrating these initiatives and wisely deploying the power of public and private sector resources for the best outcome is crucial in ensuring that the EU asserts its role in the world.

COSIMO PACCIANI
Head of Unit, Group Research Hub & Chief Economist – Poste Italiane

Digital Euro: a sandbox for the virtual European society?

Recently, we observed a constant plea for further European integration through completion of a series of incomplete "unions" (e.g. Capital markets and Banking) or through new concepts, such as a single European digital market, and a Savings and Insurance common markets. This is the result of what we learned through the recent experience of the Covid crisis and the Ukrainian war. In a conflictual and fragmented geopolitical context, where new emerging powers are challenging the political and economic relevance of the European Union, we rediscovered the value of sticking together.

This is where the Digital Euro project could make the difference: it can be seen as the supply of another payment method to the European citizens, or a 'competitive need' as other projects around the world are racing to introduce and launch CBDCs. Broadening our horizons, the Digital Euro is a quantic moment, akin to when the physical Euro became part of our daily lives back in 1999, but with much more potential to become the testing ground of the new Digital European Society.

Therefore, we could imagine the project as a "sandbox" to test and link a series of other innovations, a safe place where it will be possible to landscape the Digital Europe, not leaving anyone behind, as the European Commission's Digital manifesto proclaims.

We are entering an era where it will be crucial to redefine the basic services we define as European Public Goods, alongside creating new forms of Universal Services for the digital and virtual spaces. Hence, the challenges and opportunities, if we will allow the project to be a transformative and not only a normative place. Some ideas on how to deliver this:

Inclusivity as basic principle – The Digital Euro will be delivered to every European, even the ones not banked or not used to technology. A substantive effort that will need many different partners, with the capacity to reach out every single European community, closing the digital gap created by demographics, territorial distribution (marginal zones) and education to digitalisation. Inclusivity is also linked to supporting citizens, dispelling fears and concerns about the safety and privacy characteristics of immaterial currencies and digital finance assets. In a world getting more and more used to e-commerce, we still need the physical reach.

A gateway to innovation – As the European citizens will get accustomed to the Digital Euro, it will be possible to disseminate other important concepts to create that digital landscape defined above. Digital or E-IDs, tokenisation of assets and launch of health services through wallets and apps are examples of add-ups to the Digital Euro, as they all need a coherent and associative-connected digital platform, available on-line and, more relevantly, off-line. The Digital Euro will imply convergence between financial and digital education. And this is related to tokenisation, the main revolution in fieri behind the CBDCs: we will have to transform in digital value equivalents all our assets and holdings, so that any possible financial or commercial transaction will be based on one own's tokenised profile. A concept still elusive to many, but a true gamechanger. The new generations in Europe are already accustomed to digital assets, through gaming and social platforms, or, in some cases, to trading crypto or NFTs via microtrading platforms.

Interoperability and cross-border functionalities – The capacity to access one's wallet or one's digital Euro will pose challenges in a fragmented payment network, with different suppliers and levels of service across European countries. It is not only about finding the last European left behind, but also to allow a seamless experience when the Digital Euro is used. This will imply careful consideration of regulatory issues and integration of different payment models-platforms.

We could imagine the Digital Euro project as a "sandbox" to test other innovations, a safe place where it will be possible to landscape the Digital Europe, not leaving anyone behind, as the European Commission's Digital manifesto proclaims.

Revolutionising the banking model – The universality of the Digital Euro and its capacity to become the basis for further rethinking of the relationship between citizens and their own physical-digital space will impose a redefinition of banking services, transforming the industry of providing payment, credit or supporting clients for their savings and investment needs. It will be key for the main financial players to see the opportunity to transition their clients into a new world, where formation of margins, supply of financial services of any kind and investment allocation will impose more attention to pricing of services and fees. Once again, if properly engineered, the next phase of the Digital Euro project could become a space where citizens and financial institutions redefine together nature and scope of "banking 3.0".

These are only some of the initial challenges for the Digital Euro project, becoming rapidly a quantic moment for the birth of a "Digital European Union", alongside a new European Virtual Society. Ergo, ready for the challenges and opportunities ahead.

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CHALLENGES FACING THE EU SUSTAINABILITY APPROACH

JEAN-PAUL SERVAIS
Chair - International Organization of Securities Commissions (IOSCO)

Global challenges in the international sustainable finance framework

Global progress towards the introduction of sustainability disclosure requirements has been swift since IOSCO announced its endorsement of the first ISSB Standards in July 2023.

IOSCO called on its members, who regulate companies in more than 95% of the world's financial markets, to consider ways in which their jurisdictions might adopt, apply or otherwise be informed by these ISSB Standards within the context of their jurisdictional arrangements.

The ISSB can now count on a growing number of jurisdictions that have taken steps to integrate these standards into their regulatory regimes.

Currently, these jurisdictions together already account for almost 55% of global GDP, more than 40% of global market capitalisation and above 50% of global greenhouse gas emissions.

Thousands of companies around the world are now preparing for the publication of their first report for the 2024 end of year accounts. We estimate that up to 130,000 firms could use the ISSB Standards or aligned disclosures in due course.

The public sector acknowledges the implementation challenges and costs for companies, as well as what some have called the emergence of sustainability fatigue. However, the benefits of sustainability reporting outweigh the costs, and it may well be that soon the entities that do not join the sustainability reporting may incur an added cost.

In this respect, it is important to highlight that some jurisdictions will phase in the new requirements over time. Other jurisdictions are expected to follow a climate-first approach, in some cases as a step towards a more comprehensive approach to adoption at a later point. Jurisdictions may also scale up requirements gradually, starting with certain industries or a subset of listed entities.

As companies around the world are increasingly mandated by the ISSB Standards and the ESRS to disclose sustainability-related information, EFRAG and the ISSB have taken welcome steps to reduce complexity, fragmentation and duplication for companies applying both the ISSB Standards and ESRS.

To encourage convergence and interoperability of sustainability reporting regimes, IOSCO will continue to focus on and dedicate resources to implementation and capacity-building, particularly for many emerging markets. This is important because these emerging markets are the same jurisdictions that are both in need of capital market funding to finance the climate transition and that will require the most assistance in implementing sustainability reporting standards. It is therefore a priority for IOSCO to support jurisdictions in their implementation considerations of disclosure requirements within their own domestic contexts, in line with IOSCO's endorsement decision.

Recently, IOSCO has begun to work on transition plans, another piece of the ESG data puzzle, as these are seen as important in providing key information to investors and financial markets. Transition plans are relevant to investors and the market only if they allow for comparison, are consistently reported and of high quality. Otherwise, they could increase the risks of greenwashing, which leads to the erosion of investor trust. This is why we believe collaboration at international level is necessary, to mitigate the risks of fragmentation by working together. IOSCO has a role to play to prevent a new alphabet soup of voluntary transition plans and disclosure initiatives, in the best interest of issuers and investors.

To contribute to the trustworthiness and thus usefulness of the disclosures, IOSCO also encourages the global development of assurance standards. The current landscape in this regard is very heterogeneous in terms of the scope of the assurance and who provides the assurance. In order to maximize trust and confidence in sustainability disclosures, both investors and markets expect that high-quality assurance over sustainability reporting should be required on a global scale. In this respect, we are engaging with the international standard setters on their forthcoming assurance standards, to assess if IOSCO can encourage its members to take them into account as they consider assurance in their jurisdictions.

To conclude, it should be recognised that the sustainable finance regulatory framework, at both global and EU levels, has been created at exceptional speed, given the complexity of the matter and all the elements of the investment chain it covers.

To avoid regulatory fatigue, the focus is now on stabilizing and converging the regulatory framework at international and European levels and on devoting due attention to the implementation phase.

LUCA FERRAIS

Director, Sustainable Finance and International Affairs – Ministry of Economy and Finance, Italy

Streamlining ESG: regulatory simplification and technological innovation

The path to sustainable finance is complex and multifaceted, requiring a careful balance between regulation and competitiveness.

The debate over the best approach for sustainability focuses on market-led initiatives, which encourage voluntary adoption of sustainable practices through market incentives, and formal transition policies, which mandate these practices through regulations. Market-led approaches foster innovation and flexibility, as seen in the growth of green bonds in Europe, while formal policies ensure minimum standards and prevent "greenwashing." Both approaches aim to integrate sustainability into business practices, balancing innovation with accountability.

Recent opinion trends and political developments suggest that while robust regulation remains important, there is a growing need for simplification and adaptation to support a business-friendly environments. Regulations that are too rigid and complex can lead to compliance fatigue, where businesses, especially SMEs, become overwhelmed by the administrative burden of adhering to numerous and frequently changing technical requirements. This fatigue can result in diminished engagement with sustainability initiatives and potentially higher operational costs and competitive disadvantage.

There might be a possible shift from a transparency-focused sustainability approach to one centered on risk mitigation, regulatory simplification and enanched digital solution. This shift may require a renovated focus on:

1. **Usability and renewed balance of existing frameworks:** A review of current rules to address inconsistencies, simplify processes, and ensure proportionality, especially for SMEs, is essential. This could involve consolidating overlapping definitions and streamline technical requirements across sectoral legislation (i.e. banking, investment funds, insurance, non financial). This can be achieved also through dynamic principles-based regulations tailored to specific sectors that set clear objectives but allow businesses the flexibility to determine how best to achieve them. There may be also a shift towards measuring and managing the actual impact of sustainability initiatives rather than merely focusing on transparency. This could involve developing new metrics and standards to assess the real-world outcomes of ESG efforts and ensuring that they contribute to broader sustainability goals.

2. **Innovative technologies**: Collecting reliable ESG data is a significant challenge. Companies must often rely on third-party data providers, which can vary in terms of methodology and quality. Making ESG raw data readily available and comparable for all stakeholders is key. It is pivotal to work on a centralised and effective management system, that should be publicly managed given the nature of public good of these data. The forthcoming creation of the European Single Access Point represents a promising tool for Europe. Similar initiative should be carried out with reference to raw data on ESG risks. In addition, advanced technology, particularly fintech solutions, plays a pivotal role automating data collection and reporting, improve accuracy, and providing real-time insights into sustainability performance along the supply chain, making it easier for businesses to comply with regulations and for investors to assess ESG risks and opportunities. By leveraging AI-driven platforms or cloud computing for example, both financial institutions and SMEs can enhance their sustainability performance while remaining competitive.

Regulatory balance and tech innovation are key to advancing sustainable finance.

3. **Collaborative Approaches**: Collaboration between policymakers, financial institutions, and other stakeholders will be crucial to developing effective and pragmatic sustainability solutions. This could involve public-private partnerships and multi-stakeholder dialogues to share best practices and drive innovation. In Italy we set up a Sustainable Finance Platform at the Ministry of Finance, involving the Ministry of the Environment and Energy Security, the Ministry of Entrepises and our financial supervisors. The Platform aims to be a forum for interaction and open dialogue between public institution and various stakeholders (public and private ones) and it is offering tools and solutions to promote and ease to private investment in sustainable projects.

By fostering an environment that supports both compliance and innovation, policymakers can drive a sustainable transition that is both effective and economically viable. Addressing ESG fatigue requires a balanced approach that includes clearer rules, better data management practices, and support for companies, especially smaller ones, in navigating these requirements.

SUZANNE LLOYD
Vice-Chair – International Sustainability Standards Board (ISSB)

Equipping investors with decision-useful sustainability information

Three years ago, the IFRS Foundation – the independent global standard-setter for the capital markets known for developing a global accounting language – announced the creation of a new standard-setting board: the International Sustainability Standards Board (ISSB).

The ISSB's task is to develop a global baseline of sustainability disclosures to meet investors' need for high-quality, comparable information about companies' sustainability-related risks and opportunities.

One important motivation for creating the ISSB was harmonisation in the sustainability reporting landscape. The fragmented landscape made it complex and costly both for companies seeking to provide sustainability information and for investors relying on that information and seeking to compare investees.

Three years on, the landscape of sustainability disclosures looks very different to 2021. The so-called 'alphabet soup' of frameworks, standards and reporting initiatives has been significantly reduced and jurisdictions around the world are incorporating sustainability-related disclosure requirements in their regulatory and legal frameworks. Investors will get the information they need to make informed decisions.

Embedding the global baseline

In June 2023, we issued our first two sustainability disclosure Standards – one covering general sustainability-related disclosure requirements and one setting out climate-specific disclosure requirements.

More than 20 jurisdictions around the world, representing over 50% of global GDP and global greenhouse gas emissions, are already taking steps to adopt or use the ISSB Standards with reporting beginning as early as [2025].

In Europe, the European Sustainability Reporting Standards (ESRS), developed by European standard-setter EFRAG, require European companies to report on sustainability matters from this financial year.

The ISSB's goal is to inform investor capital allocation decisions through globally comparable, targeted and decision-useful disclosures. The EU requirements also seek to meet various policy objectives, so require additional disclosures. While the EU and ISSB have different objectives, there is a high level of alignment in the Standards, particularly in relation to climate. This matters – especially for companies that are required or choose to use both sets of requirements.

To help companies navigate between the requirements, the IFRS Foundation and EFRAG published interoperability guidance earlier this year, providing practical materials explaining how companies can efficiently comply with both sets of standards.

The next chapter

The ISSB recently embarked on a new two-year work plan with clear priorities, informed by public consultation, to strengthen and build on the foundation created by our first two Standards.

The main priority is continuing to support the implementation of those Standards. We recognise that providing sustainability disclosures is a new territory for many companies, requiring upskilling and system changes.

Another priority is enhancing our SASB Standards – resources supporting companies in providing industry-based disclosures – and starting two new research projects, which could result in future standards. One project is centered on the risks and opportunities associated with biodiversity, ecosystems and ecosystem services. The other on human capital, including employees and workers in the value chain of a company. As with our first two Standards, our work in these two topic areas will consider building on existing materials, rather than starting from scratch.

Global sustainability disclosure landscape shaping up.

The ISSB has identified three core activities that underpins all our work. First, ensuring connectivity between sustainability-related disclosures and the information reported in financial statements. Second, engagement with stakeholders and continued work with jurisdictions. And third, our work with other standard-setters – the Global Reporting Initiative (GRI) and EFRAG – to reduce fragmentation and duplication in reporting where possible - one of the reasons for creating the ISSB.

Collaboration is key

The ISSB continues to work closely with investors to understand their information needs. We've been encouraged by the strong investor response to our work already – investors have called for voluntary use by companies of the ISSB Standards, responded to jurisdictional consultations, provided feedback directly to us and been strong advocates for regulatory adoption of our global baseline.

We look forward to continued collaboration in our new phase of work – over the next two years and beyond.

LINDA-ELING LEE
Founding Director and Head of the MSCI Sustainability Institute – MSCI

Transition finance needs to reach beyond the boundaries of Europe

Capital is a prerequisite for decarbonizing our economy and so is policy. Nowhere is this more evident than in the European Union, where policy and capital are together driving progress. Emissions from electricity generation in the EU are set to fall by far more than any other region, according to the IEA. Earth's climate, however, is global, and progress remains uneven.

A greening EU in a brown world

Companies in the EU outperform the rest of the world in their decarbonization journey. Our data shows that 14% of EU-domiciled companies are "aligned to a net-zero pathway" (according to the Paris Aligned Investment Initiative's framework), compared with 3% outside the EU. While a majority (58%) of companies in the EU are still "not aligned" with a net-zero pathway, that compares favorably with 88% of listed companies elsewhere.

This success means EU companies now represent a dwindling share of the world's emissions. Global emissions are increasingly fueled by the Asia-Pacific region, which accounts for more than three-quarters (78%) of global coal-power generation capacity. Stemming climate change depends on investors' willingness to transition emissions-heavy assets in jurisdictions that may be far from their own.

The unevenness of the transition should be instructive for decision makers in finance and policy alike, as climate finance evolves from aligning portfolios with climate ambitions toward achieving decarbonization in the real economy. "Transition finance" marks this shift and should be guided by data showing where we are making progress and where we are not.

The data shows two growing chasms for transition finance to bridge: one between European companies and the rest of the world; another between the emissions associated with financial institutions' portfolios and the physical emissions of the economy.

Financial portfolios' emissions diverge from the real economy

Financial institutions are reducing the emissions they finance, yet overall company greenhouse gas emissions remain near record highs. That's because climate-focused capital is chasing a dwindling number of fast-decarbonizing companies that represent a fraction of global greenhouse gas emissions. To illustrate, an investment strategy designed to track a Paris-aligned benchmark must, by EU regulation, reduce average emissions by at least 7% annually. That means only 32% of the original investment universe of global companies are eligible; and for emerging markets, only 28%.

Data suggests that such strategies have had limited impact on economy-wide decarbonization so far. Further, an investment portfolio or lending book that decarbonizes much faster than the real economy risks becoming concentrated and less diversified over time.

Transition finance needs to go where the emissions are, and that's increasingly beyond the EU's borders

The movement to define and measure transition now sits at the crossroad of two camps. One takes a broad, inclusive view that every company should produce a transition plan. Transition capital flows to those with better plans. But the history of tying capital flows to better corporate disclosures and sustainability performance suggests that this will favor large companies in the EU, UK, and US. Without levers to even the playing field, smaller companies and those based in emerging markets, which need transition finance most, will miss out.

Another camp would double down on financing only those assets that are most difficult to decarbonize. The simple math shows no path to net-zero can bypass phasing out coal-fired power plants in emerging markets or transitioning companies in emission-heavy sectors such as cement.

> **The data shows two growing chasms for transition finance to bridge.**

From our experience in helping financial institutions align investments with sustainability, we see financial, regulatory, and reputational roadblocks to financing high-emission assets. Overcoming these hurdles is essential for attracting private finance, which seeks high risk-adjusted returns while satisfying activists and regulatory green finance ratios. We support the many collaborative efforts to remove the roadblocks, including levers for retiring high-emitting assets in the Asia-Pacific region; initiatives to build confidence in the voluntary carbon market; development of definitions, taxonomies and financing instruments targeting transition assets; and quantifying emissions reduced or avoided.

Halting climate change demands speed and scale. That's why we need to experiment, learn quickly and concentrate the confluence of policy and capital on decarbonizing the most impactful assets, which increasingly lie beyond the EU's borders.

IGNACIO GUTIÉRREZ-ORRANTIA
Chief Executive Officer – Citi Europe

Mind the gap: leveraging capital markets to boost the EU's green transition

The EU has made strides towards decarbonising the continent's economy and meeting its ambitious climate targets. Bridging the financing gap, however, remains the EU's biggest challenge to successfully progressing down its transition path.

Despite the progress made, and an average of €764 billion invested annually in the EU over the past decade, more is needed. The European Commission estimates that investment needs to be ramped up by about 60% to reach the EU's legally binding 2030 target. With public finances overstretched across member states, the investment gap can be filled by the capital markets.

Fortunately, the EU has a deep pool of savings that it could draw on to support this effort, but it is currently sitting in unproductive bank deposits. What the EU needs is a structural shift to market-based financing, deepening its capital markets to put these savings to work, earning a return investing in strong European companies with robust transition plans.

European leaders have recently recommitted to the Capital Markets Union (CMU), recognising the need to spur private investment. This initiative, and the efforts to minimise regulatory obstacles, encourage more equity financing, and integrate capital markets, are important to enhance the EU's competitiveness. A clear strategy for a well-functioning CMU, as well as policies to enhance the attractiveness of the EU to international investors and companies, are needed.

The Green Bond is one of the most successful financial instruments for tapping debt markets to fund environmental projects. Even before the EU's new Green Bond Standard comes into force, EU member states have been active in raising €270 billion in green bonds, particularly under the Next Gen EU programme. EU corporates have themselves raised €363 billion in green bonds, led by European giants such as Engie and Iberdrola.

At Citi, we are already playing our part, supporting European companies and governments access the capital markets to fund their transition. In June of this year, we acted as Joint Bookrunner for Heidelberg Materials, a cement and concrete company, when they issued a €700 million green senior bond, the first green bond from a European manufacturer in the heavy building materials industry.

We were equally proud to act as Joint Bookrunner and Joint Structuring Bank for the Government of Romania's inaugural green bond issuance. Some of the €2 billion raised will fund Romania's energy transition, including the conversion of coal power plants to combined heat and power, and retrofitting of gas pipelines to allow for the flow of low-carbon gases such as hydrogen.

Completing the CMU and leveraging the sustainable finance framework are two sides of the same coin, which together can drive the investment needed to fund the EU's green transition. But further efforts are needed to close the funding gap and minimise regulatory obstacles.

As stated by the International Energy Agency in their Net Zero Roadmap (2023 update), international cooperation and coordination is a must-have for companies operating in the EU and to advance the EU's transition. Supporting global frameworks and enhancing the international interoperability of EU regulation will enable international capital to flow more freely to support companies in Europe.

Secondly, market-based incentives are crucial to driving decarbonisation without stifling growth. The EU's European Emission Trading Scheme is the world's pre-eminent carbon market, and the EU should enhance its cooperation with other jurisdictions to promote the development of their compliance carbon markets and possible future integrations.

Thirdly, the usability of the EU Taxonomy should be improved. This core part of the EU's sustainable finance framework could be a key instrument for directing capital towards green projects in the EU. However, it currently acts as a complex reporting burden for many corporates and is insufficient for the needs of investors looking to fund transition projects. Citi welcomes the work of the Platform for Sustainable Finance to increase the usability of the Taxonomy.

Completing the CMU and leveraging the sustainable finance framework are two sides of the same coin.

Finally, while the financial sector is a powerful catalyst, it is the real economy that underpins the transition. Capital markets rely on regulatory stability and the rule of law to function effectively. Reducing risk and maximising the support of Europe's capital markets for decarbonisation, additionally require greater clarity of sector specific transition pathways, including the policies needed to deliver them.

The EU Green Deal has made great progress towards building a more sustainable European economy. Filling the Green funding gap will require equally ambitious strides in completing the CMU.

LARA INÉS DE MESA GARATE
Global Head Responsible Banking – Santander

Transition requires growth, joint action and greening the brown, with the regulatory framework as an enabler

The transition to net zero is a journey, not a point in time, and it encompasses three key elements to succeed:

- First, growth - critical to afford the investment the transition requires and on which Europe has not been excelling recently – less than 30% GDP growth over the last two decades, vs almost 60% in the case of the US.
- Second, joint action across public and private agents. Banks are enablers of the transition, and we are progressing towards aligning our business strategy to net zero pathways. But the challenge requires action from many more, including – governments, regulators, companies and individuals. Governments need to define specific transition pathways for key sectors and technologies, together with the accompanying policy tools and incentives to facilitate the transition.
- Third, the efforts must be directed towards greening what is brown today. The challenge is not for European players to stop financing brown, but greening it in a way that supports economies, communities and the transition, acknowledging that starting points are different.

These three points should all be reflected in the climate related regulation, so it drives an agenda that fosters the transition and creates the necessary conditions for growth, competitiveness and investment to happen. We should always assess whether the all-encompassing regulatory and supervisory framework the EU has, and remains developing, is contributing successfully to promoting sustainable growth.

Banks´ role is to focus on how to best support our clients´ transition journey, by engaging and defining new solutions addressing their needs. We are spending too much time implementing complex requirements stemming from the Taxonomy, CSRD, SFDR and other initiatives. As a result, many see sustainability as a practice that comes with too additional costs and risks, while opportunities are still nascent and uncertain. An enabling environment that fosters innovation to find better solutions is required, providing players with trust and confidence to explore and decide on key action to support the transition, motivated by opportunities more than fearing risks or penalties.

The goal is clear: net zero economies by 2050. The different political momentum can explore different ways to get there. In Europe the new political cycle presents an opportunity to, first, assess how the initiatives adopted to date are contributing to the goal of financing the transition of the economy, and second, simplifying certain approaches that prove too complex to be implemented by companies, while providing little upside. The EU Taxonomy, in addition to rigorous significant contribution criteria, includes Do not significant Harm and Minimum Social Safeguards even for retail operations. Taxonomy criteria should be ingrained in activities and information should be available and flow across market agents. Banks cannot be investing on gathering information from different sources of which not even the debtor is aware. Hence, simplifying the taxonomy approach whilst keeping the same level of ambition (science-based target of 1.5º) should be sought.

In addition, Europe has the chance to seek further coordination with other jurisdictions to progress on the task ahead. Welcomed progress has been attained between the ISSB and EFRAG on reporting standards, but, still, differences remain which make it difficult for companies operating globally. As both standard setters continue with their mandates, it is essential that maximum interoperability is reached across them. Simplification efforts are also needed, including reviewing the number of templates and detailed information that companies need to report on.

The magnitude of the challenge ahead requires pragmatic approaches and alignment of all agents towards the end goal – driving transition, without undue distractions.

The way forward is not to slow down on the transition efforts. We need to do more, following the premise that orderly, just transition depends on concerted action, supporting transition and growth and a regulatory framework that is an enabler, not a trap.

We need more targeted, feasible and efficient approaches, fit for purpose. The temptation in sustainability is often to aim for perfection, but the magnitude and shortage in time to succeed requires pragmatic approaches and alignment of all agents towards the end goal – driving transition, without undue distractions.

SIMPLIFYING THE EU SUSTAINABILITY FRAMEWORK

CARLO COMPORTI

Commissioner – Commissione Nazionale per le Società e la Borsa (CONSOB)

Regulators in action to fulfil the promise of sustainable finance

Over the past decade EU has adopted a comprehensive regulatory framework on sustainable finance. The Sustainable Financial Disclosure Regulation (SFDR), the Taxonomy regulation and the Corporate Sustainability Reporting Directive (CSRD), just to name three of legislative acts that are part of the EU ambitious plan for sustainable finance, are deeply changing the way business and financial institutions integrate sustainability into their operations and investments.

The regulations referred to above mandate greater transparency and accountability in ESG practices, pushing organizations to disclose more detailed information on their sustainability impacts.

Clearly, the ability of investors to understand this increasingly complex set of information is crucial, as the ultimate goal of regulation is to channel private capital towards more sustainable activities.

In their joint opinion to the European Commission on the assessment of the SFDR (June 2024) the European Supervisory Agencies (ESMA; EBA and EIOPA) noted that consumer testing exercises found that SFDR templates are difficult to understand for investors. Additionally, it emerged that, in practice, SFDR disclosure regime has been prominently used by financial market participants to "label" their financial products for competitive purposes.

Disclosure requirements laid down in Article 8 of SFDR (for funds that promote sustainability characteristics) and in Article 9 (for funds that pursue sustainable investments) have been used in marketing materials as 'quality labels' for sustainability, often creating confusion rather than adding to transparency to the benefit of end investors, who are also confronted often with complex sustainability metrics. And that's not to mention the risk of greenwashing, that can materialise until effective verification of the genuine sustainability features of funds prove possible.

On the other side, business and financial markets participants point to the inconsistencies of the framework which lead to unpredictable and costly implementation across the industry.

In response to these challenges, regulators and stakeholders are discussing several proposals aimed at streamlining the regulation to reduce costs for business and to enhance the usability of information for both the industry and investors.

Along with the ESAs and other national authorities, Consob is actively revising these proposals and has identified three areas of improvements of the current framework.

First, simplify disclosure to investors. Consumer testing conducted in Italy, France, the Netherlands and Poland converge in showing that concepts as "EU taxonomy investments", "Sustainable investments" versus "investments that promote ESG characteristics" used in disclosures for investors are difficult to understand. Consob favours the introduction of a categorisation system based on regulatory categories of sustainability for financial products as this would enable investors to better assess the sustainability features of financial products. Also, with clear product categories, sustainability disclosures could be differentiated, with only essential information to be provided to retail investors and more detailed information to professional investors.

Second, align terminology across the various pieces of legislation. The coexistence of two parallel concepts of "sustainable investment" as defined in the SFDR and "Taxonomy-aligned investment" as defined in the Taxonomy regulation is an area of concern, both for industry and investors. The EU Taxonomy constitutes a science-based reference point against which to measure environmental sustainability, whereas SFDR is more principle based and less prescriptive. The completion of EU Taxonomy with social sustainability and its overall reconsideration might allow to overcome the difference.

Simplifying the sustainability framework for a better information to investors.

Third, support market participants in implementing the framework. A key concern in this process is the availability of ESG data. In this regard, a robust ESG data infrastructure would significantly facilitate compliance with the framework. Consob along with the Italian Ministry of Finance, other national supervisory authorities and other stakeholders has launched a national platform on sustainable finance. One of the priorities of the platform is the identification of data on climate and natural hazards, through mapping of existing local and national, private and public databases, with the final goal to overcome the fragmentation of databases and assess the possibility to make these data available to all market participants.

These actions also emerge as key recommendations in the June ESMA report on greenwashing. By addressing these areas, regulators aim to protect investors from misleading sustainability claims and ensure that private capital is effectively directed towards sustainable activities. The ongoing efforts by the ESAs and national authorities demonstrate a commitment to improve the framework and support the transition to a more sustainable economy.

NADINE WIEDERMANN-ONDREJ

Deputy Director General for Financial Market Regulation – Federal Ministry of Finance, Austria

Sustainable Finance: a framework fit for purpose

It is hard to imagine that the European Commission's Action Plan on Sustainable Finance of 2018 was only published 6 years ago. Since then a legislative framework on Sustainable Finance has been created at record speed, starting with the SFDR, Taxonomy and CSRD. Given the speed and the dynamics of the legislative process it is no surprise that the legal acts are incomplete and often also lack coherence. These shortfalls are unpleasant from a regulatory point of view, but unacceptable for users. Companies - including banks and insurance companies - are often faced with irresolvable contradictions even with additional application guidance and explanation papers. If regulatory and sometimes also criminal consequences are attached to this, it is not surprising if the entire framework is called into question.

But the implementation of the framework also means that issues that previously attracted little attention are suddenly becoming visible in companies on director levels. This applies to issues such as the gender pay gap as well as Scope 3 emissions. These issues are sometimes difficult to digest and lead to many follow-up questions both internally and externally. This process is often unpleasant, time-consuming and, above all, expensive.

What can be done now? It is undisputed that the implementation of the Green Deal is necessary in terms of both economic policy and environmental needs. Europe has embarked on this path and has already invested many resources in its implementation. Rolling back the requirements would often be seen as stranded assets. The question is therefore how companies can be supported on this journey and the answer to this lies primarily in a regulatory framework that is balanced, harmonised and fit for purpose.

One of the main points of criticism is that the framework is still incomplete. Firstly, not all sectors are included in the Taxonomy Regulation; this should definitely be added. Furthermore, the framework for the Social Taxonomy is missing completely, which was already expected by many companies. The inclusion of additional dimensions to the Taxonomy also increases complexity and interdependencies. How should the DNSH be interpreted for an all-encompassing taxonomy? How do the minimum safeguards relate to the social taxonomy? This is reinforced by other legal acts such as the requirements of the SFDR, CSRD and CSDDD. In any case, these issues should already be fully regulated at L1 and not left to individual users.

Another essential but missing component is transition finance. Transition plans are already provided for at company level in SII, CSD and CSRD, however, it is important to consider the conditions under which transition plans can be linked to the provision of transition finance. To ensure the comparability of companies' transition plans, further standardization of the scenarios, interim targets, and metrics used is required. This could be achieved by developing and publishing national sectoral decarbonisation pathways to ease the process of developing transition plans.

The SFDR is definitely worthy of revision for multiple reasons. In any case, the current version showed that there is a great need for a sustainable label. Although this was not the intention of the SFDR and has also led to great uncertainty and greenwashing, this need should be taken into account when revising the SFDR and a labelling system should be introduced.

Another area with potential for improvement is the area of reporting. We have entity reporting in the Taxonomy, CSRD, SFDR, but reporting requirements are also implemented in horizontal legislation such as CRD and Solvency II. In order to be truly user-friendly, the reporting obligations would have to be harmonised at Level 1, both in terms of wording and content. EFRAG has put a huge amount of work into analysing the various European legal acts and taking into account the reporting obligations enshrined therein, but this exercise can only succeed with the full support of L1. It would therefore be up to the European legislator to harmonise the legal acts and refrain from duplication.

Streamlining the SF-Framework is essential to reduce complexity and to increase acceptance.

Sustainability reporting of the CSRD is only applicable to large companies, in practice, however, ESG-information is also required from SMEs, which they have to prepare according to the individual needs of these contractual partners. Although EFRAG will issue a VSME standard and the information will be available in ESAP on a voluntary basis, it would also be important that the information requirements of the counterparties can essentially be covered with it. Only then would ESAP with VSME be a truly one-stop shop.

In addition to these topics, there are many other opportunities for regulatory improvement. As a regulator, it is our responsibility to create a set of rules that achieves the required objectives while minimising the implementation effort.

GEORGE THEOCHARIDES
Chairman – Cyprus Securities and Exchange Commission

The impact of the sustainability framework on a small island nation

Since the European Commission published its Action Plan on Financing Sustainable Growth in 2018, the EU has gone further and fastest than any other jurisdiction in setting wide-reaching rules for sustainable finance.

Achieving net-zero requires unprecedented investment, so it's appropriate that the private sector plays its role in the transition. As a recent PWC report noted, global assets under management by the investment industry are estimated to rise to US$145.4 trillion by 2025 and have the "power to literally change the world from an ESG perspective."

As a small island nation facing climate threats first hand in the Eastern Mediterranean region, Cyprus recognises the imperative in achieving net-zero emissions by 2050 alongside the EU's other environmental targets. Implemented effectively, the sustainable finance framework will minimise the risk of greenwashing and increase transparency.

However, there are concerns for smaller NCAs, both for the regulated entities under our supervision and for us as regulators tasked with establishing, monitoring and enforcing the new standards of practice.

The EU's ambition requires profound regulatory changes. The Corporate Sustainability Reporting Directive (CSRD), Taxonomy Regulation and Sustainable Finance Disclosure Regulation (SFDR) serve as the foundation of the sustainable finance framework; the laws interact with and cross-reference each other, presenting an incredibly complex landscape to navigate. To prosper in this environment, firms need first to understand the different requirements that already go well beyond existing international frameworks and prepare to implement them, but also re-invent their systems to adapt to ambitious – and often moving - implementation timelines.

The EU's CSRD is the first regime to incorporate the concept of double materiality, so firms not only need to report on their impact on the environment, but also the impact of the environment on them. While the double materiality assessment is a long and detailed process, it provides some administrative burden relief as firms now only need to report on areas deemed as material. This is an improvement to the original proposal where firms would be required to report against every metric.

Even so, the most challenging aspect for many firms is the materiality assessment itself. Most investment firms will be carrying out this analysis for the first time, and will need to significantly adapt their processes, systems and data collection capacity to cope. Alongside this, the legal requirements present huge logistical and administrative burdens, and as well as costs from hiring external providers to undertake and verify the assessments. Some estimates, I've heard, have stretched to hundreds of thousands for one assessment, so it's not just the small firms that will struggle. Whilst CySEC is supportive of the overall objective of the framework, we believe it will be critical for firms to be given time to understand and implement the changes, while still being able to compete with other global players. For both the materiality test and the DNSH principle, continued support from the EU for both firms and NCAs is essential for successful implementation.

In the same way, European SMEs are a core part of European ecosystem and are vital to the EU's overall competitiveness and Capital Markets Union objectives. They also play a key role in supporting the EU's transition to net-zero and, as they grow and succeed, should rightly be reporting sustainability-related data via frameworks such as the SME standard under CSRD. What we do not want is for them to perish under an avalanche of regulatory requirements. We welcome developing SME frameworks for climate disclosure, but any new reporting requirements for SMEs need to be fair and proportionate, and they must be given sufficient time to implement.

Firms need time to make the transition while still being able to compete with other global players.

Regulators too will need time to build capacity and expertise to ensure the legislation is being put into practice. Not all regulators are resourced in the same way. Smaller member states, like Cyprus, diligently trying to achieve this transition need predictability from the EU around the application of legal provisions to be able to support and encourage the transformation.

CySEC is developing an action programme for sustainable finance, focusing on the implementation of sustainability requirements and cultivating a culture of compliance. We are also working to boost ESG investor education through a guide to sustainable investing. In terms of resources, we are adding additional staff to enhance our supervision departments to address challenges such as the risk of mislabelling or misrepresenting financial products under the SFDR.

We all want to meet climate goals, but reaching this objective will require close cooperation with EU policymakers, national authorities and the market to ensure a realistic path to net-zero.

ANNA DUNN

Chief Financial Officer, EMEA – JPMorgan Chase & Co.

Disclose the present, plan the future

Disclosure requirements are a helpful tool to increase transparency. Transition itself however will be driven by factors such as government policy, infrastructure investments, support for technological development, and consumer demand. Disclosures, at their best, provide a transparent window onto the current landscape, rather than changing the view. In looking to simplify sustainability disclosures, I'd suggest that we judge the framework across three principles: meaningfulness, materiality, and usability.

Meaningful information: meaningful information for JP Morgan includes critical metrics such as our clients' current emissions intensity, projected future emissions intensity, and track record of emissions intensity reduction. The profile of JP Morgan by one of our leading investors uses approximately thirty metrics drawing from a couple of data providers. CSRD, by contrast, requires over a thousand data points. This amount of data is excessive for business and investment decisions, and creates a competitiveness and productivity drag for firms subject to EU rules.

Material information: meaningful information by definition is material information. Much work is currently required for immaterial information given detailed templates with metrics broken down by client and asset class. This is an area that would particularly benefit from EU alignment with international standard setting bodies such as ISSB. Double materiality has been particularly challenging due to a lack of underlying data, a lack of clarity regarding quantification of impact, and the lack of a clear definition for 'value chain' particularly for financial institutions.

Useable information: True benefit comes from alignment rather than interoperability with international standard setting bodies. Interoperability can provide a technical alignment with expert resource applied, whereas for investors and educated generalist readers of accounts the disclosures need consistency to be useable. The EU is truly admirable in the extent and sophistication of its language translation capabilities, whereas in the company disclosure arena we observe that if the same language is not used there is incomprehension and the credibility of the disclosure is undermined.

Implementing the above principles into the EU sustainability framework would reduce the scope for greenwashing controversies. Data has shown that key regulatory developments with SFDR were consistently accompanied by sizeable waves of fund reclassifications. The sheer magnitude of reclassification leads to questions regarding the value of the label. The EU Green Bond Standard is also facing challenges in uptake given concern with potential for greenwashing allegations. Defining a reduced set of meaningful data that is applied with a materiality overlay will give confidence in published information.

True benefit comes from alignment, rather than interoperability, with international standards.

Moving beyond disclosures, transition plans reflect a more direct contribution to decarbonisation. Many financial service firms have set voluntary targets in this sphere and are considering transition plans as part of their broader business strategy. Transition plans effectively operationalise firms' commitments in a way that tailors their decarbonisation actions to their individual business, geographical footprint, clients and consumers. These plans will not be static, as they will need to adjust to support the real economy transition as it evolves with governmental policies, new technologies, and shifting consumer demand. Therefore, transition plan disclosure requirements need to avoid being overly prescriptive by dictating company strategy or the use of specific scenarios.

Science-based, highly credible transition scenarios exist to assist firms in their transition planning, provided by well-established and internationally recognised organisations. Notably, the Intergovernmental Panel on Climate Change (IPCC) and the International Energy Agency (IEA) have developed a detailed set of scenarios. IPCC and IEA scenarios take into consideration both regional differences and global outcomes. IEA has a regional breakdown which covers the EU, allowing users to derive EU-specific, sectoral pathways. These scenarios are supported by the scientific community and updated regularly based on the latest evidence.

There has been tremendous progress in Europe and globally over the past five years in understanding the drivers of carbon emissions, researching promising technologies to reduce carbon consumption and capture carbon offsets, and understanding likely transition scenarios. We now need to coalesce around international standards for disclosure and transition to allow for global progress.

SVEINUNG UELAND

Attorney-at-Law, DNB Legal – DNB Bank ASA

Simplifying the EU sustainability framework

The introduction of any new regulatory topic will always add to the existing compliance burden for banks. While regulations can be justified to ensure a healthy financial system, regulators should bear in mind that implementation of regulations divert resources and attention from banks' primary function as facilitators of effective and safe capital markets. The sum-of-all-parts impact of a constantly changing regulatory landscape should not be underestimated, especially in a period where institutions are needed to support the overall growth and innovation in the European economy. The sustainable finance framework also comes on top of many other comprehensive revisions of the CRD/CRR and AML frameworks. Any legislative proposals and revisions should go through competitiveness and necessity checks. From the EU sustainable finance framework, there are som lessons that can be learned.

The green transition is at the core of DNB's business model and the bank was an early adopter of the push towards sustainable finance. DNB has long contributed to initiatives such as UNEP FI, TCFD and the Equator Principles and has supported the EU green initiatives. While recognizing the need to eliminate greenwashing and increase transparency, our experience was that the legislators did not provide the leg room to adapt and develop existing practices of sustainable finance, which made it more difficult to leverage know-how built up over the past decade. Some lessons on the balance between flexibility and minimum requirements, between speed and adapting best-market practices, can be drawn from the roll-out for the EU sustainable finance regime.

Though a framework to push the speed of the transition was justified, a significant increase in costs stemmed from a rushed roll-out. Compliance costs increase where level 1 acts enter into force before level 2 drafts are finalized. Legal uncertainty also arises where the ESAs and the Commission publish FAQs which depart from the Level 1 rules. One example is the FAQ-guidance on taxonomy reporting for financial conglomerates, which was contrary to industry understanding and issued on 21 December of the financial year that it would apply to.

There are opportunities to simplify the sustainability framework without encouraging unacceptable greenwashing practices. As the EU is moving towards a regulatory landscape of few and narrow "safe harbors", we would like to point to some examples that demonstrate the need for greater flexibility to ensure a real and more efficient green transition.

> There are opportunities to simplify without encouraging greenwashing.

The industry is currently preparing for the first year of reporting under the extensive regime of CSRD, which determines how European banks manage and disclose their sustainability impacts and strategies. Although CSRD dictates that financial institutions shall be guided by a sector-specific rulebook, such rules have not been finalized nor even submitted to public consultation. As the ESAs have pointed out, specific adaptations to CSRD are needed to account for the particularities of the financial sector. Similar insights led to the late amendment of CSDDD, temporarily excluding banks' downstream value chain from its scope until further guidance is developed. No such accommodation has been offered under CSRD, which can lead to confusion and misunderstandings in upcoming dialogue with auditors and financial supervisors.

In terms of simplification and flexibility, the primary priority for banks should be sector alignment of CSRD. The rulebook needs to recognize that the financial sector has, compared to non-financial undertakings, an indirect relationship to sustainability impacts. For certain topics, such as climate change, there is sufficient data to establish a baseline and therefore set credible targets. For other topics we will lack such insights until corporate borrowers disclose data of acceptable quality.

Moreover, DNSH criteria for retail mortgage and auto finance KPIs has been a considerable hurdle for banks' taxonomy reporting. There are well-known shortcomings in the quality and availability of NZEB and EPC data needed for mortgage DNSH that must be addressed. Until then, credible proxies should be accepted as the next best thing. For electric vehicle finance, the requirement of determining what tyres each individual vehicle is equipped with is practically impossible can only result in nil-reporting. This could easily be fixed in the Commission FAQs.

Going forward, the same haste should not be repeated for the remaining elements of the sustainability framework. Banks face new concepts and complex requirements in CRD6 that aim to integrate sustainability risks into the prudential regime. It is capital that technical standards and other implementing standards are carefully designed to not duplicate or contradict existing requirements under the sustainability framework. To that end, the Commission should either make sure that the rulebook is completed during the transposition period or provide adequate phase-in arrangements.

HARM BOTS

Chief Executive Officer and President of MUFG Bank (Europe) N.V. and Head of EU

Not just on paper: a sustainability framework for a "real" economy transition

Over the last years, the EU has been one of the leaders for global discussions on sustainability frameworks for financial undertakings. While these rules have positive objectives in steering the discussion in this field, there is a perception in the industry that the granularity of this agreed framework for companies has created challenges.

When considering how best to shape the EU legislative framework to be fit for purpose, it is helpful to have a clear objective in mind. At MUFG, our approach has been to support the real economy towards a "whole economy transition" starting with focusing on the energy transition. Over the last few years, including via our involvement in the NZBA, MUFG has been working on the transition planning process, aimed at delivering this objective. It is important to note that banks are enablers and cannot deliver this transition alone. To help deliver a whole economy transition, all levers - including policy actions by governments, incentives and public-private partnerships - are key to this process and all actors should come together to move forward in the transition and enable banks to be as effective as possible in supporting the journey. There is a balance to be found over the coming years in attempting to match industrialisation and economic growth targets with objectives of emissions reductions.

During our transition planning journey, which culminated in the publication of the MUFG Climate Report in May 2024, two important lessons have been learnt: 1) safety and soundness of our banking operations is a top priority, with a thorough assessment of the "bankability" of all projects we finance; and 2) transition finance will likely only materialise where there is a demand for it. The process benefits from being demand-driven rather than supply-driven.

In our view, the EU and other frameworks globally would benefit from taking these elements into account when designing and amending their sustainability rules. The objective should not be limited to disclosure or the design of transition plans on paper. The EU could consider simplifying its sustainability framework and adapting it to be more pragmatic. In particular, the framework could support the assessment of a plan's credibility in the real economy. An example of this can be observed from the sectorial roadmaps designed by the Japanese government for achieving carbon neutrality in 2050 for GHG-intensive industries. These governmental roadmaps are meant to support financial institutions in assessing the credibility of the strategy and initiatives towards decarbonisation of the financed companies, while taking into account the different particularities of each jurisdiction. A similar concept of public sectorial roadmaps could be harnessed by the EU, which would account for the market-driven initiatives designed by GFANZ and NZBA.

Given the regulatory activity over the last few years, companies including financial institutions in the EU are now facing a significant amount of ESG reporting obligations that have to be considered when debating the potential framework changes, especially through the lens of international competitiveness and strategic security. These frameworks also create risk of transition on paper, rather than in the real economy. In the Europe's sustainability transitions outlook report from July 2024, the European Environment Agency called for EU authorities to embed competitiveness, fairness and security in a renewed narrative focused on sustainability transformation.

In the area of disclosure, we welcome the publication of the ESRS-ISSB standards interoperability guidance in May 2024. Ensuring a level playing field that avoids duplication will be hugely beneficial for global companies such as MUFG to comply with local requirements while ensuring a "group" approach. Further to this, the practicalities of gathering information within the EU to comply with the requirements may not be as simple in other non-EU jurisdictions. Another element to consider for review is the EU taxonomy and the potential new prudential framework for climate risk taking into account the transition approach described above. Without banks having the ability to support the transition of hard-to-abate sectors, such as steel, power and chemical, it will be difficult for a net zero economy to become a reality, especially in emerging economies where considerable emissions are located. The EU taxonomy is a useful tool but has so far appeared to be limited in practice such as with the example of the Just Energy Transition Partnership Projects (JETP).

A whole economy transition should remain the ultimate aim of every regulatory framework.

In conclusion, MUFG is engaged in the common objective of achieving net zero target by 2050. Policy makers could further support this industry efforts by considering the broader picture of all the elements to develop meaningful and achievable targets and ensuring that the framework becomes more practical for the financial sector to enable the support of a real economy transition.

DAVID
HENRY DOYLE

Vice President, Head of Government Affairs & Public Policy, EMEA – S&P Global

From crisis to crossroads: transitioning the EU Sustainable Finance agenda

At an unfamiliar crossroads, sometimes we must look back to move forward. It is nine years since the signature of the Paris Agreement, six since the publication of the EU's Sustainable Finance Action Plan, and five since the launch of the European Green Deal. The SFDR has been live for three years and the EU Taxonomy for two. The first wave of CSRD double materiality reporting will begin next year. Beyond these financial sector reforms, new waves of EU sustainability regulation for corporates are on their way.

And yet, the sustainability crisis not only persists, but it must also compete for policy attention and resources with emerging strategic challenges. These include war, interstate economic competition, and the realisation that the European economic model may have a competitiveness problem. As a result, renewed clarity is needed to advance the EU's vision for sustainability transformation. However, this vision must account for, rather than ignore, the prevailing industrial, economic, and security context.

As companies, financial markets, and regulators grapple with these new paradigms, which direction should the EU sustainable finance agenda take next?

First, Do No (Significant) Harm

First, do no harm. This medical maxim from the Hippocratic Oath applies equally to policy. The scientific diagnosis is clear: to prevent a planetary crisis, economic activities must change. In the EU, the prescription to treat this condition, mitigate risks, and deliver an improved prognosis has primarily been regulation. The next policy phase must stabilise and calibrate, rather than re-engineer, these regulatory foundations. While not perfect, they are solid enough for forward progress.

Instead, where faults in the foundations have been found, they should be repaired. The upcoming SFDR review should be a stabilisation exercise. Interventions should focus on critical elements that require surgical attention: a coherent definition of sustainable investment, clear and unambiguous sustainability labels for financial products, and a robust framework for assessing Do No Significant Harm thresholds. Closer alignment of SFDR with the Taxonomy, as suggested by ESMA, could also help stabilise the broader system by further consolidating the regulatory foundations through a common definition of sustainable investment.

From Crisis to Crossroads

Second, we are – and will remain in coming years – at a point of crisis. The word crisis comes from the ancient Greek for "turning point". It was used to describe the point in an illness when patients either got better or worse. At this critical juncture for planetary health, renewed policy commitment to the transition as an economic turning point can enable financial markets to plot a path beyond the current crossroads.

Greater longterm policy certainty regarding which transition paths will be viable could help unlock more finance. This could be achieved through formal recognition in the Taxonomy and SFDR that a range of incremental or intermediate steps towards the transition represent legitimate and worthwhile progress for financial markets to support.

Signposting the Transition

Third, the sustainable finance agenda needs the support of an EU transition strategy, including public spending. As Plato tells us, the true physician is a healer of the sick rather than a maker of money. As the primary agent for public health, government has a major role to play. The financial sector cannot engineer the transition alone. The scale of an EU transition plan could mobilise new financial firepower and forge channels for private investment to follow. This public incentives model has been successful in other regions by activating wider market-based funding mechanisms.

Which direction should the EU sustainable finance agenda take next?

Indeed, certain EU policy tools already provide a clear transition trajectory for some activities, including financial support. In those instances, ample funding is generally available today. For example, renewable energy and lower carbon fuels have been recognised as central to climate targets and an ecosystem to finance them has emerged. However, other activities necessary for the transition do not have the same degree of policy clarity. This creates blind spots in technology paths and obstacles for market-based finance. Where private finance is unable or unwilling to these fund projects, public money will need to play its part in bridging the gap.

To conclude, a quarter of the time available to achieve the 2050 objective has elapsed since the signature of the Paris Agreement. During this decade, new expectations for the EU financial system and economy have been introduced. However, the 2033 climate halfway point will be reached shortly after the end of this coming EU mandate. The next decade must therefore convert policy expectations into reality. Incremental, if necessary, but substantial wherever possible. In the face of economic, industrial, and security challenges the path forward should provide stability and clarity. There is no time to lose.

JULIA SYMON
Head of Research and Advocacy – Finance Watch

Reducing the workload, not the transparency

The legislative mandate 2019-2024 saw the establishment of the EU sustainable finance legislative framework, which has been crucial in enabling financial institutions to support the transition towards a more sustainable economy. However, legislative developments have also faced growing criticism and accusations of imposing a high regulatory burden, a high pace of regulatory change and legal uncertainty due to inconsistencies, as well as a lack of clarity on certain concepts. As the implementation work continues, calls for a more streamlined approach to reduce the compliance burden have grown louder.

Several initiatives have been launched to address these concerns. For instance, the European Single Access Point (ESAP) will provide investors with higher quality and more cost-effective information to comply with their own reporting requirements. Concurrently, the European Securities and Markets Authority (ESMA) has been working on several publications to harmonize data points across various legislative texts. An example is the revised Sustainable Finance Disclosure Regulation (SFDR) Regulatory Technical Standards (RTS) published in 2023, which are yet to be endorsed. Finally, the ISSB, EFRAG and GRI have done work to foster interoperability between the reporting rules. These efforts are ongoing, and their impact will unfold over the current political mandate. Furthermore, the scope of application of the Corporate Sustainability Reporting Directive (CSRD) has been substantially reduced.

Enhancing the Framework without Compromising Transparency

Despite these efforts, there is still room to streamline certain requirements, and concerns about the cost of compliance relative to other jurisdictions must be addressed. Striking a balance between reducing the reporting workload and maintaining the informational content will be key.

Any regulatory measures should be carefully crafted to make sure that changes to the reporting requirements do not lead to a loss of crucial data for investors or hinder comprehensive assessments of sustainability impacts, risks and opportunities by different economic actors. The complexity of the information chains and horizontal nature of sustainability topics need to be taken into account.

Instead, the focus should be on enhancing consistency across legislation to align data points and reduce the workload. Aligning the Taxonomy, SFDR, PRIIPs and the consideration of sustainability preferences, and solving inconsistencies—such as the conflicting definitions of GHG intensity under SFDR and the Benchmark Regulation—would make the legislative framework simpler, more coherent and more effective. This approach would address the issues that have emerged as the maturity on the sustainable finance topic increased and as legislative negotiations have occurred in silos.

> **Consistency, clarity and harmonised implementation will reduce the workload and increase credibility.**

Focusing on Targeted Adaptations to Limit Costs

As implementation progresses, it is crucial to avoid repetitive burden and the pitfalls of continuous changes, which would only increase the costs associated with legal interpretations and implementation. It should also be stressed that the cost of compliance will decrease over time. To keep this cost manageable, regulators should focus on making incremental improvements where necessary.

Switching from qualitative information to structured data, where possible, would also simplify the reporting and provide automation opportunities for companies, thereby streamlining the reporting process.

Bringing certainty to reduce workload

Legal certainty is vital for reducing the workload. The SFDR experience has shown that excessive flexibility can lead to accusations of greenwashing and legal uncertainty for financial institutions. To address this issue, we should accept that clarity will be achieved by reducing flexibility on implementation. Making the sustainable finance framework credible requires a holistic and harmonised approach to the key concepts.

This is the reason why sector-specific reporting standards are essential. They would allow moving SFDR entity-level reporting to sector-specific standards for financial institutions. Further, sector-specific standards would clarify the expectations on transition plan disclosures depending on the sector of activity and foster convergence on the use of transition scenarios. Ultimately, this would facilitate data aggregation and analyses at both sector and country levels.

Finally, simplifying the legislative framework also requires a better alignment of the supervisory actions and interpretation by national competent authorities. The uncertainties left by certain requirements, gold-plating when transposing directives and new local rules to solve loopholes in the EU rules lead to increasing market fragmentation. This jeopardises the objectives of the EU sustainable finance framework, as well as the broader objectives of the Capital Market Union.

SFDR REVIEW

CHRISTOPHE BORIES

Assistant Secretary for Financial Regulation – Ministry of the Economy, Finance and Industrial and Digital Sovereignty, France

The SFDR epitomizes what needs to be improved in the sustainable finance regulatory framework

The Sustainable Finance Disclosure Regulation (SFDR) is an essential cog in the sustainable finance regulatory framework established by the European Union. It has put in place transparency requirements in order to remove asymmetries of information, thus enabling financial market participants and retail investors to effectively redirect private capital flows towards a more sustainable economy. The regulation has surely played an important role in the qualitative leap observed in the ESG strategies of asset managers since its entry into application. Nevertheless, it also suffers from important flaws, even if some of them can be attributed to the fact that the SFDR came first within the EU sustainable finance framework. Therefore, it had to overcome the difficulty of regulating a still nascent activity, while not yet able to rely on later important regulations like the European Taxonomy of sustainable activities or the Corporate Sustainability Reporting Directive (CSRD). Other flaws are more pervasive to the rest of the sustainable finance regulatory framework.

While the SFDR has increased transparency, it still fails to provide enough common understanding of ESG strategies. The concepts used are too often ambiguous and difficult to grasp, even for some market participants and financial advisors, let alone for retail investors. This can only contribute to the prevailing distrust on the positive impacts of sustainable finance, as expressed in successive surveys. Bearing in mind the viewpoint of retail investors, these concepts should be revamped together with the sustainability preferences on the distribution side. Their consistency with the rest of the sustainable finance framework should also be ensured. As disclosure requirements on the financial sector trickle down to investee companies, they should be designed while taking into account the capability of corporates, including SMEs, to provide sustainability related information at a bearable cost. To this aim, the CSRD and its materiality principle should be used as a reference point. Large scale transition efforts are needed to achieve global environmental and social objectives, with immense financing needs. But the SFDR is currently not fit for supporting transition financing and should be adapted accordingly.

The current architecture of articles 8 and 9 ESG financial products has not proven suitable to meet the objectives of readability for retail investors and of support to transition financing. The difference between "promoting environmental or social characteristics" and "pursuing sustainable investment" easily eludes non-experts. Besides, it cannot put transition financing on an equal footing with the financing of sustainable activities, as it establishes an implicit hierarchy between broadly defined article 8 products and article 9 products structured around the more demanding notion of sustainable investment. Inspiration could be drawn from the pragmatic approach followed by the United Kingdom's Financial Conduct Authority, which has established the transition focused product category of "sustainability improvers" beside the "sustainability focus" category. Product categories should remain open to the variety of ESG investment strategies **(thematic investment, active stewardship, best in class, etc.) and investment universes (public and private equity)**.

The SFDR review should be treated as a priority by the EU institutions.

Going beyond disclosure requirements by adding minimum standards into the SFDR would help disseminate best practices and enhance the comparability of financial products. It would also draw conclusions from the observation that market players repeatedly misuse articles 8 and 9 products as labels. Minimum standards could notably rely on key metrics of the European regulatory framework, like transition plans and taxonomy KPIs. They should also remain adaptable to the developing maturity of the market.

The SFDR review should be treated as a priority by the EU institutions. The regulation suffers in particular from an insufficient focus on transition financing, on retail investors, and on the trickle-down effect of disclosure requirements on investee companies. A renewed version of the SFDR should not confine market players into a straightjacket but should be conducive to the development of ambitious and diversified ESG strategies, thus helping the EU sustainable finance market to keep its competitive edge and to fully gain the trust of retail investors.

KATARZYNA PRZEWALSKA

Director, Financial Market Development Department – Ministry of Finance, Poland

Transparency is the key to sustainable financing

Another hot, restless summer passes, but the fear that this one is likely to be cooler than the next does not go away. Worrying forecasts indicate that climate change will intensify if we do not take immediate and decisive steps. Therefore, actions to mitigate climate change and transition to a low-emission economy are crucial.

One of the first actions in the regulatory sphere to achieve green transformation goals is the Regulation on sustainability-related disclosures in the financial services sector (SFDR). Its entry into force can certainly be described as a watershed moment.

Since its inception in March 2021, it has changed the perception of financing objectives and investment policymaking toward transparency and disclosure of sustainability risks.

On the other hand the regulation continues to pose challenges for financial market participants (FMPs), who identify interpretive difficulties and gaps in its application. These problems relate, in particular, to the lack of legal clarity regarding key concepts, such as what constitutes a "sustainable investment." Additionally, there is a need to establish criteria to distinguish between the concepts of green and dark green investments (Articles 8 and 9). These ambiguities can be used as a tool for labeling and marketing financial products and services rather than disclosure framework as intended, thereby increasing the risk of greenwashing.

Another important issue raised by FMPs is the limited relevance of some disclosure requirements and aspects related to the lack of availability of good quality data and information, especially those on companies. Problems are also pointed out regarding the relationship of the SFDR regulations to other regulations, such as the Taxonomy, the Corporate Sustainable Investment Reporting Directive (CSRD), the sustainability principles established under MIFiD II and IDD, and the Climate Transition Benchmarks Regulation. These inaccuracies are the main cause of difficulties in implementing the indicated regulations and cause an unjustified increase in the cost of doing business.

Consultations conducted in 2023 indicate that the European Commission is aware of the challenges related to the current framework, including the lack of clarity regarding the definition of sustainable investment and the difficulty in identifying the relationship between the SFDR regulation and other regulations. The selection of key areas of focus, taking into account also potential directions for change, including considering the creation of a system for categorizing financial products, indicates a desire for a comprehensive look at these regulations.

It is important to maintain the main goal of increasing transparency in the operation of FMPs through sustainability-related disclosures in their investment strategies, in order to effectively support the green transition.

At the same time, changes to the SFDR should not be expansive, as regulations must not be unduly burdensome in business operations, and must support rather than hinder business transformation. In addition, the information presented should be reliable, simple and understandable to its audience.

It is also important to clarify the definition of "sustainable investment" to ensure greater consistency with similar regulations in Taxonomy. Another important issue remains the division of green financial products into light green under Article 8 and dark green under Article 9 of the SFDR. While the regulations are not perfect, it should be borne in mind that the market and consumers have already become accustomed to them, so it would be advisable to consider improving or clarifying them rather than introducing new product "labels" based on different criteria.

Changes to the SFDR should be of a necessary clarifying nature - transparency should be simple and easy.

It would be advisable to provide more support to FMPs in obtaining the necessary ESG data from companies that will report under the CSRD/ESRS. The CSRD and ESRS are based on the principle of materiality assessment. This principle implies that selected information may not be considered material and will not be reported by some companies. On the other hand, under the SFDR, FMPs have no choice but to report the data required by the regulation, even if it is not provided by the companies in their portfolios. The two pieces of legislation should therefore be made consistent, preferably by adapting the materiality assessment principle from the CSRD to the SFDR. It is also worth noting the problem of including ESG data from companies that are not and will not be covered by the CSRD for a long time (small and medium-sized unlisted companies that do not form a large group).

It is also worth continuing work on a social taxonomy, which should be based on the scope and types of data/indicators that will be reported by CSRD companies under the ESRS. The lack of a social taxonomy may hinder sustainable investments that do not harm the environment but achieve certain social and labor goals.

SHANEERA RASQUÉ

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Assessing SFDR is a necessary step in the green transition

The EU regulatory framework for "sustainable finance" has made considerable progress in the last few years, with several legislative initiatives either finalised or nearing completion. These developments continue to place the EU in a pioneering role in the sustainable finance area. If there is one particular regulation that plays a central role in the sustainable finance framework, it is SFDR.

By requiring financial market participants (FMPs) to publish sustainability-related disclosures on the products they manage or manufacture, SFDR should help build the bridge between the real economy's financing needs and investors looking for green(er) investment opportunities. From that perspective, it is important that SFDR is designed in a way that adequate information is provided to investors, while giving due account to their different levels of sophistication. The investor should be at the heart of such a regulation, as the end-objective is to allow investors to make an informed judgment of contemplated investment(s).

Since its entry into force in March 2021, SFDR has proven a challenging regulation to implement and to comply with. Questions on whether the regulation has delivered against its specific objectives have arisen.

Among potential shortcomings, despite SFDR being conceived as a disclosure regulation, it is largely used by FMPs as a labelling regime and being understood as such by investors. Foundational concepts of SFDR still lack clarity, increasing the threat of greenwashing. For instance, the framework allows every FMP to have its own understanding of what a sustainable investment is, thus hindering comparability among financial products and most importantly shifting the responsibility of investment due diligence on (retail) investors. The category of financial products disclosing under SFDR Article 8 is too broad, insofar that those products may have very different levels of sustainability ambitions, making it difficult for investors to navigate the products. Finally, the relevance of all the SFDR disclosure requirements for (retail) investors has been questioned. The SFDR disclosure templates also require significant data-driven information, which is not always straightforward to fulfil, considering the current availability and reliability of ESG data.

Against this backdrop, different initiatives have been launched to trigger a comprehensive assessment of SFDR, namely the 2023 targeted and public consultations of the European Commission on the topic and the Joint ESAs Opinion on the assessment of SFDR published in 2024. Allowing the sustainable finance package to deliver on its objective of further transitioning the economy shall be the main objective of the assessment of SFDR. Bridging existing differences is not an option, but an absolute necessity.

Disclosure categories under SFDR shall give due consideration to market practices having developed in the area, including on transition finance. Categories shall rely on clear and science-based, objective criteria like the Taxonomy framework to foster a common language/ understanding among stakeholders. The EU Taxonomy must be further developed/extended to account for all potential environmentally sustainable investments and social investments so that the Taxonomy becomes the sole reference point against which sustainability performance can be measured, also under SFDR. Key foundational concepts of the SFDR, such as the definition of what constitutes a "sustainable investment" need to be clarified. SFDR disclosures shall become more investor centric, be simplified and cater for different investor needs. Disclosure templates shall focus on essential information and be further standardized to allow investors to make an informed judgement of the investments. In addition, supervisory convergence is key to a well- functioning sustainable finance framework. In that regard, practices which create market fragmentation, such as the introduction of national "top up" SFDR and ESG rules and regimes, or differences in the application of SFDR for different financial products (like fund naming conventions), shall be remediated. Because such fragmentation puts into question the good functioning of the European passport for investment products, and thus the EU Single Market in those areas.

A review of SFDR in the spirit of resolving existing issues once for all.

SFDR has been subject to iterations and clarifications since its entry into force. But revisions which do not bring the necessary clarifications create legal uncertainty as well as undue complexity and, in the end, undermine the credibility of the EU framework.

A review of SFDR should now be undertaken in the spirit of resolving existing issues once for all and looking at the challenges ahead. Addressing potential shortcomings as such will not only lead to a more effective framework but also allow to increase investor trust. Which is pivotal to supporting the development of sustainable finance, and thus the transition to a greener economy.

MURAT BOZDEMIR

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Breaking down regulatory complexity in the market for ESG funds

The market for ESG green funds is rapidly expanding – according to Bloomberg data, there are $7.7 trillion assets under management (AUMs) on Article 8 or 9 products, exceeding Article 6 AUMs that are just shy of $5 trillion. To put some more context on this rapid growth, 'light green' Article 8 AUMs have seen a steep increase of 28% compared to Q1 2023.

The Sustainable Finance Disclosure Regulation (SFDR) has played an important role in driving this uptake. It has improved and standardised the quantity and comparability of sustainability disclosures in financial market participants' investment policies and products available to investors, and has empowered investors to make sound and informed decisions in line with their sustainability goals.

As a data-driven business committed to improving transparency in financial markets, Bloomberg is fully supportive of the objectives of the SFDR. However, with Article 9 funds only accounting for 3%-4% of AUMs, has the SFDR achieved the real world impact of directing capital to address environmental and social issues? How can financial companies fully leverage the SFDR to promote transparency and credibility in the market?

First and foremost, to bring about lasting change, it will be crucial to finalise the implementation of other pieces of the EU's sustainable finance framework. The Corporate Sustainability Reporting Directive (CSRD) is a critical piece of legislation, which should significantly improve the accessibility and availability of ESG data. However, in order for the SFDR to work effectively, the European Sustainability Reporting Standards (ESRS) must complement the SFDR requirements, as financial companies need the Principal Adverse Impacts (PAI) and EU Taxonomy-aligned metrics from their investees' CSRD reports to fulfill their disclosures under the SFDR.

Furthermore, fund managers are given flexibility by the SFDR on defining how their fund's ESG goals and sustainable investments are met. Investment managers show wide variations in the way they define sustainable investments in Article 8 and 9 products, and whether they consider certain PAIs, which lies in a lack of industry standardisation and comparability in the terminology used for identifying sustainable products. It will be paramount to clarify the interpretation of key concepts and legal requirements contained in the SFDR to reduce uncertainty and fragmentation in the ESG market.

For the SFDR to act as a catalyst in the transition, focus should be placed on end-investors' needs.

The upcoming review of the SFDR should also strive to reduce complexity for the global investment community. For the SFDR to act as an enabling force in the transition to a more sustainable economy, greater attention should be placed on the needs of end-investors. For this reason, a common, less ambiguous categorisation system is a welcome proposal that would help identify products, and enable financial advisors and the investment community to more easily direct capital to the desired outcome.

Likewise, labeling regimes can be a helpful tool to build trust and credibility in the market. In the US, the SEC amended its Names Rule to include new criteria as part of efforts to prevent misleading investment fund names. In the UK, the FCA set out criteria for UK asset managers using sustainability-related terms and introduced four new labels through the new Sustainability Disclosure Requirements regime. It will be important for the EU to consider these developments in its review of the SFDR, as consistent regulatory approaches to ESG fund labeling will help counteract greenwashing, and ensure clarity and interoperability for the global investment community.

It will also be imperative that the various pieces of legislation fall into place. Although greenwashing represents a very tangible threat to the integrity of financial markets, addressing this threat requires concerted action. It will be vital to clarify how ESMA's Guidelines on funds' names using ESG terms will interact with the upcoming legislative revisions expected for the SFDR. EU Member States will be able to choose whether to endorse the Guidelines, which poses a significant risk of fragmentation in and of itself. Additionally, a large number of funds are expected to make divestments and change their portfolio mix, or update their name and objectives – possibly leading to a new wave of SFDR reclassification of Article 9 funds. These abrupt changes, coupled with the uncertainty of what is to come in the SFDR review and a potentially disjointed regulatory approach, may create headwinds for the ESG investor community in bringing new products to market.

Revising the SFDR will require a coherent and complementary approach across different aspects of the EU's sustainable finance framework to encourage ESG investment best practice and deliver real world changes. Financial markets need a regime centered on bringing clarity to the global investment community. Should the SFDR succeed in this endeavor, it can be a powerful catalyst for the transition to a more sustainable economy.

VINCENT DAMAS
Group Head of Sustainability – CNP Assurances

Improving SFDR to address the objectives of the Green Deal

1. The Burdens of Implementing SFDR for Financial Market Participants

The Sustainable Finance Disclosure Regulation (SFDR) represents a significant step toward integrating sustainability into the financial markets of the European Union. However, the implementation of SFDR has presented numerous challenges and burdens for financial market participants (FMPs).

1.1. Complexity and Compliance Costs

The SFDR requires FMPs to disclose how they integrate sustainability risks into their investment decision-making processes. This involves a substantial increase in reporting requirements, demanding detailed information on sustainability indicators, adverse impacts, and sustainability risk management practices. For many FMPs, the resources required to collect, analyze, and report this data are considerable. The need for potentially new IT systems to handle the increased data volume adds to the burden.

Compliance costs have surged, with many firms needing to hire new staff to navigate the complex requirements. For CNP Assurances, the one-off costs linked to the implementation of SFDR were greater than €5 million and the recurring costs are greater than €1 million per year, whereas the number of customers downloading SFDR disclosures on our website is below a thousand per year, compared to a base of 14 million savings customers.

1.2. Interpretative Uncertainties

One of the major challenges has been the interpretative uncertainties surrounding the regulation. The SFDR's broad and sometimes ambiguous language has left many FMPs struggling to understand how to comply fully.

Definitions of key terms like "sustainable investment" and the criteria for categorizing products under Articles 8 (products promoting environmental or social characteristics) and 9 (products with a sustainable investment objective) have been particularly contentious. This lack of clarity has resulted in inconsistent application and hesitancy among market participants, fearing non-compliance and potential penalties.

2. Recommendations to the New Commission

The consultation process for the SFDR reform has revealed divergent views on several key points, particularly concerning Articles 8 and 9. Bridging these differences is crucial for ensuring a coherent and effective regulatory framework. As the new European Commission takes office, there are several recommendations that can help ensure the successful implementation and evolution of the SFDR.

> **The new European Commission should improve SFDR's usability and understandability.**

2.1. Provide Clear and Detailed Guidance

One of the primary points of contention has been the definitions and criteria for what constitutes a sustainable investment and what constitutes an Article 8 or Article 9 product. A harmonized, clear definition is essential for ensuring consistent application across the market. This could involve setting clear thresholds and metrics for determining what qualifies as a sustainable investment, thereby reducing ambiguity and fostering greater confidence among market participants. Detailed Q&A documents, case studies, and practical examples could help FMPs better understand and meet their obligations.

2.2. Foster Continuous Dialogue with Stakeholders

Engaging with a broad range of stakeholders, including FMPs (not only asset managers but also banks and insurance companies), distributors, non-governmental organizations and academic experts, can help bridge the differences in opinions.

Ongoing dialogue with stakeholders is essential for the effective implementation of SFDR: the Commission should establish regular forums and consultation processes to gather feedback and address emerging issues. This could help in identifying and resolving practical challenges faced by market participants. This could also involve iterative feedback loops where stakeholders can comment on draft guidance before it is finalized.

2.3. Improve Usability by FMPs and Understandability by Retail Customers

To address the objectives of the Green Deal, the Commission should improve usability of SFDR, based on FMPs experience collected so far. This could involve phased implementation timelines or simplified reporting requirements, ensuring that participants can comply without facing undue hardship. The Commission should implement test so that the SFDR disclosures produced by FMPs are understandable by retails customers.

2.4. Promote Alignment with other European and International Regulations

Consistent definitions and implementation timelines between SFDR and other European regulations, like the Corporate Sustainability Reporting Directive and the Taxonomy Regulation, are of course key to ensure a smooth implementation.

Given the global nature of financial markets, promoting international cooperation on sustainable finance standards is crucial. The Commission should work towards aligning SFDR with other international frameworks, such as the UK Financial Conduct Authority (FCA) Sustainability Disclosure Requirements (SDR). This can help reduce fragmentation and promote a harmonized approach to sustainability disclosures.

MITCH REZNICK, CFA
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Reforming SFDR: a call for the EU framework to foster transition finance

Based on responses to consultations regarding the implementation of SFDR, it is clear that nearly all financial market participants (FMPs) support the regulation's goal of enhancing transparency in funds' sustainability credentials through uniform, EU-level disclosures. However, a significant concern is that the investment industry has mistakenly used Articles 8 and 9 as a labelling regime—an unintended consequence of SFDR. Federated Hermes agrees with the majority view that the EU should address this issue by establishing an EU-level labelling framework for investment products. This framework would address a critical gap in SFDR: the specific recognition of, and regulatory support for financing the transition to a low-carbon economy. This is particularly important for fixed-income investors, given the characteristics of sustainability bond markets.

The European Commission (EC) emphasizes the need for the economy to "transition from current climate and environmental performance levels towards a climate-neutral, climate-resilient, and environmentally sustainable economy." Currently, SFDR does not recognize investing in the transition as a distinct class of sustainable finance. This essential step—de-risking the planet through transition investments—falls outside the narrow scope of "sustainable investments" under Article 9 funds. Meanwhile, funds directing capital to companies with credible transition strategies are often overshadowed by "ESG integrated" Article 8 funds. To address this, the EC should create a distinct labelling regime with a category specifically for transition investment products.

The transition product category should encompass companies that either have defined transition strategies or are identified by FMPs as capable of improving their environmental and social characteristics through credible engagement. Recognizing this transition category is essential for investors to align with the EC's directive to mobilize capital toward sustainability. While supporting sustainability leaders is crucial, it is equally important to provide access to capital at lower costs to companies in emissions-intensive sectors that earnestly seek to decarbonize, rather than financing those that perpetually sink capital into activities that degrade the planet. Transition (or engagement) funds raise capital that finance the transition to a low-carbon economy. They can invest across a broader spectrum of sectors than a limited group of leaders, an important aspect for fixed-income investors.

Transition (or engagement) funds raise capital that finance the transition to a low-carbon economy.

Green and other labelled bonds fund activities and projects that benefit society or the environment. The labelled bond market, currently valued at $4 trillion, is expected to grow even more in 2024. A transition label could incentivize entities in challenging sectors and emerging market regions to issue green or other sustainability bonds, broadening the market's investor base. Given the unique characteristics of labelled securities in the fixed-income market, a transition label is particularly critical for fixed-income investors.

These transition funds can also enhance bond investors' leverage in corporate engagement. As key financial stakeholders, similar to shareholders, bond investors have not only the right but also the responsibility to engage with companies on sustainability practices. Their influence is amplified by companies' recurring need to refinance debt in the capital markets. Like shareholders' influence through ownership, bondholders' influence arises from companies' dependency on access to debt capital markets.

Sustainable investment funds must achieve financial performance. A dedicated transition category for investment products enhances their ability to do so. Emerging regulations, shifting value chains, and changing consumer preferences drive structural changes in the economy toward sustainability. Companies that acknowledge and embrace these changes will likely be the future's resilient businesses. A transition category within a new EU labelling regime could serve as a catalyst, attracting capital to support the transition while offering superior, risk-adjusted returns to investors.

Reopening the SFDR legislative text is a tremendous opportunity to correct misconceived requirements in the EU sustainable investment framework. This includes addressing issues such as KPIs based on "enterprise value including cash" (EVIC) and some unintended disincentives related to carbon accounting to invest in green bonds.

We must also incorporate nature-related risks into the EU framework—a considerable task ahead of us. The science-based Intergovernmental Panel on Climate Change and Convention on Biological Diversity identified the systemic risks caused by the planet's declining health. We owe it to future generations to make the systematic changes to the financial ecosystem if we are to succeed in mitigating the risks.

AGATHI PAFILI

Vice President, Head of Government Relations, Europe – Capital Group

Building on what we learned and seeking improvements with caution on disruption

Europe is faced with critical challenges, from climate change to competitiveness to security. These make it a priority to re-assess many of the region's policies through the lens of competitiveness and speed of delivery to create prosperity for EU citizens and companies.

The Sustainable Finance Disclosures Regulation (SFDR) should be evaluated in this context. Initially aimed at enhancing investor disclosures and decision making, it quickly evolved into a de facto product label, with less use by savers on the disclosures themselves. With more than three years of implementation, the on-going review, prompted by last year's Commission consultation, should seek to build on what we learned from clients, investee companies and markets in order to address the priorities in this area.

What we know so far[1]:

- Clients value information that is simple and meaningful to their investment needs and objectives.
- Accessing reliable, and consistent data is a key challenge for investment decisions and ESG asset allocation. Whereas for companies generating data, costs and materiality are key concerns.
- Obscurity around key SFDR concepts such as the definition of sustainable investments (SIs) and the Do-No-Significant-Harm (DNSH) persists and resulted in more sophisticated investors building their own set of ESG definitions and preferred types of strategies.
- While investors value some guidance on types of sustainability-related products, too much prescription hinders investment solutions dedicated to their needs.
- Transitioning companies are seen as key to capturing investment opportunities across the globe.

For over a decade we have witnessed increasing demand for ESG investments and an equal growth in the types of strategies available to investors. SFDR's main objective on transparency remains as relevant as ever; however, the type of information captured is critical. The diverse range of disclosures at entity and product level isn't always material from investors' viewpoint or relevant across all markets and asset classes and is costly to produce. Excessive, inconsistent, and irrelevant information can lead to confusion and potential misinformation. Therefore, it is no surprise that while most respondents to the consultation agree with the objective of the Regulation, there are concerns whether the information disclosed is fit for purpose.

Product disclosures should focus on a core and limited set of universal and material indicators, such as climate and human rights, where data collection is feasible. Subsequent additional information can be customized to each product's specific ESG characteristics and strategy. This can enable disclosures that provide comparable and meaningful data points for investment decisions.

Considering the Corporate Sustainability Reporting Directive's implementation as of 2025, it's important to evaluate the relevance of entity-level reporting under SFDR, especially regarding Principal Adverse Impact (PAI). The data underpinning PAI reporting is currently inadequate, and aggregating across diverse strategies and assets offers little value to investors. Asset managers and importantly clients might be better served by a narrative description of the sustainability risk management practices.

When it comes to the ongoing question on establishing EU sustainability categories to further guide retail investors, it is also important to reflect what we have learnt. The main issues investors struggle with are the unclear definition of SIs, the PAI application at a product's level not always being aligned with their sustainability preferences, the interaction between DNSH and PAIs, and the low use of the Taxonomy. These issues highlight the difficulty in crafting suitable concepts and definitions. A potential solution is to refine and clarify existing terms, simplifying them to better reflect investment solutions and capture investor goals.

As SFDR has established market practices in a remarkably short period of time, there should be caution on the speed of change. Moving too quickly away from these can be distortive and perpetuate risks for legal uncertainties. If formal sustainability categories are deemed necessary, they should be optional and focus on transitioners and credible transition paths, aligning with the key interests of both investors and regulators.

Support the momentum and knowledge gained and deliver the simplicity and flexibility investors need.

We recognise all that has been achieved so far by policymakers, asset managers, investors and companies through the adoption of SFDR. While its widespread adoption should be viewed as a success, it has inevitably identified areas for further improvement. The purpose of the review should be to support the momentum and knowledge gained in the past years and deliver the simplicity and flexibility that investors and projects need to channel finance successfully.

1. *As presented in Capital Group's global ESG study conducted for the third consecutive year (https://www.capitalgroup.com/advisor/pdf/shareholder/ITGEOT-073-1043294.pdf)*

Forum organized with the support of the Eurofi members

PRIORITIES FOR DEVELOPING TRANSITION FINANCE

CHRISTINA PAPACONSTANTINOU

Deputy Governor – Bank of Greece

The necessity and challenges of transition finance in the current environment

The first global stocktake of the implementation of the Paris Agreement in 2023 highlighted that current efforts to mitigate and adapt to climate change are insufficient. There is an urgent need to implement appropriate pathways to deliver the required reductions in global greenhouse gas emissions through increased and accessible financial support, capacity building and technological advancements.

Europe is the fastest warming continent in the world and has long been a leader in climate action. The implementation of the relevant EU policies and mechanisms, such as the Green Deal and the Fit-for-55 package, as well as the EU Emissions Trading System aim to mitigate climate change and shape the direction of future growth, creating both challenges and opportunities for individuals, corporates, as well as the financial system and the economy as a whole.

In particular, transition finance facilitates the flow of capital towards activities that are more sustainable and supports high-emitting activities to decarbonise, while creating value for the private and the public sectors. Thus, transition finance can act as a catalyst towards a future of sustainable economic growth.

In recent years, significant efforts have been made at the global, European and national levels to scale up transition finance. From a policy and regulatory perspective, different tools have been put in place, including (i) policies, such as the Paris Agreement, (ii) strategies, such as the national and sectoral transition plans, and (iii) regulatory frameworks, such as the EU Taxonomy Regulation and the Corporate Sustainability Reporting Directive.

However, transition finance is not yet at the level required to meet the ambitious targets towards net-zero emissions, not least because of insufficient global political will and the uncertain geopolitical and economic environment. Moreover, shortcomings in the functioning of the financial system hinder the flow of investments towards sustainable economic growth. These relate to the lack of clear definitions of transition finance and of the products, activities and sectors, which may be eligible for transition financing. In addition, enforcement of the existing regulatory framework is inconsistent or weak, partly due to the voluntary application of standards. At the same time, the financial sector does not fully incorporate sustainability issues in decision-making processes, business models and risk management. Financial institutions have yet to develop the necessary processes, tools and competences to be able to assess the transition pathways of counterparties and manage the risks in their own portfolios that may arise from the process of adjustment towards climate neutrality by 2050.

To overcome these challenges, regulators, policy-makers and the financial sector should be more proactive. There is a need for more decisive political action globally, together with more regulatory clarity on the sector transition pathways, for the financial sector to be able to assess the alignment of financial portfolios to these pathways. The coverage and consistency of application of existing regulation, such as the EU Taxonomy and the disclosure standards require improvements, in order to promote transparency and trust in markets. The financial sector also needs to develop the appropriate structures and policies, engaging with stakeholders, in order to be able not only to manage the risks of the transition, but also to harvest the opportunities that stem from it.

Transition finance as the catalyst towards a more sustainable economic future.

The transition requires vast amounts of investments and therefore the mobilisation of all sources of funds, both public and private. All available financial tools and instruments – such as sustainable bonds and loans, equity and blended finance – as well as innovative financial instruments, can be useful in financing the transition under certain circumstances. The issuance of these instruments should be supported by robust controls, frameworks, and disclosures that will further promote trust and transparency in markets and reduce greenwashing risks.

In parallel, efforts should be made to improve the conditions for deepening the markets of financial instruments to facilitate the financing of transition. To that end, it is necessary to advance the completion of the Capital Markets Union (CMU). A unified, deep and liquid CMU with harmonised rules and transparency, can promote the free flow of funds, foster innovation and facilitate the cross-border flow of investments and savings. This, in turn, allows the efficient use of available funds in the EU, which are much needed for meeting the EU's greenhouse gas emissions reduction targets.

ZOLTAN KURALI
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Overcoming the barriers of transition finance

Governments, companies and financial institutions globally have committed to carbon neutrality, which requires a huge amount of investment and an economy-wide transition. According to several sources, between 0.9 and 1.6 trillion euros are needed annually in the EU to reach this objective, which calls for the participation of both the public and private sectors.

Transition finance provides an excellent opportunity to raise capital from both sectors to achieve net-zero. Three main barriers however interfere with the development of the transition finance market.

First is the lack of consensus around the perimeter of transition activities and the regulatory definition of transition finance. On the one side, although several international organizations have created their own guidelines and taxonomies promoting sustainable finance, certain sectors do not have technologically or economically feasible low-carbon alternatives yet, hence are not able to fit under standard sustainable finance's criteria. On the other side, as the market lacks concrete definitions and regulations, investors' confidence toward transition finance instruments is affected by the risk of greenwashing and disinformation.

Second is the absence of transition plan obligations under sustainability reporting standards for corporates, worsened by the lack of country/regional-specific sectoral roadmaps.

Third is the absence of standardization regarding Environmental, Social and Governance (ESG) data, which makes their collection, assessment, and comparability an arduous process.

The implementation of an array of tools, including globally or regionally-accepted transition finance guidelines, taxonomies, roadmaps, standards, assessment tools and standardized ESG-related data reporting, is essential in unlocking the potential of transition finance. Regulators will thus have a major role in promoting credibility and transparency by taking into account market best practices and rely more on well-established and globally accepted guidelines (e.g. the principles by the International Capital Markets Association /ICMA/ or the EU or Climate Bonds Initiative /CBI/ Taxonomies).

A common definition and under-standing of the scope of transition finance is needed to lift the first abovementioned barrier. Guidelines including "Basic Guidelines on Climate Transition Finance" by the Japanese Ministry of Economy, Trade and Industry acknowledging the role of transition labelled instruments is a great example in that regard.

Additionally, taxonomies must establish how specific transition activities can align with the Paris Agreement across various regions, considering that some activities currently lack viable low-carbon alternatives. For instance, the EU Taxonomy includes transitional activities, and the Climate Bonds Taxonomy permits financing for hard-to-abate sectors such as cement and chemicals.

Making the adoption of transition plans in line with the Paris Agreement mandatory for corporates, such as under the EU Corporate Sustainability Due Diligence Directive (CSDDD), could address the second challenge by reducing the risk of disinformation. Meanwhile, establishing national or regional technology roadmaps would offer a clear transition trajectory for different geographies. Based on these sectoral roadmaps, corporations could develop robust transition plans, set targets aligned with the Paris Agreement, and issue credible transition labels.

Specialist ESG data providers can bridge the third challenge by evaluating ESG-related data, validating sustainability disclosures and reports, offering insights on ESG risk management, and providing second-party opinions on labelled transition finance instruments to ensure that proceeds are used appropriately. In this sense, the implementation of regulations akin to "Proposal for a REGULATION OF THE EUROPEAN PARLIAMENT AND OF THE COUNCIL on the transparency and integrity of Environmental, Social and Governance (ESG) rating activities" and ICMA's "Code of Conduct for ESG Ratings and Data Products Providers" are essential in ensuring that ESG data providers are providing credible, reliable and high-quality data.

Transition finance's necessary further development is vital to achieve net-zero.

Overall, transition finance is crucial for achieving net-zero, and its necessary further development should not be underestimated. Several initiatives, including the setting of guidelines, assessment tools, frameworks, road-maps, labelled financial instruments, taxonomies, and regulations concerning ESG data providers, aim to improve the transition finance market. However, numerous shortcomings still hinder its growth. In order to enhance transition finance and unlock its full potential in the process of achieving net-zero, market-based regulations need to be developed.

CARLA DÍAZ ÁLVAREZ DE TOLEDO
Director General of the Treasury and Financial Policy – Ministry of Economy, Commerce and Business, Spain

Supporting an orderly transition: putting the pieces together

The EU sustainable finance architecture is now in place, resting on three pillars: the EU Taxonomy; disclosure, with the CSRD and the European Sustainability Reporting Standards as milestones to enhance the availability of harmonized information; product regulations, including climate-related benchmarks, the European green bond standard and the regulation on ESG rating providers. The ambition for Europe is to become the first climate-neutral continent by 2050.

This requires significant amounts of investment, both from the private and public sector, and in this context transition finance emerges as a key topic requiring a coordinated approach from all stakeholders. A number of companies cannot immediately change their models to become fully climate neutral but have the ambition to do so. Developing transition finance requires giving financial intermediaries and investors sufficient and comparable information to differentiate between projects and direct investment flows in line with sustainability objectives, while preserving the competitiveness of our economy.

Indeed, companies will need to transform their business models and develop procedures to gather and report the required information. Transition plans cannot become a mere check-in-the-box exercise and should become part of the corporate culture, with a sound governance framework. This will enable our companies to grasp the opportunities offered by the new model.

In order to preserve the credibility of the framework the following elements are key:

Common definitions: in their absence, investors are unable to compare across companies, with a risk of losing trust. The definitions should be preferably global, but the EU can lead the way and set a standard in the single market to preserve the level-playing field.

Sector-specific reference scenarios and pathways, compatible with EU climate and environmental objectives, against which individual companies' progress can be measured, preferably developed by sectorial associations. Without clear targets, investors will lack information on the degree of ambition of a company's targets set out in their transition plan.

Harmonized reporting standards to ensure comparable information. Sustainability disclosures streamline the exchange of information between financial intermediaries and corporates in transition and protect fair competition. In this respect, the Directive on Corporate Sustainability Reporting is a milestone in ensuring the transparency and accountability of information.

The EU has made progress towards defining transition finance with the Commission Recommendation of 2023 providing guidance to clarify basic concepts and to determine individual transition targets, as well as with regards to financing instruments. The latter involve green or sustainability loans and bonds, with competitive rates depending on the envisaged environmental performance and proceeds dedicated to projects supporting the transition. However, some investments entail higher risk-taking, with more innovative technologies and procedures and call for equity financing and specialised lending. Their development is closely linked to the Capital Markets Union and is a timely reminder of the urgency of adopting the necessary measures.

A final element to take into account is the support to SMEs in their transition planning and the principle of proportionality adapted to their size, administrative capacity and resources. Bank lending will play a larger role and banks can draw on close client relationships to provide guidance and offer specific transition-related financing solutions linked to climate or environmental targets. SMEs should be aware that, even though formally excluded from a number of regulatory requirements, they will also be impacted by the framework in order to benefit from a number of opportunities, notably the integration in the value chains of larger corporates.

With a sustainable finance framework in place we now need to support an orderly transition.

At the national level, Spain is developing a Green Book on Sustainable Finance, with a focus on supporting SMEs in transition. The proposed actions will support the implementation of the sustainable finance framework through the dissemination of relevant information and sharing of best practices, by fostering the dialogue with supervisors within a green sandbox and promoting the development of sectoral guidelines with business associations. To support a close dialogue and coordination, the Green Book envisages the creation of a Sustainable Finances Board, with relevant representatives from all stakeholders, in order to steer the proposed actions.

The transition to a climate neutral economy entails significant challenges, but also opportunities for the EU economy in terms of competitiveness and strategic autonomy. The key to reap the full benefits will be an orderly transition that ensures fair competition and leaves no one behind, with a constant dialogue and close coordination between all stakeholders involved, including cross-border coordination among authorities.

BIRGIT PUCK
Managing Director Securities Supervision – Austrian Financial Market Authority

Financing the transition – Setting the path with transparency and standards

Transition finance should finance companies and projects to enable a timely transition to a sustainable and climate-resilient economy and society and to meet Paris Agreement goals. It covers investments to help greenhouse gas-intensive companies reduce their emissions and transform their business models. It also includes necessary infrastructure investments (such as energy supply, transportation systems etc.) to enable the transition of the economy. According to the WEF's estimates in 2023, there is an additional capital expenditure until 2050 of USD 370 billion annually needed for decarbonization of steel, cement, aviation, shipping, trucking, aluminium, and ammonia industries. Put starkly, solely financing the development of (already) green activities will fall short in delivering the net-zero objective by 2050.

Transition plans are therefore an important tool for translating climate or environmental goals at company or economic activity level into specific measures and associated financing and investment plans. They also form an important basis for communication with financial market players and are relevant for financial institutions to assess the physical and transitory risks of counterparties and financial products. The requirements for transition finance are already being legally defined by the EU taxonomy (disclosure of green investments), the CSRD and CSDDD (development and disclosure of transition plans).

Earlier this year, EBA held a public consultation on Guidelines for the management of ESG risks and prudential transition plans. Beyond the scope of CSRD/CSDDD, which only focus on the disclosure of transition plans, prudential transition plans will become a supervisory risk management tool for credit institutions under the CRD. On EBA level, the Austrian Financial Market Authority (FMA) is contributing to the finalisation of the Guidelines. Importantly, especially for our Austrian market, the principle of proportionality should be applied. That means, when preparing transition plans, proportionality applied based on a company's exposure to sustainability risks rather than on size of the company.

The FMA is also implementing the growing importance of transition finance in regulatory guidance. To help facilitate supervised entities' efforts to integrate sustainability and climate-related risks in their processes, in 2020 we published an FMA Guide on Handling Sustainability Risks addressed to the Austrian financial market. Due to the dynamic nature of sustainability risks, we are currently updating the Guide, expected to be published by the end of 2024, to also include specific guidance and supervisory expectations on transition planning and transition plans, highlighting the growing importance of transition finance.

Credible transition plans and a definition of transition financing activities essential for success.

In the draft version of our updated FMA Guide, we highlight that the management of a company has the prime responsibility for implementing and monitoring credible transition plans. Furthermore, a robust governance structure and its implementation at process level throughout the institution are a key element of an effective transition plan. In this regard, it is important to ensure appropriate documentation and accountability. This also includes quantifiable goals (including KPIs and KRIs) and appropriate processes to address ESG risks in the short-, medium-, and long term. In this context, assessing the credibility of transition plans will be a very relevant criterion. For example, considering whether business activities and the development and forecasts for business segments match the goals and KPIs set out in the transition plan.

Besides credible transition plans by companies, we still need a regulatory framework that effectively facilitates **transition financing**. In my opinion, suitable disclosure and harmonised product classifications in transition finance are the most effective strategies for preventing greenwashing and promoting transparency. In this regard, I strongly support the policy proposals highlighted in the Joint ESAs Opinion from June 2024, namely that the Commission should consider the introduction of a product classification system and adapted disclosure for financial products that promote sustainability and transition. There should be a clear, simple and transparent definition of the economic and financing activities that are covered by transition finance. This ensures the quality of financial products in relation to transition finance to promote market transparency and to facilitate the flow of funds towards transition. This helps investors navigate the broad selection of financial products and supports the full transition to sustainable finance

LORI WING-HEIER

Co-Chair Climate and Resiliency Task Force - National Association of Insurance Commissioners (NAIC) & Director, Alaska Division of Insurance

Principles, communication and coordination are key to transition finance success

Like many issues in the early stages of discussion, transition finance remains open-ended and can encompass different meanings to different people across different jurisdictions. What one should or should not consider for purposes of this discussion has become a subject of debate within the U.S. and across the globe (for example, climate risk, protection gaps, inclusive finance, DEI). While having a universally accepted definition could help facilitate consistency and commonality, given the variety of differences and needs across jurisdictions, having sufficient flexibility along with communication and coordination are imperative to moving the issue forward.

In the insurance industry, there have been calls on insurance supervisors to take a leading role in transition finance and take actions such as strengthening rules around the types of industries that can be underwritten and in which industries insurers can investment. While insurance supervisors have a role in the discussions around transition finance and climate risk, it remains important to note that an insurance supervisor's role is to ensure that insurers are solvent and can cover their obligations to policyholders.

As insurance supervisors consider their other roles in these discussions, it is important to have a mix of strategies and tools that can help address holistically transition issues. This includes acknowledging the risks and challenges insurers face when trying to govern their underwriting, investing, or other business decisions - regardless of where they may come, whether climate-related or otherwise. It also involves working on climate risk, race and insurance, corporate governance, and other related factors generally included in the discussion around transition finance, to the extent they directly pertain to the responsibility to protect policyholders and supervise the financial condition of insurers.

With the differences in jurisdictions across the U.S., we are addressing transition finance by taking a high-level approach rather than a prescriptive one – essentially providing a framework to guide the efforts of the NAIC and its 56 members to address the future of insurance in the face of evolving climate risks, protection gaps, and inclusive finance.

That framework, the *National Climate Resilience Strategy for Insurance* ("the Strategy"), approved by U.S. state insurance supervisors in March 2024, outlines our goals in the near to medium term, including closing protection gaps, promoting risk mitigation efforts across the industry, and understanding risks by gathering comprehensive data.

Notably, the Strategy prioritizes pre-disaster mitigation and includes creation of a common roadmap for state insurance supervisors to contribute to risk mitigation programs that would reduce future losses and promote insurance availability in their jurisdictions.

Regarding protection gaps, state insurance supervisors are conducting a national data collection on the availability and affordability of insurance, empowering NAIC members to better understand each jurisdiction and regional trends. State insurance supervisors will also be implementing tools that analyze future scenarios to understand solvency issues for the insurance sector. These actions address the challenges we face in a forward-looking, comprehensive and coordinated way.

Likewise, we continue to stress the interrelated issues with diversity, equity, and inclusion, in finance that affect every insurance department and the NAIC, spanning across various insurance lines and impacting multiple facets of the insurance system. This includes rating, underwriting, fraud detection, and marketing – aspects of insurance supervision that we can find common ground on among the states as well as our counterparts abroad.

Agreed-to principles, communication, and coordination are keys to success in transition finance.

Finding ways to navigate these issues in a changing insurance sector does not occur in a vacuum. Collaboration among insurance supervisors globally can help ensure risks are being addressed in an effective and timely manner. The International Association of Insurance Supervisors, the OECD, and the UN Sustainable Insurance Forum have a variety of workstreams focused on these evolving risks and are taking steps to finalize important policy developments, some of which have been incorporated into our ongoing efforts.

In the U.S., insurance supervisors appreciate that the conversation on transition finance is evolving. We are also aware that each state will see these issues manifest in different ways and, thus, take specific actions to address their respective challenges. As such, in the U.S. we have found that agreed-to principles, communication, and coordination are keys to success in transition finance.

RAMI FEGHALI
Global FS Risk Services Leader – PricewaterhouseCoopers Advisory

Sustainable Finance needs now to come to age, but it can not do it alone

Sustainable finance has expanded rapidly in the last few years. As Bloomberg reports, sustainable bond issuances went from almost nothing in 2013 to over 1 trillion USD in 2023. The sustainable loan market is also very active, and even though most of the issuance is in Europe, all regions have seen significant growth.

The European Union has also created a comprehensive set of regulations. It has, among other things, established what counts as sustainable (the EU Taxonomy), what needs to be done to support sustainable fund allocation (SFDR, MIFID/IDD) and how to produce reliable and standard sustainable data and information (CSRD). This regulatory activity has made sustainable finance a priority for all companies in the EU and abroad.

Many financial and non-financial companies have set net zero goals and there is now widespread awareness of sustainability issues among businesses and various stakeholders. All this has been achieved in a short span of time, and there has probably never been before such mobilization both from the market and public authorities to address an emerging new problem.

A lot has been done, but it won't be enough. We are just at the beginning of a profound transformation of our economies and the more challenging work lies before us. While we have established a foundation and raised awareness, we need now to look at the concrete steps for the transition of the whole economy, not just a part of it. Two levers could be used to do so: regulation and transitions plans.

Regulation is a powerful tool to drive transformation provided it is clear and it is translated in the day-to-day operations of companies. The sustainable finance regulation should be simplified precisely to make it clearer and operationalize it. Simplification should not mean reducing regulation or replacing old regulation with new regulation but rather evaluating existing regulation, adjusting what need to be adjusted and providing further clarification and precision on the requirements to make them more operational. This should be done by taking the time to learn from implementation challenges and best practices to feed the changes in the regulation. This would apply to the entirety of the sustainable regulation, which has been developed in a short period of time on a new and immature topic. The regulation couldn't be perfect from the start, and we should recognize that a process of continuous improvement should be applied at least in the beginning.

This is particularly true for the CSRD, which is the cornerstone of all sustainable finance regulation. The foundations have been laid for a robust Sustainability Reporting with CSRD but many areas of the CSRD will require further work and clarification and doing it right will be key to make CSRD a real transformative tool and not a pure compliance exercise. Implementing CRSD is a journey, and we should allow all stakeholders to ride that journey.

We need to look at the concrete steps for the transition of the whole economy, not just a part of it.

The second lever is to focus on transition plans, since the challenge is essentially about transitioning the economy. Finance has a key role to play in this transition but it will not drive the whole economy transition on its own, and unless we address this in a comprehensive manner, all the efforts will ultimately have a marginal impact. The sequencing should be the following. Countries and jurisdictions should provide stable rules of the game to economic actors through targets, regulation, taxation or incentives. Then the real economy should implement credible transition plan. Finally, the financial sector should finance these plans and build its own transition plan. Credible transition plans along this value chain will be the backbone of the transition, they will be even more important that significant uncertainty (such as international coordination, political commitments, technology developments ...) will remain for many years and should be included and assessed in these plans. The AEFR (Association Europe Finances Regulations) suggested in a recent debate paper twelve recommendations on how to ensure credible transition plan ("Transition Plans: ensuring their comparability, credibility, and effectiveness to accelerate the low carbon transition"). It emphasizes among other things on the importance of setting clear public policies, their coordination and monitoring, on the transparency and monitoring of assumptions of the climate scenarios and on clear guidelines on what constitute good and robust transition planning.

The challenge of sustainability affects the economy extensively and profoundly. The transition finance is crucial in tackling the sustainability issue, given that the appropriate conditions are established. This includes having credible transition strategies from both public and private sectors and practical, relevant regulations.

NAOAKI CHISAKA

Managing Director and EMEA Advisor to Chief Sustainability Officer – Mizuho Financial Group, Inc. & Senior Advisor to the Chief Executive Officer for EMEA – Mizuho Bank, Ltd.

Beyond green or brown: importance and challenges of transition finance

2023 was the warmest year on Earth in 170 years since direct observations began, and Japan also marked most number of "extremely hot days" with temperatures above 35 degrees Celsius. Also, UN Secretary-General Guterres has stated that "the era of global boiling has arrived," making the response to climate change an increasingly urgent global issue.

To realize just and orderly transition to a decarbonized society, utilizing both transition and green technologies is essential and will require a large amount of funding. Pathways to decarbonization vary widely depending on the characteristics of each region, such as geography and industrial structure. In reality, there are cases where decarbonization from brown to green cannot be achieved in one step, so it is important to work toward low-carbonization at the same time. Therefore, a binary approach of green/non-green and a just divestment from non-green assets does not work, and transition finance is essential.

Since it released Carbon Neutral Declaration in October 2020 with an aim to reduce overall greenhouse gas emissions to zero by 2050, the Japanese government has been actively working to expand transition finance. In May 2021, the Japanese government formulated its Basic Guidelines on Climate Transition Finance. These guidelines address Japan's unique characteristics, such as by incorporating the government's sector-based roadmaps into the 'science-based' climate transition strategy disclosures. To date, the government has disclosed roadmaps for the electric power, oil, gas, iron and steel, cement, chemical, pulp and paper, shipping, and aviation sectors.

Furthermore, in February 2024 the Japanese government started to issue the Climate Transition Bonds worth 20 trillion yen over 10 years as the world's first sovereign bond labeled as transition bond. It intends to raise funds for GX investments from a wide range of investors, foster understanding of Japanese GX policies, and serve as a catalyst for the expansion of transition financing in Japan and abroad.

Since the International Capital Market Association released its Climate Transition Finance Handbook in December 2020, Japanese firms have taken a leading position in fundraising under the transition finance framework, both in the number of deals and amount. One major reason for this is that firms have been provided with some clear benchmarks for deciding their decarbonization plans, due to the government clarifying its technological milestones up to 2050 in its sector-based roadmaps. Also, companies may feel an incentive to gain approval for aligning their decarbonization strategy with that of the government through using the government's transition finance framework.

Even so, the issue remains of how to address various uncertainties that exist in the development of transition finance. For example, in December 2017, the Japanese government announced the world's first national hydrogen strategy, the Basic Hydrogen Strategy, which aims to realize a hydrogen society. It also goes without saying that 2050 hydrogen demand estimates assume the establishment of new supply-side and demand-side technologies, such as those for hydrogen power generation, and hydrogen steelmaking. However, these technologies' realization is not guaranteed and financing for these technologies involves various risks such as technological risk, development risk, reputational risk, or political risk. Because of this, in moving forward transition finance, it is essential for financial institutions to carefully assess and appropriately allocate these risks. In this way, blended finance is one of the useful methods to make highly uncertain projects more bankable and to mobilize private capital.

Mizuho is taking proactive steps in the area of transition finance, where we have become a global leader. We have long maintained a front-runner position in the sustainable finance market, and been establishing a leading position in transition finance as well. Aside from this, we have also announced the Sustainable Business Strategy in 2024, in which Mizuho aims to lead the structural transformation of industries toward decarbonization and to proactively support the transitions of our clients. In this way, we revised the Environmental and Social Management Policy and established an exception clauses so that we could consider financing and investing to the early retirement of existing coal-fired power plant.

A binary approach of green or brown is not enough to achieve carbon neutrality.

Mizuho is a financial institution with more than 150 years history and has supported the development of heavy industries since our establishment, inheriting our founder's DNA of pursuing prosperity for customers, economy and society, which leads to a sustainable future. We will continue to support clients' transitions from both financial and non-financial perspectives in a consistent manner, aiming to achieve carbon neutrality. We will not be held back by short-term increases in financed emissions when they are part of us fulfilling our duties as a financial institution.

We thank **the Hungarian EU Council Presidency** and **our partner institutions** for their support in organizing the Eurofi Budapest Forum

J.P.Morgan

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CAPITAL MARKETS UNION: FUTURE STEPS

VERENA ROSS
Chair – European Securities and Markets Authority (ESMA)

Picking up the pace in building EU capital markets

Well-functioning capital markets enable citizens and companies to reach their financial goals and realise their dreams. This can be about building an innovative start-up into a blue-chip company, creating wealth and employment in the process. It can also be about parents saving for their children's future, saving for retirement or investments making it possible to buy a home. While, in recent years, the CMU agenda has led to gradual progress in improving efficiency, scale and resilience, European capital markets still remain largely underdeveloped and fragmented. At this juncture, given squeezed budgets and the need to support the green and digital transition, there is an urgent need for more market-based finance to support European competitiveness in a challenging geopolitical landscape. It is in this context that the European Council has called to accelerate work on deepening the Capital Markets Union and Ursula von der Leyen has committed to push forward with a European Savings and Investments Union.

At the end of May, ESMA published its position paper on "Building more effective and attractive capital markets in the EU". In the paper, we outlined 20 recommendations to strengthen EU capital markets and address the needs of European citizens and businesses. The publication was the culmination of the work of an ESMA Board-level Task Force which analysed the functioning of capital markets from a national and EU perspective, considering regulatory, market and international developments. The recommendations focus on three key areas: EU citizens and investors, EU companies and the EU regulatory and supervisory framework. To ensure citizens can save effectively for their future needs, including through pension plans, they need to have access to simple, cost-efficient investment options. EU companies need funding that enables them to grow and innovate, creating jobs, growing the economy and promoting European competitiveness. Underpinning all of this is the regulatory and supervisory framework, ensuring that markets are transparent and fair, that they are resilient and operate with integrity. A regulatory framework needs to stay abreast of market developments and innovation. Based on our experience, we consider that the EU's regulatory framework should be modernised to make it simpler and more agile, allowing for faster action when so required. We also need to work to improve supervisory consistency and in certain cases evaluate the case for direct supervision at EU level. Where local knowledge is key, national authorities remain best placed to carry out supervision. However, where entities operate with a cross-border, pan-European model, such as large pan-European market infrastructures or crypto asset service providers, the benefits of EU-level supervision should be considered.

There is an urgent need for more market-based finance to support European competitiveness.

Europe is at the vanguard of regulation in the digital space. Regarding cyber security and crypto-assets, ESMA, together with our ESAs colleagues, have been given mandates through DORA and MiCA and measures are currently being taken to prepare for their application. Moreover, we are closely following other market developments, for example in relation to the role of finfluencers and the use of AI. To develop our European capital markets, we should make use of technological advances, in full consciousness of the opportunities and challenges they bring. Digital solutions can support retail investors' participation in capital markets, making them more inclusive and accessible and empowering citizens in their investment journeys. This is why, in our position paper, we call for supporting investor friendly innovation, promoting interactive financial education and incorporating safe and suitable investor tools. Similarly, technology can help EU companies to effectively engage with investors, reduce reporting burdens, facilitate automation of processes and overall free up resources and increase efficiency. While conscious of the benefits that new technologies can bring and supportive of their safe deployment, as regulators and supervisors we need to keep up to date, monitor developments and build capacity to deal also with the risks such innovations may pose.

There is a lot to be said for step-by-step progress, indeed you need to be able to walk before you can run, but hopefully by sharing experiences, knowledge and expertise we can pick up the pace and move forward together in building EU capital markets that are fit for the future. At ESMA, we stand ready to do our part in supporting these efforts.

JURAND DROP
Deputy Minister of Finance, Poland

Reframing the EU's Capital Markets Union: balancing regulation and innovation

The Capital Markets Union (CMU) project was launched almost a decade ago due to the lingering effects of the global financial crisis on the European economy. Additionally, the value of capital flows between member countries was low, and Europe's capital market-based financing was underdeveloped compared to other parts of the world. To achieve integrated capital markets in the Union, the Commission published two action plans for the creation of the CMU (in 2015 and 2020), each consisting of several legislative initiatives aimed at significant progress in CMU introduction. Most of these initiatives have been implemented, yet financial integration indicators have not increased, and the expected rise in transnational market transactions has not occurred.

Therefore, it seems obvious that the CMU objectives need to be reframed. However, the direction of the changes is not yet known. The discussion about the CMU's further development in the next European political cycle is underway, involving various stakeholders. Everyone is contemplating how to improve European capital markets and secure funds for necessary digital and green transformations. New reports keep emerging, but the same ideas are often repeated, indicating a need for fresh perspectives and innovative solutions to these longstanding issues.

Many of these ideas are valid: developing the European securitisation market, ensuring targeted convergence of national corporate insolvency frameworks, and further harmonising accounting frameworks. However, the most evident feature of the EU regulatory system—its overregulation—is often overlooked. While proper regulations enhance investor confidence, overly complex ones can be counter-productive. The EU's regulatory complexity disincentivizes investment and diverts resources away from innovation towards compliance. Extensive documentation demands consume company resources that could be better spent on productive work, innovation, and market competition. It's crucial to acknowledge that investing involves risk, and a risk-free Capital Markets Union is unattainable.

Therefore the incoming Commission should focus on assessing the feasibility, impact, and effectiveness of existing legislation before proposing new requirements. Measures to reduce regulatory burdens in the EU's financial market framework, particularly for smaller participants, should be prioritized. Any new legislative initiatives should always be based on thorough impact assessments to ensure they do not add unnecessary complexity.

Even with effective tools to deepen European capital markets, changes won't happen overnight. It will take years for the introduced changes to bring results, while the financial needs for digital and green transformations are immediate and pressing. This reality suggests that the hopes placed on the CMU might be too ambitious and need a more grounded approach.

Additionally, the EU should reconsider the banking sector's role. Instead of aiming to replace banks with capital markets, the focus should be on the synergies between them. Banks are significant capital market participants as service providers, issuers, and investors, and they remain active intermediaries in securities issuance and sales of securities. Capital markets also collaborate with banks, especially in credit-related activities, securities financing transactions, providing collateral for OTC derivatives, and repo transactions. These synergies indicate significant mutual relations between the banking sector and capital markets.

Therefore, the EU should leverage these synergies rather than overlook its banking sector. The CMU should be considered in the medium or long term, with a focus on market development. A contingency plan is also essential in case the CMU actions don't meet expectations for financing green and digital transformations. This approach does not undermine the CMU idea but highlights the need for the EU to be prepared for various outcomes.

EU should reduce regulatory burdens and leverage bank synergies to improve capital markets.

This means the EU should not forget its banking sector but rather harness the synergies between credit and capital markets. By recognizing the interconnectedness and mutual benefits, the European Union can better navigate the complexities of financial market integration and address immediate funding needs. The CMU remains a valuable goal, but the strategy must be adaptive and realistic, considering both short-term and long-term perspectives. Effective integration of banking and capital markets will ensure a robust and resilient financial system capable of supporting Europe's economic and transformative goals.

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BERTRAND DUMONT
Director General of the Treasury – Ministry of the Economy, Finance and Industrial and Digital Sovereignty, France

Paving the way for an ambitious CMU agenda

The past year has allowed for significant progress in the discussions on the Capital Market Union initiative. The sense of urgency to finance adequately the European economy, including through the massive investments required to support the green and digital transition, is now widely shared. The approach followed since 2015 has brought some incremental progress but will not be sufficient to strengthen significantly the depth and liquidity of European Capital Markets.

Both the Noyer and Letta reports, as well as the April 2024 European Council Conclusions, the ECB Board of governors' April 2024 statement and the ESMA June 2024 position paper sent converging messages, calling for significant progress on several key issues including supervision, securitization and savings products.

The Noyer report, published in April, formulated concrete recommendations on 4 main themes: integrating the supervision of capital markets activities, relaunching Europe's securitization market, developing long-term savings products and addressing the fragmentation of post-trade infrastructures. Beyond the usual adjustments of the EU's financial services regulatory framework, these proposals can transform significantly the financing conditions of European companies.

The relaunch of Europe's securitization market has benefitted from a wide support by political leaders as well as private institutions. It is now identified as one of the next Commission's key priorities. In this regard, we welcomed the announcement of an upcoming consultation this fall. It should cover both the prudential and regulatory adjustments needed in the short-term, and explore the suggestion formulated in the Noyer report of designing a common issuance and guarantee platform. A legislative package in late 2024 or early 2025 will be pivotal to enable the targeted adjustments required on the regulatory and prudential aspects. Longer discussions could be needed regarding common platform.

Substantial adjustments to the EU's financial supervision architecture are also warranted, and have received a broad political support in the past months. These adjustments are motivated by the need to overcome market fragmentation, support the competitiveness of European financial actors and, ultimately, offer better financing opportunities to all EU firms.

One crucially needed reform is a more centralized supervision at the European level. Indeed, while building the single rule-book was a necessary first step, national-level supervision will always lead to differentiated interpretations of our single rulebook and therefore, fragmented markets. This fragmentation generates significant costs, both for EU citizens, who miss on cross-border investment opportunities and pay higher fees on their asset management products, and European financial actors who, unlike their US peers, are unable to rely on a deep and integrated market to generate significant economies of sales, and efficiently channel funds to support companies across the continent.

In this context, a more centralized supervision would be particularly useful for large, pan-European financial actors, which currently have to engage in bilateral dialogues with several national supervisors, often without coordination. Beginning with cross-border and systemic market infrastructures therefore seems the most suitable option. The Commission was given a mandate to explore ways forward by European leaders in the April 2024 European Council conclusions. A thorough preparatory work is required without delay, and reflections around the adjustments required for ESMA's governance and architecture will have to be conducted. In particular, considerations should be made with regards to the role that national competent authorities could play, in coordination with the European supervisor, in this new architecture, in order to build on their expertise and knowledge of national ecosystems, without creating additional layers for the supervised entities. Particular attention should be given to the effects of this new architecture on smaller capital markets through the detailed impact study to be performed by the Commission.

Another key issue that will have to be addressed is the misallocation of our savings, which given their abundance (European households savings' rate is for instance notably higher than American ones), should constitute a key support to long-term development of European firms as well as innovation but are currently underutilized, being massively held as deposits or invested in the US.

To correct the current misallocation, the Noyer report suggests the creation of a European Savings Product label through an inter-governmental approach, aimed at channelling more adequately our vast pool of savings towards the long-term financing of Europe's economy. It identifies several fundamental principles or criteria which should be integrated within the label, including a predominant allocation in European assets, a long-term investment horizon, no permanent capital guarantee, an attractive tax regime and a managed allocation by default.

The Noyer report also pointed to post-trade fragmentation as significant source of costs for financial institutions and a barrier to more pan-European investments. Among the various ways to address this issue, the Eurosystem's settlement system, T2S could play a pivotal role.

Key priority areas are now well identified, and there is an agreement on the general approach and the need to act quickly, which is very encouraging. Now is the time to focus our work on the concrete implementation of these existing proposals. The contribution of European industry participants will be crucial, notably through the various consultations to be launched in the coming months.

VALÉRIE URBAIN
Chief Executive Officer – Euroclear S.A.

Activating the drivers of market growth and integration

As we begin a new European political cycle, I believe two areas of focus should be prioritised in the next five years. These are the need to support business competitiveness, particularly in strategic sectors, and the expansion of European capital markets to meet the major financing needs of the coming years.

Attracting issuers and investors - key to expanding market capacity

Successful capital markets are driven by the participation of the end-users. Europe must continue to enhance the incentives to turn savers into investors and borrowers into European issuers. Increased participation generates greater depth and liquidity, leading to more attractive conditions for investment and capital raising.

Companies and investors need to benefit from cost effective regulatory frameworks, the scale of the single market and appropriate public support mechanisms. The recent reports and analyses by leading European figures, authorities, think tanks and stakeholders have provided an extensive body of recommendations. European authorities and Member States should move quickly to target the most impactful measures to advance competitiveness across the main economic sectors. A pressing priority remains the problem of undersized risk capital pools and a limited retail investment base in parts of Europe. Retail investors need simple and inexpensive products, with appropriate tax treatments. At the institutional level, we should lift any undue biases against listed and non-listed equity investments.

It is also important to continue to foster conditions to attract external investment. As we have seen through the growth of the Eurobond market, European issuers of all types benefit from access to a globally connected ecosystem of investors.

Enhancing the efficiency and integration of post-trading

EU market integration and efficiency needs to advance across the issuance, trading and post-trading ecosystems.

Focusing on post-trading, further progress should be made in the practical integration of our architecture, guided by the need to foster scalability.

Europe already has leading infrastructures - occupying a central position in the European and global financial ecosystems - to advance this agenda.

As a starting point, reflections need to take into consideration the advances of the last decade in reducing fragmentation and promoting connectivity. They include ambitious Eurosystem projects - such as TARGET2-Securities (T2S) - which have required considerable resources and efforts.

Major industry initiatives have also been pursued. In the case of Euroclear, the integration of the leading international CSD and our network of EU and UK infrastructures have concentrated the majority of Europe's assets under custody in our group structure and contributed to generating synergies. Among the various initiatives, we have established a single settlement platform for France, the Netherlands and Belgium. Our international CSD has also been instrumental in facilitating integration in fixed income markets.

Our consolidation efforts have gone as far as the existing frameworks in the EU and Member States have allowed us. To go further - particularly in equity markets- authorities and markets participants need to work together to foster the conditions for the concentration of activity, development of cross-border flows and increased scale.

Europe already has leading global infrastructures to advance the CMU agenda.

One of the key conditions is the removal of impediments arising from national policies that prevent true competition among EU CSDs. This will require further work on legal and market convergence, as well as a rigorous application of open access and interoperability principles. Custody and asset protection regimes are still subject to widely different national approaches, thus limiting the level of potential market integration.

These obstacles are well known. Political will and consistent market efforts - not just on the part of CSDs - are needed to move forward.

Despite the challenges, I am confident that we can make significant progress building on our successes. As the leading provider of CSD services, Euroclear is ready to play its part in strengthening the European architecture to support high levels of liquidity and investment.

NIELS BRAB

Head of Group Regulatory Strategy & Chief Regulatory Officer – Deutsche Börse Group

Destination SIU: work like a gardener – the growth and competitiveness marathon

With the ambition around a new European competitiveness deal, the need to overcome structural weaknesses that make EU capital markets underperform has become an urgent task of utmost socio-economic importance. But despite a perceived fatigue after many years of hard work, we should be optimistic: The new EU legislative period and renewed political impetus offer a key window of opportunity to finally make the long-standing endeavor around the Capital Markets Union (CMU) a true success story.

Against the background of profound changes in geopolitical realities, enormous challenges around economic growth and huge financing needs, time has come to fundamentally reshape the EU's policy-approach and strategy. The first crucial step has been taken with a new vision on the horizon: The CMU's transformation towards a Savings and Investment Union (SIU).

The valuable work conducted by the Eurogroup, ESMA, Letta, and many other colleagues, has meanwhile laid the foundation to fill the SIU with lifeblood. An extensive list of game-changing ideas is on the table. What we now need to focus on is step three: Execution excellence and endurance in the marathon ahead.

After having agreed a bouquet of supply-side oriented measures during the last mandate, the focus is shifting towards a complementary set of targeted measures on the demand side – fostering a true investment culture. We should be clear: Mobilizing private capital will be key to make the SIU a success – and there are three very concrete measures that could significantly move the needle.

First, the momentum for individual savings and investment products paired with targeted tax incentives is promising – look at the success story of the Swedish ISK. Trillions of Euros continue to sit on bank deposits across the EU. Mobilizing this money towards productive investments will not only boost our economy – but also strengthen citizens' participation and democratic endorsement of the SIU.

Second, while state pension schemes should be less pay-as-you-go and more equity-oriented, we need to develop the PEPP into a true "401k EU" with employer sponsored auto-enrolled retirement accounts. Also on this end, we do not need to reinvent the wheel but simply learn from key case studies, such as in the US.

And third, we should pursue the establishment of an EU equity fund concept based on a public-private partnership under the wings of the EIB. The example of Norway shows how an equity fund can truly benefit a whole society – and the EU would not only establish a streamlined management for eligible investment and pension products in a new universe, but also send a much-needed message to global markets, i.e. the aspiration to be a competitive, pro-business marketplace that is a natural home to key capital flows and the interests of investors and issuers.

Taken together, these demand-oriented measures would inject a huge amount of fresh capital into the real economy, boost growth, create jobs, foster innovation, strengthen participation, increase tax revenues, and ultimately create a positive interplay with fiscal and monetary policy.

In all of this, we should not forget about the importance of primary markets and their ecosystems as backbone. The EU is only home to about 10% of all global IPOs and continues to suffer from a structural loss of companies that choose other jurisdictions as their preferred listing business location, a huge socio-economic damage.

We need to continue cutting red-tape for SMEs, tech and growth companies and facilitate their ability to go public. And most importantly: The EU should review its market structure vision – not only via a conversation on stock exchanges and CSDs paired with a natural empowerment of private sector to drive consolidation by reducing existing barriers, but also by reexamining the MiFID realities that have created more than 500 trading and execution venues – and with that a hyper-fragmentation of liquidity as well as a high level of dark trading.

Mobilizing private capital will be key to make the SIU a success.

The regulatory realities need to match the political ambition around deeper, more liquid and globally competitive markets. They need to incentivize investments and build on the positive case studies that other jurisdictions have successfully demonstrated – supporting the EU's ambition around a competitiveness deal, the international role of the Euro or an open strategic autonomy.

"Work like a gardener" as Miró would have put it, and remember: A rolling stone gathers no moss. The time has come to boost the CMU into a next generation of excellence SIU that delivers on our societal expectations and truly transforms EU capital markets to act as a key leverage for the global role of the EU in a new geopolitical context.

ANN PRENDERGAST
Head of EMEA, Executive Vice President –
State Street Global Advisors Europe Limited

Seizing the momentum on CMU for a prosperous and competitive European economy

Over the last year, a new political impetus has built behind the Capital Markets Union (CMU) project. A succession of high-level reports by prominent EU policymakers (former Italian Prime Minister Letta and former Banque de France Governor Noyer) and EU institutions (ECB, ESMA, Eurogroup and EU Council) have generated a rich set of proposals. All point to a fundamental reality: capital markets, and the role that the investment funds sector plays within it, are essential to build a competitive, prosperous and sustainable EU.

As announced during the first plenary session of the new European Parliament, the incoming von der Leyen "Investment-focused" EU Commission will build on these proposals over the next 5 years and focus on a European Savings and Investments Union. As the new European Commission takes shape, it is a good moment to consider the priorities for the next cycle, the proposals on the table, and the role of the funds sector in delivering on EU Competitiveness.

A competitive economy needs liquid and open capital markets

The fund sector sits at the heart of the EU economy by helping turn savings into economic growth. Households and savers secure their financial future by investing for their pension and, in doing so, savings are directed to companies and projects, fuelling economic growth. In his report, Enrico Letta rightly identifies the mobilisation of private capital as the main area where the EU is lagging behind. The report underscores a significant inefficiency in the use of the EU's economic assets, which should be better deployed in achieving the EU strategic objectives.

One note of caution, however, is that the asset management sector performs this role as a fiduciary, with the aim of achieving the best returns for households and savers. Savings are never artificially "diverted" but channelled to the best performing assets and investments, irrespective of their location. Where the CMU has so far under-delivered is in creating bridges for savings to finance economic growth and EU strategic missions. This cannot be achieved without delivering first an organic growth of capital markets in the EU, and this is something that regulation or supervision alone cannot fix.

Investor participation is about nudges, incentives and ease of access

Instead, policymakers need to focus on fostering among investors a high degree of confidence in markets and growth prospects. As ESMA points out in its position paper on CMU, domestic tax policy should be used to incentivise retail investors to participate and benefit from capital markets, while companies need to be nudged towards equity financing, corporate debt and private financing. These financing options should complement bank financing, and the revitalization of the securitization market will help bank and market-based financing reinforce each other.

More generally, the next European Savings and Investments Union should be supported by a new risk-taking culture in Europe, while safeguarding investor protection and financial stability. Here a bottom-up approach can help in socializing across the EU best practices in national markets such as the implementation of auto-enrolment or the experience with digital wealth platforms, which help bring new retail investors to capital markets. A more risk friendly culture should also extend to the way regulation is currently made in the EU, and the renewed efforts of the incoming Commission for simplification and better law making, including a new competitiveness check, are the right approach.

The time of low-hanging fruits of CMU is over, now the transformational change must happen.

Simple and long-term investment products are constantly evolving

Finally, the European Savings and Investments Union should be a call for action for the fund sector to continue evolving its product offering and adapting it to new types of investors. The UCITS brand is a strong basis from where to start and it should continue to evolve to make sure it remains relevant and able to deliver the best diversification, protection and performance to retail investors. Learning from the democratization of investments that ETFs have brought to the investing word, UCITS should continue to represent the wrapper of reference for retail investors. New labels for savings products can help, but should not limit the investment universe into which asset managers may invest.

The time of low hanging fruits of CMU is over, let's hope that with the Savings and Investments Union the EU will now engage in the transformational change that our capital markets as well as the EU economy and its citizens need.

JAMES CHEW
Global Head of Regulatory Strategy – HSBC Holdings plc

Could business growth funds be one small step for CMU?

CMU must deliver results

The focus of past CMU action plans has been legal and regulatory, creating the infrastructure to support investment and the rules to govern it. But, for all the new rules, administration and acronyms, banks remain the predominant source of finance in the EU and there has been no significant expansion in private or public equity markets for small and mid-sized companies. In this action plan, there needs to be a new approach with a greater focus on front-line delivery.

In particular, companies must be offered more appropriate equity products, with increased supply and broader deliver across different sizes of firms and geographies. And companies must be more willing to accept these investments, taking risks and fuelling growth. Some countries have been successful in this but there are many low spots across the EU. We can learn from the experiences of countries such as France, Sweden and the Baltics where long-term programmes have delivered results but there are other models worth considering.

Business Growth Funds – one small step?

One example is the business growth funds (BGFs) which have been established in the UK, Ireland, Canada and Australia. These have raised around €4bn of permanent recycling capital for minority equity investments in smaller growing companies. HSBC helped create these and provided financial support in line with its footprint.

As an example of the impact they can deliver, in the UK and Ireland, BGF has invested in over 500 companies in a range of industries and across all regions. Some businesses have failed, but the majority are successful, contributing to the economy. BGF has a current portfolio of around 350 firms with a collective turnover in excess of €6bn and employing around 70,000 people.

These BGFs offer a product which is attractive to entrepreneurs, increase the supply of finance, and deliver good long-term financial returns. They make minority equity investments, sometimes with subordinated debt, with a long-term view on realisation at a time driven by the business, not the investor.

Investments are typically between €1m and €15m, funding companies often ignored by private equity and providing follow-on funding for those backed by venture capital. They provide support through non-executive directors and BGF in the UK and Ireland has a network of 15 offices to deliver local connectivity.

They are owned collectively by the major banks in their countries, benefiting from introductions from these banks but operating independently to avoid conflicts of interest.

This separation also allows a specialised team to operate with a 'risk-on' mentality, where failures are accepted (and expected), to be offset by successes which deliver many multiples of invested capital.

They are a permanent source of capital reflecting the patient capital approach, creating an enduring intervention, recycling proceeds into new investments alongside dividends to shareholders.

They can be financially efficient vehicles for banks. Under Basel 3.1, equity investments intended to be held for more than three years will be risk-weighted at 250% and subordinated debt at 150%. As a result, the capital allocated is considerably less than the headline size of any fund. Risk-weighting and the inherent leverage in bank balance sheets then improves the return on equity, delivering reasonable results, albeit over the longer term.

Focusing leverage at the bank level, rather than in individual businesses, further reduces the risks of company failure. Banks also benefit as more equity improves their customers' appetite for risk and growth, and capacity to borrow.

These BGFs offer a product which is attractive to entrepreneurs, increase the supply of finance, and deliver good long-term financial returns.

The multi-lateral structure spreads the burden across individual banks, allowing the parties to create larger funds with diverse portfolios, lower risks and better operational efficiency. For example, a €2bn fund, supported by four banks over five years, would only require capital of €35m per bank for each of those five years.

This is not a 'grand projet' such as a pan-EU retail investment strategy. It is more national or regional scheme, executable within current regulations and focused on delivering more equity investment in smaller firms in the near term. It is a manageable proposition for banks if they are willing to work together. The Commission and governments can encourage that co-operation and institutions such as EIB and EIF might be able to help with additional financial support. It is a way in which banks across the EU can play their part, in an effective and efficient manner.

NEXT EUROFI EVENTS

THE EUROFI HIGH LEVEL SEMINAR

9, 10 & 11 April 2025

WARSAW - POLAND

THE EUROFI FINANCIAL FORUM

17, 18 & 19 September 2025

COPENHAGEN - DENMARK

CMU TOP DOWN OR BOTTOM UP APPROACH?

PASCHAL DONOHOE
President of the Eurogroup & Minister for Public Expenditure, National Development Plan Delivery and Reform – Department of Finance, Ireland

Unlocking Europe's economic potential: the imperative of the CMU

Creating a well-functioning single market for capital is a necessity for Europe. It is not a new necessity, but it has certainly become a more urgent one. The free movement of capital is one of the four original pillars of the single market at the heart of the European Union project. But realising that promise has turned out to be a challenging project.

The political and economic imperative to make progress on a truly integrated Capital Markets Union (CMU) is only growing. Governments are now operating with limited budgetary space and higher borrowing costs, while at the same time facing multiple and ever-increasing demands on public finances. Europe faces an investment gap that could conservatively be placed at €1 trillion per annum when climate, digital and defence needs are added together. With an ageing population and an enlarged European Union, these numbers will only get bigger. It is clear that we will not be able to fund Europe's future through the public purse alone.

CMU also plays a key role for the competitiveness of European companies, for the possibilities they have to access financing to grow, innovate and realise their full potential in Europe. European start-ups attract less than half the funding of their US counterparts. The volume of investments in scale-ups in the United States is more than four times greater than in Europe. That is why creating a well-functioning and effective single market for capital through advancing the CMU is and should be one of the key components of our renewed focus on euro area competitiveness.

EU leaders, finance ministers and institutions have devoted unprecedented political attention to the CMU project in the past year. Starting with a call from EU leaders at the Euro Summit last March, EU finance ministers in the Eurogroup began a year-long, comprehensive and forward-looking review on how we can make the CMU a reality. This led to the Eurogroup issuing a statement in March this year, agreed by all EU finance ministers, on the shared priorities and measures to make a decisive push in getting the CMU where we want it to be. This was later endorsed by EU leaders and has been at the core of subsequent discussions at the highest political level.

Political will and ownership remain key for getting results. I am convinced that we now have both.

The agreement comprises a series of measures, targeting not only EU level initiatives but also actions required by Member States and industry. Many argue that the CMU can only be delivered top-down. I would argue it needs to be a combination of top-down and bottom-up efforts. We need the right framework conditions, the right incentive systems, but we cannot legislate or regulate deep and liquid capital markets into existence. As we now shift the focus on delivery, I see three main pillars for our efforts, which reflect the essence of the Eurogroup statement and the common views of EU finance ministers on how to progress.

One relates to what needs to be done at the EU level. In a year of transition in EU institutional leadership, this will be for the next European Commission to actively follow-up in due course.

The second and a very important one is what needs to be done at the national level. The EU is often compared unfavourably to the US when assessing the state of its capital markets. But the reality of 27 national capital markets which need to be integrated and deepened remains. This should not be used as an excuse, but it is a reality with which we need to work. The divergence in depth and development among the different national capital markets is substantial. Integration will require reducing these divergences. Much is happening at national level, from developing auto-enrolment private pension systems which have proven to be an excellent instrument for stimulating deeper capital markets, to initiatives for improving financial literary and creating cross-border investment products. The Eurogroup's work programme has been carefully calibrated to take account of the current period of institutional renewal, with an immediate focus on driving progress at the national level, before turning to EU legislative measures following the formation of the new Commission.

The last pillar relates to what the EU-based industry can do. EU institutions and member states have a major responsibility in developing the enabling conditions and removing the barriers for a deep and robust CMU. But industry has a central role to play in making full use of these opportunities to create a genuine single market for capital.

We are often reminded that political will and ownership remain key for getting results. I am convinced that we now have both.

EVA WIMMER

Director General – Federal Ministry of Finance, Germany

CMU – Bottom-up or top-down approach?

EU Finance Ministers and policymakers are advocating for actions to drive forward the Capital Markets Union. The scale and depth of capital markets align well with the immense investments required for the eco-friendly and digital overhaul of our economy. Market-based financing is the backbone for innovators to transform their concepts into novel creations. Therefore, the existence of profound and efficient capital markets in the EU is vital to stimulate growth. In recent years, several measures have been already implemented as part of the European Commission's 2020 CMU action plan, some of which are yet to fully take effect. While by now there is no question the Capital Markets Union is high up on the European agenda, tangible steps are still being debated in depth.

In the Franco-German roadmap from September 2023 the idea was brought up to explore the potential of a bottom-up approach to the CMU. The CMU agenda had been focusing on harmonization primarily. The idea is that it can be beneficial to improve buy-in and ownership at domestic levels by both private and public stakeholders as well as to address the heterogeneity of capital market structures and the domestic peculiarities of funding sources in each Member State. In a nutshell: Deeping national capital markets can also contribute to deepening the EU capital market as a whole. The Eurogroup in inclusive format has taken up this idea in its March statement on the future of Capital Markets Union and regularly coordinates the exchange of best practices among Member States, with input from the European Commission.

In line with this concept, the German government is focussing on fostering capital markets access for SMEs and especially start-ups and cutting red tape (e.g. Financing for the Future Act, German "Wachstumsinitiative"). Further regulatory measures are on the political agenda. Furthermore, a dedicated industry task force consisting of practitioners has taken up its work: Their goal is to advise in more detail what concrete measures are needed to help the EU securitisation market play its role for financing our economies and their transition. Moreover, in order to expand financial education and to mobilize more private capital, the Ministry of Finance and the Ministry of Education and Research have started a national financial literacy initiative. Within this initiative, the OECD is currently developing recommendations for a financial literacy strategy for Germany which will be presented this September.

It is essential to state that the question of the right way of proceeding with respect to CMU - bottom-up or top-down approach - is not a matter of either-or. Rather, they should be viewed as complementary strategies that must go hand in hand.

A bottom-up or top-down approach should be viewed as complementary strategies that go hand in hand.

One example for the complementary nature of the approaches is the discussion around European Investment Products. The Eurogroup has invited interested Member States and the European Commission in the Eurogroup statement from March 2024 to examine the potential of developing a framework for a common cross-border market-based investment or savings products for citizens and assess its impact. Well-designed investment products for retail investors might be a good way to deepen the EU capital markets, provide more funding for the EU economy and infrastructure and simultaneously involve citizens directly in the CMU project. In addition, this can serve as a stepping stone towards an improved financial literacy. In order to avoid creating duplicate structures, an important principle in the development of the investment product framework should be a direct integration into existent national structures. Here, the cooperation on both the European and national level is essential.

Another case where both bottom-up and top-down initiatives come together is the topic of supervision. On the one hand side, we should start with improvements in the convergence of the legislative framework. On the other hand, at ESAs, the promotion of cross-border competition, and the reduction of red tape should be more in focus. As pointed out by the new President of the European Commission, better lawmaking and reducing red tape has to be a joint task – with all institutions involved. So, also the ESAs can contribute to building an efficient and safe but less burdensome regulatory environment for all stakeholders involved. In any case, however, a bottom-up approach should not be confused with a Capital Markets Union of the willing, that would lead to a fragmentation of the process. Like the IMF Managing Director Georgieva has recently said: Let us not forget that the U in CMU stands for Union.

Building a strong Capital Markets Union is, though worthwhile, a manifold endeavour. A combination of EU-wide and national measures will be the key to advancing the European capital market.

DUŠAN HRADIL
Director, Financial Markets Section – Ministry of Finance, Czech Republic

A top down approach for a healthy bottom up evolution of the CMU

The Capital Markets Union - for already a decade one of the key projects in the EU. Looking at the recent reports and this year's discussions of the regulators on the way forward, one may see the CMU as a Common Main Urgency. No doubt, capital markets are important. They shall be cared for, deepened and interlinked. And here we run into the question – shall we go the usual top-down route or rather leave the way free for a bottom-up evolution?

The EU regulatory framework shall set boundaries for financial market participants in order to preserve financial stability, especially by setting key prudential requirements, as well as fair competition and adequate level of investor/depositor protection. These are the basic elements of a desirable EU top-down approach, applicable for capital markets and the CMU as well. These boundaries shall not represent unnecessary, not to say unintended barriers, like excessive administrative burden or any limitations beyond what is really necessary. The role of the regulators is, first of all, to create adequately simple, understandable and easily applicable set of rules, whilst avoiding duplications and overlaps across the framework. All directives and regulations relevant for capital market, which are indeed many, are pieces of a puzzle that need to fit together. Such an easy-to-use framework will attract the industry and let the market grow. Better attract than force! Less barriers and no unnecessary regulatory burden will lead to lower costs and help the national markets to evolve naturally, become more interlinked and be together a strong competitor on the global playground as well as a robust funding partner for EU needs.

Is it time now for the top-downers to take a break, when it comes to deepening of the CMU? Absolutely not. They may now seize the moment of the birth of a new political cycle, take a helicopter view over the EU financial market legislation in all its interactions and carry out a holistic analysis, where we are, followed by the necessary cleaning, if identified as useful. A well-polished diamond is of a greater value and so is a well-tuned EU regulatory framework.

It is more than clear the EU needs to secure financing of its flagships – green and digital transition, overall resilience, including enhancement of its defence industry and future enlargement of the club. No time to rest, on the contrary. But this does not mean that the best or the only way how to finance the priorities has to be one particular sector of the financial market. It shall be left up to the interaction between demand and supply, conducted within the correctly set regulatory boundaries. A healthy functioning market is the one to determine itself which sector of the financial market or particular product satisfies the financing needs best. There may be some high-level guidance to spotlight the important goals if deemed overlooked, but this political push shall stay limited. Tax spices may boost the taste, but are in hands of EU member states and can easily cross the fine line of an unhealthy interference in the competition. There are good examples, worth following, like national Individual Savings Accounts, often linked with a more favourable tax regime, aiming at increasing savings for retirement as well as promoting capital markets. But these shall not favour one concrete product but rather leave the investor a wider choice. And as taking care of citizens of retirement age is a national responsibility, promotion of long-term products shall be handled the same way, respecting national needs and specificities.

In general, we shall not prescribe our depositors and investors a concrete way or product to go for but rather educate them in order to increase their financial literacy, thus helping them to identify all relevant options in the market, assess them correctly and pick the right option to go for. For example, the Czech Ministry of Finance developed a Corporate Bond Scorecard tool in a form of a spreadsheet guiding retail investors in assessing corporate bonds, if they decide to invest in. This tool shows which indicators are worth assessing and how to do it – just by filling the fields, getting the final score and a "traffic light style" outcome. No less important is that there needs to be wide range of investment options accessible. The EU Retail Investment Strategy should take all this into account.

The CMU will benefit most from a natural market evolution in an easy-to-use regulatory environment.

Citizens, well equipped with all necessary information and capable to make informed choices will constitute a strong demand also in the capital markets. Similarly, the SMEs may be given access to all necessary information and a helping hand in assessing these, in order to take full advantage of capital markets as a possible source of funding. All these will create a strong demand that will, together with a corresponding supply, give rise to a robust market-based bottom-up approach to increase the importance of capital markets on national level and consequently also on union level, trough natural evolution.

KATHARINE BRADDICK
Group Head of Strategic Policy – Barclays Bank

A window of opportunity for pan-European capital markets

2024 has been a festival of democracy globally and nowhere more so that in Europe where we've had the European Parliament elections, followed quickly by the UK General Election. In both the EU and the UK, we are entering new five year political cycles facing significant economic issues and with both administrations placing a heavy emphasis on capital markets as a vehicle for financing some of our major challenges. In the EU, there have been a plethora of important reports and recommendations made over recent months and we now have a menu of potential policy actions to support the further development of CMU. In choosing from the menu, policy makers should keep the following principles in mind.

- **Keep CMU on the agenda:** Literally. Political buy-in is key and it is encouraging to see that CMU is increasingly focused on at the highest political levels, including the European Council. Keep it on the agenda regularly to exchange ideas, to ensure that there is policy delivery and to ensure that there is a focus on some of the politically more difficult issues.
- **Don't ignore the hard stuff:** Looking across the reports and recommendations from the Eurogroup, the European Council, Enrico Letta, Christian Noyer, the European Central Bank, and ESMA, the only area advocated by all is securitisation. This is an important part of the picture but is clearly not enough. Progress on thorny issues such as harmonisation of the corporate insolvency framework is particularly important in addressing the challenges of fragmented legal regimes that hinder the debt market, including on securitisation.
- **Combine bottom up and top down:** It shouldn't be a question of either/or, a combination of the two is required, often in the same area. Take pensions reform, for example, where action at member state level will have a more significant effect than action at EU level but reform of the Pan-European Personal Pension Product by the EU institutions would also help on the margins. Similarly with supervision, national authorities should be working to converge supervisory practice but EU level action is required to allow the ESAs the possibility to issue no-action relief to the market.
- **Don't boil the ocean:** A limited number of significant actions will do more than a long list of more minor initiatives. It will also help give the financial industry more regulatory stability than it has enjoyed in some time. EU policymaking should now focus on supporting growth and competitiveness. To help, the EU should prioritise proposals through the lens of CMU. Any potentially costly or complex initiatives which risk the attractiveness of investing in European markets should be de-prioritised.

It isn't a question of either/or but a combination of top down and bottom up.

- **Remember Green Finance:** While we can see that across Europe there appears to be an electoral backlash against ESG policies, a policy environment supportive of net zero remains crucial. Net zero is not just good for the climate, but good for security as well, as it gives us more energy supply options. Financial services policymakers should proactively promote policies that are likely to result in greater volumes of sustainable and transition finance. While new, innovative, companies will make a substantial contribution to our transition, most of the work will come in pivoting our existing businesses and industries.
- **Resist any protectionist reflexes:** While you can allocate public money you must attract private money and that means ensuring Europe is an attractive and competitive place to invest. That said, there should be further analysis of where the large pension and other investment funds put their investors money and whether in a 'global equities' allocation model, Europe is not seeing more outflows relative to inflows from funds in other regions. This could also be something to look at in the retail market, particularly where there are tax incentives. The UK needs to look at these issues too.
- **Think about a broader European capital markets space:** The EU now has well-functioning financial services dialogues with the UK and Switzerland and should use them to look innovatively at how some of the common capital markets challenges can be met.

Finally, we should be honest that capital markets union is not the answer to all our economic ills. Addressing productivity is the bigger challenge and it will require significant focus, and often policy restraint, in the technology space, particular around Artificial Intelligence. But using our capital more productively too will certainly help along the way.

ROLAND CHAI
President Nordic Markets, Executive Vice President – Nasdaq

Change is needed for CMU – Post-trade is a problem

As Europe enters the middle of the decade, we have seen fundamental challenges that began with the COVID pandemic, inflationary shift from quantative tightening, war on our borders and the transformational impact of climate change. As the EU deals with the impacts of radical changes in energy, security and defense as well as economic competition from both Asia and the US, how do we regard the CMU approach that commenced in 2014? The acceleration of change is increasing at pace as the US markets move towards T+1 and Artificial Intelligence is finding its way into the markets and the lives of the European consumer. What radical measures are needed? How can European capital markets increase in order to support the financing needed by European infrastructure and enhance the competitiveness of Europe? How does Europe generate broader and deeper pools of investments from investors as well as better flow of capital across borders?

A strong and competitive EU capital market requires developing large pools of liquidity and leveraging the savings and pensions power of the European consumer to generate a formidable base of risk capital.

The markets Nasdaq and others operate in Europe are of different sizes and stages. Local and national environments for the capital markets ecosystem have been a differentiating factor. This is why the Swedish market has developed into such a success story.

Other countries can do this as well. How? The fundamental start is to draw up local capital markets action plans, focusing on resolving specific gaps and challenges in each market. Areas to focus on are pension systems, financial literacy, retail investor engagement, digitalization, tax policies (not only tax rates but – importantly – simplification).

The European Commission should make it its mission to ensure that all Member States take these measures, by collecting best practices, and by agreeing upon updated CMU KPIs to measure our competitiveness. With a close collaboration between individual states and the European Commission we can then work to identify and implement local improvements through a CMU monitoring mechanism to counter fragmentation and strengthen our European market.

To be competitive Europe must make the commitment to remove the legacy national, legal and regulatory barriers that prevent our companies from accessing capital domestically and our investors from allocating efficiently to EU investments. Europe must allow simple interoperability between markets. Cross border differences within EU states fundamentally impact the ability of corporates to raise capital and finance. Both primary and secondary listings are materially impacted by the cost of asset servicing and the operational complexity in managing custody and securities processing across 27 different EU states with different legislation.

The CSDR has enabled consolidation of the CSDs across the EU member states. However, it has been largely ineffective in creating competition or driving down the settlement costs of investors, primarily due to substantial investments required by a CSD and the market, and the national differences in company, securities, and tax laws.

Nasdaq has taken a holistic approach to leveraging technology platforms and operational efficiencies, to develop harmonised post-trade services that deliver cross-border efficiencies and lower costs to investors and corporates. Thanks to the merger of the 3 Baltic CSDs and Icelandic CSD into the Nasdaq CSD, shared trading, settlement platforms and common rulebooks, the Baltic markets have achieved the highest degree of regional integration among the EU markets, benefiting participants and investors.

The Nasdaq example demonstrates that there are material harmonization steps that can be taken to create cross-border integration. The key obstacle in that cross-border integration is the commercial incentives of CSD owners to subscribe to harmonized, open access platform principles.

Beyond platform harmonization there still exists a further set of obstacles. National differences in laws and regulations, such as insolvency regimes, taxation (incl. tax withholding and reporting) and company laws and securities market laws. Consequently, to service issuers in their home jurisdictions, Nasdaq CSD is required to maintain local Securities Settlement Systems in each Baltic country, where issuers are registered, and securities are issued and serviced.

Europe must allow simple interoperability between markets.

The inability to harmonise CSD post-trade has a direct impact on the attractiveness to corporates for listing in the EU and equally the attractiveness of the EU securities as an investment for offshore institutional investors when they look at the comparative high costs in Europe vs other markets. Post-trade and asset servicing costs are borne by the end investor.

EU institutions need to address the issues regarding cross-border post-trade as a priority, in order for European Capital Markets not to be left behind.

FRANCIS MALIGE

Managing Director, Financial Institutions – European Bank for Reconstruction and Development (EBRD)

Of national exchanges and airlines...

Among EU countries, the EBRD focuses on Central and Southeast Europe, a region with entrepreneurial vitality and world-class innovation, with success stories like Skype and Bolt from the Baltics. However, the region suffers from an acute lack of access to capital; corporate success stories, when they emerge, tend to seek listing elsewhere.

In this context, the EU is discussing a broader capital markets union as a critical engine for growth, especially in competition with the US and Asia. It is an agenda that EU institutions cannot drive by themselves. Building bigger, deeper, and more integrated capital markets in Europe requires EU-wide 'top down' measures for harmonization and national-level 'bottom up' measures to increase capacity. Savings, pensions, taxation, and insurance are normally national policy matters. There are also not enough political champions aware of the crucial role of capital markets or their interlinkage with savings policies. Those who do appreciate it don't make enough noise.

Currently, the two most pressing issues of European capital markets are the lack of deep pools of long-term capital – pensions, insurance assets, retail investment, and private equity – and the complexity and fragmentation of capital market infrastructure.

Pools of capital in the EU are much smaller than in comparable economies. The gap is mostly in funded pensions, tiny in comparison to North America. In EBRD EU countries, retail investors have insufficient access to mutual funds and investment funds. Shifting more retirement savings from bank deposits to investments and building pension assets would deploy more flexible long-term capital to support the economy, jobs, and growth in the region. One way to achieve this could be for the European Commission and Member States to develop long-term investment products, such as the Pan-European Personal Pension, to create deeper funding pools for the EU economy.

Tax considerations significantly influence investor choice, affecting asset allocation, investment horizon, and choice of investment products. Member states should draw on successful experiences of Asia, Australia and North America that offer tax-advantageous investment savings accounts with a low administrative burden. These schemes channel savings into capital markets. More critically, they are often the first step toward greater financial literacy, as investors are incentivized to learn more about investment options offered through these accounts.

The true cost of fragmentation and underperforming exchanges are in lost economic opportunity.

Stock exchanges are, like national airlines, often seen as symbols of national sovereignty. However, unlike national airlines, they don't require costly bailouts and can remain profitable due to high fees, thus tend to escape scrutiny. Nevertheless, the real economy struggles because of the absence of local long-term financing alternatives: the true cost of fragmentation and underperforming exchanges are in lost economic opportunity.

The small size of individual exchanges is compounded by the complexity of clearing and settlement. There is little hope to develop single pool of capital in a continent with 22 exchange groups operating 31 exchanges for listings, 34 for trading, and 39 central clearing counterparties (CCPs) and central securities depositories (CSDs). The success of the Euronext approach and Nasdaq Nordic and Baltic markets proves that consolidation creates value.

The EBRD, building on its longstanding partnership and commitment to Central and Southeastern Europe's success, is participating in a rethink of the regional model, where consolidation focuses on integration at the operational level rather than the ownership level. This model rests on strong cooperation of local markets as equal partners, avoiding the difficulties of a takeover where the interests of one country or a single exchange group dominate. Integration built on connecting and strengthening local ecosystems makes support of a wide range of local stakeholders, especially country governments, much more achievable.

The benefits are real. By joining forces, participating exchanges could meet the growing challenges of fast-changing technological development in the financial sector. Creating a single liquid pool of assets could facilitate the graduation of countries in Central and Southeast Europe from frontier to emerging market status. Making it possible for retail investors from any country to invest in any security in the region through a single system also improve liquidity. That would draw the attention of global investors and bring new investment flows to the region.

ATTRACTIVENESS OF EU CAPITAL MARKETS FOR ISSUERS AND INVESTORS

RODRIGO BUENAVENTURA

Chair – Spanish Securities and Exchange Commission (CNMV)

Revamping EU capital markets: a tough task without simple solutions

The appeal of European capital markets has decreased in the last decade, and they have not developed enough if we compare them with those of other geographies. We have fewer listed companies and their weight with respect to the economy has shrunk.

Capital markets have not either succeeded to attract European citizens to invest more in stocks, funds and fixed income compared to bank deposits or real estate investment.

Europe needs much deeper and more liquid capital markets if we want it to catch up our economic position in the world. Our economic future is linked to this. European leaders, thinkers and institutions clearly agree that either we enhance capital markets and Europeans' investment in these markets, or the European economy will regret it for decades.

There is consensus on what needs to be done, but divergences on how to achieve it. Political initiatives such as Capital Markets Union (CMU) flow to achieve this goal, but in my opinion, it is necessary to focus on a broader and more holistic vision that would focus on several factors. There is no silver bullet but a series of complex and costly policy actions.

The first and most important one is to boost a European strategy that promotes retail investment in financial instruments. This requires a cultural and structural change so that investment in shares, bonds, investment funds, and pension funds become the main destination for the long-term savings of European citizens. But a transformation of this magnitude, although possible, is not simple, and requires a stable framework maintained over time. Among the most important ones is to offer stable tax incentives to retail investment in financial instruments that allow investment through personal financial savings accounts as in the Swedish market. And, also, incentives to issuers that equate the taxation of financing through debt with equity financing. Similarly, a favorable framework is needed for investment in funds and pension plans that boost long-term investment and a promotion to financial education for teens and adults with much greater resources than the current ones.

Secondly, Europe must continue to be open to international capital in a double sense. The opening of the market means the freedom of non-European investors to invest and disinvest in Europe and the freedom of European savers to invest and disinvest their savings outside of Europe. It would be a mistake to lure EU citizens (through tax measures) to invest only in EU companies. If EU companies are going to succeed attracting investment, they better do that on their own merits. And if EU citizens are going to invest more, they should be allowed to do so in the pursuit of the higher return, be that in the EU or abroad.

Thirdly, it is necessary to advocate for a single regulation and a coordinated supervision that consists of a single rulebook that is applied in a consistent way, where ESMA must have the role of a strong coordinator and overseer of national supervisors. Europe must show more trust in ESMA and provide it with greater capabilities, so that we are more agile in the EU adjusting the regulation to the dizzying changes of markets. This does not mean having a single supervisor for everything, because in most areas national supervision will always be more effective and efficient, and the existence of a single supervisor (as we have seen in banking) is not a recipe for faster market development or more integration.

As a fourth factor, care must be taken to ensure that listed companies do not become an experimental population for new regulations that address much broader social or economic problems, like climate change or gender diversity. These are cross-cutting for all companies regardless of whether they are listed or unlisted on a stock market.

There is no silver bullet but a series of complex and costly policy actions.

And finally, I would add a fifth element, which is to be open to potential market consolidation. This should not be imposed by new regulation, it should not be forced but neither should it be hindered if market forces themselves see that it is necessary in order to achieve greater competitiveness.

ESMA has published a proposal on how to strengthen EU capital markets, with 20 proposals. And CNMV stands behind it in full. But we cannot cut corners. The main risk in the next political cycle in the EU is to pick a couple of flashy measures (like securitization and central supervision) to pretend that the CMU dossier is achieved, leaving out true incentives to change how Europeans are investing long term. That would be a huge mistake and a lost opportunity.

JÉRÔME REBOUL
Head of the Regulatory Policy and International Affairs Directorate – Autorité des Marchés Financiers (AMF)

The attractiveness of EU capital markets should be reflected on at global level

Capital markets at EU level are underdeveloped and reliant on third countries' players. European markets are not deep enough and don't provide sufficient liquidity to issuers and investors.

At the same time, a race amongst European jurisdictions is happening, that has become even more important after the UK's decision to leave the EU, as a more multipolar model seems to emerge within Europe.

In this context, a number of initiatives have been taken in the various countries, and legislations adopted, to promote attractiveness. This is the case for instance in France, Germany, Italy…As a national regulator, the AMF takes its full part in the effort to promote the French and European markets, and has included these goals in its strategic orientations for 2023-2027.

The main message that the AMF wants to bring to stakeholders in its strategic plan is that the quality of supervision is a fundamental asset. There is no contradiction between promoting the attractiveness of Paris as a financial center and being a demanding supervisor, as a well regulated and predictable environment is a prerequisite for the financial sector to thrive.

At EU level, competition between jurisdictions can be a powerful engine to promote EU competitiveness provided that it remains fair. In particular, it must not play on regulatory arbitrages that ultimately impair the unicity and efficiency of the European single rulebook. To be attractive, Europe must therefore set and implement a unique set of rules, in order to offer local and third country market players a simple, legible and safe set of regulations.

In this context, the fragmentation of the supervision landscape has a detrimental effect on the quality of the EU rulebook, as each country tries - be it at Council or ESMA level - to make sure that no possible loophole exists in the applicable regulation.

Having a single supervisor in Europe, for which France has for long been a proeminent advocate, is key to ensure a harmonised application of the EU legislation across jurisdictions. A single supervisor applying a common rulebook would be a benefit for the EU as a whole. This is even more important, as the attractiveness of EU capital markets should be reflected upon at global level, for the EU to be competitive with third country jurisdictions.

Having a single supervisor in Europe is key to ensure a harmonized application of the EU legislation.

AMF strongly welcomes the recognition of these facts in ESMA Task Force's recent report. This report has also identified a number of possible improvements to be made to optimize the effectiveness and attractiveness of capital markets in the EU.

ESMA's recommendations for a well-functioning EU capital market focus on three dimensions, to address the needs of European citizens and companies, and to improve the EU regulatory and supervisory framework.

Among the main possible improvements identified, broadening investment opportunities for EU citizens is crucial. Options in this area include the development of basic long-term investment products and pension systems that are suitably incentivised and contribute to the development of capital markets, complemented by efforts to improve financial education. Revitalising a dynamic securitisation market in the EU through a comprehensive review of the current framework – particularly looking at prudential treatments, due diligence rules for institutional investors, reporting requirements for certain types of assets, the consistency of STS criteria and the supervisory process – while remaining conscious of potential risks, is also important.

Stimulating the development of diverse funding options beyond raising on public markets seems also key - venture capital and private equity may support the lifecycle of SMEs, at late stage or IPO phase, to allow the emergence of an ecosystem. In that objective, and to support innovation and growth, the potential to further mobilise and scale institutional and retail equity capital through dedicated funds, including public/private partnerships, to better support the growth of critical business sectors in the EU should be evaluated thoroughly.

Consolidation is also often mentioned as a necessary development for more competitive EU markets. It may make sense to a certain extent and for some activities to allow European champions to emerge (and to lower risks and fix costs for banks, asset managers). However benefits have to be carefully evaluated in other instances. In particular, consolidation is not sufficient to ensure a smoother and homogeneous trading and post-trading environment in Europe, which should also be a key objective.

Other issues have to be examined with a high level of priority within the next Commission's mandat: improving regulatory agility by giving EU authorities the power of forebearance, to suspend temporarily some dysfunctional rules, as it is the case in other jurisdictions such as the US (no action letters) ; and most importantly, ensuring the harmonisation of tax and insolvency laws, without which there cannot be a truly integrated EU capital market.

NATAN TIEFENBRUN
President – Cboe Europe

CMU – Daunting dream to practical reality

How do we create a truly European capital market that is accessible and works for all? How do we support the capital and funding needs of small member states, large member states, retail investors, professional investors, pensions, banks, private companies, public companies, your family, and my family and finance a green transition while we are at it? How can we continue to develop and enhance an entire capital markets system - on every front - in order to better the lives of all Europeans and support their financial independence?

There is no single answer. However, important strides have already been made in many areas which serve as the building blocks of more efficient and integrated capital markets that are attractive to investors and issuers alike.

The equities consolidated tape will be a great leap forward for European markets when it is introduced from 2026. The consolidated tape will democratise access to market data and give more European and international investors greater visibility to European companies via a single access point.

Competition, pricing and risk management via EMIR 3.0 reaffirmed the importance of interoperability of equities clearing, which places the needs of market participants first, and brings significant operational and capital efficiencies to the benefit of the end-investor. Put more simply, it enables firms to mobilise more of their capital into growing their businesses, furthering the development of the capital market as a whole.

The EU Listing Act also simplifies the listing process to make it easier and more cost effective to raise capital in European markets.

These are foundational elements on which much can be built, and at Cboe Europe we can speak from experience.

Our philosophy mirrors the EU Capital Markets Union, and the pan-European approach we have taken to all of our services enhances their attractiveness and the competitiveness of European markets as a whole. Through this approach we have galvanized the support of market participants and succeeded in building one of the largest pan-European stock exchanges and the most connected pan-European CCP. More recently, we have invested in the development of a pan-European equity derivatives exchange (CEDX) and will soon launch a corporate listings initiative designed to attract global capital to European markets.

Competition, innovation, and customer choice: These are the tenets on which the future CMU can be built.

As a longstanding supporter of the CMU, pan-European solutions, and meaningful legislative enhancements (e.g., consolidated tape and interoperability in equites clearing) that benefit investors, Cboe Europe remains open and committed to exploring enhancements that will grow European markets through choice and competition.

In our experience, investors are naturally drawn to capital markets that are efficient, accessible, driven to innovate, and incentivized to reduce suboptimal, high-cost outcomes. If we pursue supervisory frameworks – centralised or not – that support efficient product approval processes, encourage innovation, and allow for the principles-based application of rules, we will have a solid foundation. If we pursue an ecosystem that supports competition (beneficial fragmentation) through openness and interoperability – rather than unproductive fragmentation or uncompetitive silos that are driven by rules, infrastructures and service providers that avoid pan-European solutions and sever Pan-European networks – we can build a CMU that embraces connections and reduces inefficiencies. If we pursue an ecosystem that rewards competitive infrastructures rather than national silos, we can build a CMU that improves outcomes for all.

Cboe embodies a pan-European approach rather than a country-by-country approach in the belief that it helps simplify access to European markets, reduces unproductive fragmentation, while improving capital efficiencies and reducing costs for investors, to the benefit of issuers in large and small markets.

As new ideas are proposed, we encourage policymakers to consider a simple rubric; does the idea/provision/legislative text support competition and innovation? Does the proposal support the ability of investors to make informed decisions? Does the proposal reduce bureaucracy and encourage dynamism? Does the proposal improve retail investor access to transparent investment products? Will it make it easier for a company to raise initial or additional capital in public markets?

If the answer to any of these questions is 'no' we encourage policymakers to strongly consider whether the proposal is fit for purpose. We must not lose sight of the core tenets at the heart of these questions; competition, innovation, and customer choice. Markets that support these principles empower and attract investors. These are the tenets on which the future CMU can be built.

PILAR MARTÍNEZ

Head Public Affairs EU and Latin America – SIX Group

Empowering the EU: paving the way for global competitiveness

If one looks at the Capital Markets Union of the Juncker Commission in 2015, it could as well be the next European Commission's action plan. When considering the challenges and needs for capital markets in the EU and measures proposed then, they are very similar to those that we face today. The world, however, is in a very different place now than it was almost 10 years ago: competition is fierce, uncertainty has raised, and stakeholders are navigating a rapidly changing landscape.

Despite the efforts of Europe to emulate the United States, it is paradoxical how we are not yet arriving to the desired results. The issue, then, must lie not in the goals, but in the means to get to them. Perhaps we should try not to replicate the US, but to build on the strengths the EU has and work together with all different stakeholders for that purpose.

For decades the EU has tried to become an appealing market vis-à-vis the outside, with regulation improvements to capture external investors and companies. And yet, those changes have not necessarily replicated for those participants that are already inside the EU and to whom listing in the Member States brings cumbersome and complex analyses. This partially explains the phenomenon of EU companies choosing to list, for instance, in the US. It is clear at this point that being listed in the EU should not be perceived as a burden for issuers, but rather a means to add value.

Precisely on the value added of listed markets, fragmentation is a pivotal point: in the European Economic Area there are more than 500 execution venues, out of which near 190 are systematic internalisers. Exchanges compete against each other in a healthy manner and obeying the same rules. Furthermore, Exchange groups compete with one another meaning that, in practice, there is already consolidation in the trading space for lit markets happening. Nevertheless, there is the widespread understanding that for fragmentation to decrease, exchanges must reduce in number.

If liquidity was found only in Exchanges this will certainly increase it, but SIs capture it in an opaque manner and reduce its availability for companies listed. In practice, that liquidity that is drawn away to dark or semi-dark venues, becomes unreachable. As a result, issuers have less and less incentives to go public in the EU.

Policy makers have the capacity to make EU markets attractive also by listening to the concerns of companies, and good proof is the recent Listing Act, but it should certainly not stop there.

The potential of the EU needs the joint effort policymakers, institutions and market participants.

At the same time, financial market infrastructures need to be able to innovate and align with NCAs to ensure consistent and harmonised application of regulation across the Union as we play a key role in ensuring that our market is competitive and attractive.

Looking at the investor side, with very few exceptions, for retail investors the range of assets and the moments of the lifecycle of a company where they can invest is very limited. While investor protection needs to be secured, participants need to be able to channel their savings in the long term via investment in capital markets. Informed and responsible investors should be able to access a wider catalogue of assets, and for doing so, fiscal policy also needs to provide incentives. Elements such as the FTT or the equity-debt bias that disincentivise investment need to be reconsidered.

The EU must focus on creating a long-lasting investment culture, and that means inevitably increasing financial literacy. Not only for investors, but also for issuers and companies looking to be listed. Europe can, and will compete with other regions in the world, but for doing so, it must change its narrative and leverage on the good measures it has implemented over the past ten years: Growth markets, solid and robust lit markets for listing, proportional regimes for smaller issuers and certainly the route to harmonisation across Member States.

Given that non-EU countries, as Switzerland or the UK, are fundamental stakeholders both as cross-border investors, but also as competitors, the EU cannot overlook the fact that harmonised rules and principle based approaches will work towards creating a less differentiated competitive ecosystem, and a more attractive investment centre towards which domestic and third-country investment can gravitate.

By now it is clear that there are no silver bullets for addressing the challenges the EU faces, but it is also evident that there are several measures that can be taken to start creating a virtuous circle to make the EU attractive and competitive.

The EU has the tools and the will to create a multifaceted approach that can focus on harmonised regulatory approach, issuer confidence and investor engagement, but it must do so swiftly to seize opportunities. To unlock the potential of the EU it is fundamental to work towards a joint effort between policymakers, institutions and market participants, and it must be done just like the EU, united in diversity.

TAREK TRANBERG

Head of Government Relations, Europe – Optiver

Time for meaningful progress on capital market competitiveness

Integrating European capital markets to make them more competitive and attractive for institutional and retail participants has been a hot topic over the past few months. EU policymakers are increasingly realising that meaningful progress on this decade-old project is critical to address a number of challenges the EU is facing. These include the sustainable and digital transitions, the ticking timebomb around pensions, increased demand for defence spending, and the spectre of being left even further behind (in economic terms) by the United States, India, and China. The chorus of voices calling for progress on creating more competitive, more integrated, more efficient, and more liquid capital markets in the EU is therefore very welcome.

This time needs to be different, though. The past decade has seen its fair share of ideas on how to make this happen, but progress has been somewhat limited. Whilst none of the focus areas are new – reviving the securitisation market in Europe, increasing retail participation, overcoming post-trade fragmentation and addressing the elephant in the room that is supervision – it is a welcome change that this topic seems to finally have been given the political priority that it deserves.

If we are serious about making markets more competitive and more attractive for domestic and foreign institutional investors, delivering better investment opportunities for savers, and creating capacity for European firms to grow locally and compete globally, here is a (non-exhaustive) list of things to consider:

A streamlined and more nimble single rulebook

Whilst a lot of progress has been made, we should reconsider the overall complexity and prescriptiveness of European financial regulation – especially the balance between primary legislation and technical standards. Financial markets evolve significantly faster than the time it takes to pass new or amended laws in the EU. One of the hallmarks of a competitive capital market is the ability of regulators to react nimbly to changing market circumstances and tweak the regulatory framework. This means that more power over substantive aspects of the regulatory perimeter should be delegated to the supervisory and regulatory agencies than is currently the case.

> **If we are serious about competitiveness we need to recognise that markets don't only belong to banks.**

Better recognition of different business models

The narrative on capital markets integration has long emphasised the need to reduce the bank-centric funding model, but this has not always translated to the regulatory set-up for capital markets. Here a largely bank-centric approach still reigns. As a result, different business models with different risk profiles that play a fundamentally different role in supporting capital markets are chronically underrecognised. If we are serious about making capital markets more competitive and attractive for both domestic and foreign firms, we need to recognise on a fundamental level that capital markets do not solely belong to banks – and that anyone active at scale in those markets should not be regulated the same as a bank. This needs to be urgently addressed when revising the prudential regime for investment firms (IFR/IFD).

More powers for ESMA

This is one aspect of the discussion on capital markets that often provokes passionate responses, but it is important to highlight that capital markets will not function efficiently unless there is a single view on how to interpret the rulebook. This would make conduct of business for market participants significantly easier. It would also lower the cost of entry for new domestic or foreign players looking to scale their activities across the Union. This in turn will pay dividends in terms of growing the overall size and attractiveness of Europe's capital market. A larger, more liquid secondary market will drive better outcomes for all types of investors, but it will also make primary market activity more attractive. So yes, centralised supervision (which can come in different forms) is not the silver bullet that will create a competitive capital market, but it is a necessary element on the way to making it so.

Is this time different?

Staunchly defending the status quo is one reason why we have made little progress on this project over the past 10 years, so we can only hope that policymakers finally inject some real ambition into their decision-making in the interests of the common good. Otherwise the outlook is clear: We will continue with the current downward trend, see activities move out of Europe at an ever increasing pace, all while lacking the fiscal capacity to overcome our societal and transformational challenges, and reconvene in a few years, wondering what happened.

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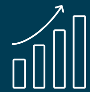
Economic and stability challenges



Capital market regulation

Banking and insurance regulation

Digitalisation and new technologies

Sustainability challenges

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PRIORITIES FOR THE ASSET MANAGEMENT SECTOR

MARTIN MERLIN
Director, Banking, Insurance and Financial Crime – DG for Financial Stability, Financial Services and Capital Markets Union, European Commission

Priorities for the EU asset management policy - Roadmap for the next 5 years

The European asset management industry is evolving under the influence of technological advancements, shifting investor preferences and regulatory changes, including those relating to financial stability, competitiveness and sustainability.

The recently completed review of the AIFM and UCITS Directives aimed to enhance the efficiency of those frameworks by addressing key issues, such as to increase transparency through improved supervisory reporting, to introduce harmonised rules on loan originating funds and to improve the resilience of the sector against liquidity mismatches through harmonised rules on liquidity management tools. In a similar vein, the review of the ELTIF framework sought to boost the uptake of ELTIFs across the EU by introducing more flexible, yet robust, rules while preserving the highest level of investor protection.

These reforms constitute an important step towards boosting the resilience of the EU financial markets and contributing to the realisation of the Capital Markets Union, hence it will be essential to focus on their implementation and enforcement.

Nevertheless, as the European Commission embarks in a new mandate and sets its policy agenda for the next five years, it is the right time to reflect on the functioning of the EU legal framework and consider whether it is conducive to fostering a resilient and competitive asset management ecosystem able to support the green and digital transformation of European economies.

The European Commission will continue with its objective to reduce supervisory fragmentation and promote convergence through the development of a harmonised regulatory framework on investment funds and a continuous dialogue with national supervisors and ESMA. To that end, the recently revised frameworks and the accompanying implementing rules introduce a uniform set of rules on areas not previously harmonised at EU level (e.g. liquidity management tools, loan origination, transparency on delegation). In parallel, the Commission is contemplating to revise the UCITS eligible assets Directive. As the Directive is in force since 2007, it is deemed important to take stock of the market and regulatory developments and to consider adjustments that would minimise diverging national practices.

In line with our objective to maintain the highest standards for a robust European investment fund sector, the European Commission is assessing the merits of revising the MMF regulatory framework. Whilst the decision to review the MMF Regulation remains the in the hand of next Commission, targeted reforms such as decoupling the activation of liquidity management tools from the level of the liquidity buffers, increasing liquidity buffers or enhancing the stress tests could further strengthen the ability of EU MMFs to address systemic risks.

As highlighted by our President in her address to the European Parliament on 18 July, the European Commission is committed to promote European competitiveness, a policy objective that is particularly relevant for the asset management sector, where Europe enjoys a strong position. To that end, the Commission could reflect on further measures to facilitate the growth of the ELTIF market, including promoting the efficient and wide distribution of ELTIFs across Member States and in third countries and discussing with Member States appropriate national tax incentives. This could incentivise asset managers to channel more capital into long-term investments that support the EU real economy.

The Commission could also explore whether EU rules are sufficiently supportive of the UCITS exchange-traded funds (ETFs) to satisfy the growing investors' demand, and whether, and if so how, measures should be taken to improve the functioning and the competitiveness of the EU ETF segment.

Moreover, the Commission envisages to look at which policy measures could increase start-ups and scale-ups' access to diversified sources of private funding. As the lack of funding opportunities for late-stage scale-ups in particular seems to be a source of renewed attention, the Commission will consider whether regulatory intervention could make it easier for private investors and venture capital to finance fast-growing companies.

> **A framework "conducive to fostering a resilient and competitive asset management ecosystem".**

Finally, subject to the steer of the next Commission, a review of the Sustainable Finance Disclosure Regulation might be warranted to simplify the framework and bring it in line with the expectations of retail investors. This could be done via the introduction of product categories which would help distinguish between products with different sustainable investment strategies. This reform would therefore contribute to deliver on the promise of simplification and competitiveness.

MARCO ZWICK
Director Executive Board – Commission de Surveillance du Secteur Financier (CSSF)

Considerations on macroprudential policy for investment funds

The CSSF published in June a paper on macroprudential policy for investment funds. The objective is to contribute to the current discussions at international and European level on macroprudential policies and tools for investment funds, more specifically on whether to repurpose or adapt existing tools or on whether to potentially develop additional tools.

Specific and appropriate regulatory objectives apply to investment fund managers and products, in acknowledgment of justified differences existing with the regulations applying to the banking and insurance sectors: "Investment fund managers (IFMs) manage investment funds on behalf of investors who own the assets and benefit from the return of the investments on the basis of a pre-agreed investment policy and risk profile (so-called "agency model"). IFMs therefore have to comply with fiduciary obligations with the objective of acting in the best interest of their investors."

When stating that "the UCITS and AIFMD rulesets present a robust and proven framework that generally provides for the resilience of the investment fund sector", the CSSF recognises at the same time the need to address certain vulnerabilities that have been identified during recent crises.

Liquidity mismatch and leverage remain key areas of interest for investment funds. Considering the inherent characteristic of liquidity mismatch between assets and liabilities of open-ended funds, market players need to adopt a holistic liquidity risk management approach, including having access to an extensive toolbox of liquidity management tools (LMTs), as part of their usual overall risk management process, and which is available particularly for crisis management. In this context, further guidance on the selection and use of LMTs, their calibration, timing and operationalisation should be defined. It is noteworthy that the recent AIFMD/UCITS review includes amongst others the common availability of LMTs for AIFs and UCITS across the EU.

There is merit in enhancing the Money Market Funds (MMF) framework for non-government MMFs "through adapted liquidity requirements, the "releasability" of buffers in times of market tensions, the availability of anti-dilution LMTs, as well as by a decoupling of regulatory thresholds from mandatory implementation of suspensions, gates, and redemption fees, where applicable."

As part of the review of the Eligible Assets Directive, it is recommended that liquidity be systematically assessed at security level to match the fund's redemption policy, with no presumption of overall liquidity of the fund's portfolio.

The CSSF is of the opinion that IFMs should remain responsible for activating LMTs and considers that "IFMs, in charge of the day-to-day management of investment funds, are best positioned to activate LMTs, subject to guidance from competent authorities. Having authorities decide on the activation of these tools could entail significant moral hazard issues for IFMs and would in addition possibly provide the market with (unintended) signals that competent authorities see a specific market situation as being critical, and thereby possibly aggravating the situation."

As evidenced by the Liability Driven Investments episode, inter-connectedness with other market participants, either via direct links or via derivatives or similar asset holdings, remains a key area to monitor for the sake of mitigating risk spreading and market tension affecting other market participants and sectors, which could ultimately result in systemic risks.

The CSSF advocates an integrated collection of supervisory data under the AIFMD/UCITS review, with an enhancement of data on leverage and a consistent definition of leverage for undertaking for collective investment in transferable securities and alternative investment funds.

To support the ultimate goal of the EU Capital Markets Union (CMU), it will hence be important to:

- avoid national/local standards which generally lead to market fragmentation;
- improve the availability and access to reliable data to increase transparency to the respective stakeholders, including investors and supervisory authorities;
- consider the international work which has recently been worked out on liquidity risk management at IOSCO, FSB and ESRB level and to which national control authorities contribute as a starting point to (i) evaluate existing tools, (ii) repurpose and adapt existing tools where necessary, and (iii) decide, after a later assessment, whether these tools are fit-for-purpose, sufficient or whether new ones should be developed.

Europe is not alone to regulate a global financial industry, such as the investment fund sector.

We must remain mindful of the fact that, in light of the upcoming CMU, Europe is not alone to regulate a global financial industry, which is in fact what the investment fund sector is. The debate needs therefore to include a thorough discussion on the competitiveness of Europe vis-à-vis other financial centres and the competitiveness of investment fund products vis-à-vis other financial products.

MICHAEL J. MCGRATH

Assistant Secretary, Financial Services Division – Department of Finance, Ireland

CMU is an opportunity to deepen the Single Market to the benefit of everyone

The EU asset management and funds sector has developed apace since the early 2010s, with a strengthening of the frameworks including associated investor protection measures. One of the sector's key strengths is its diversity – with an assortment of products offered by a variety of providers operating across the Union. This is a model that truly represents the best of what the Single Market has to offer. It has operated well for both firms, and investors, with the potential to deliver much more for retail investors. The UCITS and AIFMD frameworks having become the references at the global level for investor protection and transparency; and recent legislative changes should improve the operating environment for firms. In this context, the EU is rightly seen as a global leader.

The AIFMD review has strengthened the funds regulatory framework and supported CMU objectives through, in particular, a harmonisation of rules concerning the availability and use of liquidity management tools, the introduction of an EU framework for loan origination and providing for enhanced data for supervisors. The availability of long-term financing is also critical to the future development of Europe's economies. The ELTIF review has the potential to significantly support this policy objective through legislative amendments that make this product more attractive from both a supply and demand side perspective.

That being said, retail investor participation in the market remains relatively low, with an estimated €33 trillion held by European consumers in deposit accounts. Some of these funds could be put to much better use, both for individual investors and society at large in terms of providing much needed capital. Accordingly, it is important that we work on measures to increase retail and professional participation, through continuing to build trust and confidence in the system.

The future of the EU asset management sector is one that is intertwined with the development of the EU capital markets. As a leading provider and regulator of financial services, Ireland strongly supports measures to build the capacity and strength of the EU financial sector. Legal frameworks need to evolve according to the policy priorities and imperatives of the day. Over the course of the last number of years there have been significant changes to the investment funds legislative framework and this is ongoing through further work on delegated acts as well as level 3 measures. While there remains a case for further reforms to the rulebook, targeted at certain fund types or activities, all in all the focus should now be on getting the level 2 rules and level 3 measures right and ensuring that the legislative changes are implemented effectively. In other words, we should not lose sight of the value of certainty and stability in the regulatory environment.

One of the sector's key strengths is its diversity.

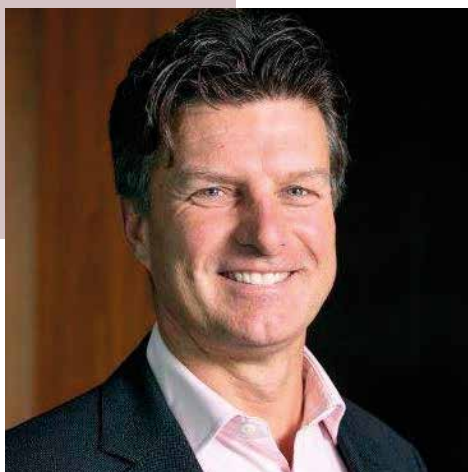
In terms of CMU, the Eurogroup roadmap from May provides a positive pathway forward with ongoing work focused at both the EU and national dimensions to ensure that an evidence-based programme can emerge.

Much has been done so far in relation to delivering this multi-year structural reform project. Over recent months, we have seen a number of important reports and high-level statements on chartering where we might go next. It is clear that CMU will be an important priority for the incoming mandate and in that context Ireland will actively work to deepen capital markets both at home and right across the EU.

There are many areas where we can expect broad support at EU level and this is where we must concentrate our efforts. Stimulating equity funding, enhancing the role of pensions, reviving securitisation markets, promoting the EU as a green finance hub and improving financial education are just some of the topics where results can be achieved.

Moreover, we should work to introduce measures which would unlock the capacity of the market to support the real economy, as well as the development of important green and digital infrastructure. In order to improve engagement with the sector, it is also important that we demystify investing for the average citizen and ensure the benefits of deeper capital markets are reaped by many. In this regard the EU asset management and funds sector should have an important role to play.

Finally, advancing the CMU project, as well as benefitting the EU internally, will allow for the improvement of European competitiveness on the global stage. The EU asset management and funds sector provides real evidence of the benefits of the Single Market for those within the EU as well as in terms of the global role that the EU plays. During the next mandate we should aim to secure our position as a global leader, remain open to capital and expertise, while ensuring financial stability and investor protection.



PATRICK THOMSON

Chief Executive Officer, EMEA – J.P. Morgan Asset Management

The partnership between policymakers and industry is the key to success

Europe's asset management industry continues to demonstrate its resilience and indeed thrive. Despite facing geopolitical unrest, uncertainty in global financial markets and the lingering effects of the pandemic, the industry has consistently delivered for investors. Recent statistics published by the European Fund and Asset Management Association show that, over 2023, all major UCITS types delivered positive – and in some cases inflation-busting – average annual performance. This resilience and success underscore the industry's ability to navigate a challenging operating environment while meeting the diverse needs of investors.

By continuously innovating, the asset manager sector ensures that end investors have the choice of and access to investment products and strategies that are best suited to their objectives. Looking ahead, we expect to see the continued rise of active exchange traded funds (ETFs), which allow investors to earn excess returns while retaining the benefits of the ETF structure. We also expect to see greater interest from retail investors in alternative and long-term assets, in light of the recently revised European Long-Term Investment Fund Regulation.

This spirit of innovation extends beyond product offerings. We are observing an evolution in the relationship between asset managers and other parts of the investment ecosystem, with the growth of bespoke partnerships that touch on everything from portfolio management to the distribution of products. One must also acknowledge the transformative impact that technology and artificial intelligence is going to have.

Nevertheless, the industry is having to contend with significant challenges on the horizon. For example, the green transition and demographic changes, which will have a profound impact on the provision of pensions. In the more immediate term, there is the need to find an engine for economic growth and the question of Europe's security. The financial services sector, and the asset management industry in particular, can play a prominent role to help identify and develop solutions to these.

As intermediaries, we support the flow of capital to the wider economy, as we identify investment opportunities on behalf of our investors. To fully harness this role, it is essential that European policymakers embrace a collaborative approach and engage closely with the industry.

As we look to the start of the next EU mandate, there is significant focus on the policy actions that will be taken by the European Commission, Council and Parliament to address some of these challenges, to further progress the Capital Markets Union and advance the EU's strategic priorities. Within this context, a key question will be on the role of legislation.

There are of course outstanding legislative proposals that will need to be completed, notably the flagship Retail Investment Strategy. As the EU institutions gear up for trilogue negotiations, we continue to encourage a shift away from equating value solely with low costs. Policymakers should instead pursue the development of an investment framework that balances investor protection with informed and responsible risk-taking. Regarding sustainable finance, particularly the Sustainable Finance Disclosure Regulation, it is clear that the status quo is inadequate, which is why we are closely following the European Commission's ongoing comprehensive assessment and their expected proposal to improve the current framework.

With regards to potential new legislative proposals, we encourage policymakers to take a thoughtful and considered approach. In short, we believe the EU would benefit from a period of regulatory stability. The flurry of legislation introduced following the 2008 Global Financial Crisis was undoubtedly necessary. Similarly, the pandemic and subsequent periods of market volatility highlighted potential gaps which reforms such as the review of the AIFM and UCITS Directives have sought to address. However, it is now crucial to allow these rules to settle and fully take effect, thereby offering stability and certainty to market participants and investors.

A stable & innovative environment will allow asset managers to continue to support the wider economy.

A stable policy and regulatory environment is also crucial when considering the current focus on improving Europe's competitiveness. As policymakers consider how this can be enhanced, it is crucial that we do not distance ourselves from the principles that have served us well to date. Europe's openness has been one of its strengths, best demonstrated by the global appeal and success of the UCITS brand. Rather than seeking to direct private capital, policymakers should instead focus on creating the optimal conditions, incentives, and product offerings to activate private domestic savings and continue to attract international capital. By fostering a stable and innovative environment, Europe's asset management industry can continue to thrive, grow, and support the broader economy.

ANDY BLOCKER
Global Head of Public Policy – Invesco

European citizens need a more productive EU; it's time to deliver for them

Household investment rates in the Eurozone are declining.[1]

Almost 10 years on from the launch of the first Capital Markets Union Action Plan, Europeans are voting with their feet in a manner which is not, in my view, in the interest of their collective long-term financial wellbeing.

And this trend has not emerged because households do not have the money to invest. In the past two years as investment rates have declined, household saving rates have increased![2]

While the decision to hold onto cash rather than invest it could be seen as a response to the post-Covid economic uncertainty that many households in Europe (and around the world) have faced, with economic conditions normalising, inflation receding[3], and wages rising[4], there is now an opportunity – and need – to address this trend.

It is for this reason that we welcomed recent reports issued by President of the Eurogroup, Paschal Donohoe, and former Prime Minister of Italy, Enrico Letta, both of which seek to address this very issue through better integrating and improving the effectiveness of capital markets in the region and, more importantly in my opinion, making the ecosystem more productive in citizens' long-term best interests.

In this regard, it is important that Europe does not repeat past missteps in taking forward the Capital Markets Union agenda by pursuing legislative initiatives that, while well-intended, do not ultimately contribute towards a more productive capital market ecosystem.

At its core, this will require, in my view, a more pragmatic and coherent approach to the EU's often complex rulemaking process. For example, legislation should not generally have effect until the relevant underlying rules or guidance are implemented.

I also believe that the EU requires a more appropriate attitude towards investment and investment risk, and the management thereof. For example, while some policymakers have sought to provide investors with access to potentially higher-yielding assets via the ELTIF, others proposed rules which would have rendered the vehicle inoperable. It should not be the case that EU institutions operate at cross purposes in this way.[LK1] [AB2]

More broadly, developing a more attractive capital markets ecosystem will require fewer, more targeted policy initiatives, not all of which may require regulation.

First, the European Commission should maintain its efforts to coordinate Member States' implementation of financial literacy initiatives and to rollout the financial competence frameworks for citizens developed jointly with the OECD. Citizens' financial literacy should be seen as the foundation upon which the Capital Markets Union is built.

Second, policymakers should continue to support innovation and ease of access for citizens to a broad range of investment opportunities and vehicles, including private market assets, in a manner which ensures an appropriate level of protection while offering exposure to potentially more productive assets.

Third, to enhance EU citizens' long-term wellbeing at the point of retirement and beyond, where not already in place, Member States should establish autoenrollment savings plans as a supplement to, not a replacement for, state-provided or occupational pensions. Any such work on pensions should pay equal attention to both the accumulation phase and the decumulation phase, with a focus on ensuring financial security in retirement.

In support of the three policy initiatives outlined above, for those providing services to citizens in pursuit of their investment objectives and long-term financial goals, the EU needs to deliver on its ambition to maintain a more proportionate regulatory framework. The constant cycle of regulatory change must be addressed to allow firms to deliver client services more efficiently and effectively, otherwise significant resource will continue to be diverted away from the development of products and solutions which respond to clients' evolving needs.

EU investment rates are declining while savings increase; capital must be deployed more productively.

Each of these issues were referenced in the Donohoe and Letta reports and it is my sincere hope that EU policymakers can deliver on the recommendations attached to such initiatives as we move towards the articulation of the CMU 3.0 agenda.

With a new college of Commissioners and a refreshed European Parliament, it is my strong belief that policymakers must remain laser focused on addressing the trend which I highlighted at the beginning of this article and, in doing so, improving the long-term financial security and wellbeing of citizens across the region.

1. *Source: Eurostat, July 2024*
2. *Source: Eurostat, July 2024*
3. *Source: Eurostat, July 2024*
4. *Source: European Central Bank, May 2024*

SIMON JANIN
Head of Governance and Public Affairs – Amundi

Still a lot has to be done to reach a real Savings and Investments Union

"A concerning trend is the annual diversion of around €300 billion of European families' savings from EU markets abroad, primarily to the American economy, due to the fragmentation of our financial markets."[1] This sentence from the Letta report summarizes well the core of the challenges Europe is facing.

Indeed while savings are flying abroad, EU imports capital from the rest of the world to finance the long-term development of its businesses. This can be illustrated with the example of investments in stocks: non-euro zone equities held by residents based in the Eurozone amount to €5,724 bn. while euro zone equities held by non-residents reach €8,912 bn[2].

There are various reasons of this imbalanced situation, but two are of particular relevance for the asset management industry. The first one is the persistent lack of integration in European markets. Fragmented, EU capital markets cannot compete with their main peers. The second reason can be attributed to a bias of allocation in favor of the US market, which is notably reinforced by the evolution of market shares in the asset management sector that has evolved to the disadvantage of the EU industry. Over the past 10 years, US asset managers saw their market share in Europe rise from 27% to over 41%[3].

In view of these figures, there is urgency to help EU actors to be more competitive and unleash the significant untapped potential of investment of European savings. In 2023, these savings represented 14.02% of gross disposable income, whereas in the United States they were about 7.9%[4]. With a more appropriate framework, these huge amounts of savings could be channeled towards the financing of the European digital and green transitions.

This assessment has already led EU authorities to conduct a series of reforms as part of the EU Capital Markets Union (CMU) action plan. Notably the successful review of ELTIF Regulation should help boost long-term European investments in the real economy. Similarly, the new provisions adopted in AIFM and UCITS Directives, notably on liquidity management tools, will provide funds with even more autonomy and resilience - as long as the expected level 2 rules are properly designed.

However, a lot has yet to be done, with much stronger ambition, for Europe to become a really integrated, resilient and competitive market. In this regard, the positive momentum to relaunch the CMU project, be it renamed Savings and Investments Union, both at Members States (Eurogroup, European Council) and ESMA levels and with the conclusions of the Noyer and Letta reports should be maintained.
In particular, three key concrete actions should be taken.

The positive momentum to relaunch the CMU project should be maintained.

First, it is essential to promote more long-term investment in the EU towards retails investors. In this respect, E. Letta proposes to create an auto-enrolment EU Long-Term Savings Product. The Noyer report also puts forward this recommendation but through a European 'label' whereby each country will have the choice of creating a new product or adapting an existing one and supporting it with a tax advantage conditional to significant investments in the EU. Indeed, it is essential to make sure that products that would benefit from this label – and therefore from a tax incentive - would be predominantly invested in the EU economy.

Second, reducing fragmentation is key. This will be achieved through EU wide policies such as making sure that legal texts and their related implementation measures converge across the different Member States, without the temptation of adding burdensome local requirements ('gold-plating'). This should also be achieved through specific measures that would help pan European actors to fully benefit from more regulatory and supervisory convergence. In this respect, the recognition of the concept of group at the EU level, as notably proposed in the Noyer report, would enable European asset managers to benefit from the economies of scale generated by the single market.

Third, more attractive securitization markets could free up more capital from institutional investors. Among the proposals made by both Letta and Noyer reports, the launch of a European agency – similar to the ones existing in the US - that would provide a guarantee to securitized assets is an interesting way forward. This should be complemented by targeted reviews to the existing prudential framework. The revision of Solvency 2 in 2023 has been a promising start but this regulation, together with CRR, has to be better adapted to current market needs to enable securitization to operate at its full potential.

Although there is still a long way to go, an ambitious Savings and Investments Union could help Europe meets its challenges. Now it is time to move forward.

1. *Enrico Letta, Much more than a market, April 2024*
2. *Christian Noyer, Developing European capital markets to finance the future, Proposals for a Savings and Investments Union, April 2024*
3. *Broadridge, December 2023*
4. *Banque de France, Eurostat, July 2024*

RETAIL INVESTMENT STRATEGY NEXT STEPS

RODRIGO BUENAVENTURA
Chair – Spanish Securities and Exchange Commission (CNMV)

RIS: moving to a larger market through quality and competition

The Retail Investment Strategy (RIS) is one of the most important and far-reaching legislative initiatives of recent years initiated by the European Commission. The objective pursued is necessary for the revitalization of European capital markets as a flagship measure aimed at deepening the Capital Markets Union: to broaden the retail investor base in the markets.

Despite the heated discussions and different positions it has caused in the industry, the investment community and the EU institutions, legislators have designed a wide range of measures aimed at improving the information that investors receive, making it more suitable for digital distribution and increasing transparency, accessibility and understanding in terms of costs and returns. It also includes measures to improve value for money, improving the quality of advice to clients and skills of advisors, financial education and the communications and dialogue with investors.

The two main issues of discussion focused on the concept of value for money in financial products and the prohibition of inducements in the fund distribution process. However, an important question remains: why is it necessary to regulate prices (to some extent) and rebates? Is competition not sufficient to expel the least competitive producers and distributors and to ensure that only the most efficient, best and cheapest products and providers survive? Why do we need to intervene products and commercial or management fees? Is competition not working properly? And, if so, why?

Part of the answer relates to complexity for retail investors in differentiating total costs charged, value for money obtained and in comparing products in a multi-variant fashion. Comparing products is not a one-dimension exercise (volatility, risk, price, target, fees, liquidity…all of those matter). But the other part of the answer relates to the difficulty of comparing providers and even combining providers. In the European investment distribution model, it is common for retail investors to invest through a single intermediary (in many cases, their general-purpose bank). Changing intermediaries, when a better product is identified, is an operational problem, having to reproduce all the necessary information (KYC, AML, personal profile, experience, suitability) in each and every one of the providers, keep multiple apps and websites and control different tax information sources, with all the operational problems and attached fuzz. Matters such as a digital portability of the client's profile - in terms of portfolio, investment experience, knowledge and investment profile - or aggregators of investments through multiple intermediaries in a single app or dashboard, are not yet widespread in the European investment services industry. This hampers true and effective competition and may be the reason behind more invasive regulatory measures.

The Retail Investment Strategy, fortunately, also contains a set of interesting proposals to redesign the information provided to the client, adapting it to the digitalization era that we are living in. These proposals, which have almost gone unnoticed, should make it possible to lay the groundwork for a healthier relationship between investors and providers and even expand the investment distribution model we currently have, in order to improve the experience of the retail investors, bring more competition and therefore better service and lower fees.

> Why do we need to regulate products fees? Is competition not working properly? And, if so, why?

The main focus of the Retail investment Strategy should not be exclusively to expand the retail investor base. Quality of service, fairer treatment of clients, better tailoring to their investment profile, significant cost reductions and improved products should also be a major driver of the legislative proposal. Indirectly, better quality should also attract more investors to the market and strengthen the competitiveness of the European asset management industry, its efficiency and its growth.

Looking forward, when the trialogues conclude, the successful implementation of the new legislation, will greatly depend on the subsequent legislative development of the measures designed. One of them, the definition of benchmarks, will be one of the most complicated. The regulation will have to establish the principles, the comparison methodology and the different product clusters. Also, how to determine what levels of deviation from the benchmark are considered acceptable and what threshold deviations should be justified with a catalog of reasons explaining the deviations. A lot of further work is still needed to make this new regime work.

ALEKSANDRA MACZYNSKA
Managing Director – BETTER FINANCE

A missed opportunity to turn EU savers into investors

BETTER FINANCE, the European Federation of Investors and Financial Services Users has supported the EU flagship project – the Capital Markets Union (CMU) – from the very beginning. In 2023, we welcomed the publication of the Retail Investment Strategy (RIS) that had the potential to finally improve the situation for individual investors. Moreover, at the beginning of 2024 with the Eurogroup statement (calling e.g. for "low-cost investment products with appropriate risk return profiles for all EU citizens") and then subsequently with the Letta report we have been pleased to see more effort on the political level to look for solutions to drive retail participation in capital markets.

However, we have not seen this effort from the side of financial industry. There have been numerous independent reports and analyses published over the years with the accompanying evidence of the consumer detriment caused by the current state of the distribution system in the European retail investment market. Unfortunately, many market participants still fail to even acknowledge and address these core problems, instead opting for short-sighted defensive strategies like the ones proposed in the recent industry paper[1].

Moreover, apart from the EC, the co-legislators seemed to be more influenced by the industry point of view and than by consumers' best interest. The final text of the European Parliament's negotiating mandate from April 2024 and the agreement of the Council of the EU from June 2024 pave the way to start interinstitutional negotiations. Regrettably, the amendments introduced by the co-legislators are pushing the CMU (aka Savings and Investments Union) further out of reach and don't offer solutions to 1) access to good quality independent advice, i.e. competent financial advisors whose advice is beyond doubt in the interest of their client, 2) value for money (and in case something goes wrong there is no real access to an EU collective redress mechanism).

The EU Parliament and Council neglected the interests of retail investors and the establishment of a competitive CMU for the sake of keeping the status quo favourable for the financial industry that will not drive the retail participation. The European Commission's proposal was not perfect, in particular regarding its stated objective of ensuring "bias-free advice". Nevertheless, it included several significant advancements, notably on the Value for Money (VfM) requiring investment firms and life insurers to quantify and justify the costs of their products in relation to their performance ('value for money'). We were disappointed to see that the EP and the EU Council did not prioritise improving the financial wellbeing neither the competitivity of the European economy and effectively removed the crucial valuable elements of the Commission's proposal (like the ban of inducements on execution-only investments) or diluted them (like the VfM framework).

One of the most dire needs is the one for a clear and robust VfM framework.

BETTER FINANCE has put forward many concrete recommendations on the way forward in our Manifesto[2]. We remind that advisors should assess and recommend products based on their quality, i.e. their capacity to meet the investor's specific objectives and needs selecting the most cost-efficient products among those deemed suitable, and in line with the risk profile. Investors want advice, not a sales pitch. To this end, in our Manifesto we propose that the terms 'advice' and 'advisors' should be reserved for situations where a professional is remunerated by its client for researching and selecting the most suitable and cost-efficient products. One of the most dire needs is the one for a clear and robust VfM framework. However, reading the co-legislators' compromise texts we have concerns about its effectiveness as there would not be mandatory benchmarks integrated in manufacturer's and distributors' product governance process, but instead only European supervisory benchmarks and it is not clear how they should interact with peer group assessments conducted by companies.

The critical negotiations between Parliament, Council and Commission will take place behind closed doors. The obscurity of the trilogues process itself is not going to drive EU citizens trust in the new law either.

1. *BETTER FINANCE's comment on the recent industry's report Charting the Course: Unlocking Retail Participation in EU Capital Markets that was published on 11 April annexed to the report itself.*
2. *https://betterfinance.eu/publication/individual-investors-key-priorities-for-2024-2029-sustainable-value-for-money-reconciling-individuals-enterprises-the-planet/*

JEROME LACHAND

General Secretary – CCF Group

European Retail Investment Strategy: two important success factors

Further incentivize individual consumers who wish to invest in EU capital markets : the Retail Investment Strategy (RIS) approach is fully in line with the previous regulations (MIFID and IDD in particular), that banks and insurers have been implementing for years now. The need for the regulator to come back on the same issue tends to show the complexity of the topics. This should lead to pay a specific attention to two sets of issues in particular, to ensure the goals are properly met.

1. A principle based regulatory approach will make this new regulation more effective

Within the EU, diversity prevails in terms of cultures, markets, laws, banks. Given the current market fragmentation, a fully harmonized set of rule will be more effective if implemented via a flexible framework under the supervision of the national competent authorities (NCA).

A principle-based approach allows banks to tailor their implementation strategies to their specific contexts and business models. This flexibility is crucial for small or medium-sized banks that may not have the same resources as larger institutions but need to comply with regulatory standards effectively.

By focusing on the desired outcomes, such as enhanced investor protection and market transparency, rather than prescriptive rules, banks can innovate and find efficient ways to meet regulatory objectives. This encourages a culture of compliance that aligns with business goals and client needs. It would foster innovation by allowing banks to explore diverse solutions to meet regulatory requirements, such as investing in fintech and digital platforms to enhance their service offerings.

Principles provide a robust framework for risk management by emphasizing the importance of sound judgment and ethical decision-making. This can help banks develop more effective risk management practices that are tailored to their unique risk profiles and business environments.

Adopting a principle-based approach can improve client trust and satisfaction by demonstrating a commitment to high standards of conduct and client-centric service. This can strengthen client relationships and loyalty, which are critical for banks competing in a crowded market.

A principle-based framework can help banks use their resources more efficiently by focusing on high-impact areas and avoiding the rigidity of prescriptive rules. This can lead to better resource allocation and more effective compliance strategies.

Two RIS success factors: principle-based regulation and strong banks advisory role.

2. Banks' advisory role should be promoted

One of the challenges to be taken up is to improve EU retail customers' understanding of financial markets. In addition to public sector initiatives to promote financial literacy, such as educational programs and online tools, banks can and should play a pivotal rule.

Banks are employing experienced financial advisors with a good knowledge of market trends and investment products. This investment in staff education should be pursued: banks should expand certification programs for bank advisors to ensure they possess the necessary knowledge and skills to provide high-quality investment advice. Promoting ongoing training and professional development for bank advisors would keep them updated on market trends, regulatory changes, and innovative investment strategies.

Highly skilled advisors will make the difference when discussing with customers the best investment possibilities. Because of their knowledge of their customers, they will provide suitable advice aligned with clients' best interests. This could also involve adopting data analytics technologies to better understand client profiles.

In the CCF, our advisors are already keen to propose the best products for the customer regardless of productor. In todays' bank highly competitive environment, the upcoming "value for money" test is something that already exist, otherwise affluent customers in particular are quick to move to another bank. Decoupling more production and distribution could allow for an enhance level of competition within the industry, and ultimately benefit to the final retail investor.

Expanding bank's advisory role obviously has a price, that banks need to be able to ultimately charge to the customer in a transparent way. That is why any regulatory ban on inducement should be carefully weighted. Automation helped the industry to significantly lean the securities management process over the past years, and customers have to benefit from these evolutions. Time has probably come for banks to step up their investment in human capital.

The significant additional costs that the RIS project will impose to EU banks who are facing an already highly competitive market is a clear challenge. But there might be a path to a joint success, if the regulation is implemented in a way that will allow for local flexibility under the NCA's close scrutiny, and if banks invest more in their human capital.

GIULIO TERZARIOL
Chief Executive Officer, Insurance – Generali

Retail Investment Strategy at the service of an Investment and Savings Union

The RIS proposal aims to position citizens and investors at the center of regulatory design and implementation. Positive impacts in terms of market accessibility are foreseen, following the enhanced transparency of PRIIPS and the effort to promote financial education. The latter, alongside sound and meaningful advice, is crucial for secure and efficient participation in financial markets. However, to unlock the full potential of retail investment in the EU, Generali believes that some elements could be further improved during the finalization of the political discussions. The most relevant are:

Inducements: Generali, despite opposing a total ban on inducements, appreciates that the restriction was limited to independent advisors by the Council and the European Parliament. While we expect the final agreement to reflect these elements, concerns remain about the 'inducement test', whose adoption appears complex. In addition, the possibility for varied local implementation approaches could disrupt the Single Market's uniformity negatively impacting market functionality.

Value for Money: The latest political developments have reduced operational workload by curtailing reporting obligations, through the exclusion of data submission already accessible via the IBIPs KID and other existing reports. Furthermore, additional European regulations regarding the definition of VfM methodology and the criteria for justified and proportionate costs have been excluded. However, the focus remains mainly on costs and performance, and we recommend the inclusion of additional elements to fairly consider for instance the value of advice or the financial stability of the product manufacturer.

Benchmarks: both EU benchmarks and the peer grouping analysis are maintained in the co-legislators' positions and manufacturers will be charged a fee for the provision of peer group data. This approach will be a considerable challenge in case benchmarks are made public. They could be perceived as implicit definitions of thresholds or caps along the different dimensions analyzed. Companies could therefore start focusing only on the elements captured by the benchmarks, thus limiting product innovation and excluding features that might effectively provide value, leading ultimately to less choices for the customers and degrading the competition between products.

Industry attention on RIS persists despite the important developments from EP and Council proposals.

Furthermore, if the proposed benchmarks (which would not reflect the complete value proposition of insurance-specific solutions due to a simplified reporting) are made available to the public, there's a concern that customers may misinterpret them, potentially leading to choices that don't match their requirements and needs. This might be more pronounced for customers with less financial literacy or those using self-service or direct platforms. In this sense, financial education is a fundamental lever to guarantee customers' protection. Our recommendation would be to maintain the use of benchmarks for regulatory activities, excluding the introduction of further "peer grouping" as it appears to be a duplication with disproportionate effort and without clear benefits .

Best Interest Test: We also welcome the proposed improvements to the best interest test, including the exclusion of the reference to the "cheapest option". However, some refinements are still needed to make it more suited for the insurance market (e.g. wide products catalog still required, lack of qualitative elements to reflect customer needs).

Finally, we very much support the view that the Retail Investment Strategy's political outcome should be framed within the objectives of a Savings and Investment Union, as per the Political Guidelines of President von der Leyen and the Letta Report: this should be the blueprint for action for the 2024-2029 political cycle, which presents a pivotal opportunity to embrace a renewed, comprehensive approach to EU policy action. It is therefore key that the RIS attains the objectives of genuinely facilitating an investment and risk-taking culture in Europe, whereby consumers are encouraged to shift their savings from bank accounts to the capital markets. In this endeavor, co-legislators should be guided by the need to empower citizens so they can consciously participate in capital markets by making investment practices simple and transparent.

The finalization of the RIS proposal is crucial to steer a paradigm shift in the way retail investors perceive and access EU capital markets. Notably, long-term returns on retail investments can help increase household wealth and support retail investors with their financial planning. For example, saving for retirement, in addition to state pension systems, can help close the growing pension gap and ensure adequate resources for retirement. Moreover, mobilizing EU citizens' savings will increase the liquidity and depth of EU capital markets contributing to the development of the real economy and driving further growth through long-term investments.

DANIEL KAPFFER

Chief Financial Officer & Chief Operating Officer – DekaBank Deutsche Girozentrale

Retail investors increasingly understand the need to invest – but still deterred

Historically retail investors did not have a strong desire to invest into capital markets. Retirement benefits have largely been based on state and company pension schemes – up to 75 % in some countries. Additional savings were mostly invested in life insurance and private pension funds and not directly into the market. However, an aging society means that the traditional pension schemes will not be able to sustain the level of benefits anymore. Another factor is the low interest rate environment. Hence retail clients are becoming increasingly aware –28 % have already invested in financial products.

In addition the green and digital transformation cannot be financed just by states or banks.

So if investing in capital markets should be desirable why is the majority of the population not doing so? here are two reasons. The first one is widely accepted – the lack of financial literacy. Most educational systems in Europe do not cover finance in school at all. While this has to be fixed at national level, the legislation on the European level needs to support investment advice. And secondly ease of investing. Well intended but way to complex rules aiming at investor protection deter retail clients from investing into capital markets and give an incentive to investment managers to provide less complex but also less attractive types of investments.

Need for personal advice to access the capital market

One of the main barriers to retail financial investment is indeed the lack of financial literacy and risk culture. Most customers have a lack of understanding of financial instruments and their view tends to associate capital markets with gambling. This means that most consumers need personalized advice to find a suitable investment and build their confidence. Trying to educate consumers to a level where they all can be investment managers themselves underestimates the level of know how required.

However providing investment advice is costly and implies conduct risk. It requires a thorough understanding of the consumer's financial background, his investment goals and willingness / ability to bear losses. While charging the cost of investment advice appears to be more transparent it would deter a significant proportion of consumers from investing in capital markets instead of increasing the participation. So giving the consumer the freedom to choose between fee and commission based models is essential. In addition very often, consumers use non-advised services in the aftermath of investment advice.

Need for personal advice to access the capital market.

At the savings banks, customers are free to choose whether they want to place an order with an advisor in the branch, on the phone without advice, or whether they want to execute it themselves through app or online banking. Customers can switch between channels or even into the advisory service at any time ("multi-channel approach"). More than half of non-advised orders are placed via an advisor - in branch or by telephone.

Value for money clause - no need to repeat history of overregulation by MiFID

The complex investor protection rules of MiFID lead to irritation and uncertainty among customers and deter them from investing. Most of the required documentation is focused on downside scenarios and risks. Sometimes they sound like information sheets provided to patients for surgery.

The RIS was intended to make the investment processes more consumer-friendly and convenient. Instead, the processes are becoming even more complex and cost-intensive due to additional review obligations (expansion of the appropriateness review). The information obligations are to be extended once again (e.g. disclosure of the impact of inducements on returns, disclosure of the calculation method for estimated costs, obligation to provide information also to professional clients and eligible counterparties).

The current value for money proposal focuses on costs and does not take into account the actual qualitative elements of the products and services offered to retail investors. Such an approach would further limit choice without offering additional benefits to investors, ultimately favouring passive allocations via ETFs. As a result, the systemic risk of unidirectional investments will increase further.

A comprehensive assessment of value for investors should go beyond cost considerations. These factors include performance outcomes, the quality of services provided, sustainability outcomes, and effective risk management. The task of the asset manager is to manage default risks which must be done actively.

Furthermore, the main contents of the new requirements are either vague ("best interest test") or are shifted to Level II ("value for money test"), which means that there is huge legal uncertainty regarding the specifics of these regulations.

It is high time to focus on building a RIS that promotes the protection of the majority of consumers, truly finances the EU economy and enables open competition in a market economy.

We thank **the partner institutions**
for their support in organizing this Forum

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MOODY'S

DEVELOPING LONG TERM RETAIL INVESTMENT

SÉBASTIEN RASPILLER
Secretary General – Autorité des Marchés Financiers (AMF)

Drawing from national experiences to increase EU long-term retail investment

EU citizens' savings are abundant, but allocated to low risk instruments. In 2022, the EU had accumulated EUR 33.5 trillion in household savings, but these were quite largely composed of currency and deposits (34.1%)[1]. Increasing long-term retail investment might offer better returns for EU citizens, and finance the EU's engines of long-term growth.

Several policy avenues can contribute to it. Developing financial education is a consensual lever to empower EU citizens into making more informed investment decisions. It made its way into most recent reports on the future of the Capital Markets Union[2]. This is also a long-term effort, albeit financing needs are immediate. Where appropriate, easing regulatory requirements so that the industry may develop and recommend attractive long-term financial instruments products may be a good avenue.

We should in any case ensure that retail financial products have strong governance and transparency requirements, and provide good value for money, as introduced by the RIS. Finally, reviewing the tax treatment of long-term retail investment products can steer EU citizens' investment decisions. Successful domestic experiences from a number of Member States3 show that this may be the most promising policy avenue.

In France, the Plan d'épargne en actions (PEA) is a regulated savings product which enables retail investors to invest in, and manage a portfolio of EU company shares over the medium and long term, while benefiting from tax benefits. At the end of 2022, the number of PEA securities accounts stood at 5.2 million, amounting to total assets of EUR 101 billion[4]. Taxation being the remit of Member States, it is crucial that they closely cooperate in designing their respective long-term retail investment schemes. For this reason, the Noyer report[5] advocates for EU-wide monitoring in order to encourage national reforms while building on common principles to develop long-term savings products with similar features. Moreover, as soon as public funds are involved - for instance through capital gains tax exemptions - it seems legitimate for governments to require a certain share of investment into EU securities. Insofar as this scheme is optional, and retail investors are free to invest in non-EU securities or funds with exposures in non-EU markets, there is no basis for dismissing such policy measure. In light of this, rather than a single financial instrument, or yet another label, a package with an attractive tax treatment stands out as one of the best ways forward to develop long-term retail investment while financing the EU industry.

In parallel, a complementary approach revolves around the development of employee share ownership among EU companies. This is widely implemented in France through corporate mutual funds, but remains under-developed throughout the EU. In 2019, about 65% of EU firms did not provide any form of financial participation to their employees[6]. Developing employee share schemes at the EU level could substantially increase EU citizens' participation in capital markets, as well as favouring a culture of ownership. This policy measure enjoys strong support among European financial markets regulators[7]. At the EU level, its design could range from a voluntary framework recognized throughout Member States, to Enrico Letta's ambitious EU-wide auto-enrolment Long-Term Savings Product[8].

A package with an attractive tax treatment stands out as one of the best ways forward.

Successful national experiences in implementing tax packages and employee share schemes provide the templates to fuel long-term retail investment in the EU. In turn, this should yield higher returns for EU citizens, as well as channelling funds into the EU's most strategic sectors.

1. *Eurostat, 2023.*
2. *Recommendation 7 in ESMA Board of Supervisors' position paper "Building more effective and attractive capital markets in the EU".*
3. *PEA in France, Bertiebsrente in Germany, pension funds in the Netherlands, PIR in Italy, ISK in Sweden.*
4. *Banque de France, 2023.*
5. *In January 2024, Finance Minister Bruno Le Maire entrusted a committee of experts chaired by Christian Noyer with the task of formulating concrete proposals to relaunch the Capital Markets Union.*
6. *ECS (European Company Survey) for the European Commission "The Promotion of Employee Ownership and Participation", 2014.*
7. *Recommendation 6 in ESMA Board of Supervisors' position paper "Building more effective and attractive capital markets in the EU".*
8. *Report "Much more than a Single Market".*

CHRISTIAN NOYER
Honorary Governor, Banque de France

Building a real Savings Union to finance the future

Europe is experiencing a significant financial paradox: while it holds vast savings and faces enormous long-term financing needs in the coming years, especially for the green and digital transitions, these savings are poorly allocated.

While the European Commission estimates that the EU will need to invest over €800 billion annually by 2030, European households held €35.533 trillion in savings in 2022, nearly double the EU's GDP, and savings represented an average of 13.3% of gross disposable income for European households, compared to just 7.9% in the United States. Therefore, this substantial pool of savings should greatly support Europe's strategic priorities.

However, despite this abundance, European household savings are not effectively directed towards financing the European economy over the long run. Most of these savings are tied up in liquid and guaranteed products, limiting the amount available for higher-risk equity investments, such as listed stocks. These products alone are insufficient to meet the long-term investment needs necessary for Europe's green and digital transitions.

The inefficiency in the allocation of European savings largely stems from the nature of savings products and their tax frameworks, which often discourage long-term investments. Banks and insurance companies predominantly offer liquid and guaranteed products, making it challenging to channel savings into riskier assets like equities, which are crucial for fostering innovation and growth.

Therefore, it is more important than ever to foster the development of long-term savings products at the European level to address the significant financing needs ahead. This calls for a new Savings and Investments Union, focusing on a limited set of transformative reforms.

Given the failure of the PEPP, the variety of existing products, and the complexity of national frameworks, a decentralized approach based on shared principles and implemented domestically by willing Member States seems more relevant. Specifically, introducing a new category of European savings products with a common label could be effective, with Member States potentially modifying existing products or creating new ones to fit this framework.

To channel European savings effectively towards long-term financing, several core principles should be included in the label criteria.

First, these products should emphasize a long-term investment horizon. Restricting liquidity is essential to meet long-term investment needs, especially for riskier equity investments that are crucial for innovation, competitiveness, and growth. However, some degree of flexibility should be built in to address savers' concerns about accessing their funds.

Second, risk exposure needs to be carefully managed. Labelled products should not offer a permanent capital guarantee but could provide a form of guarantee at maturity. Offering a full, non-time-bound capital guarantee would severely limit the ability to invest in high-risk assets, such as equities.

Third, investment allocations should be managed according to investment horizons. While savers should be able to manage their savings themselves, labelled products should offer the default option of being actively managed according to the investment horizon. This approach would ensure that assets are allocated based on savers' risk profiles, with a gradual shift towards lower-risk investments as the maturity date approaches.

Fourth, involving employers could be beneficial. Labelled products should be available through collective, company-provided schemes, featuring automatic enrolment and possible regular contributions. This would help employees build up their savings more easily and provide a larger pool of funds for long-term investments.

Therefore, it is more important than ever to foster the development of long-term savings products at the European level to address the significant financing needs ahead. This calls for a new Savings and Investments Union, focusing on a limited set of transformative reforms.

Fifth, an attractive tax regime is crucial. Labelled European savings products should benefit from favourable tax treatment compared to other national savings products. This would make them more appealing to a broader range of savers and help generate the resources needed for long-term investments.

Lastly, a significant focus on European assets in the investment allocation is recommended. Investment criteria should be straightforward to facilitate product development, with a primary requirement being a minimum investment threshold in European assets, such as 80%. Generally, any product offering advantageous tax benefits should be subject to investing in European assets.

Recent calls from the Eurogroup to develop attractive, cost-effective, and simple cross-border investment and savings products for retail investors, combined with ongoing discussions among Member States, highlight the urgency of this initiative. A new European savings label could unlock significant long-term investment flows and help address Europe's pressing financing needs.

FAUSTO PARENTE

Executive Director – European Insurance and Occupational Pensions Authority (EIOPA)

Simpler and better value products to enhance trust, increase retail investment

Although Europeans save more than their American peers, they remain worried about their financial situation at retirement. In 2022, the EU saving rate was at 12.7%, compared to 3.7% in the US.[1] Despite this relatively high savings rate, only 42% of Europeans feel financially confident in their retirement, with confidence levels varying significantly by gender – 37% of women and 47% of men, according to EIOPA's 2023 Eurobarometer Survey.

The high EU saving rate shows potential for increased direct retail participation in capital markets. Nevertheless, more efforts are needed to ensure that Europeans have access to a broad range of long-term saving products which offer value for money. This includes insurance-based investment products, life insurance and personal pension products. The Survey also shows that European consumers who save through these products tend to feel more secure about their retirement.[2]

Increasing retail investment in capital markets requires a higher level of consumer trust in product providers (currently, consumer trust in insurance manufacturers is 45%, while trust in pension providers is 38%).

Therefore, it is important that consumers are offered choices that are simple, transparent and easy to understand, including regarding key trade-offs such as safety versus potential for higher returns, liquidity versus better long-term returns.

Products must align with consumers' needs and objectives and offer value for money. Products with low returns and high costs (about 15% of the products within EIOPA's Costs and Past Performance sample) can significantly impact consumer trust.

The digital transformation of the insurance and pensions sectors is creating new opportunities by lowering costs and enabling the development of increasingly tailored and personalised offers that better meet individual needs. Providing Europeans with insurance-based investment and pension products that deliver adequate and sustainable returns can also contribute positively to capital markets more broadly.

Beyond the core objectives of delivering adequate, safe and sustainable returns, increased insurance and pension savings can supply the capital needed to finance the long-term growth of the real economy and its green and digital transitions, while ensuring diversification of investments across the continent.

To improve returns and close pension gaps, consumers would benefit from more diversified savings.

The increased choice and availability of products and the range of product features can sometimes feel overwhelming for consumers, making it crucial to simplify and clarify options to avoid confusion. Hence, it is important to promote the development of simpler products informed by behavioural insights, focusing on how consumers perceive and understand product features.

Enhancing the governance of conduct risks by assigning clearer responsibilities on the boards of insurance undertakings and pension providers would help ensure that, throughout their lifetime, long-term products offer consumers value in line with their needs and objectives.

We must also streamline the distribution process. Incorporating new technologies such as AI, machine learning, and open finance can facilitate this. These tools allow insurance distributors to obtain information about customer needs indirectly, reducing the number of touchpoints during the pre-contractual phase and delivering a more effective purchasing process which fully considers the needs of consumers.

To facilitate innovation while protecting consumers, robust and impactful conduct of business supervision is a must, avoiding "one-size fits-all" blanket measures. It is important to swiftly and decisively identify and address cases of misconduct, using appropriate enforcement measures, including those that cover cross-border business activities.

Increased cross-border activities by insurers and pension providers can deepen the Single Market by providing consumers with a wider range of investment opportunities for their savings and pensions. Citizens must trust that rules are enforced consistently throughout Europe. When national supervisors are unable or unwilling to act, the supervisory framework needs to allow for swift remedial actions at European level to address consumer detriment.

1. *Eurostat, Household statistics; Bureau of Economic Analysis*
2. *Amongst respondents with an occupational pension scheme and/ or a private/ personal pension product, 53% report feeling confident in their retirement. In comparison, only 38% of those who rely on a State pension report being confident in their retirement.*

LUÍS LAGINHA DE SOUSA

Chair – Portuguese Securities Market Commission (CMVM)

Capital markets and retail investors, a vital attraction!

The PEPP hesitant evolution clearly shows that the success of a new product in financial markets depends on a variety of complex factors. This does not mean that financial innovation should not be pursued, especially considering that investing in the capital markets can provide solutions to challenges faced by European citizens, such as achieving an adequate level of income after active working life. Indeed, the context of an ageing population, alongside contributory and pay-as-you-go social security systems, creates a critical setup where savings products must be an area of focus in deepening capital markets, for the benefit of people.

The proposal for a decentralized approach for pan European savings products based on national products that meet common criteria, allowing Member States to adapt or create new savings products as needed, deserves consideration and may point the way to developing a product that truly attracts retail investors across Europe.

The relevance of introducing new long-term investment products is also related to the need to channel savings into investments that can boost the European economy. The proposal in the Letta Report to create a "Union of Savings and Investments" to unlock the potential of the single market underscores this second aspect. This union aims to promote long-term savings products predominantly invested in European assets, aligning with the EU's green and digital strategic transition goals.

However, if Europe aspires (and it should) to use its example to play a more relevant and influential role in the world, the goal shouldn't be to trap European's investment in Europe, but rather to win over investors to Europe based on the attractiveness of the risk-reward-cost balance products on offer.

We know that Europe has increasingly exported savings to other geographies. And the fact that investors seek diversified investment solutions may, indeed, be positive from an individual standpoint, including from the perspective of risk diversification. It may even be advantageous from a collective standpoint, since Europe's sustainable development also depends on the development of other geographies to which European investors channel their savings.

Therefore, establishing a "Fortress Europe" in financial markets, however appealing it may seem (particularly in an increasingly complex and belligerent world), is not a path that best serves Europe's long-term interests. Developed capital markets are certainly open, interconnected, and global. By encouraging investments both within and outside Europe, the European Union can strengthen its global position, positively influence the global economic landscape, and promote a more balanced geopolitical scenario.

The goal shouldn't be to trap European's investment in Europe.

Nevertheless, it is also clear that the deficit of European retail investment in European companies can represent a missed opportunity for better returns and also limit the financing available for these companies, not only for the large ones, but also for those starting up or on their way to becoming large.

Thus, alongside adequate retail products, it is necessary to promote the reduction of friction costs in the investment of European savings in financial instruments, as those costs usually translate into a significant loss of profitability and therefore negatively influence the investment decision.

Among these costs, taxation costs are clearly not negligible and require adequate calibration. However, instead of focusing solely on incentives - which admittedly are, most times, gamechangers, but also face political resistance -, it may be more effective to adopt an approach of "neutralizing" tax distortions between different forms of financing. These distortions result in an inefficient allocation of resources, where debt investments are often favoured over equity investments.

It is also crucial to promote a culture where large investments and high returns are not seen as a threat or as something negative, but as an opportunity for society. Creating an environment that celebrates financial success can encourage more individuals to invest. This can also be incentivised through financial education campaigns that highlight the benefits of long-term investments, of a more balanced financing and savings structure, not as reliant on bank deposits, and of a resilient and innovative business fabric for economic growth and shared prosperity.

A balanced approach that includes cost reduction, robust financial infrastructure, attractive retail targeted products and financial education is certainly needed to facilitate Europe attracting significant investments and offering competitive long-term returns for its retail investors, as well as a more balanced allocation of its citizens' financial assets.

SILVANA PACITTI
Global Head of Products – Allianz Global Investors

A client-first philosophy to EU long term investing

The Capital Markets Union (CMU), a visionary project by the European Union, aims to sculpt a healthier financial ecosystem by unifying capital markets across Member States. This is not just about connectivity; it's about democratizing the flow of capital, creating a gateway for (at least part of) the EUR 33 trillion in savings held by EU households to actively fuel businesses and nurture citizen's wealth across Europe.

To propel this vision forward, clever product design is an essential first step. Yet, the CMU initiative also calls for a shift in the EU mindset, championing a culture where investing is as natural as saving, and where the long-term benefits of growing wealth are widely understood and pursued. A cumulative combination of financial education, tax incentives, intuitive digital access and balanced product labelling can effectively support this shift.

Something old, something new

The investment landscape today presents a plethora of products designed to cater to the diverse needs of European investors. These range from mutual funds to pension savings vehicles, each with its own set of features, underlying investment strategies and benefits. Yet, product design on its own does not seem to sufficiently attract retail clients. This prompts the question: what more can be done?

Looking ahead, the focus should be on enabling product innovation, particularly to meet new retail client's investment preferences, but also on elevating existing investment solutions. Issues such as portability of investments across borders and the need for harmonized, more attractive tax treatments for long-term investments are obstacles that need to be addressed. These challenges require not only a solid and constructive commitment from Member States, but also a collaborative effort between European policymakers, regulatory bodies, and industry stakeholders to create a more coherent, accessible environment for present and future retail investors.

Recent regulatory advancements, such as ELTIF 2.0, are milestones explicitly aimed at nurturing a culture of long-term investment. Patience is key as we allow for this promising vehicle to take root, allowing asset managers to continue to innovate within the new regime. With these enhancements in place, the necessity for additional pan-European products catering to a similar need diminishes. On the other hand, introducing appropriate labelling could effectively serve as a navigational aid, helping investors to identify – and more easily access – products that align with their investment goals and risk appetite.

Product optimisation, balanced labelling, tax incentives and literacy bring us closer to our goal.

While product labelling can serve as a signpost for quality and trust, it can also carry unintended consequences. Labels can inadvertently create misconceptions about unlabelled products or add to the complexity that investors face when making financial decisions. It is, therefore, essential to approach labelling with care.

"Client-first" philosophy

This also applies to the criteria to access such a possible label, which should be driven by a "client first" philosophy. In fact, the main goal for any asset manager when designing a product is to cater to the needs and financial objectives of our clients. The possibility to reasonably diversify investments beyond the EU is crucial to create a well-balanced and risk-weighted portfolio, capable of delivering sustained long-term returns for our clients. More intuitive digital distribution options should be also explored and supported for significantly wider distribution reach.

No participation without education

Regulatory and policy initiatives are commendable, yet they alone may not suffice in attracting retail investors to capital markets. For these individuals to truly engage in this arena, they must be given the tools to appreciate the nuances and opportunities that investing offers. This is where financial education plays a pivotal role. It is especially important for retail investors to understand the value and risk propositions of long-term investments, which may require them to lock away their savings without immediate access or flexibility. However, the benefits of long-term investments and the higher chances of financial gain that come with the long-term element should be promoted by Member States.

Conclusion

Each stone laid in the form of tax incentives, product optimisation, digital distribution and educational initiatives brings us closer to a market that caters to all. This journey is not about constantly reinventing the wheel but refining it to roll more smoothly – ensuring every step we take is imbued with attractiveness, simplicity, and a steadfast commitment to putting clients first.

MARTIN PARKES

Managing Director, Co-Head EU Policy – BlackRock

Strengthening retail investment and long-term savings in the EU

European retail investors are increasingly drawn to innovative solutions harnessing digital technologies and communication tools, with better transparency, and easy to set up investment accounts. EU investors are served by a diverse market of suppliers ranging from neo-brokers and neo-banks to traditional branch-based bank networks building out their digital offerings with new ways to meet the financial planning needs of European retail investors.

The product tool kit in Europe is already very broad with traditional UCITS and the fast-growing ETF sector giving access to publicly traded assets. This allows Europeans to achieve their investment goals by investing in successful global and European companies, innovative future champions, while reflecting their sustainability preferences such as transition investing. Retail investors have now a greater choice of tools to build diversified portfolios and manage risk.

Most recently, the ELTIF 2.0 opens the door to retail access to private assets – these include investment in infrastructure, innovative small and medium companies and private debt which are essential to the growth of the European economy. While an exciting development, we are still at the initial stages of ELTIF rollout with considerable focus needed on the education of both retail investors and their advisors.

Future policy action could draw on the success of national long-term savings products: France's Plan d'Epargne Retraite (PER) uses easy to understand life-cycling strategies, and has seen the opening of over 9.8 million accounts. Digital providers have witnessed similar success with ETF savings plans: These offer innovative and easy to use retail access to markets with around 7.5 million trades of €170 on average being executed on ETF savings plans every month. At the European level, the pan-European Personal Pension Product (PEPP) has still to take off. A successful relaunch of the PEPP at scale should take on board the best user features of existing investment solutions.

An essential factor in encouraging the take-up of long-term retirement saving strategies is the roll out of life-cycling strategies, as seen in the French PER or US target date funds. These have proved to be successful in reducing the complexity of making ongoing investment choices by institutionalising the suitability process within the ongoing product design. When paired with tax incentives and/or workplace auto-enrolment strategies these can be highly effective solutions for encouraging regular-term investment. Investing successfully for the long-term means allowing investors to invest across a wide range of assets – incentives to restrict diversification across asset classes, e.g. by favouring equities at the expense of broader exposure to fixed income and private assets or across geographies are likely to be counter-productive over time.

Despite many positive trends, too many European investors still consider that investment is too complicated or simply not for people like them. As an example, a recent OpinionWay survey for BlackRock showed that while 71% of the French population recognises the importance of savings to achieve financial security, 82% found investment products too complex. Future policy actions should tackle these behavioural and operational barriers to simplify the investor experience rather than increasing the number of product categories and labels. Likely success factors include simplicity of access by reducing the number of clicks needed to open basic investment accounts while also encouraging investors to invest regularly on a diversified basis with enhanced educational support. The roll out of fractional share dealing has made it far easier for investors to set up monthly savings plans allowing them to allocate a fixed monthly amount to ETFs and shares regardless of the underlying nominal value. As ESMA focuses on best practices we continue to see divergent positions at national level on the acceptability of fractional dealing – a common approach to this operational utility has yet to fully emerge.

European investors use a wide variety of sources for support before investing, ranging from finfluencers, family and friends, employers to regulated firms. In addition to financial literacy programmes, supportive policy actions may include regimes for financial health checks and for guided advice to bridge the gap between execution-only services and full portfolio advice.

Too many European investors still consider that investment is too complicated.

This goes further than proposals in the Retail Investment Strategy for simplified advice, with a regime allowing providers to roll out financial planning linked to a choice of investment goals at scale. Labels can help catalyse investor interest provided they do not become a source of complexity or reduce investor choice. With such a broad product choice available we need collectively to make it easier for European investors to choose an appropriate combination of products and reduce the administrative and operational complexity of investing.

GUILLAUME PRACHE
Founder – BETTER FINANCE

Competitivity: EU economy and investors badly need a total EU stock market fund

A political consensus seems to be emerging at last that Europe badly needs a real "Savings & Investments Union" (the new name rightly proposed by Enrico Letta for the nine year old "Capital Markets union") to improve economic competitivity, as well as the net returns of long term and pension savings, i.e. to improve pension adequacy.

Simple cross-border savings products for retail investors

The Eurogroup in March 2024, the Letta and Noyer reports in April, recent proposals from France and Germany, and the elusive Draghi Report, all point to the need for "easy access to simple, transparent and low-cost retail investment products", and to "develop attractive, transparent, cost-effective and simple cross-border investment/savings products for retail investors" (Eurogroup, March 2024). The French and German public statements are more precise and practical by proposing long term equity investment plans with a tax incentive for investments into European equities.

Tax incentives are indeed needed to counterbalance the ones already benefiting less useful and less performing "retail" investment products, and to counterbalance the much higher before tax returns of US equities versus EU ones.

But a key requisite is overlooked: The content of the long term savings product(s) does matter: in the US there are very simple and very effective products for retail investors to invest massively into US equities, and not only into large caps, but also in mid, small and micro caps. This last but not least feature makes it also very effective for the US economy and innovation, as it provides massive inflows and liquidity to mid, small and even micro caps companies. It therefore also provides a major exit door for US private equity funding, by facilitating IPO.

> **The launch of total Europe stock market index funds should become a priority.**

Not one broad EU equity index fund

These products are called total stock market index funds (whether in standard or ETF format). It enables any individual saver / investor to very simply get instant exposure to the total listed equity market with only one fund, and with maximum diversification. The long term historical returns are also excellent for individual investors and therefore for pension adequacy.

In Europe, such a simple and effective equity investment product just does not exist:

- The largest Europe-wide equity index used by any fund manager includes only 600 companies: mostly large caps (smallest market cap is €1,4 billion), very few mid caps, and no small or micro caps.
- The biggest such fund gathers 200 times less capital than the equivalent US fund.

The main reason for this highly damaging lack of an adequate retail equity funding product is that the broadest European equity index (the STOXX® All Europe Total Market) currently includes about 1 800 listed companies (versus 3 700 for the CRSP US Total Market Index) and is not used by any index fund sold in the EU[1].

Also a matter of competitivity and survival for the EU fund industry

It is at last a stated EU policy priority to channel the very large EU savings much more to the financing of the EU economy, of its energetic and environmental transition, of its digitalization and of its defense. The main way to achieve this is to thoroughly increase retail investments into European equities, in particular into mid and small cap European companies. It should therefore be a priority for EU policy makers to promote the development of broadest possible indices of European and EU listed companies, and to help find the seed money to create Total Europe and/or Total EU stock market index funds (exchange-traded - ETF - or not) benchmarked on those indices.

The technology is there to manage such index funds by using very effective sampling techniques - instead of full replication - for small and micro cap stocks.

It is also a matter of competitivity of Europe's investment and industry … and of its long-term survival. In particular, Europe should consolidate its index investment management industry asap if it wants to have a chance to survive in the future.

1. *There is one index fund benchmarked on the Stoxx All Europe total Market, but it is US-domiciled, in US $, not sold to EU individual investors, and with only $322 million assets under management.*

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T+1 AND OTHER POST-TRADING PRIORITIES

JULIAN REISCHLE

Director General Payments and Settlement Systems – Deutsche Bundesbank

Rome wasn't built in a day: the same goes for frictionless European post-trading

We all do very much appreciate the significant improvements in post-trading implemented over the past decades. However, further progress towards completing the CMU still needs to be made.

Ever since the initial impulse to begin the work of removing significant cross-border post-trading barriers almost two decades ago, the post-trade community has gone to considerable lengths to transform the formerly highly fragmented landscape in Europe into a much more efficient and almost seamlessly interconnected part of the securities value chain. Notably, the Eurosystem's T2S has achieved progress through the standardisation and harmonisation of various operational cornerstones. As one of the CMU's financial backbones, T2S provides overall frictionless settlement facilities for all European securities transactions. However, unless financial market players have already done so, it is now high time to exploit the full potential of T2S's core design by adapting their behaviour accordingly. Another vital push towards harmonisation – this time for European collateral management – is expected coming soon with the implementation of the "SCoRE standards" in the context of the go-live of the Eurosystem Collateral Management System (ECMS).

Besides this, current practice shows that several operational procedures still lack additional harmonisation in key regulatory areas such as law and taxation. From the stakeholders' point of view, fundamental divergences in those regulatory areas that come under national sovereignty are considered to be problem-prone per se and would thus result in post-trade inefficiencies. Furthermore, it seems to be that the post-trading industry has to put the spotlight on important weak points as well, i. e. ensuring open market access. Ideally it resolves these as soon as possible on the path towards timely CMU fulfilment, thereby improving and strengthening the efficiency and competitiveness of European capital markets.

However, further progress towards completing the CMU still needs to be made.

Certainly, one of the most prominent of the upcoming challenges is the aim of introducing a shorter settlement cycle in Europe, working towards T+1. From a purely functional perspective, T2S is agnostic vis-à-vis the settlement cycle and a large number of big tickets are already being regularly settled on the very same day. Nevertheless, a concerted effort towards achieving T+1 could shorten the overall settlement cycle. We expect the bulk of the necessary adaptations to take place in the area of pre-settlement. The impact on T2S is believed to be manageable. Ongoing analysis at various levels has mainly focused on assessing the benefits to be reasonably expected, most notably risk reduction resulting in significantly lower margin and collateral requirements and improved capital flow, as well as on the thorough overall evaluation of other relevant impacting factors. From a general perspective, any ambitions that drive European post-trade actors towards even more efficient automated riskless processing, with all the positive effects this will likely have, are highly appreciated. Respective actors should ensure a smooth and rather noiseless transition to the shorter cycle by means of adequate European market readiness preparations. Moreover, they should duly consider – especially with regard to the timeline for such a shift – aligning with other relevant financial markets. What is by no means evident to all stakeholders is that the overall European setup is very different from a fully consolidated landscape like in the US.

Last but not least, many players perceive the emerging new technologies such as DLT or blockchain as some kind of panacea that will cure persistent frictions in the securities value chain as a whole by technically enabling the formerly inconceivable atomic processing of (simultaneous) procedural steps throughout the whole securities value chain (almost) all at once, especially via programmable features. Such ground-breaking innovations by nature harbour the intrinsic potential for a fundamental change in the entire ecosystem and therefore deserve more in-depth consideration.

NATASHA CAZENAVE
Executive Director – European Securities and Markets Authority (ESMA)

Moving to T+1 – 'not if, but when'

A decade ago, CSDR entered into force and set a harmonised securities settlement cycle within the EU at T+2. Since then, financial markets have evolved, driven by societal and technological changes that have prompted some countries around the world to consider shortening their settlement cycles to T+1. In the US, the 'GameStop saga' shed light on the severe risks associated with excessive volatility between trade and settlement, and acted as a catalyst for the industry, under the auspices of the SEC, to move to T+1. On the innovation front, the state of the art in IT has opened up for enhancements in traditional post-trade system architectures, while DLT solutions offer opportunities for improvements across the whole trade and post-trade lifecycle.

In the EU, the discussion on the compression of settlement cycles has recently gained momentum, in particular since ESMA released its feedback statement in March and even more so following the positive shift to T+1 in the US and other jurisdictions at the end of May. Overall, the views expressed in response to ESMA's call for evidence both highlight the substantial benefits that T+1 could bring and the acute challenges to overcome to ensure a smooth transition.

From the EU internal perspective, moving to T+1 would first and foremost deeply change how our financial markets work. All actors along the value chain would have to adapt their processes and showcase efficiency gains to meet tighter deadlines. Shortening the settlement cycle would be conducive to risk reduction in the system, which in turn should lead to lower margin requirements. Such advantages should not be underestimated.

From the international viewpoint, there would also be merit in addressing the misalignment with jurisdictions with which the EU is highly interconnected, especially the US. The complexity, costs and risks that EU stakeholders have to bear as a result of the current one-day delay will become harder to justify. Concerns for issuers seeking funding in the EU and in the US and the difficulties stemming from the misaligned settlement cycles for their corporate events have been raised. Issues for the asset management industry, for instance with regards to ETFs invested in securities in jurisdictions with different settlement cycles have also been mentioned.

Moving to T+1 would not only bring clear benefits for EU financial markets but also serve a broader and shared political purpose: international realignment, enhanced efficiency, reduced risk and lower margin requirements would support EU competitiveness.

Nevertheless, Rome was not built in a day. If not a change to CSDR, shortening the settlement cycle will require clear regulatory guidance to ensure alignment of all market participants. The timeframe for implementation will be of the essence. In this respect, as mentioned by many market participants, agreeing with the UK and Switzerland on a consistent timeline would be desirable. The onus will also be on industry players to cooperate closely with a view to ultimately adjusting market practices. Last but not least, it will be important to establish a robust governance framework that will help overcome the inherent complexity of EU financial markets.

The US have remarkably managed to switch to quicker settlement cycles. Although European capital markets feature different attributes – with notably several currencies, multiple market infrastructures – the smooth transition that happened across the Atlantic is somewhat reassuring. ESMA is committed to continue to duly assess the implications of a shorter settlement cycle for the EU, including by identifying the key factors behind the North American experience so that the Union can draw inspiration from them wherever possible. Its final report that will be submitted to the co-legislators by mid-January 2025 at the latest will also outline the cost-benefit analysis requested under CSDR Refit, as ESMA does its utmost to understand, evaluate and quantify the impact of a potential move to T+1.

Enhanced efficiency, reduced risk and lower margin requirements would support EU competitiveness.

The journey towards more efficient settlement started ten years ago when EU Member States followed diverging cycles. While awaiting the next phase to be officially kicked off, ESMA will continue engaging with the European Commission, relevant third-countries authorities and the market to provide its technical expertise and contribute to developing more attractive EU financial markets.

RICHARD KNOX

Director, Financial Services International – HM Treasury

Our path to T+1: building on the momentum in the UK and Europe

For two hundred years, the London equity market settled on a fortnightly basis. With the rise of electronic trading, settlement times have been progressively shortened. In 2001, the UK moved from T+5 to T+3. In 2014 this was reduced further to T+2. Each of these moves has delivered important benefits: reducing systemic, operational and counterparty risks, reducing liquidity and margin requirements, and delivering quicker access to returns for investors.

There is now significant global momentum towards even faster settlement cycles. The US, along with Canada, Mexico, Argentina and Jamaica, all moved to T+1 settlement on 28th May. India's equity market has been operating on a T+1 basis since early 2023, and since March has offered the option for market participants to use same-day settlement. Other countries such as Chile, Colombia and Peru are also moving to T+1 in 2025.

In the UK, the momentum towards T+1 is also building. The Accelerated Settlement Taskforce, the industry group that the government established in December 2022 to examine the potential for the UK to move to faster securities settlement, reported back in March.

The report highlighted the benefits that T+1 could bring to the UK market – such as improved market resilience, reduced counterparty risk, margin cost savings and a more efficient post-trade ecosystem. But it also noted the challenges that we face in making the move a success, and it will require a concerted effort from the industry, the government and our financial services regulators to address these.

The taskforce, chaired by Charlie Geffen, gave some clear recommendations – that the UK should move to T+1 by the end of 2027, that we should pursue collaboration on this move with other European jurisdictions where possible, and that a successor group of industry experts should determine the detailed operational and technical changes needed for a smooth transition to take place.

In response the government established a 'Technical Group', led by Andrew Douglas, to take forward the next phase of the implementation of T+1 in the UK. This group has been working hard over the past few months to drill down into how we can make the move to T+1 a success in practice. There are workstreams focused on the right scope of a UK move to T+1 and the potential for alignment with other jurisdictions, trading and liquidity issues, operational changes, lessons learned from the recent US transition and finally how the changes need to be implemented, whether through legislation, regulator rules, market standards or other means.

I want to record my thanks to everyone who has given up their time to get involved in this project – it has been impressive to see the industry come together to drive this work forward. This was highlighted at an event the Group hosted in June where the workstreams presented their initial findings, held panel discussions with representatives from different stakeholder groups including the European Commission, and also heard from SEC Chair Gary Gensler about lessons that could be learnt from the US move.

We expect the Group to report to government by the end of this year with recommendations on the next steps for the government, regulators and market participants to take in order to implement T+1 in the UK. This will include key timelines for the necessary technical and operational changes, and for the overall 'go-live' date when the full transition will take place.

Another important driver for T+1 is harmonisation across international markets. This is particularly relevant in the European context given how interconnected the UK, EU and Swiss markets are. While each jurisdiction has their own decision-making process to determine how to proceed, we recognise the importance of cooperating closely with the EU and Switzerland on T+1. This will help us to tackle key issues such as how we manage the transition for exchange-traded funds that are traded on two or more UK, Swiss, or EU exchanges.

Thinking even further ahead, increased use of distributed ledger technology (DLT) is something that could also transform securities settlement - instantaneous settlement of transactions has been regularly cited as a potential benefit of DLT. If industry were to implement this then I am sure that the need for coordination across the sector, both domestically and internationally, will become ever more urgent. What we learn from implementing T+1 will no doubt heavily influence future efforts to deliver even faster settlement and other changes to our post-trade ecosystem.

T+1 is coming, and there is strong momentum behind it in both the UK and Europe. Now we all need to build on this to prepare for a successful transition.

VAL WOTTON
Managing Director and General Manager, DTCC's Institutional Trade Processing (ITP) – The Depository Trust & Clearing Corporation (DTCC)

Proposed path for a successful T+1 transition in Europe

In May, the US was joined by Canada, Mexico, Argentina, and Jamaica in a successful move to T+1. In the US, the move to a shortened settlement cycle has driven reductions in risk and clearing fund requirements as well as greater operational efficiencies. At the same time, trade fail rates have remained stable despite some initial concerns that they might rise sharply.

Across the Atlantic, the UK and the EU are in the early stages of T+1 planning. There are several factors in these jurisdictions that will need to be considered when preparing for a T+1 transition. In particular, the EU has added complexity due to the different tax and legal systems across the 27 countries as well as a high number of stakeholders in different jurisdictions, including around 30 CSDs. There are, however, lessons that can be learned from the successful US transition that can support Europe's preparation for T+1.

First, industry collaboration is crucial to a successful transition to T+1. In the US, DTCC worked with SIFMA, ICI and the T1 Industry Working Group to outline key steps required for the shift and communicated those changes to the industry via educational materials such as the T+1 Playbook, T+1 Test Approach and T+1 Documentation. These types of initiatives are critical to ensure a smooth transition to T+1, and should be supported by ongoing engagement with, and education for, the industry. The UK and the EU are making some headway in this area and have established industry taskforces to coordinate preparations, with the UK on track to finalize its industry action plan by year end.

Second, efficient post-trade processes and automation are vital to achieving accelerated settlement. Trade-level matching is a critical part of the post-trade lifecycle that allows counterparties to identify exceptions that may cause the transaction to fail. By completing the allocation, confirmation, and trade matching processes on trade date, firms can increase the time available to address errors, thereby reducing the risk of settlement fails.

A crucial part of the US success was that, in the final T+1 rules, the Securities and Exchange Commission (SEC), included new requirements around same-day affirmation practices for broker-dealers to help ensure timely settlement. Similarly, we strongly recommend that the UK and EU markets consider mandating that trade confirmation, allocation, and matching take place on trade date. A mandate will provide regulatory certainty to the industry and encourage market participants to make the necessary investments to automate manual processes, increasing operational efficiency and resiliency.

Post-trade automation and standardization can increase settlement efficiency paving the way for T+1.

In the EU in particular, investment in straight-through processing must be a priority since there are more intermediaries and messages in the settlement process than in the US. Industry and regulatory bodies in the EU should also consider mandating these same-day processes ahead of T+1 implementation to ensure preparedness.

The benefits of automation are not limited to matching and confirmation, they also apply to standing settlement instructions (SSIs). The prevalence of manual SSIs and the absence of storing and sharing SSI data in a standardized, automated way remains an issue. Inaccurate or incomplete SSIs are one of the primary reasons for settlement fails, and with a shorter settlement cycle where there is less time to resolve fails, it is critical the industry moves away from manual processes. The EU and UK markets would also benefit from further standardization by using Unique Transaction Identifiers (UTIs) to increase visibility into a transaction's movement throughout the trade lifecycle, ensuring greater settlement efficiency. The good news is that both automated trade matching solutions which generate UTIs and SSI golden source databases are already available to be leveraged by market participants today.

The fourth important factor is global coordination. With globally interconnected markets, the risk of misaligned settlement cycles could affect end investors. While there is now an increasing consensus on the need for close coordination and alignment between the EU, UK, and Switzerland, it will be important for this to extend to other jurisdictions including Asia.

Overall, post-trade automation and standardization are critical to settlement efficiency, and they pave the way for T+1 settlement. By leveraging greater levels of automation, collaborating and coordinating across the industry and jurisdictions, firms will be best prepared for an accelerated settlement cycle. Doing so will not only decrease risks and costs, it will also help to increase the competitiveness and the attractiveness of financial markets, which are goals pursued by the Capital Markets Union (CMU).

At DTCC, we are actively participating in industry T+1 Taskforces with our peers globally and will continue to leverage the lessons we have learned in North America to help guide global markets in their own journeys to shortened settlement. The time to start preparing is now.

HAROUN BOUCHETA

Head of Public Affairs and Chief of Staff for Company Engagement & General Secretary, Securities Services – BNP Paribas

How T+1 could really be a catalyst to improve our European markets

In the context of the new legislative cycle soon to begin, it seems that the European Commission should consider the post-trading area as a major concern with the objective to remove remaining barriers, reduce fragmentation and promote further consolidation of post-trading infrastructures.

This focus should be part of a renewed Capital Markets Union (CMU) action plan in which, as always, competitiveness of EU markets and EU firms ought to be the main driver of the legislative agenda.

The central issue is to understand if the current pressure for the EU to move to T+1 fits with this objective and in particular if a rush to move to T+1 would not hurt EU markets and EU firms rather than an orderly transition. In other words, how could T+1 really be a catalyst to improve our European markets?

1. When? Do not rush a move to T+1 or it will ultimately hurt EU firms and EU markets.

Providing a cost estimate at industry level has proven a rather complicated exercise because the "how we move to T+1" has not been defined by authorities. The industry still does not know which T+1 scenarios will be chosen in terms of product scope and operational requirements and whether the ultimate aim is not in fact T+0.

But what we know for sure is that it will be a very costly project. It is difficult to identify comparable projects in terms of size and complexity. One could take T2S as a benchmark but even in this case we expect T+1 to be globally much more impactful on the entire trading, clearing, custody and settlement chain.

The expected benefits of shortening the settlement cycle – in terms of margin gains and potentially competitiveness – would probably not bring enough added-value to justify such massive investments. In addition, with the drainage of industry resources for a T+1 project, it will imply that less resources and investments for other strategic projects or innovations for clients are available.

We recognize that there is an opportunity to move to T+1 in the EU but the timing is critical. Given the magnitude of the transformation project as well as the specificities of the European market structure, a rushed transition could be detrimental to EU competitiveness and efficiency for years to come. A failed transition could be far more costly overall than any perceived negativity associated with a delayed transition compared to global peers. Moving too quickly to T+1 without taking into account the specificities of the EU environment would be far from giving a competitive edge to EU financial markets and EU firms.

> **We recognize that there is an opportunity to move to T+1 in the EU but the timing is critical.**

2. Should the EU follow the UK? A coordinated approach is needed.

The move to T+1 in the US should shed some light on the real effects of misalignments of settlement cycles between jurisdictions. Although the exact impact of misalignment still needs to be determined according to real criteria such as the volumes of cross-border transactions between jurisdictions and the dependencies between markets, there are some merits in considering coordination of approach within a same region in order to reduce impacts on market liquidity.

The EU and the UK should therefore be encouraged to coordinate their approach to limit disruptions to the markets and avoid any unintended consequences. In terms of governance, the UK and the EU should put in place a governance to be able to discuss and assess whether having a coordinated approach makes sense, which might not be the same thing as moving together at the same time.

The UK has already indicated flexibility in its 2027 timeline to align with the EU. As 2027 is probably not a realistic timeline for the EU, the Commission and ESMA should leverage on this flexibility.

3. How? To be a real catalyst, T+1 should be part of the CMU roadmap

The EU should enhance its attractiveness and competitiveness to global investors. T+1, along with ongoing post-trade improvements to facilitate the CMU, presents a significant opportunity for the EU to strengthen its infrastructure for future growth perspectives.

Whether T+1 is able to improve the highly fragmented post-trade settlement environment in the EU remains quite unsure but it could help create the conditions for the removal of some post-trade barriers and help harmonisation. Forcing market players to adapt their operational set-up in order to move to T+1 should encourage to tackle some of the root causes of fragmentation like national diverging laws, standards and services along the trading and settlement chain.

To truly achieve CMU, the European Commission may decide to create an expert group composed of relevant industry representatives and authorities to operationalise the need for greater harmonisation. Its objective would be to define a realistic timeline to move to T+1 but also to identify the relevant preliminary steps and establish priorities to truly increase interoperability, the competitive landscape and consequently decrease post-trading costs in the best interest of investors.

STÉPHANE GIORDANO
Deputy Head of Public Affairs, Société Générale & Chairman, AMAFI

The Olympian challenge of the T+1 relay in the post-trade field

10 years after the shortening of the settlement cycle in Europe from 3 days to 2 days, European markets and authorities are now considering a further reduction of the settlement cycle to 1 day (T+1), taking inspiration from the transition recently implemented for the United States's (US), Canadian and Mexican securities.

So far, the feedback on the American move to T+1 is remarkably positive. For most actors, this issue has proven uneventful, on both the securities – with a slight bump in fail rates resorbed in a matter of days – and the Forex market. Although the consequences of shortened settlement cycles will need to be studied over a longer period, this positive result is a relief not only for the jurisdictions where it took place, but also for the United Kingdom (UK), Switzerland and the European Union (EU), all envisaging their own move to T+1.

These early results in North America are encouraging but should not blind us to the difficulties of implementing this change in the EU. The success of T+1 in the US for shares, ETFs and corporate bonds came after a long preparation and was preceded by a long T+1 experience on US government bonds. More importantly, the EU market infrastructure for securities, where fragmentation remains ubiquitous (29 CSDs, 16 CCPs and 14 currencies), can hardly be compared with the particularly simple and streamlined structure of the US, where unicity rules (1 CSD, 1 CCP, 1 currency). The EU preparation should therefore follow two principles: a. only fools rush in: the US took about 3 years to execute T+1, so we must ensure that the EU gives itself enough time; b. align the conditions for success: the US prerequisites will undoubtedly need to be multiplied to consider the difficulties inherent to EU fragmentation.

In the spirit of the Olympics season, I like to think of T+1 as a relay where team members bring their individual performance to the end-result, one after another. Similarly, in the move to T+1, where some Asian markets launched the race, followed by North American markets, and where all eyes now turn to Europe, each jurisdiction bears a responsibility in the stability and attractiveness of its own market, but also in the good functioning of the global financial markets. This makes it even more important, for EU authorities and the financial industry alike, to approach the T+1 project with a heightened sense of responsibility and care. Coordination is especially needed with the UK, to handle markets that present specific liquidity challenges (notably, corporate bonds and ETFs). We therefore welcome efforts by both the UK and EU authorities to build on the industry's views and gather forces.

Drawing from the fruitful discussions that took place within the EU industry taskforce, I believe that authorities should pay attention to the following:

- Harmonization of the EU landscape is a primary requirement. Failure to reduce disparities between countries (processes between CSDs, treatments of tax reclaims, transpositions of norms, etc.) would mean having to manage up to 27 T+1 transitions instead of one, undermining the intended benefits.

- Liquidity providers are expected to encounter challenges due to the shortened settlement period, particularly in the corporate bond market, with the most significant impact on the high-yield segment. It is imperative to carefully assess, and ideally find ways to minimize, the economic implications of a potential worsening of market liquidity due to T+1.

- Post-trade activities, which previously took about a day to complete, will now need to be compressed into a few hours between trading and the commencement of the settlement cycle. It is essential to ensure that this compression from a day to few hours can be handled.

- The settlement model that the European markets benefit from (via night cycles) offers a high degree of optimization, so it is essential to establish the preconditions to avoid deteriorating it.

- The capacity to manage multiple large-scale projects concurrently is not infinite, which raises the question of which ongoing projects will need to be expedited or potentially abandoned to accommodate the time and costs associated with the transition to T+1 in the EU. This reprioritization should be carefully assessed, in terms of costs and benefits. Would it make sense to deprioritize such as ESAP, CSRD, FASTER?

Encouraging results in North America should not blind us to the challenges specific to the EU.

- In this light, and to ease the burden of the transition to T+1, it may be prudent to envisage a temporary suspension of the settlement discipline regime, and in any case to delay the implementation of a new penalty regime in Europe. Given the potential risk of increased settlement fails, the cautious approach is to maintain the current penalty framework until the T+1 transformation is successfully completed.

I am therefore looking forward to the ESMA report at the end of the year or in early 2025, which should build on the taskforce report to propose solutions, bearing in mind that haste and competitiveness do not necessarily go hand in hand.

ROBERT MOSCH
Head of Policy and Regulatory Affairs – Dutch Authority for the Financial Markets (AFM)

Post-trading improvements to support CMU – this time for real?

The European Commission adopted its first Capital Markets Union (CMU) Action Plan in 2015 in order to strengthen Europe's economy and stimulate investment to create jobs. Stronger capital markets will complement Europe's strong tradition of bank financing. Progress has been made since. The availability of data to market participants through the agreements on a European Single Access Point (ESAP) and a consolidated tape (CT); increased retail participation and investor protection; and enabling the single market through simplifying cross-border services. Unfortunately, there is still a lot to do as well. As the Letta Report highlights[1], the CMU needs to strengthen the European competitiveness, break down existing barriers, and promote consolidation and growth. In this contribution, the focus is on potential improvements for the post-trading landscape.

Over the last year, there has been much discussion on whether to move to a shorter settlement cycle in the EU, so-called T+1 settlement. The US recently moved to T+1, with the UK stating they will follow before 2027. A joint UK-EU-Swiss move would be preferable, and the EU needs to make up its mind soon. There are many benefits, for example, shorter settlement cycles lead to less counterparty credit risk, less need for collateral and thus less capital locked up in capital requirements, and cash and securities becoming available sooner for end investors. Whilst all these are all tangible benefits, they are not likely to lead to more consolidation or integration of EU post-trading. A shorter settlement cycle could however serve as a catalyst for more automation of the post-trading processes, which in turn could help improving the efficiency of EU capital markets. In the current world of "instant everything", and with the technical possibilities to facilitate this, it would be a missed opportunity not to go ahead with the move to T+1 settlement, staying aligned with other economies like the US and the UK.

Besides moving to T+1, the most recent conversations as regards enhancing post-trade in the CMU relates to updating the European Market Infrastructure Regulation (EMIR). This EMIR review is relevant from the perspective of enhancing the attractiveness of the European clearing landscape, while at the same time preserving financial stability of clearing in the EU. By simplifying and shortening procedures for EU CCPs and addressing some of the previous shortcomings, such as specific measures for non-financial companies, a clear improvement has been achieved compared to existing EMIR rules. However, more could be done to enhance the attractiveness and competitiveness of clearing in the Union further. Not by directly increasing prudential incentives for clearing members to move from third country CCPs to EU CCPs, but through constructive and pragmatic steps forward. For example, by increasing the range of EU CCPs' clearing product offerings: increasing and diversifying liquidity pools could greatly benefit the clearing landscape in the EU. Given that this is difficult for policymakers to achieve on their own, CCPs could step up their game to broaden their product base where needed. It takes two to tango when enhancing the attractiveness of clearing in the Union. This could even make the new active account requirements under EMIR 3.0 less 'operational', as clearing members could decide to move a bigger part of their clearing activities from third countries to the EU.

As market conduct supervisor, the AFM sees merit as well in further improving Europe's supervisory architecture, especially if this goes together with the afore mentioned goal of attracting more clearing activity towards the EU. As we wrote in our CMU position paper earlier this year[2], we deem the CCP and CSD environment as suitable areas for further centralization of supervision. It would break down barriers creating by potentially different supervisory practices and interpretations across Member States. In that regard, the outcome of the EMIR review has been somewhat disappointing and can only be perceived as an intermediate step, as the cross-border characteristics of the post-trade markets could benefit a lot from further increasing supervisory convergence. If cleared volumes would increase in the period ahead, cross-border and systemic risks can be better managed if supervision takes place on a more pan-European level.

For a true CMU & integration in the post-trading area, shorter settlement cycles are not enough.

In summary, these are three potential areas to improve the post-trading landscape to support the CMU: moving to T+1, increasing the attractiveness of clearing within the EU, and centralizing supervision of post-trade infrastructure where appropriate. With the global political landscape evolving, the CMU needs to become both more resilient and competitive. It is not option, but a necessity. These three areas would be a good starting point.

1. *https://www.consilium.europa.eu/media/ny3j24sm/much-more-than-a-market-report-by-enrico-letta.pdf*
2. *https://www.afm.nl/en/sector/actueel/2024/februari/position-paper-cmu*

ILSE PEETERS
Head of Government Relations and Public Affairs – Euroclear S.A.

CMU – How fragmented is post-trading really?

Recent months have seen a renewed focus on securities post-trading as shown in the reflections on CMU, discussions on the shortening of the settlement cycle and various initiatives on digital assets.

These initiatives are related and interdependent as they touch upon the same ecosystem of CSDs and market participants. Yet, they also have their own objectives, adoption path and timeline. Finding out what is the better approach to designing a roadmap for EU post-trading in the coming years may require a fresh focus.

CMU – Putting the right focus

Recent reports from Enrico Letta, the Eurogroup, ESMA and Christian Noyer include recommendations on increasing the attractiveness of the European capital markets for issuers and investors and deepening liquidity in the region. These reports also include recommendations related to post-trading and generally point to the continued fragmented nature of the post-trade environment.

While it is true that the CSD landscape is fragmented – certainly by the metric that there are 27 EU CSDs authorised under the CSDR – we should avoid an excessive focus on this indicator. It provides both a limited and overly simplistic picture of the way the market operates in practice and understates the improvements brought over the last years. There are several other measures of market integration and EU strengths that paint a more nuanced and certainly a more positive picture:

- The Top 5 domestic CSDs in the EU account for more than 80% of the EU securities depot, the concentration of settlement activity is even more important with those 5 CSDs accounting for over 90% of the settlement activity in the EU.
- T2S, the EU's common settlement platform across 20 markets, has been an important driver for harmonisation and efficiency in post-trading.
- The EU hosts two international CSDs (ICSDs), which not only have a truly pan-European scope but also offer a gateway to global markets and international investors, thereby operating alongside the CSDs that are more domestic or regional in focus.
- Success of the Eurobonds, a market served by the ICSDs: with EUR 13.2 trillion, it is the largest debt market in Europe and number 3 world-wide (only surpassed by US and China).

Of course, the remaining fragmentation should be further reduced to increase scalability. To achieve this, CSDs need an environment that improves conditions for competition. While one of the objectives of CSDR is to increase competition for issuers and for investors and to ensure CSDs can establish efficient links, in practice this competition is often hampered by unharmonised rules across Member States. The upcoming European Commission study on trading and post-trading should provide reflections on the way forward.

T+1 – Date and governance decisions needed

With the US successful transition in May 2024, the attention now turns to the UK and EU. For the EU transitioning to T+1, the challenges are compounded by the fragmented nature of the post-trade sector. It is therefore important that preparation for the implementation of T+1 starts as quickly as possible, even before the ESMA report expected by early 2025 and formal decision on a transition date.

Digital assets – Avoiding unmanaged risks and new fragmentation

Euroclear, like many market players, is actively investigating, testing and using new technologies such as DLT. Euroclear launched its Digital Financial Markets Infrastructure with digitally native note in October 2023 and is participating in the ECB wholesale central bank digital currency (wCBDC) experiments with its D-FMI platform.

While the potential of digitalisation is widely recognised, it is not a silver bullet to fix all the inefficiencies and harmonisation challenges in securities post-trading. Certain risks and challenges will need to be managed to enable European markets to benefit from the full potential of new technologies and avoid the recreation of a fragmented landscape.

Designing a roadmap for EU post-trading in the coming years may require a fresh focus.

If not managed appropriately, this fragmentation could slow down the adoption of digital assets and discourage users from making the necessary investments and converging towards the most appropriate solutions. A transition to a digital ecosystem will also involve a long period of co-existence between digital and traditional networks, even if the latter may be fully phased out in the future.

These challenges require a continuous dialogue between the EU post-trade ecosystem players and public authorities to understand the challenges and opportunities and agree on the way forward to bring most benefits to the capital markets.

CLEARING: EMIR3 AND FURTHER PRIORITIES

KLAUS LÖBER
Chair, Central Counterparties Supervisory Committee – European Securities and Markets Authority (ESMA)

Implementing EMIR 3

In February 2024, the co-legislators finally reached a provisional agreement on the third revision of the European Market Infrastructure Regulation (EMIR 3) proposed by the European Commission. This agreement has triggered an intense phase of implementation work for ESMA, both in terms of developing the necessary implementing measures and establishing new processes and structures to fill the legislative text with life.

ESMA has been mandated to develop no less than 28 Regulatory and Implementing Technical Standards and Guidelines, most of which will have to be finalised within the twelve months following the publication of the review in the EU Official Journal. Given these ambitious timelines and the absence of any additional staff or resources granted for the new tasks, ESMA will have to strictly prioritise and sequence the preparation of the level 2 work.

For the centrally cleared space, this will mean focusing first on measures addressing financial stability risks stemming from the exposures of EU clearing members and clients to third-country CCPs of substantial systemic importance for the EU. ESMA will have only six months to specify the conditions for operational and representative active accounts, which certain counterparties clearing relevant derivatives contracts will be required to maintain at EU CCPs. ESMA aims at swiftly publishing a public consultation on those draft standards to allow sufficient time to consult a broad range of stakeholders and fellow EU authorities, which are associated in the preparation of the RTS.

Second, ESMA will develop measures and processes aimed at streamlining and shortening supervisory procedures, reducing time to market and enhancing the competitiveness of EU CCPs. Under EMIR 3, CCPs will be able to benefit from new accelerated procedures for extensions of services under certain conditions and non-significant changes to their models and parameters. To support these efforts, ESMA is also mandated to build a new central database where EU CCPs will be able to submit in one place their applications for authorisation, extension of services, validation of risk models, as well as their monthly reporting.

Third, ESMA will work on strengthening the resilience of EU CCPs and the wider clearing ecosystem, particularly in light of the lessons learnt from the 2022 energy crisis. In this context, ESMA has been mandated to improve the transparency of margin requirements collected by CCPs and clearing members and to consider the potential procyclical effects of haircuts on collateral on the broader ecosystem. ESMA is also required to clarify the minimum requirements for the onboarding and continued participation of clearing members, including the specific case of Non-Financial Counterparties (NFCs), and to specify under which conditions NFCs can use uncollateralised bank guarantees as clearing members and clients.

EMIR 3 will also strengthen ESMA's role within the supervisory framework for EU CCPs. Under the new provisions, ESMA will co-chair with the relevant National Competent Authorities (NCAs) the supervisory colleges of 14 EU CCPs and adopt newly required opinions on the CCPs' annual reviews, supported by on-site inspections to which ESMA may be invited to participate. The toolkit of ESMA to support supervisory convergence has been expanded, as the CCP Supervisory Committee will be able to adopt supervisory priorities, as well as new opinions assessing EU CCPs' compliance with EMIR 3 provisions subject to a 'comply or explain to the Board of ESMA' mechanism. ESMA will also have the authority to request meetings with NCAs and CCPs on matters of concern, including emergency situations or compliance issues, and request information directly from CCPs under certain conditions, when the NCAs has failed to answer in due time.

While these steps are significant for strengthening a common supervisory approach for EU CCPs, greater progress could have been achieved in advancing the Capital Markets Union, particularly for the most systemic CCPs. The creation of a Joint Monitoring Mechanism, whilst being a positive step towards a more comprehensive view on the central clearing ecosystem, will by itself not be sufficient to address all risks related to the increase in clearing activity in the EU.

A more integrated and coordinated supervisory framework for CCPs at the EU level is necessary.

Clearing members and clients often reside in different Member States from the CCPs' place of establishment. In the event of a CCP disruption, the impact is not confined to a single national fiscal domain and may not even primarily affect the CCP's home jurisdiction. The repercussions can spread across borders, impacting key financial and corporate entities throughout the Union and beyond.

A more integrated and coordinated supervisory framework for CCPs at the EU level is necessary. It would go a long way in addressing this situation and the interests of the Member States potentially most exposed in the event of a CCP failure – such improvement should be considered under the new Commission.

CHIARA SCOTTI
Deputy Governor –
Banca d'Italia

Enabling central clearing in the EU to respond to its challenges

The aim of the new EMIR 3 regulation is to enhance the EU's central clearing ecosystem, making it safer, more transparent, and more efficient. To achieve this, several key changes are introduced, including implementing an active account requirement, tweaks to the overall supervisory architecture and relevant supervisory processes for EU central counterparties (CCPs), and targeted amendments to CCP requirements. In this context, some of the biggest priorities to address moving forward relate to the integration of new asset classes and technologies, the adequacy of liquidity risk management in times of stress, as well as the ever-present concern relating to data quality and the ensuing quantitative analyses.

First, crypto-assets and crypto-derivatives are already on the radar of CCPs. At least seven CCPs on both sides of the Atlantic have planned or already started to offer clearing services for crypto investments. This innovation is not without challenges. The level of standardization of contracts for these instruments may be lower, which increases legal and operational risks. The availability of historical data is limited, hampering risk management tools and possibly causing distortions when estimating underlying risks. The volatility of these new asset classes, compared with traditional ones, can be higher – often linked to huge hype cycles – and the participant base may be different, with implications for the overall liquidity of trades. For public authorities, understanding the nuances of crypto activities better is critical to determining whether the current regulatory requirements and supervisory approaches remain suitable safeguards or require adaptation.

The technological stack that characterizes the cryptocurrency domain could also impact the clearing ecosystem through the adoption of new settlement models, where payments are made through digital currencies. In this regard, one key factor is the availability of a safe settlement asset. The Eurosystem is conducting experiments and trials on three alternative interoperability solutions between its payment infrastructures and DLT platforms – including Banca d'Italia's technologically neutral TIPS Hash-Link solution – that would allow wholesale financial transactions to be settled in central bank money. Looking at payments and settlement more broadly, we must consider how EMIR interacts with other regulations, particularly MICAR.

Second, as the clearing ecosystem becomes larger and more interconnected, the importance of CCPs grows, but so do the risks they bear. A cornerstone of financial stability remains CCPs' liquidity safeguards, which include access to central bank facilities. While CCPs are responsible for having sound risk management, access to central bank liquidity may be crucial in times of stress. However, such access is at the discretion of central banks and requirements may change depending on whether the CCP has a banking licence. Allowing CCPs in the European environment to have proper access to central bank facilities – subject to appropriate rule-based safeguards and procedures to monitor their fulfilment, and mindful of potential moral hazard issues – is fundamental. This is recognized by EMIR 3, which mandates the European Commission to report to the European Parliament and the Council on generalized central bank access for EU CCPs, assessing level playing field and financial stability considerations, and in relation to the situation in third countries.

Lastly, the availability of timely, high quality data is a must for supervisory authorities, as well as industry experts and academic researchers. For instance, Banca d'Italia monitors changes in margins and other indicators of supervised CCPs on an intra-day basis. EMIR mandates the reporting of derivatives transactions, a unique source of information for financial stability and market supervision. EMIR data, as they are called, provide a better understanding of financial markets, facilitate the development of real-time risk metrics, and help visualize and capture interconnections between counterparties. Unfortunately, dealing with EMIR data is still no easy task, due to its complexity, stemming from its dimensionality, the nature of derivative instruments, and the heterogeneous quality of the information reported. Although EMIR reporting reliability has improved significantly over time, it is crucial for each stakeholder (e.g. reporting counterparties, trade repositories, and competent authorities) to work on further enhancing the usability of the records. CCPs play an important role in ensuring the quality and completeness of EMIR reporting.

Innovation and the increasing range of services require more knowledge and better risk management.

The supply of central clearing services in the EU is set to grow, driven by regulatory action and innovation. An environment with increasing interdependencies among sectors, functions and actors requires market participants and public authorities to monitor and manage risks adequately, ensuring systemic implications are duly considered, while seizing opportunities.

EMMANUELLE ASSOUAN

General Director Financial Stability and Operations – Banque de France

Beyond EMIR 3.0: the future has just started

The definitive text of EMIR review (EMIR 3.0) has finally been published, bringing much-needed visibility after years of uncertainty on the European post-Brexit regulatory landscape. While a broad consensus emerged among EU member states and market participants on the materiality of the risks posed by the overreliance of the EU financial sector on UK CCPs, the critical debate centered on defining an effective strategy to reduce this dependency, while mitigating costs for market participants.

The main measure of EMIR 3.0 to initiate the rebalancing of the exposures toward the UK is the obligation for EU financial and non-financial counterparties to have an active account with an EU CCP. One can only regret that a more ambitious set-up of the measure was not retained, especially in the context of interest rate market normalisation, triggering more need for interest rate risk hedging and where, as a consequence, the volumes of EUR IRDs cleared in the UK have kept increasing significantly in the past year (more than +40% since 2022). ESMA will assess the effectiveness of the measure 18 months after its implementation and regulators will stand ready to take stronger measures if the reduction of this heavy dependence is not achieved.

There won't be any complacency: **the stakes are too high. It is crucial that Europe achieves strategic autonomy**. This, alongside strengthening EU authorities' powers, the creation of attractive and adequate clearing services to fund the real economy, based on resilient EU CCPs, are essential foundations of the Capital Markets Union / European Savings and Investment Union, which remains a key priority for Europe. We are not there yet, EMIR 3.0 is a decisive step in this direction but not the endpoint.

During the past four years many events and developments unfolded. The financial system has come under severe strain, which has raised questions on procyclicality and clients' liquidity preparedness in high volatility contexts, but also proved the overall good resilience of EU CCPs' risk management and the importance to maintain adequate regulatory and supervisory framework. In parallel, the European clearing ecosystem has been changing fast: the clearing sector is expanding into new markets and developing models to better adapt to the profile and demand of clients in terms of access, products and collateral. Evidences of this evolution include the increasing demand for direct access from the buy-side through sponsored and special membership models and the development of crypto derivatives clearing. These initiatives raise challenges linked to risks and model complexification. Challenges are even higher in a context of emerging new technologies and increased cyber-risk.

> **The stakes are too high: it is crucial that Europe achieves strategic autonomy.**

For instance, when it comes to crypto derivatives clearing, CCPs have to adapt their margin models to capture the volatile behaviour of these assets, often coping with limited historical data, and risk management framework to take into account higher operational and cyber risks. On another operational hand, the implications of the T+1 settlement transition in North-America have to be assessed. The modalities for the transition to T+1 in the EU also need to be defined.

European regulators and supervisors play a key role in ensuring the creation of a safe financial environment, which helps strengthen and preserve the competitiveness of European participants. EMIR 3.0 is a first significant leap toward the building of a European framework that should also consider strengthening the supervision at European level, at least for systemic cross-border entities, not only for the most important CCPs, but also for funds and trading venues. This could be a way to ensure an agile, resilient and more integrated European financial sector, accelerating supervisory approvals, and gain in attractiveness.

These are the key priorities for the future of EU clearing. First, reducing dependency on other jurisdictions, while strengthening and developing capacity in the EU, with a rationalised clearing offer. Besides, financial institutions must both step up their adaptation to structural cyber risks and take stock of the opportunities offered by innovation, looking at AI to improve internal risk management tools, but also anticipate potential impacts on business models of the DLT adoption along the CCPs' value chain. Regulators and supervisors will also maintain a strong focus on the EU cyber resilience strategy, of which DORA is a significant milestone. Working together in this direction is an essential prerequisite for developing a stronger European framework and the infrastructures of the European Savings and Investment Union.

NIELS BRAB
Head of Group Regulatory Strategy & Chief Regulatory Officer – Deutsche Börse Group

After 3 comes 4: staying ahead of the curve

Looking at the past decade and the long way we have come since EMIR 1.0, we can safely agree that the EU has set the global benchmark on clearing regulation. A new financial stability reality can be observed around the most significant periods of market stress, where EU CCPs have proven best-in-class across key issues such as anti-procyclicality, transparency and predictability of margin calls.

Rather than falling into the complacency trap, we should continue to challenge ourselves and structurally improve the attractiveness of the EU's clearing ecosystem – in-line with the thinking around EMIR 3.0. The revised framework contains critical elements that will make a real difference and move the needle on a number of well-known issues.

A shorter time-to market reality will significantly improve the ability of EU CCPs to launch products and services in a competitive manner – whilst also meaning that liquidity around new asset-classes and instruments can in future evolve around a stronger Euro-denominated reality, a key aspect in the context of the open strategic autonomy and the future EU Competitiveness Deal.

And: We should not forget the important positive contribution the shorter time-to-market makes for an improved resilience and stability: In future, risk models can be adapted in a much more reasonable timeframe to factor in recent stress events that are key to consider for appropriate risk management and margin calibration.

Beyond this, EMIR 3.0 has also brought a broader pool of eligible collateral, improvements around portability, a reduction of regulatory hurdles for the buy-side to use CCPs, and an enhanced supervisory regime with automatic information sharing and emergency intervention powers for ESMA. Finally, let us not forget about the active account regime, intended to address the financial stability concerns associated with offshore clearing and a reduction of the systemic overreliance on third country infrastructures.

With entry into force expected by the end of this year, ESMA is already advancing its important work to boost preparedness for the new requirements on time. Ensuring readiness and effective implementation will remain a key priority in the months ahead. At Eurex Clearing, we remain committed to supporting customers and advancing on our "Home of the Euro Yield curve" strategy that will drive new realities around cross-cutting efficiencies.

Efficiency is also the buzzword when it comes to the vision for the new EU legislative period and what it means for the clearing regulation beyond the implementation of EMIR 3.0. In light of the challenges around growth and competitiveness but also a different geopolitical reality, the next years should cater for a necessary reflection on a number of topics and trends where the EU needs to stay ahead of the curve to ensure its clearing ecosystem remains globally competitive.

Boost the attractiveness of the EU's clearing ecosystem in-line with the ambition around the SIU.

The most important dimension in this context evolves around the need to foster a true level playing field for EU CCPs and non-EU CCPs but also vis-á-vis bilateral markets. A bouquet of different topics has emerged that require further assessment.

For instance, no other major jurisdiction requires their CCPs to hold a banking license to access central banks and adhere to banking regulation on top of the stringent CCP rules. While we see progress around the upcoming report contained in EMIR 3.0 and the Eurosystem's active work around the IMF's recommendation to harmonize access policies, a timely solution remains critical.

Another key item in this context concerns the EU's more conservative approach to MPOR requirements as well as APC measures. In both dimensions, a trend towards flexibility could prove to support the attractiveness of the EU's clearing ecosystem – noting that other jurisdictions, such as the US, have shown that this does not necessarily come at the expense of financial stability.

Speaking about the US: The introduction of a repo clearing mandate for US Treasuries should be further discussed in the EU. This seems particularly important in light of potential new pockets of risks that require more attention. Past crises have taught us that sound risk-management practices should be ensured before a potential accident happens – and in light of the global financial system remaining susceptible to further shocks, certain aspects, such as minimum haircuts in bilateral repo markets, seem long overdue.

Finally, the EU should continue with its global thought-leadership role in the digitalisation context, advancing on its important CBDC work as a key ingredient for the technological evolution across global capital markets – and pair it with the ability to capitalise on CCP innovation, such as cross-margining.

Taken together, this will pave the way to boost the attractiveness of the EU's clearing ecosystem in-line with the ambition around the SIU (Savings and Investments Union), matching a more demand-oriented approach that reflects the need for growth, competitiveness and a safeguarding of the EU's global role.

CORENTINE POILVET-CLEDIERE

Chief Executive Officer, LCH SA – London Stock Exchange Group (LSEG)

Building towards a competitive EU clearing framework

During the past five years, markets have witnessed a legislative flurry similar to the aftermath of the Great Financial Crisis. Foundational EU laws underwent extensive reviews, and markets are now looking for certainty to deliver growth and competitiveness.

For EU CCPs, two major pieces of legislation have been at the forefront: EMIR and DORA.

The third iteration of EMIR has brought positive changes to the clearing landscape. Chief among them is the improvement of 'time-to-market' for products and services. By significantly reducing the authorisation time for new products, services, and changes to risk models, from up to two years to approximately 90 days, CCPs will be better placed to react and adapt to market demands. A shorter approval time with clear timelines will also not only improve the competitiveness of EU CCPs, but also drive down compliance costs. EMIR even introduced a short non-objection period designed to expedite non-substantial changes.

Another important improvement relates to the supervisory level-playing field among EU supervisors. National Competent Authorities occasionally take diverging interpretations of EMIR, resulting in an unlevel playing field. By bringing ESMA closer on supervision, it should drive a much-needed regulatory alignment, ensuring all EU CCPs adhere to the same rules.

Yet, despite this progress, we remain far from a true level playing field in the EU clearing landscape. Due to the political gridlock, EU policymakers have resorted to ever more granular legislative texts to compensate for the lack of a common, centralised supervisor. Regulation should be focused on controlling and managing risk rather than digging deep into every single process, which inevitably hinders the ability of market players to adapt to an ever-changing environment. Instead, we urge lawmakers to put aside national interests and support a single supervisory body for EU CCPs. The EU clearing framework must be organised to nurture fair competition, scale, and speed. That can only be achieved if we are all answering to the same sheriff.

Similarly, DORA will also have a transformational impact of the clearing landscape. By raising the bar across Member States, it will strengthen EU CCPs' operational resilience and harmonise approaches to incident risk management. Yet, much as with EMIR 3, policymakers opted for a detailed, all-encompassing approach that leaves little room for manoeuvring. For example, the new incident reporting rules will result in a considerable number of insignificant incidents having to be reported, creating noise around the incidents which are in fact material.

The EU clearing framework must be organised to nurture fair competition, scale, and speed.

DORA also clashes with certain national laws which restrict the range of providers from which financial institutions can choose. Operational resilience can be undermined by sovereignty requirements, and imposing the use of specific providers to the detriment of best-in-class technology providers can weaken competition. Managing risks is crucial, but taking the wrong approach can lead to controlling a safe graveyard.

To conclude, we offer three recommendations for the upcoming new EU political cycle.

First, we commend the calls to focus on implementation versus the initiation of new legislation. We urge policymakers to use this implementation phase to undertake a thorough holistic review of the EU financial services legislative framework through the prism of competitiveness. Such an exercise, together with the help of industry, will identify existing barriers and impediments to a real level playing field with both EU and non-EU competitors.

From a CCP point of view, we encourage finding pragmatic solutions to simplify the complex supervisory framework. Among the many CMU reports published before the summer recess, there are calls to centralise supervision for critical EU CCPs. As the CEO of one of them, I welcome this intermediate step. Most importantly, it would level the playing field between top market participants, raising competition and innovation as a result.

Lastly, we believe CCPs can play an instrumental role in managing the vulnerabilities resulting from liquidity mismatches which have been identified in many of the international and EU non-bank financial intermediation (NBFI) reports published in recent months. CCPs have developed models that facilitate the buy-side's access to deep pools of liquidity through clearing in both normal and stressed times. Not only would increased access be beneficial for the buy side's liquidity needs, but expanding the membership of CCPs to non-banks will also provide additional stability to the entire ecosystem. Yet, many of the EU regulations underpinning buy-side operations raise barriers to their direct interaction with CCPs. In line with measures taken in other jurisdictions such as the US and the UK, we suggest that policymakers can review such rules for the benefit of financial stability.

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RELAUNCHING SECURITISATION IN THE EU

CHRISTIAN NOYER

Honorary Governor – Banque de France

Revitalizing Europe's securitization market: a key pillar for the new Commission's CMU agenda

The European Union faces a critical need to bolster its capital markets to support substantial investments related to the green and digital transitions, while facing the challenge of an aging population. A key element of this strategy is revitalizing the securitisation market, which has suffered significant setbacks over the past decade.

The securitisation market's revival is indeed crucial for the EU's economic strategy, particularly in light of the additional €1 trillion needed annually to meet investment demands. This figure encompasses the green transition, which alone requires €700 billion per year, and the digital transition, which could demand up to €125 billion annually. The EU's underdeveloped capital markets present a significant hurdle, with European companies facing higher capital costs and often turning to the U.S. for fundraising.

Indeed, despite its importance, the European securitisation market has seen a dramatic decline over the past 15 years. From 2007 to 2022, annual issuance volumes fell from €407 billion to €157 billion, a 61% decrease. The market for publicly placed issuances shrank even more drastically, by 80%, indicating a severe liquidity crisis. In contrast, the U.S. securitisation market has bounced back robustly, underscoring a stark regulatory disparity.

This decline is largely due to the EU's stringent regulatory and prudential requirements. These were put in place after the GFC as an urgent response to the toxic origination practices developed in the US market. In the following years, the European framework for securitisation has been strongly reinforced, making it one of the safest in the world : e.g. Europe has prohibited potentially harmful practices like re-securitisation and securitisation without retention; and at the initiative of the ECB, a Data Warehouse has been created allowing an unchallenged level of transparency. But the very restrictive framework has been kept, imposing excessive burdens that hinder market growth. To address this, several critical adjustments are proposed.

Firstly, reforming the prudential frameworks is essential. This includes adjusting capital requirements for insurers and for banks, in order to align them with the risk of the underlying assets, and extending eligibility for liquidity buffers to banks, making securitised assets more attractive. Simplifying transparency rules to facilitate the issuance and acquisition of these assets will also enhance market liquidity.

Moreover, the development of a European securitisation platform is paramount. Such a platform would foster the emergence of a reference market, deep and liquid. It would standardize and massify demand, providing transparency and cost-sharing benefits for smaller banks. Beyond enhancing the securitisation market, this platform would create a new common safe asset, improving the efficiency and depth of European markets.

The guarantee provided by the platform should exclude any transfers between Member States and commitments of budgetary resources, instead being priced proportionally to the risk taken by the guarantor. Targeting homogeneous and low-risk asset classes, such as residential loans, would further ensure the platform's stability and efficacy.

By implementing these measures, the EU can not only revitalize its securitisation market but also significantly enhance its capital markets' capacity to finance crucial investments. This approach could transform European financial markets, making them more competitive and resilient in the face of global challenges. The inefficiency of the current market structure not only hampers growth but also risks marginalizing European financial actors on the global stage. Revitalizing the securitisation market through regulatory adjustments and the establishment of a securitisation platform will be a decisive step in overcoming these challenges. By aligning more closely with global standards and practices, Europe can unlock the potential of its capital markets, ensuring they play a pivotal role in financing the continent's future.

The EU's focus on revitalizing securitisation is not just a technical adjustment but also a strategic imperative.

The EU's focus on revitalizing securitisation is not just a technical adjustment but also a strategic imperative. It addresses both immediate financial needs and long-term economic goals. By fostering a robust, integrated market, Europe can secure the investments necessary for sustainable growth and maintain its competitive edge in the global economy.

ALŽBĚTA PAZDERKOVÁ
Head of Capital Market and Financial Innovation Unit – Ministry of Finance, Czech Republic

EU CMU and securitisation: competition needed

Securitization is important piece of puzzle for functioning and deep capital market and it is generally agreed that more securitization is needed in the EU. The benefits of securitization on the financial market have been repeatedly enumerated and described; I would like to emphasise the positive implication that securitization has on further financing SME, where other financing through capital market on individual basis might not be economically viable. Also, when SMEs are finance through the capital market, they are still financed mostly locally. Securitization could be the right tool to enhance cross-border financing and, consequently, the CMU. For the deepening and functioning of CMU we need well-functioning securitization market, which unfortunately is still not fully in place in the EU when compared with size of securitization market of other jurisdictions.

The securitization market in the EU is underperforming, even though some of it might be due to the market development, some of it is a result of the EU prudential financial regulation and still persisting negative connotation of the securitization in the EU. Noyer's report highlighted the EU's more cautious approach to prudential regulation for insurers and banks compared to other jurisdictions, which has unfortunately curtailed full development of the securitization market in the EU.

Further steps should be taken to revive the market, to provide more investment opportunities and bring more competition to the securitization market without introducing undue risk to the EU financial market. This should be done by elevating and further calibrating the prudential treatment of securitization for credit institutions and insurers as well as further assessing capital treatment for both STS and non-STS securitizations. The current framework has an overly conservative default rate assumption for a product that has demonstrated a low default rate, even during crises. We need to be careful in cutting down the requirements, however we might have doused the market a little too much in the past.

EU securitisation market needs diversified participants and rules that are more proportionate.

The requirements on due diligence and transparency should be more proportionate and differentiated as they are too stringent for sophisticated investors as well as issuers of securitization, such as alternative investment fund managers ("AIFMs"). The current due diligent requirements create administrative burden that might have discouraged from investing in securitization. Our goal should be enhancing capital market, thus incentivise qualified investors to invest in variety of instrument, which includes securitization, and not deter if from it. There are duplicative layers of due diligence between sector legislation and the securitization regulation. For further efficient market, the compliance cost while investing in securitization should be lowered and mentioned barriers removed. Also further investing opportunities like investing in third countries securitization should not be thus limited.

The revised AIFMD recognises AIFs as loan originators, requiring them to retain 5 % of originated loans. This requirement seems to be inspired by retention provisions of the securitization regulation that now should reflect this shift in AIFMD rules and allow the AIFM to act as sponsors of securitization, which is so far limited by securitization regulation to credit institutions and investment firms. Market data illustrate that AIFMs have been creditors to the institutional investors through CLO and top CLO managers are already AIFMs. While allowing them to sponsor securitization they would be less limited in their investment strategies, which in the end would allow further competition at securitization market and thus investment opportunities. The recent review of AIFMD has brought enough safeguards for AIFM and UCITS managers to become sponsors of the securitization.

The CLOs are on the rise in the EU, which illustrates further role the capital market plays in financing the market, yet they are considered ineligible for STS criteria for actively managed nature of them. These instruments have showed strong track records and lower default rated to other securitization products and thus they should not be disadvantaged on the securitization market. Also the application of STS label need to be made less burdensome and limit the steps the qualifying investors must undertake in order to apply more preferential treatment.

The CMU topic has been discussed over a decade and we have securitization regulation applicable for five years now, we should learn from the comparison with other jurisdiction as well from further development of the market and take steps to make market more effective.

KAUSTUB SAMANT

Principal, Head of Mortgage Credit Research – PGIM Fixed Income

Securitisation: this time it must be different

In an increasingly geopolitical world, size matters. Economically speaking, the world is getting bigger while Europe is getting smaller. Nowhere is this truer than in the comparative size of the European vs. other global securitisation markets. While many global markets have grown since the global financial crisis, the European market has collapsed. Rule-makers have attempted to establish securitisation reform in Europe for over a decade but with limited success. Only now does the urgency of the situation seem to be registering. Fortunately, help might be on the way. EU policymakers are preparing their third attempt at shaking up financial markets through the Capital Markets Union (CMU). They see the urgent need to reinvigorate Europe's lagging securitisation markets.

At PGIM, we welcome policymakers' focus on the securitisation markets. As a global asset manager with US $1.34tn in total assets under management (as of 1 August 2024), we are active in securitised markets for European and non-European clients. Along with our role as a top 10 CLO issuer in Europe and the United States, this gives us a unique insight into the impact of regulations across securitisation markets.

We feel that the EU has been excessively and unnecessarily risk-averse in its regulation of securitisation to the detriment of individuals and businesses who lose out on affordable financing. Pension funds, insurance companies and other institutional investors are missing out on investible opportunities and reliable return on investment.

EU investors are often limited in what they can invest in outside the EU due to the granular and onerous transparency requirements for securitisation investments. While this detailed reporting may create a cottage industry for third party data providers, it creates significant cost and provides little or no value for investors. US issuers, for example, already provide detailed loan-level data coupled with historical performance that is sufficient for sophisticated investors to produce a risk assessment. Because this information is not being provided in a specific template, it should not prevent EU investors from participating in these markets. We welcome the European Securities and Markets Authority's (ESMA) recent consultation on the revision of the securitisation disclosure framework. Hopefully this will result in lessening the burden on issuers, thereby encouraging non-US issuers to issue securities compliant with the EU regulation.

Risk retention in certain markets is also optional. Broadly syndicated CLOs - or mortgage-backed securities backed by high quality mortgage loans in the US - often do not require risk retention. Despite these types of securities complying with local risk retention requirements, EU investors are prohibited from investing in these assets. Addressing such cross-border investment barriers is critical to sharpening European investors' competitive edge.

Political momentum behind securitisation reform today gives hope that this time could be different.

The ability for UCITS to invest in securitisation is also hampered by regulation. UCITS are inhibited by the strict limit on acquiring no more than 10% of the debt securities by a single issuing body. This may make sense for corporate debt securities, but securitisation issuances are often much smaller but naturally diversified. Ironically, this requirement works against overall diversification of UCITS and puts them at a disadvantage to funds in other jurisdictions.

From an issuer perspective, the framework for Simple, Transparent, and Standardised (STS) Securitisation could be doing much more to re-energise the market. The scope for the STS is too narrow and includes a blanket ban on 'actively managed' structures. This excludes even AAA-rated tranches of collateralised loan obligations (CLOs). These instruments have never defaulted since their invention in the late 1980s. Reforming the STS label to qualify transactions where CLO active management occurs, with the right safeguards in place, would unlock an important channel of growth finance to European companies including SMEs.

Risk-based capital requirements for insurers should also be reviewed to increase their participation in the securitised markets. Asset profiles of many securitised products are a natural fit for insurance liabilities. Yet in 2022, only 12 per cent of EU insurers invested in securitised products, largely due to onerous capital requirements.

These are well-known shortcomings with the EU's regulatory framework, but risk aversion and inertia have resulted in a standstill for too long. The current political momentum behind securitisation reform gives hope that this time could be different. Anxious about under-investment, we have heard policymakers describe today as a 'now or never' moment for CMU. We look forward to actions being taken to boost Europe's competitiveness.

FRANÇOISE GILLES
Group Chief Risk Officer – AXA Group

Securitisation: another brick for the CMU

In 2024, EU leaders called for a "new European competitiveness deal," focusing on enhancing the capital markets union and revitalizing the securitisation market through regulatory and prudential changes, recognizing its potential to drive EU growth, which is essential for supporting both the climate and the digital transitions.

As such, securitisation has been staged as one of the pillars for relaunching the Capital Market Union as (i) it enhances credit systems by promoting disintermediation, (ii) gives some air to banks' balance sheet hence provides additional financing capacity and (iii) increases the velocity of European banks thereby boosting their competitiveness relative to their American counterparts. On the other side of the Atlantic, the securitisation market is indeed frequently regarded as a benchmark due to its significantly larger outstanding amount compared to the European market. For instance, pre-Great Financial Crisis, Europe used to have a decent securitisation market, but in 2023, the US issued €1.3 trillion in securitized assets, compared to just €213 billion across the EU's 27 Member States. Such vast disparity is largely due to the extensive securitisation of residential real estate loans in the US, supported by government-sponsored entities like Fannie Mae and Freddie Mac.

For the European Union, the main goal is to achieve scale and liquidity in order to establish a successful securitisation market that provides the necessary financing for high technology innovation, renewable energy infrastructure, and burgeoning businesses. So, what do we need to do to catch up with the most dynamic markets? In my view, lifting the barriers that prevent Europe from achieving similar dynamism requires a comprehensive approach that addresses multiple factors within the ecosystem.

As an institutional investor, we engage in a diverse range of asset investments, including securitisation, on behalf of our clients. As such, our strategic asset allocation is guided by the pursuit of sufficient diversification, attractive yields, and the consideration of associated capital charges. While the decreasing volumes experienced since the Great Financial Crisis have also been driven by the uncompetitive return (in relative terms) of these assets, the issue of capital charges has garnered political attention. It notably translated in the recent review of the Solvency II Directive, in prompting a request for the European Commission to assess the appropriateness of existing calibrations for investments in securitisation. While the potential changes will only impact standard formula users, as internal model allow for a more granular approach, it seems crucial to engage all interested parties to reach scale and build a deep and liquid market. Only a nuanced and comprehensive approach will appropriately account for these risks without imposing undue pressure on capital charge requirements. Only such balanced strategy will help ensure the regulatory framework governing securitisation in Europe remains effective and relevant, fostering a healthier and more competitive financial landscape.

Need of a comprehensive approach that addresses multiple factors.

It is also important to give all the credit it deserves to the STS (simple transparent and standardised) reform: it has definitely restored confidence by creating a safer environment. However, the relative value problem on securitisation is also driven by due diligence cost notably for STS assets, and for highly rated assets, the complexity of the framework is not balanced by higher premium. Additionally, regulatory discrepancies across jurisdictions limit a global market approach and hinder portfolio construction. In Europe, the burden on investors—including proof of due diligence and monitoring of retention—is excessively high and should be borne by issuers, as it is the case in the US.

Therefore, to unlock the full potential of the European securitisation market, a balanced regulatory approach is essential. This approach should support both issuers and investors by ensuring that the market is competitive and attractive. Key strategic adjustments should include aligning regulatory requirements, if evidenced by the European Commission assessment, reducing excessive capital charges, streamlining due diligence processes, fostering a vibrant and resilient securitisation market capable of meeting Europe's financial and developmental needs. Ultimately, a holistic strategy that addresses these multifaceted challenges will pave the way for sustainable economic growth and innovation, enabling Europe to match the dynamism seen in the US securitisation market.

PATRICIA BOGARD

Head of Public Affairs – Crédit Agricole CIB

A new chance for securitisation in Europe?

Securitisation is a critical tool for relaunching the capital markets union, and contributing to the financing of the European economy, as it has been underlined in many reports and statements since the beginning of the year.

Securitisation is a technique that shares out primarily the credit exposure of a portfolio into several bonds, the "tranches", with different seniorities to match with various investor needs. It is a way to provide alternative sources of funding for economic actors and corporates, complementary to traditional bank loans and bond financing. It can provide stable financing of the Working Capital, by securitisation of commercial or financial receivables. It is also a way to refinance portfolios of operational assets (automotive, renewable energies, ...), and can be a mean of diversification of medium/long-term financing sources through secured financing.

In addition to granting diversity of funding sources, securitisation can also be used by lenders to help managing their capital needs and alleviate their balance sheet and, for banking institutions, RWAs by making use of Significant Risk transfer mechanism (SRT), especially in the context of the negative impact of CRR3/CRD6 that will increase their capital requirements. These SRT transactions are generally private, most often carried out "synthetically" (guarantee-type format, without funding transfers).

The European securitisation market has significantly declined over the last years, as a stigma remains that is rationally no longer relevant. Indeed, since the financial crisis of 2007/2008, the regulatory framework for securitisation has been significantly strengthened in Europe with namely the ban on re-securitisations, the retention policy, transparency procedures, providing a much more secure framework than 15 years ago.

However, some rules seem no longer appropriate to the current challenges and should significantly evolve so that this market can resume significantly in Europe, while remaining properly supervised and transparent for investors.

The main impediments for relaunching the public cash market are dealing with the following:

- Market liquidity is one of the main bottlenecks: only AAA senior tranches from STS operations are eligible at level 2B of HQLA assets for the calculation of the Liquidity Coverage Ratio (LCR), which is a real problem for granting sufficient liquidity to this kind of assets, also in comparison with similar assets such as covered bonds. We would recommend allowing AA ratings and promoting STS to level 2A in order to reinforce the market liquidity.
- Capital surcharge stemming from current risk weighting parameters (p-factors, floors), that doesn't ensure capital neutrality and make securitization abnormally more expensive compared to the underlying assets.
- Streamlining the issuance related process and costs, including on reporting and disclosure, could improve the cost and operational burden on originators' side, stimulating issuers' appetite.
- Adaptation of regulatory burden on due diligence for investors, in order to introduce more proportionality in these obligations, would help improve liquidity on cash market;
- Last but not least, it is critical to get investors back. In this regard, improving capital charges for insurers is essential, as very punitive capital charges for securitisation currently act as a disincentive for insurers.

The industry welcomes the European Commission initiative to launch a consultation at next autumn, which will be an opportunity to address the above impediments. The stake is not a sole question of capital markets, but also of building a Savings and Investment Union, targeting a balance between investors and issuers expectations, and restoring competitiveness through a return on investment that is properly proportionate to the risks.

- In this regard, the recalibration of capital requirements for banking and insurance sector is a strong expectation from investors overall. The case of the senior tranches which bear the lowest risk is speaking. They are comparable to the covered bonds which are correlated to the credit quality of the issuer, but remain less competitive for banks and insurers.

The stake is to build a Savings and Investment Union, meeting issuers and investors' expectations.

- When it comes to SRT securitization, these transactions are dedicated to sophisticated and knowledgeable investors in capacity of properly assessing and bearing higher level of risk and then getting higher return. The time-to-market is critical in the process of originating and getting these transactions approved.

At the end, Europe needs to take into account the competitive landscape with the US, the UK and other jurisdictions to make sure that an investor, whatever his profile, is in a position to have an equivalent risk / return for the same quality of assets, comparing to other jurisdictions.

ALEXANDER BATCHVAROV

Managing Director and Head of International Structured Finance Research – Bank of America

Securitisation: who comes first - the issuer or the investor?

The recent efforts to revive the EU securitisation market have not led to discernible positive results; it remains far short of its potential to finance EU economic growth, dual transition and strategic autonomy.

One reason is political: despite the fact that EU securitisation did not experience the problems associated with US subprime mortgage crisis during GFC, reference to securitisation stigma persists in EU public discourse. Another reason is economic: the EU regulatory framework does not establish a level playing field among financial markets (e.g. securitisation, whole loans, covered bonds, credit funds, corporate credit) and introduces high barriers to entry to both securitisation issuers and investors (e.g. disproportionate disclosure and due diligence requirements, structuring and rating requirements, liquidity constraints, etc.), thus limiting issuers mostly to large banks and non-bank financial institutions (with limited sources of funding), and investors - to large asset managers and large insurers.

Issuers of securitisation compare the all-in cost of securitisation with that of other available funding sources. For banks, funding mortgages (be they residential or commercial) via covered bonds is much cheaper than that of securitisation; the former are favoured in repo and LCR eligibility, require only one rating to be eligible vs. two for securitisation, disclose only aggregate cover pool data vs. loan-by-loan data for securitisation and the syndication process is expedited on limited due diligence and programmatic issuance. All this translates into, say, one-hour launch-to-price execution for covered bonds vs at least one-week launch-to-price execution for securitisation, with all costs and execution risks that this entails.

From investor perspective, the infrastructure required by regulation is more prescriptive and costlier than that for any other investment, regardless of risks. The sunk cost can be economically justified only by large scale investor participation. Besides, investors consider their investments on a spread and nominal-yield basis, and on a risk-adjusted return and return-on-regulatory-capital basis. Most EU securitisation market sectors offer higher spreads, nominal yields and risk-adjusted returns than most other fixed income instruments, but the return on regulatory capital (especially for insurers) is often much lower (for both STS and non-STS) than for other comparable fixed income instruments. To illustrate: a German senior prime quality real estate loan had a risk-adjusted spread of 150bps in 3Q24 which delivered a RAROC of 11% for an insurer and 38% for a bank, both using SA capital calculation. In comparison, a AAA tranche of a non-STS securitisation of such loans had a similar risk-adjusted spread but delivered a RAROC of 3% and 81%, respectively. 75%-LTV housing loan delivered RAROC of 83% and 102% for insurers and banks, while the AAA-rated tranche of STS RMBS backed by such loans delivered 6.6% and 47.5%, and AAA-rated covered bond backed by a cover pool of such loans delivered 2% and 11 %, while a single-A rated corporate bond delivered 8% and 9%, respectively. The result change with yield and EL adjustments, but the differential magnitude remains and informs investors' preference for one investment over another.

Naturally, investors also consider the liquidity of their investments and assess it with different metrics (e.g. bid-ask spread, turnover ratios, eligibility for repo, LCR). These eligibility criteria apply only to banks, but they are also used as reference points for liquidity by non-banks. By these metrics, parts of the securitisation market compare favourably with parts of the broader fixed income market (i.e. STS auto ABS and prime RMBS with covered bonds and large corporates), but the quantitative aspects of eligibility among them differ materially. To illustrate, using Guideline EU 2016/65 of the ECB: the valuation haircut applied to a AAA-rated prime STS RMBS (Cat V), eligible credit claims and legislative covered bonds (Cat II), with comparable life of 3-to-5 years, are 7%, 8% and 2.5%, respectively. The notional value of the haircuts may change from time to time, but the size of differential seems to remain untouched.

Both issuers and investors care about the cost of securitisation.

To fully understand the need for its revival, EU securitisation should not be viewed only in the context of bank financing and risk transfer. It can be viewed as an asset-based financing technique with wide application in the financing of large and small corporates (e.g. SME loans on a pooled basis), infrastructure (e.g. utilities), sustainability (e.g. solar panels), digitalisation (e.g. data centers), etc. and applied by non-banks, private credit, non-financial corporates, etc. along with its use by the banks. To revive the EU securitisation the artificially high barriers to entry should be lowered by recalibrating and rescaling capital under CRR and Solvency II, due diligence and disclosure requirements, and also LCR and repo eligibility.

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FINANCIAL STABILITY IN EUROPE

GASTON GELOS

Deputy Head, Monetary and Economic Department and Head of Financial Stability – Bank for International Settlements (BIS)

NBFIs, systemic risk, and regulatory challenges

The non-bank financial intermediary (NBFI) sector has grown greatly since the global financial crisis (GFC), occupying an increasingly large share of total financial assets -- around one-half at present versus 42% in the wake of the GFC. NBFIs are also of increasing systemic importance to the financial system. In the euro area alone, where NBFI assets have doubled since the GFC, estimates are they provide at least one-fifth of funding for banks.

The growth of the sector has brought many benefits, but also new risks. While the NBFI sector is very heterogeneous, comprising a wide range of different type of entities, it is useful to classify vulnerabilities according to key categories, in particular liquidity, leverage, and interconnectedness.

Liquidity mismatches characterize those intermediaries with business models that involve liquidity transformation such as money-market funds and open-ended funds (OEFs). These can create a first-mover advantage for investors, with potentially shock-amplifying and destabilizing effects on asset markets.

Leverage poses additional risks, particularly at hedge funds which fund the purchase of securities with borrowed funds such as repos. These hedge funds often operate under conditions where the ability of investors to identify leverage is curtailed. The case of Archegos Capital Management, which collapsed in 2021, showed that hidden, synthetic leverage can be embedded in derivative exposures. Private market funds that provide small firm finance can show procyclical accumulation of leverage in their operations. Hidden leverage and liquidity risks are also prevalent in the crypto sphere of decentralized finance (Defi). Vulnerability is exacerbated when leverage and liquidity risks combine.

NBFIs are often tightly connected across each other and with the banking sector. For example, OEFs and hedge funds can be linked to banks through derivates exposures, banks may have substantial lending exposures to private-credit borrowers, and NBFIs hold bank securities. This means that stresses can quickly spill over to other parts of the financial system.

One insight of analysis of the NBFI sector is that risk management practices which are useful from an individual institution's perspective can amplify procyclicality of the financial system. One such practice is margining. Margins are a key element of non-bank credit intermediation and their level can affect overall debt capacity. In response to increases in risk, spikes in margins can trigger system-wide deleveraging and exacerbate liquidity shortages.

Such systemic vulnerabilities emerged during the March 2020 disturbances in US bond markets. Hedge funds, engaging in leveraged relative value trades that exploited differences in Treasury cash- and futures markets, had become a key part of the ecosystem supporting liquidity. But when volatility surged in 2020, margins on Treasury futures rose quickly, and hedge funds needed to deleverage and unwind positions. Elsewhere, bond OEFs engaged in discretionary asset sales well above the amounts needed to cover redemptions, while prime funds hoarded liquidity by shortening maturities of their commercial paper investment. These all contributed to a deterioration of system-wide funding liquidity. Similarly, in September 2022, there was a systematic liquidity shortage in the UK gilt market triggered by margin calls at heavily leveraged pension funds. In these instances, central banks had to intervene to restore orderly conditions.

The interconnectedness of NBFIs underscores the need for a systemic approach to their regulation.

Despite progress over the past years, much remains to be done in implementing adequate policy responses. One issue is that in the absence of sound regulation, implicit reliance on central bank interventions in cases of stress encourages excessive risk taking over the longer run. It is key that policy responses be characterized by a macroprudential, systemic approach. Such an approach should also take the many interlinkages between the banking and NBFI sectors into account, so that the mitigation of risk in one sector does not merely result in increased risk in the other. The cross-border activities of many NBFIs underscores the importance of international coordination. Lastly, it is well recognized that improved NBFI data availability is key for enhanced risk monitoring.

DISCLAIMER

The views in this article are those of the author and do not necessarily reflect the views of the Bank for International Settlements.

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Growing importance and potential vulnerability of NBFI -Japan's point of view

For the last two decades, nonbank financial intermediation (NBFI) has grown rapidly, accounting for around 50% of total global financial assets while the market share of NBFI is around 30% in Japan. Major players are insurance companies, broker-dealers and investment funds while private funds or hedge funds have limited presence. The share of NBFI is small in Japan but we closely monitor the development of NBFI. From Japan's point of view, I would like to raise two points.

First, as nonbank financial institutions (NBFIs) enlarged their presence in the global market, Japanese financial institutions have also increased their investment or credit exposure to these entities. This trend has strengthened the interconnectedness of Japan's financial system with these global NBFIs, increasing the risk of cross-border spillovers in cases of significant repricing.

During the 2008 GFC, the interconnectedness of banks and NBFIs led to the substantial unwinding of positions in light of counterparty risks, causing the materialization of systemic risk.

Even after the GFC we have observed similar incidents, such as the dash-for-cash of MMFs during the Covid-19 which affected Japanese market, the Archegos collapse and the unwinding of liability-driven investments in UK. These experiences suggest that NBFIs are potentially a source of systemic risk to the global financial system. While the Basel 3 reforms have enhanced the resiliency of the global banking system, it has induced global liquidity to shift from banks to less regulated entities such as NBFIs. Meanwhile, the supervisors and regulators have confronted challenges such as data gap, limited transparency or hidden leverage to address NBFI issues.

Therefore, we should be vigilant at the development of NBFI. In this regard, I am especially focusing on private debt funds. Private debt funds raise relatively long-term funds from institutional investors and extend lending to firms including SMEs that find difficulties to access bank loans due to relatively low creditworthiness, less borrowing track records or idiosyncratic business models.

While they may contribute to those firms' funding needs and enhance economic growth, their assets tend to be less liquid and they need to have appropriate risk management framework. Despite their current share in the global market being fairly limited, private debt funds have continued to grow, previously as a result of the search for yield under the low-for-longer environment before the Covid-19 pandemic, and recently amid Basel 3 implementation for banks.

The exposure of Japan's financial institutions to global private credit funds are increasing, with a concentration towards some big players. Given the systemic implication of the private credit funds and the above-mentioned challenges for supervisors or regulators, we need to remain vigilant.

Secondly, NBFI may enlarge their direct presence in Japan's market as well. There are two potential drivers: Japanese firms' strong appetite for restructuring their business and the government initiatives for shifting savings to investments. As for the first driver, many Japanese firms who have abundant cash and retained earnings are moving toward restructuring their business portfolios through M&A, spin-off/out or MBO, making fixed or research and development investments or changing their business models.

It is more important for us to exploit opportunities while mitigating risks associated with NBFIs.

The environmental changes, including improvement in corporate governance, transition to moderate inflation, structural labor shortage, digitalization, carbon neutral, increasing inbound tourists and geopolitical risk, seem to be at the back of the trend shift. These structural changes may attract NBFIs and many global private equity/debt funds are expanding their operations in Japan. NBFIs further activate financial intermediation in complementing capital constraint of banks. As for the second driver, the government has taken various measures to boost investment and to support asset management businesses, including the introduction of new NISA (Nippon Individual Savings Account) that provides account holders with a vehicle for investments with tax saving benefits. In April 2024, J-FLEC (Japan Financial Literacy Education Company) was established to enhance the financial literacy of the public with cooperation of the government, the Bank of Japan and the relevant industrial organization. As half of the Japanese households' 2,000 trillion yen of financial assets are bank deposits, there may be room for NBFIs to provide good products and services.

Growing importance and potential vulnerability of NBFI are two sides of the coin. It is more important for us to exploit opportunities while mitigating risks associated with NBFIs.

DÁVID KUTASI
Director, Supervision and Analysis of Credit Institutions Directorate – The Central Bank of Hungary

Methods of improving financial stability need holistic approach

Financial stability shows strong connection with competitiveness, financial stability risks can also be reduced by improving economic competitiveness. That is why the one of the key priorities of the Hungarian rotating presidency is to further strengthen the competitiveness across European countries. The unfavourable geopolitical and macroeconomic developments of recent years have had different effects on individual EU member states and have been treated differently, depending on the given state's size, economic structure and development, energy exposure, and their eurozone membership. At the EU level, long-term persistence of significant regional differences is still an important risk, therefore, in order to improve the long-term competitiveness, it is imperative to reduce the differences between the less developed and the developed countries and regions. This shows strong correlation with the Hungarian rotating presidency's other key priority, namely the cohesion policy, which also intends to ensure to eliminate gaps between countries and between different areas and regions in the same country. To properly handle financial stability, it would need to go hand in hand with the reduction of the financial risks of these countries and the strengthening of their financial system, which includes improving their economic competitiveness as well, therefore, a certain holistic approach would be needed.

Nevertheless, other risks could affect the financial stability. Financial stability risks increased in the past years due to rising geopolitical tensions, higher-than-expected inflation and tightening financial conditions. This highlighted several risks to financial stability: the deterioration of the macroeconomic outlook, coupled with the tightening of financing conditions, which heightened balance sheet stress for NFCs (Non-Financial Corporation) and households. The risks stemming from a sharp fall in asset prices that could trigger large market-to-market losses, which in turn might amplify market volatility and cause liquidity strains is also be mentioned. Furthermore, the risks to asset quality and the profitability outlook of credit institutions are to be regarded. In addition to these risks, there are further increase in vulnerabilities in the commercial real estate (CRE) sector, an increased probability of large-scale cyber incidents and a sovereign debt dynamic affected by slower economic growth and tightening financial conditions, as the ESRB's 2023 Risk Monitor pointed out as well. Although in Hungary, the financial stability is considered to be strong, spillover effects may arise at any time especially stemming from the current geopolitical landscape, since the small and open Hungarian economy is exposed to cross border effects and risks.

The phenomenon of Non-Bank Financial Intermediation (NBFI) has been always a challenge for supervisory authorities. The current macroeconomic context of relatively weak growth has added further risks to financial stability through the activity of NBFIs. In Hungary, there are basically two types of connected risks to be mentioned. Banks finance the lending and leasing transactions of their own subsidiaries, but also of other financial institutions, therefore due to potential deficiencies in NBFI's risk management, repayment of refinancing loans may become questionable. Countries that more heavily rely on bank-based finance, such as Hungary, exhibit much lower systemic risk related to non-banks. A systemic feature of the Hungarian financial sector is the predominance of banking intermediation and the moderate interconnectedness between the banking and non-banking financial sub-sectors. NBFIs' activity is even riskier if it connects to shadow banking, which can threaten the stability of the financial sector as a whole.

Financial stability needs holistic approach: both reduction of risks and competitiveness are needed.

The NBFI category also includes non-bank financial enterprises (NBFEs). Most of these financial enterprises are licensed to lend in Hungary, but they operate outside the banking system. Given that NBFEs are not allowed to engage in deposit collection activities, the key risk from a financial stability perspective is the possibility of non-repayment of funds by credit institutions, though the volume of loans managed by them is quite small compared to banks. Nonetheless, NBFEs also belong under the direct supervision of the Magyar Nemzeti Bank (Central Bank of Hungary) (similarly to those Hungarian NBFIs which operate in the financial corporations sector), thus the risk is more elevated in NBFI undertakings which are not under supervisory control.

SARAH PRITCHARD
Executive Director, Markets and Executive Director, International – Financial Conduct Authority (FCA)

NBFI risk - Thinking beyond size

Non-bank Financial Institutions (NBFI) such as investment funds, insurance companies, pension funds, and other non-bank providers of financing have been on the regulatory agenda for many years both domestically and at international groups such as IOSCO and the FSB. As co-chair of the FSB Working Group on Leverage in NBFI (WGLN), certain risks and issues in this sector have been a particular focus.

NBFI's perform an important role in managing savings and providing an alternative to bank-based financing but may also pose risk to the financial system. When discussing their implications for financial stability, the size of the sector is often cited, as is the risk of liquidity mismatch and use of leverage. And of course, that is right: the global NBFI sector has seen significant growth since the global financial crisis.

But to understand the extent to which there is a build-up of risk within the sector and whether that can threaten the broader financial system, it is important to move beyond a discussion of size and explore where we can detect areas of concentration and interconnectedness.

Looking at cases of crystallised risk across the diverse NBFI landscape in recent years, concentration of risk is the single common denominator. The dash for cash in 2020 saw concentration risk in the form of crowded trading in US Treasury markets, the collapse of Archegos in 2021 and the Nickel crisis in 2022 involved large concentrated exposures, and LDI funds' concentrated ownership of long-dated index-linked Gilts contributed to the LDI crisis in 2022.

So, what actions should be taken to identify and reduce the risk of build-up of concentrated and interconnected positions in NBFI?

The first line of defence must be financial services firms' own risk management processes, for which transparency is critical: NBFIs should have the necessary information to understand their liquidity needs, while banks and others should have knowledge of the counterparty risks they are exposed to. Improving systems and controls related to this is crucial, and more work is needed.

Regulators also need to consider how they can more effectively identify where concentration is building up in the system. Focussing on developing a common understanding of data needs and harmonising data standards across the international regulatory community, as well as encouraging data and information sharing, will provide more transparency.

These topics have been the focus of discussions at the FSB and IOSCO for this very reason. We are currently considering these issues in the FSB WGLN, which I co-chair along with Cornelia Holthausen from the ECB. Our group has identified concentration and interconnectedness as key vulnerabilities in the system, with the potential to amplify episodes of stress. Some of the policy solutions we and other international groups are exploring include enhancing transparency so that authorities and market participants are better able to identify and manage concentration and interconnectedness. For example, we are developing a toolkit of metrics that can help authorities better monitor and assess the build-up of risks related to leverage use in NBFI, and we are also exploring ways to enhance cross-border cooperation and sharing of information.

The first line of defence must be financial services firms' own risk management processes.

We are also considering whether there are achievable means of making certain types of data more publicly accessible. This would help both financial services firms for the purposes of their risk management, and regulators in their oversight function. Public disclosure requirements already make a wide range of information available to market participants with the aim of helping them to better understand market dynamics. For example, the Commitment of Traders reports introduced in the UK and the EU by MiFID II provide transparency regarding exchange-traded commodity derivatives positions, by highlighting open interest held by the various categories of market participants and how this evolves over time.

Similar reports have existed in US markets for decades, many of which also include information on the concentration of open interest among the largest four and eight market participants. Centralised financial market infrastructures, such as trading venues, central counterparties and trade repositories already collect significant data, and arguably further public disclosure of aggregated and anonymised information could aid the market. Clearly the utility of any information would have to be carefully weighed against its costs.

We look forward to continuing this important discussion to support enhanced confidence in our global markets, including during the WGLN's public consultation which is expected to run at the beginning of 2025

JOHN GOLDEN

Executive Vice President, Global Head of Insurance Regulation – Athene

The 'NBFI' label

Labels sometimes cloud objective analysis when they are imprecise. In the financial sector, the label "Non-Bank Financial Intermediaries" (NBFIs) has been applied to a broad range of institutions engaging in very different activities: insurance and reinsurance companies, asset managers, mutual funds, BDCs, private equity funds, hedge funds, venture capital funds, broker-dealers, pensions, money market funds, crypto-asset firms, non-bank mortgage lenders, family offices and many others. Unfortunately, this has led some to view all NBFIs as the same—and equally risky—even where their actual activities do not support that conclusion. This is particularly true for regulated businesses such as asset managers, broker-dealers and insurance companies. Policymakers should look past the NBFI label and assess institutions based on their respective activities and risks, rather than approaching NBFIs with a 'one size fits all' mentality.

Leveraging the benefits and strengths of diverse NBFIs, while considering the particular risks their various activities pose, is critical for the resilience and development of the economy. The global financial crisis prompted stricter regulations targeting the fundamental risks inherent to the bank deposit model. In turn, many NBFIs have become instrumental in providing diversity in liquidity, financing and investment opportunities, and have foundations on fundamentally safe, long-term capital positions. A nuanced understanding and assessment of these businesses is essential in making informed prudential and regulatory decisions.

As many have acknowledged, the EU and US credit markets differ in their allocation between the banking and investment sectors: in the EU, banks provide roughly 2/3rds of credit, whereas in the US, banks provide a little over 1/3. Given bank pullback following the crisis, this allocation has constrained the availability of credit in the EU on a relative basis—since 2013, the compound annual growth rate in credit to non-financial corporations in the EU has been roughly half that of the US. Over the same period, EU GDP growth has been nearly flat compared to roughly 5% compound annual growth in the U.S.

Why has this gap opened? A 'one-size-fits-all' perspective regarding NBFIs may have played a material part. For example, insurance companies with long-dated, predictable liabilities are ideally suited to hold long-duration assets that fund real economy needs, such as mortgages and asset-based loans. Paradoxically, the Solvency II framework has imposed high capital requirements on securitizations and longer-duration credit assets notwithstanding such stable liabilities, which has discouraged insurers from financing the real economy through long term investment grade investments. This often results in insurers holding assets that are much shorter in duration than liabilities. In effect, this deprives European economies from one of the major potential offerings from the diversity within NBFIs.

Modest changes to regulatory requirements can unlock significant economic activity. For example, as many have written, European policymakers should consider recalibrating rules that have treated securitizations harshly and inconsistently with their economic risk, and eventually examine methods to foster mechanisms for long-term credit formation when matched to suitable liabilities. A larger securitization market would allow banks to bring long-term investor capital to the table, in turn releasing capital and spurring additional financing activities to help grow the economy. Enabling Europe's life insurers to support long-term credit could unlock over €1 TN in financing to fund European economic growth and fuel financing needs for the green economy, infrastructure and national defense, among others.

Global policymakers committed to robust and resilient capital markets should adjust their perspective from viewing NBFIs primarily as a uniform source of systemic risk to recognizing their invaluable role in financing the real economy in a safe and sustainable manner. Tailoring regulation to address the particular activities and, yes, risks of each type of NBFI will unlock economic growth while guarding against systemic risk.

STÉPHANE JANIN

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Non-Bank Financial Intermediation: all NBFIs are not equal

Since the Global Financial Crisis (GFC) in 2007-2008, many global and regional supervisors as well as regulators have worked on enhancing Financial Stability. As a first wave of actions, the G20 leaders at the Pittsburgh Summit in 2009 decided to reinforce regulations in the financial sphere (including regarding the non-banking sector). At EU level, it led to a significant series of legislations such as EMIR for derivative markets, CRD/CRR for banks, and the Alternative Investment Fund Managers Directive (AIFMD) for non-UCITS asset managers.

The debate for further regulatory work was reactivated following the March 2020 turmoil as well as significant failures such as the Archegos case in the US. In particular, considering the non-banking nature of Archegos, the Financial Stability Board (FSB) wondered if that case should not lead to enhanced actions towards the wider non-banking sector – today known as Non-Bank Financial Intermediation (NBFI). The European Systemic Risk Board (ESRB) expressed similar reflections.

At EU level, following the March 2020 turmoil and FSB's as well as ESRB's reports, the European Commission was very active in tackling the topic of NBFIs. Based on ESRB's requests, it initiated a review of the AIFM and UCITS Directives specifically aimed at reducing the potential financial stability risks involved in investment funds: mandatory liquidity management tools, EU regulatory framework for loan-originating funds (including a leverage cap), EU UCITS fund reporting complementing the EU AIF one, EU reporting on fund risk management and portfolio management delegations. And currently, ESMA is working on related secondary legislation, which will have to be implemented by early 2026 by all EU-based AIF and UCITS asset managers.

So, what are the remaining areas of uncovered risks embedded in NBFI activities in the EU?

Regarding EU regulated fund managers, ahead of the forthcoming implementation of the new stringent regulatory measures mentioned right above, the facts show that today the leverage embedded in their activities is low: the leverage of UCITS funds is capped at 100% of their Net Asset Value, and regarding EU non-UCITS funds the European Financial Stability and Integration Report issued by the European Commission in June 2024 states that "EU AIFs do not show substantial levels of leverage and most do not use leverage or do so only to a small degree." It clearly illustrates that the progressively enhanced and implemented EU regulatory framework has reduced risk over time.

Still, for the rest of NBFIs, are they appropriately regulated and supervised as compared to the potential risks they pose to financial stability?

For instance, since the origin of AIFMD, family offices like Archegos have been explicitly excluded from the AIFMD framework (see AIFMD Recital 7). So, among NBFIs, you may still find such rotten apples which are not regulated and not limited in their actions. Importantly, the fact that some types of NBFIs are not regulated as entities means that they are hardly known (if not known at all) by regulators. Conversely, EU regulated managers and funds are by nature under the ongoing scrutiny of securities regulators, through the whole process of licensing, monitoring, enforcement and possibly sanctions by those securities regulators: being a regulated entity means that the regulator knows you and can ask you any information at any time.

To conclude and reflecting more widely on how to tackle NBFIs and the risks they represent in the EU, regulators and supervisors may act in three cumulative or alternative ways.

First, a priority action at legislative level should be given to extend the scope of regulation towards some types of currently not regulated market players such as family offices, as regulation brings knowledge and information to the related regulators: this is the safest way to anticipate and reduce the risk of occurrence of systemic risk on financial markets.

Second, on the side of securities regulators, we might wonder if the tools currently used for market surveillance couldn't be more systematically upgraded (maybe with the help of AI) to allow for improving scrutiny and detection of who is systemically active.

Being a regulated entity means that the regulator knows you.

Last, regarding banking supervisors, ensuring a better monitoring of the counterparty risk assessment obligations to be applied by banks is probably key, to avoid dramatic events generated by some non-regulated NBFIs contaminating their banking counterparts, as it was the case for Archegos. Proposing guidelines for counterparty risk management by banks is fine (see the very recent BCBS' consultation on that topic) - but effective supervision of rules is critical too.

SUSTAINABILITY RISKS IN THE BANKING SECTOR

FRANÇOIS-LOUIS MICHAUD

Executive Director – European Banking Authority (EBA)

Greenwashing: a sustainability challenge for the banking sector

The EU sustainable finance market is growing rapidly as consumers, investors, and other market participants are increasingly seeking to align their financial decisions with environmental and social objectives. However, this also poses a major operational challenge for banks and financial institutions in the form of an ever-possible risk of greenwashing. Greenwashing refers to the practice of making sustainability-related statements or claims that do not reflect the actual sustainability profile of an entity, a product, or a service. This can mislead the market and undermine the credibility, reputation, and performance of the entire financial sector.

Greenwashing is not a new phenomenon (some claims were noted already 20-30 years ago) but it has come to the surface more prominently in recent years with a growing demand for green and sustainable products and services and increased public awareness of sustainability issues. This increased demand for green and sustainable products has resulted in the market creating and offering more of these products and services, which itself tends to fuel additional demand.

This is of course a very welcomed change. Until it is not. And it is not welcomed if one discovers that "green" or "sustainable" is only a façade with not much greenness or sustainability behind it. With increased public awareness and reporting on it in the media, this may shed a dim light on the transition to green and sustainable economy. Moreover, this may create new risks for the financial sector, which require increased monitoring.

Increased allegations and evidence of greenwashing were one of the reasons why two years ago the European Commission asked the EBA, EIOPA and ESMA (the three ESAs) to investigate the phenomenon of greenwashing in the financial sector and to make recommendations to address it. Their contribution was published in June 2024 with the EBA's report focusing on the banking sector as its main remit. It is a comprehensive and timely contribution to the EU's sustainable finance agenda.

How can banks and financial institutions prevent greenwashing?

As shown in the EBA's report, the number of alleged greenwashing cases in the EU and globally have increased significantly in the last decade – 7.3 times between 2012 and 2023 – and the increase includes the financial and banking sector. This reflects the rapid growth of sustainable finance products and services, such as green bonds, sustainability-linked loans, or green deposits, as well as the rising expectations – and attention – of consumers and investors regarding sustainability information and performance. From a financial risks perspective, greenwashing entails first and foremost reputational and operational risks including litigation risk for individual firms and can also result in financial stability concerns through an inadequate allocation of capital and pricing of risks.

The EBA considers that the EU has already put in place a robust regulatory framework to address greenwashing, based on two key pillars: consumer and investor protection, and sustainable finance. The former sets out rules and principles to ensure that sustainability information is fair, clear, and not misleading, while the latter provides common definitions, standards, and disclosures to enhance transparency and comparability of sustainability practices and products. On the other hand, some of these regulations are still in the early stages of implementation, while others are being updated or developed, suggesting that their full benefits are not visible yet.

Financial institutions are the primary responsible for ensuring that their sustainability claims are accurate, substantiated, up-to-date, understandable, and that they fairly represent the actual sustainability features. To this end, the EBA provides guidance on best practices to mitigate greenwashing risk at both the entity and the product level, for instance through governance, data, external verification, and forward-looking commitments. The EBA urges institutions to review and, if necessary, adapt their internal processes and arrangements to prevent and detect greenwashing, and to fully integrate greenwashing-related financial risks in their risk management.

The EBA itself is also committed to tackling greenwashing by providing regulatory guidance on how to address it through prudential supervision. This should be done facilitating knowledge-sharing among supervisors on best practices and monitoring greenwashing-related trends and risks in the EU banking sector. The EBA is also developing specific requirements for banks to assess and manage financial risks resulting from greenwashing or greenwashing allegations as part of its forthcoming Guidelines on the management of ESG risks.

All in all, greenwashing is not only an ethical issue. It is also a strategic and operational one, that requires a comprehensive and coordinated response from all stakeholders. By addressing greenwashing effectively, institutions, supervisors, and policymakers can enhance the credibility and integrity of the financial system, foster consumer trust and confidence, and support the transition to a more sustainable economy.

ELIZABETH MCCAUL
Member of the Supervisory Board, ECB Representative – Single Supervisory Mechanism (SSM)

Operationalising climate-related and environmental risk management

Five years ago, less than a quarter of the banks under our supervision had incorporated climate-related and environmental (C&E) risk in their risk management frameworks. We have come a long way since then. Most banks have now drawn up materiality assessments that are aligned with our supervisory expectations. But this is only a first step, and much more work lies ahead.

Banks continue to face challenges in operationalising C&E risk management and ensuring comprehensive coverage of all C&E risk categories. This especially concerns integrating physical risks alongside transition risks and applying forward-looking data.

C&E risk, by its nature, is a forward-looking risk characterised by uncertainty. This uncertainty stems not only from the physical impacts of climate change but also from policy changes in the transition towards a decarbonised economy.

To navigate this uncertainty, banks need robust tools and methodologies. One effective approach is what is known as an alignment assessment. This measures transition risks by comparing the projected production volumes in key economic sectors with the required rate of change to meet given climate goals. This method allows banks to anticipate and prepare for potential changes, which makes it the best available tool for forward-looking risk assessment.

Banks have started to deploy alignment assessments broadly, incorporating various good practices to enhance their effectiveness. In early 2024, we published a report entitled Risks from misalignment of banks' financing with the EU climate objectives that outlines some of the best practices. These include:

- Selection of representative scenarios: The scenarios should be science-based and consistent with stated policy objectives such as those formulated in the Paris Agreement.
- Consistency of choice: Scenario choices used for strategic planning, risk management and disclosures should be internally consistent and well documented.
- Re-baselining: The scenario should be up to date, and the choice of base year should be well justified. If an analysis is updated, the base year of the decarbonisation pathway should be aligned with the year of the analysis.
- Geographical relevance: The scenario should be geographically relevant to the portfolio under consideration.
- Annual updates: The scenarios should be updated on an annual basis to incorporate global events, changes in the carbon budget and technological developments.

Despite these efforts, misalignment can still occur. The ECB's report on good practices for climate-related and environmental risk management sets out ways that banks can effectively deal with the risks of such misalignment.

Transition planning should become a cornerstone of standard risk management, linking banks' assessment of material transition risk drivers, strategic targets, risk appetite frameworks, risk management tools and the wider organisational set-up. For example, some banks have started managing transition risks by introducing active client engagement and offering transition finance products. Banks can enter a structured dialogue with their clients to steer them towards a trajectory that is aligned with the envisaged portfolio pathways. There are also synergies in the parallel management of transition and physical risks at client level, which could also be leveraged by means of sustainable financing products. These examples show that progress is possible.

At the same time, we acknowledge that challenges related to data and methodologies persist. The ECB has publicly supported policies to improve data availability for the purposes of C&E risk management.

For example, our opinion on the revised Energy Performance of Buildings Directive (EPBD) expresses our support for the aim of the EPBD to improve access to energy performance certificates and stresses the need for credit institutions to have access to that information. We also called for harmonised methodologies across the EU to foster comparability and reliability.

2024 is a pivotal year for banks to become more resilient to C&E risks.

Another example is the proposed ESG Rating Regulation. Our opinion highlights that increased transparency together with increased reliability and comparability thanks to comprehensive disclosure standards will help facilitate the use of ESG ratings as an input factor in banks' monitoring processes.

2024 is a pivotal year for banks to become more resilient to C&E risks. By the end of this year, we expect all banks under our supervision to be fully aligned with all our supervisory expectations on the sound management of C&E risks. This requires ongoing refinement of materiality assessments, integration into business strategies and rigorous risk management practices. ECB Banking Supervision will continue to push banks and thereby to ensure that the banking system remains safe and sound as we transition to a net-zero world.

CSABA KANDRÁCS

Deputy Governor –
The Central Bank of Hungary

Climate risks and capital requirements: possible solutions from Hungary

In recent years, climate change and environmental risks have emerged as primary concerns for central banks and supervisory authorities. A decade ago, few would have considered incorporating environmental risks into the capital requirement framework, and the idea of giving central banks a sustainability mandate seemed far-fetched. However, the landscape has changed dramatically. Today in Hungary, green exposures benefit from preferential capital requirements, and the central bank holds a sustainability mandate, highlighting the significant shift in priorities.

The Magyar Nemzeti Bank (MNB – Central Bank of Hungary) has put in a lot of efforts to build a well-functioning green finance ecosystem in the country. Consequently, sustainability now permeates various activities at the MNB. To lead by example, efforts are being made to reduce greenhouse gas emissions of own activities and offset the remainder. We set supervisory expectations to enable banks to mobilize sources to green activities. There is also a focus on building sustainable finance capacities. Crucially, these actions are undertaken without compromising the stability of financial institutions or the financial system.

Traditionally, capital requirements have been risk-based, and they should remain so. However, the emergence of climate risks as new risk drivers necessitates that financial institutions prepare to cover unexpected losses stemming from transition or physical risks. In 2020, as an initial step towards sustainability, the MNB began developing climate risk stress testing capabilities to assess risks in the financial sector comprehensively. These tools have been continuously refined to measure both physical and transition risks over short and long term. The results have revealed significant forward-looking risk differences across sectors and companies in the real economy. Fortunately, these risks are not concentrated, ensuring that Hungarian banks remain stable even in severe transition risk scenarios. To prevent substantial concentrations from building up in individual institutions' balance sheets, the MNB will require banks to conduct rigorous climate stress tests. These tests will assess exposures to climate risks, as outlined in the central bank's green supervisory expectations. Banks are also expected to integrate climate risk assessment into their general risk management processes to further strengthen the stability of the sector.

We have put in a lot of efforts to build a well-functioning green finance ecosystem in the country.

Maintaining a risk-based approach implies that lower risks should lead to lower capital requirements. Based on the green hypothesis that green loans and firms bear less credit risk, the MNB introduced a unique green preferential capital requirement program. Green exposures can receive substantial deductions from their Pillar 2 capital requirements, with eligibility criteria based on the EU Taxonomy. Although the central bank has approached this preferential treatment cautiously—setting caps on deductions and limiting the timeframe—the initial empirical results align with expectations. The credit risk of green exposures has proven significantly lower than their benchmarks. This is a very promising result since banks tend to allocate credit towards less risky companies and a capital deduction can further mobilize funding to sustainable investments. The program's performance will be closely monitored to inform international discussions on capital requirements.

Nature-related risks have also gained attention as financial risk drivers for central banks and supervisors. The MNB is at the early stages of addressing this challenge. In collaboration with the OECD, the central bank recently completed a milestone project to assess financial risks resulting from biodiversity loss. Moving forward, the main questions will be how to tackle this new challenge and whether it is necessary to implement changes to supervision processes.

Finally, I would underline the importance of clear regulation of the real economy in combating climate change and environmental degradation. Forward guidance in monetary policy is a well-established tool for managing investors' expectations. Similarly, it is crucial to provide clear signals to the market about future regulations concerning climate change and the environment. The greater the uncertainties surrounding future policies and regulations, the greater the transition risks we will face.

While central banks can support an orderly transition, governments must take the lead in this endeavor.

HIROHIDE KOUGUCHI
Executive Director – Bank of Japan

Need for a more pragmatic approach on sustainability risks

Sustainability risks, especially climate-related risks, continue to be the most significant risks on the globe and have material implications on global financial stability. In the APAC region, as in the rest of the world, we are observing increasing natural disasters, such as heat waves, devastating typhoons, floods, landslides, droughts or wild fires. The damages caused have become more exacerbated. In this regard, sustainability risks are becoming imminent risks, rather than middle or long-term risks. On the other hand, the global track record of GHG reduction or the development of temperature has not been prospective so far, partly due to the global economic recovery from COVID-19 and the rise in geopolitical tensions.

I highly appreciate the significant contributions achieved to date by the global fora, regulators/supervisors and standard setting bodies, to cope with sustainability risks. However, in order to address the above-mentioned challenges and move things forward, we need a more pragmatic approach. I wish to raise three points.

First, scenario analysis should be more pragmatic and realistic. When we assess the impact of sustainability risks on financial system, scenario analysis is very useful. That said, it is a remarkably challenging task to establish plausible scenarios and appropriate models to evaluate sustainability risks. This is because the time horizon is typically 30 to 50 years and in addition to insufficiently granular data, we face a wide range of uncertainties with technology, regulations, behavior of firms and households, and structural change of economies down the road that need to be accounted for in the many parameters of the model. Furthermore, the impact of change in temperature may be non-linear, adding to complexity. In addition, our recent experiences shed light on the potential trade-off between economic growth with price stability and sustainability risks. One approach to deal with these challenges may be utilizing the alternative scenarios that explicitly show changes in temperature, economic growth and prices assuming demand and supply side structural changes. By comparing these scenarios, policy makers can understand the extent to which the scenarios are plausible or acceptable to the public. This will contribute to well-balanced policymaking. Another approach may be utilizing short-term scenario analysis, taking into account the current economic structure in each jurisdiction to understand propagation dynamics of sustainability risks. In this regard, the Bank of Japan published the short-term scenario analysis utilizing the input-output matrix. Continuous enhancement of short-term analysis may give us pragmatic insights on long-term analysis.

As sustainability risks have become more imminent, it is time to seek a more pragmatic approach.

Secondly, transition finance is a key factor in a pragmatic approach. Transition finance plays a critical role in achieving material reduction of GHG emissions by orderly business transformation of GHG intensive industries, while also enhancing necessary innovation. In this regard, it is misleading to consider financed emissions derived from transition finance as sustainability risks when this transaction could eventually contribute to GHG reduction. While some argue that financed emissions as sustainability risks should be captured in Pillar 1 or 2 frameworks, the top priority should be establishing the appropriate methodology in quantifying these risks, taking into account the above-mentioned challenges and significant data gaps. In addition, any initiative should not jeopardize financial institutions' incentives to provide transition finance that contribute to the final goal of GHG reduction. Importantly, a successful transition would maintain the soundness of the global economy and financial system, whereas a failure would lead to the deterioration of financial stability.

Thirdly, financial disclosure on sustainability risks and market valuation will work as a practical driving force to facilitate transition process to the net-zero economy. In this regard, TCFD and ISSB are playing very significant roles. Market discipline through market valuation based on financial disclosure, including firms' commitments and strategies to address sustainability risks, will encourage firms to transform themselves. In order to enhance this process, financial authorities should focus their efforts on increasing comparability and inter-operability. Establishing appropriate financial disclosure on sustainability risks will ultimately act as a valuation mechanism that enables stakeholders to measure financial risks and the potential need for more capital held by financial institutions.

Over the last several years, the discussions on sustainability risks, as well as our understanding of various challenges to address them, have deepened. As sustainability risks have become more imminent, it is time to for us seek a more pragmatic approach.

HIROTAKA HIDESHIMA
Counsellor on Global Strategy to President and the Board of Directors – The Norinchukin Bank

Sustainability risks in the banking sector: major operational challenges

Implications of structural changes to the economy

As with any structural changes to the economy, regardless of whether it is due to technological advances or to policy changes, there will be those entities that will adapt better and those that will not. This would probably be true within those sectors that find the changes favourable, as well as within those sectors that find them unfavourable. Thus, the challenge for banks would be to assess whether each of their borrowers are capable of adapting to the forthcoming changes.

Macroeconomic implications

At the macroeconomic level, there can be debates around whether the policies towards improving sustainability will bring down the potential growth rates on a net basis, given the increase in the constraints on the supply side. There will surely be increased demand for sustainable investments, but the reduction in non-sustainable investments may be at a similar scale. More constraints on the supply side is likely to lead to higher prices, but the impact on interest rates may be unclear with the combination of lower potential growth rate and higher prices. The impact on the exchange rate will probably depend on the impact of these changes on exports and imports, and may be different across different economies.

How to incorporate in risk management

How should we incorporate these elements in the risk management of banks? As is pointed out in the Basel Committee's April 2021 document "*Climate-related risk drivers and their transmission channels*", my understanding is that they should be observed through the traditional risk categories of credit, market, liquidity, operational, and reputational risks.

Credit risk

It can be argued that sustainability risks should already be incorporated in the internal credit decisions of banks. Banks are, and should be, making credit assessments of potential and existing borrowers taking account of any structural changes to the economy, including the need to address sustainability risks. Such assessments needs to be made at the individual entity level, and not sector level. The result of such assessments should be incorporated in the outlook of the profit and loss and then on the credit ratings of the borrowers, for example by down-grading (or potentially up-grading) the borrowers. The appropriateness of such actions should be tested with the back-testing comparing the actual default rate and the estimated probability of default for each rating grade (note: do not try to adjust individual PDs of the borrowers since this will make back-testing impossible). There may be a question of the time horizon. My view is that traditional credit risk assessment should continue to be made on the traditional one to three year time horizon, and the longer time-horizon should be dealt with in scenario analyses. Any insights gained from the longer horizon scenario analyses should be fed into the traditional credit assessment process.

Market and liquidity risks

As for market and liquidity risks, there is a question of whether we can move away from the tradition of basing quantitative parameters on historical observations only. There may be a case for allowing qualitative adjustments to the parameters based on the assessments of the impact of sustainability risks on the behaviour of market indices or the behaviour of borrowers. For example, there may be a good case for assuming a higher interest rate than in the past, so there might be a need to adjust the VaR figures from that solely based on historical observations. Similarly, there may a case to assume a different drawdown rates of credit lines as borrowers adjust for the sustainability risks. One necessity may be to back these qualitative adjustments with back-testing, and adjusting those adjustments as necessary.

Operational and reputational risks

As for operational and reputational risks, my view is that banks should follow the Basel Committee's June 2022 document "*Principles for the effective management and supervision of climate-related financial risks*", except for the need to expand the concept from climate-related financial risks to sustainability-related financial risks in general.

> **Sustainability risks should be observed through "the traditional risk categories".**

The current state

Are we doing enough at the moment? Probably not. There is much more that needs to be done. However, if we adopted the notion in the April 2021 paper of the BCBS to "observe through the traditional risk categories", the issue does not seem to be unsurmountable. Some people point out that the risk is too large and that we will end up facing a huge increase in capital charges. I am not sure. Whether or not the risk will increase at a huge scale is an empirical question, and we have experienced economic transformations in the past, both due to technological advances and policy changes. As long as there is clear policy of internalising the externalities, the cost of transitioning should be borne by the economy widely, and there should not be an unduly high cost placed upon the banking sector.

JOHN MURTON

Senior Sustainability Advisor – Standard Chartered Bank

Tackling sustainability risks in banking: progress and future challenges

The impact of climate change on society and the economy is not new, but is certainly accelerating. The 'physical risks' from climate change are set to materialise in an increasingly unpredictable manner going forward. As we transition to low-carbon economies, such physical risks will be accompanied by escalating 'transition risk' (the risks of stranded assets in high-carbon sectors). Both phenomena give rise to financial risks, with the result that these issues are high on the agenda of regulators as well as a top priority for the banking sector.

Banks must build up capacity to identify, monitor and manage climate-related risks for their own sake, for the stability of the financial system overall but also to be able to provide financing to the transition to a Net-Zero economy. At Standard Chartered, we have been working on embedding climate risk into our day-today-operations since 2019, including our governance, risk management framework, and our business strategy. This includes, for instance, the individual assessment of our corporate client sensitivity to climate-related risks and their state of readiness for the transition, which is then aggregated to identify portfolio hotspots and inform decision making.

Standard Chartered has committed to mobilising USD 300bn of sustainable and transition finance by 2030. This helps our clients to manage their own climate-related risk while concurrently managing our own. We work on achieving this by dramatically increasing climate and transition finance available to clients, launching new products, and withdrawing from specific activities and assets.

As we make this journey, it continues to be difficult to measure and identify sustainability risks. The lack of data – and geographical variations in its availability - coupled with the difficulty of isolating physical and transition risks presents a range of challenges. Technical expertise in this area is still limited. Combining long-term macro-economic trends with climate impact projections (which will be felt first through extreme weather events) remains an inexact science. Assessing transition risk, even more so.

Against this background, the growing body of mandatory sustainability related disclosures regimes will act as an important enabler. This includes for instance, the EU Corporate Sustainability Reporting Directive (CSRD) as well as Pillar 3 disclosures under the revised Capital Requirements Directive (CRD VI). The wide adoption and implementation of the International Sustainability Standards Boards' guidelines is also a positive development. Disclosures by counterparts and clients will allow financial institutions such as Standard Chartered to better assess our exposure to sustainability risks and plan our own transition strategy. It will be critical that the various disclosures regimes are interoperable and do not become a patchwork of different requirements.

A globally coordinated approach between standard setters and supervisors is essential.

The introduction of regulatory obligations to develop transition plans - including the EU Corporate Sustainability Due Diligence Directive (CSDDD) - will improve matters further: transition plans are a strategic tool for banks to manage and track their climate risks. At Standard Chartered, we are currently working on developing our own transition plan, which will be instrumental for navigating the challenges and opportunities presented by climate change, and the transition to a low-carbon economy.

Whilst this improved regulatory context is hugely valuable, it is essential that standard setters coordinate their approaches in order to avoid unnecessary complexity and duplication (which might in turn risk a stagnation of financing). In this regard, we welcome the ongoing NGFS work on transition planning which will feed into the work of standard-setters to foster global adoption.

Finally, whilst such regulatory enhancements will be important, we must not lose sight of the fact that some transition risk will come from unexpected quarters and may come swiftly. Low-carbon technology such as solar panels and batteries have seen huge – 85% - price reductions over the last decade, resulting in a level of uptake and expansion thought impossible just a few years ago. Even if it's not enough to solve the climate crisis, discrete sectors of the low-carbon economy may enjoy years of explosive commercially-driven growth in a manner reminiscent of computing and mobile telephony in recent decades, with associated wealth creation and destruction. This may prove to be a headache for risk managers, but it's the sort of problem that is – in climate terms – very much better to have than not to have.

AML: KEY SUCCESS FACTORS

ANTE ŽIGMAN
President of the Board – Croatian Financial Services Supervisory Agency (HANFA-CFSSA)

AI in AML: need for a continuous oversight and updating

The increasing number and size of fines related to anti-money laundering (AML) violations highlight significant gaps in the current approaches to detecting and preventing illicit financial activities. These fines indicate the need for more advanced technologies, like artificial intelligence (AI), to improve AML processes.

Artificial intelligence in the anti-money laundering area upgrades and enhances risk management efforts by providing acceptable means for detecting, stopping, and reporting money laundry operations, ensuring regulatory practices, and strict international and regional laws that are built into the system to ensure uniformity and integrity within the financial system. AI-employed AML compliance tools with their sophisticated algorithms offer a deeper insight into money laundering risks.AI with its multiple functions is on its way to becoming a necessary tool both in AML processes and the financial industry in general. AML tools can process extensive amounts of data in a short period and provide a comprehensive insight into the patterns and anomalies that may indicate the presence of AML crimes or the existence of deficiencies that could lead to different financial crimes.There is a wide application of the AI in AML. From the initial driven risk assessment, predictive analytics proactive risk management to real-time monitoring for immediate action, streamlining compliance process, and anomaly detection by advanced data analytics. AI surely should be watched as a strong AML execution and implementation tool.

AI is on its way to becoming a fundamental tool for dealing with the latest financial and economic challenges. We agree that AI technologies hold an enormous capacity for automation, supporting rapid processes and efficient workflows. It leads to the fact that by AI usage, professionals can devote themselves to higher-level tasks and more important strategic matters.

Blockchain analysis tools have become crucial in AML surveillance for cryptocurrencies and digital assets, making it possible to monitor and identify suspicious transactions. These technologies are specifically tailored to monitor, identify patterns, detect anomalities and suspicious activities in the digital world. Furthermore, they provide investigators with a full vision of the money flow that gives institutions the power to be able to see cryptocurrency transactions effectively.

AI is fundamentally changing the AML landscape. The technology can stay ahead of sophisticated money laundering techniques that continually change to evade detection.

But we shouldn`t forget that the effectiveness of the technology is heavily dependent on the quality of the underlying data, the sophistication of the algorithms, and the continuous oversight and tuning of these systems.

By leveraging advanced data analytics and AI, financial institutions can enhance their AML capabilities, reduce risks, and ensure compliance with regulatory requirements. However, effective data management requires addressing challenges related to data quality, privacy, and regulatory compliance to ensure that AML efforts are successful and responsible.

Generative AI systems use a wide variety of data types and algorithmic models. The nature of the explanation for a decision or prediction by a system can vary greatly, depending on the specifics of the data and the algorithms used.

AI relies on inputs provided by the human factor, data that is put into the system, and rules and frameworks that are set following legal, social, ethical, and social rules. While one part of these inputs can be provided more easily, the other part is subject to continuous and significant changes and requires updating and regular control. Extreme importance should be given to the input and control of these parameters so that the results can be applied and benefited from them. Experts and educated professionals must be continuously involved in the use of AI for AML purposes and we must be aware of the responsibility that lies with them.

It is our responsibility to have a thorough awareness of the potential risks associated with AI.

Therefore it is important to stress that the AI use can open some inevitable ethical, legal, and social concerns. Special attention should be put on the training datasets, data privacy and security, and potential biases in predictive algorithms.

I would like to state clearly - AI in AML has undoubtedly an enormous, growing potential but it should be used with a clear and deep understanding of its functioning and full elimination of possible biases and non-transparency.

Financial institutions must remain cautious, professional, and well-informed on all legal, social, ethical, and social concerns while using the power of AI in AML. A complete and deep understanding of the possible risks of using AI in AML is the key to its efficient, lawful, and high-quality use.

The potential of AI usage in AML is huge and indisputable but let`s be fully aware of all possible risks and dilemmas in order to avoid possible problems and not generate new ones at the end of the day.

DERVILLE ROWLAND
Deputy Governor Consumer and Investor Protection – Central Bank of Ireland

Setting up the new EU Anti-Money Laundering Authority (AMLA) for success

The creation of the new EU AMLA is an opportunity to tackle financial crime on a pan-European basis by working together in a collective and holistic manner. We are at an inflection point in the journey of financial crime prevention with the creation of this enhanced regulatory framework. However, we cannot be complacent and assume AMLA's success is guaranteed.

AMLA, as an independent authority, has a critical role in tackling ML/TF risks through it's direct and indirect supervision of entities, and via oversight and coordination responsibilities. AMLA needs to do that in a way which fosters excellent cooperation with other supervisory authorities, EU bodies and agencies, national competent authorities and other stakeholders.

In order to fully realise AMLA's potential, there a number of steps required. A clear legal mandate, strong, independent leadership, sufficient resources and appropriate skillsets are all integral building blocks of a successful supervisory approach. In the first instance, the clear legal mandate set out in the AML Package needs to be further bolstered by level 2 texts that promote maximum harmonisation and regulatory alignment. The commencement of direct supervision of the highest risk cross border entities by 2028 is dependent on the development of a robust methodology for assessing EU wide ML/TF risk capable of effectively identifying the firms that pose the greatest risk. In the short term AMLA must prioritise the adoption of the risk methodology for identifying directly supervised firms.

An equally pressing task vital to the successful launch of AMLA is the creation of an independent and impartial Executive Board. AMLA must prioritise the appointment of individuals with the necessary technical expertise and experience in the strategic leadership of large, complex organisations with multifaceted mandates. AMLA must prioritise the recruitment of highly trained AML/CFT supervisors, policy experts and investigators. Diversity of thought, background and experience are important considerations. Similar people looking at similar information and facing similar circumstances are, unsurprisingly, likely to rely on similar assumptions and make similar decisions. This type of groupthink must be avoided.

As the fulcrum of the EU's AML/CFT framework, it is incumbent on AMLA to act as a catalyst for the development of innovative solutions in the fight against money laundering and to ensure that it does not inadvertently stifle much needed innovation. Technologies such as AI are more frequently becoming enablers of crime. These same technologies have the potential to revolutionise customer identification and verification, transaction monitoring and suspicious activity reporting. Realising the potential of AI while managing its risks requires a robust regulatory response with appropriate safeguards. Critical to such a response is ensuring that human judgement and critical thinking must remain central. AMLA must play its part in enabling the responsible deployment of AI by obliged entities through the development of clear standards and guidance that put transparency, explainability and governance at their core. In addition, with its role and responsibility in coordinating joint analysis by Financial Intelligence Units (FIUs) across the EU 27, AMLA will have to rapidly establish and make available tools and technologies to enable joint analyses and the secure dissemination of information.

Finally, in order to unlock the potential of this analyses and to ensure that it leads to the ultimate prosecution of cross-border money laundering offences, AMLA must concentrate on building effective working relationships with other authorities and agencies. This includes EURPOL, the European Financial and Economic Crime Centre and the European Public Prosecutor's Office (EPPO). AMLA must also play a lead role in supporting the development of Partnerships for Information Sharing. Such partnerships have the potential to address a long recognised gap in the EU AML/CFT framework and to resolve the perceived conflict between the public interest in fighting money laundering and terrorism and the fundamental rights to privacy. AMLA will have a vital role in the success of such partnerships by working with EU data protection authorities to develop adequate governance and legal frameworks for the Partnerships for Information Sharing.

A harmonised rulebook, overseen by a single supervisor that raises standards and delivers increased alignment and cooperation across the regulatory landscape is certainly a good starting point to realise AMLA's potential. However, history has taught us that no system is entirely 'future proof' and vigilance, agility and innovation are constantly required. Since the first AML Directive was enacted in 1991, the legislative landscape has continuously developed in line with our awareness and understanding of the ML/TF risks. AMLA will need to ensure that this process of evolution continues.

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Priorities in AMLA's start up: a multi-stakeholder effort

The design of AMLA as an organization is complex and seems unprecedented among EU agencies. It has to accommodate for the fact that one Authority is in charge of two well definite and separate functions, each assisted by its own governance and decision making structures and procedures: AML/CFT supervision across different financial and non-financial sectors and in various forms; support to Financial Intelligence Units, also in various forms, including impulse and coordination of joint analyses. Distinct governance settings and procedures are designed in Regulation (EU) 2024/1620 (AMLA Regulation); their actual configuration and effective functioning will depend on implementation.

Here lies one of the most compelling priorities for AMLA after its recent creation as a EU legal person: setting, testing and launching its governance system. AMLA will have to bootstrap itself under two complementary respects: configure and convene its General Board; envisage an internal structure that can support multiple and separate tasks, absent any track record. All this while the staff will be recruited gradually and the assigned tasks will kick-in progressively over the next three years, to reach a steady-state in 2028 with the start of direct supervision.

As for the governance, it is well known that national supervisory authorities are several and diverse, in and across Member States. This is accounted for in AMLA Regulation, which foresees that national supervisory authorities "shall share a single vote and shall agree on a single common representative", either permanent or ad-hoc for particular meetings or votes. Much less known is which authority supervises what sector in each Country and which will sit in the General Board as a national representative, particularly for the non-financial sector. The undefined composition of the Board in supervisory configuration poses a challenge. Efforts are currently being deployed to make sure that national representatives are designated soon, in view of possible meetings already in 2024. Heterogeneous supervisor s will very likely sit alongside each other.

As for the internal organization, its features are not envisaged in the Regulation. The Authority will set itself up by allocating connected tasks in suitable "units". The articulation of such units, their levels and relations, the underlying working procedures will have to be worked out against a backdrop of still scarce, if not absent, experience. While different approaches are possible, it is reasonable to assume that the organizational design will be kept lean in the start-up phase, with short reporting lines; Members of the Executive Board could directly oversee operational structures, in line with the approach followed for the Single Resolution Board, an Agency of comparable dimension. A rigorous separation should be maintained between the supervisory and the FIUs' "arms".

While AMLA sets itself up, amidst some uncertainties, important decisions are looming.

Important decisions await the General Board not too far into the future. The Board will have to devise its own rules of procedures, participate in the selection of the members of the Executive Board and, in the FIU configuration, set up the "Standing Committee" that will play a key role in the FIUs' Mechanism.

AMLA should be able at the soonest to take stock, and ownership, of preparatory work that is being conducted by, respectively, supervisors and FIUs to facilitate the transition to the new supranational framework. In March the European Commission requested EBA's technical advice for the preparation of regulatory technical standards in some "priority areas", important for the implementation of the risk-based approach. The call for advice concerns the methodology for classifying the risk profile of cross-border credit or financial institutions that may be selected for direct supervision, the methodology for risk-based supervision, the information necessary for customer due diligence, criteria for determining pecuniary sanctions or administrative measures. EBA has set up an ad-hoc "Forum" where national AML supervisors contribute to prospective AMLA's technical standards.

FIUs are equally committed to perform technical work that AMLA can consider and use in areas of priority for the Mechanism. Based on a work plan articulated in 20 projects under 5 thematic areas, the EU FIUs' Platform has accomplished results in matters that fall under AMLA's competences for the adoption of implementing standards or guidance. Templates have been designed for the reporting of suspicious transactions; these will facilitate the gathering and processing of information by FIUs and simplify obliged entities' compliance. Templates have also been prepared for FIU-to-FIU exchanges: these cover the entire cycle of FIUs' cooperation (requests, responses, spontaneous disclosures, feedback). Other streams of work are currently pursued by FIUs: a "methodology" for the joint analyses; indications for the selection of suspicious transaction reports that, being of a cross-border nature, should be mandatorily shared.

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Transforming EU AML/CFT supervision: AMLA's immediate priorities

In financial regulation, crisis and financial failure have created the political will for change, including for the establishment of new agencies in response to specific policy needs. The establishment of a new authority for AML/CFT, the Anti-Money Laundering Authority (AMLA), is expected to fundamentally reshape the regulatory landscape. This presents both short and long-term challenges, each of considerable complexity. This article focuses on three of AMLA's short-term priorities: establishing a new supervisory framework, organising its internal infrastructure, and engaging with stakeholders.

1. New Supervisory Framework

The establishment of AMLA aims to enhance supervision across EU member states by directly supervising high-risk financial institutions operating on a cross-border basis and achieving convergence of supervisory practices with respect to all other obliged entities. AMLA will harmonise the quality and effectiveness of supervisory practices throughout Europe. One of AMLA's foremost priorities will be to develop a regulatory framework and a risk assessment methodology to facilitate supervision. This involves the implementation of comprehensive policies, technical standards, guidelines, and reporting requirements.

Respecting the principle of proportionality is important with respect to the development of this framework. AMLA's risk assessment methodology must strike a delicate balance—providing effective risk identification and supervision without overburdening National Competent Authorities (NCAs) and obliged entities. Setting proportional requirements is critical to ensure that AMLA's regulations are robust yet implementable. A consistent approach towards supervising non-obliged entities indirectly is also crucial to maintaining an equitable and comprehensive regulatory environment.

2. Internal Infrastructure

Equally important is the establishment of AMLA's internal organisational structure. This includes the setup of governance mechanisms—such as the board, executive team, and advisory committees—and the recruitment of key personnel and experts to ensure efficient resource management. A well-defined training plan for new regulations, technical standards, and guidelines will be essential for effective internal operations.

AMLA must implement robust IT tools for communication, monitoring, and reporting. Ensuring data security is imperative, especially as AMLA will be managing and further developing the European Banking Authority's EuReCA database. A solid IT foundation will be vital for AMLA in executing its supervisory duties efficiently and securely.

Moreover, the possible establishment of a Financial Crime Academy under AMLA's framework would significantly enhance capacity and effectiveness in AML/CFT supervision at both national and supranational levels. This specialised institution would offer targeted training programs, promoting standardisation and consistent supervisory practices across the EU. It would ensure continuous professional development, adapting to evolving financial crime threats, and foster interdisciplinary collaboration for innovation and knowledge sharing. The Academy would build robust capacities, facilitating effective cross-border cooperation and the development of advanced analytical tools, essential for a comprehensive approach to financial crime prevention.

3. Stakeholder Engagement

The effectiveness of AMLA will hinge on its ability to engage with stakeholders from the very start of its operations. One of AMLA's short-term priorities will be to establish cooperation with national AML agencies for seamless exchange of information. This will align its operations with international standards and regulations. Building public awareness, education, and cooperation with financial institutions and relevant obliged entities will ensure compliance and foster a collaborative approach to AML/CFT efforts.

Moreover, as a new EU agency, AMLA should integrate into the broader framework of the European System of Financial Supervision (ESFS). The ESAs and the ECB play pivotal roles in aligning prudential supervision with AML/CFT risks. Therefore, they will be crucial stakeholders in AMLA's collaborative network, ensuring that AML/CFT considerations are deeply embedded in the supervisory fabric of the EU's financial system.

A critical aspect of AMLA's integration will be the convergence between the Single Supervisory Mechanism (SSM) and AMLA's supervision. This convergence should aim to create a more cohesive and effective supervisory environment where prudential and AML/CFT supervision work in tandem. This is also important in the context of national supervisors, efforts between different supervisory authorities need to be synchronised for overall financial integrity.

The success of AMLA's implementation will not solely rest on its own efforts. Its operations will directly influence NCAs' supervisory activities, necessitating that each NCA takes a proactive stance during this transition. For example, Maltese authorities such as the FIAU and the MFSA actively participate in EBA working groups to lay the groundwork for AMLA's supervisory activities.

By engaging in these working groups, NCAs can provide critical insights and practical perspectives, shaping AMLA's approach to be robust, comprehensive, and adaptable to the diverse regulatory environments and challenges faced by different member states. Such engagement is vital for creating a harmonized, yet flexible, AMLA that can effectively combat financial crime while accommodating the unique needs and contexts of various EU jurisdictions.

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AI is a game-changer in Europe's fight against financial crime

How will the EU's Anti-Money Laundering Authority support deployment of artificial intelligence (AI) to combat crime?

One priority for the European Union's Anti-Money Laundering Authority (AMLA) in the short term is to support the implementation of the anti-money laundering/counter-financing of terrorism (AML/CFT) regulatory framework, with the aim of implementing a single set of rules across the bloc by 2027.

The AMLA will help to develop tools and processes to enable consistent application of AML/CFT rules, including the exchange of information among key financial intelligence units (FIUs) in the bloc. As part of this drive, the AMLA will evaluate the capabilities and risks of artificial intelligence (AI) and machine learning (ML) models for AML/CFT.

It is likely the authority will classify models with systemic risks, establishing codes of practice for AI development and outsourcing in collaboration with developers and experts to ensure the advancement of trustworthy AI systems used to combat financial crime.

How will AI and digital technologies improve defenses and make it easier to spot criminal activity?

AI-enabled technologies are already improving execution of AML processes and will continue to do so. There is a constant technological arms race as the bad actors laundering money are also exploiting AI innovations. That makes AI an important area of focus for AMLA, FIUs, and technology providers alike.

The power of AI hinges on data, and organizations have access to vast quantities to identify where money laundering risks lie. Data may be ingested into AI systems from sanctions lists, watchlists, lists of politically exposed persons, negative news stories, and many more sources. AI is the ideal technology to process this information and turn it into real insights. Where a risk and compliance analyst might drown under the weight of adverse media stories published each day - and even struggle to match a correct name against a story - AI thrives on it.

AI technologies are enabling advances such as the development of virtual know-your-customer research assistants to support, speed, and improve human decision-making; as well as other tools for quicker detection of suspicious activities, and to indicate where money laundering risks exist in real-time.

With AI, digital AML/CFT processes can be more proactive, accurate, and scalable, ultimately strengthening the fight against financial crime.

What are the hurdles to deployment of AI?

There may be a number of challenges to overcome when implementing AI in AML processes, as Moody's identified in a study in 2023.

One of the major issues is what we call "the AI data dilemma". Data is everywhere yet many organizations lack access to the high-quality, unified, and mature datasets needed to train AI algorithms. It is important to solve this problem to ensure accuracy, completeness, and relevance because good data is the starting point for the successful use of AI in AML.

The AMLA and business leaders are also concerned about transparency and interpretability in AI algorithms. These technologies can be perceived as "black boxes" – making it difficult to understand how decisions are made, which is crucial in an AML context. As part of a responsible, consistent development process, it is therefore important that the way AI systems reach decisions can be explained and that bias isn't trained into them. The AMLA and the businesses it governs don't want discriminatory outcomes or inaccurate results.

How much more can AI improve risk assessment and the identification of suspicious activities?

Keeping in mind the issues of accessing data, addressing bias, and delivering transparency, AI could deliver game-changing impacts in efficiency, effectiveness, and insight in the fight against money laundering.

AI can enable real-time monitoring of risk across a counterparty network to detect suspicious activities and potential money laundering schemes. Analyzing vast amounts of data from sources such as sanctions lists, watchlists, and negative news stories, AI can provide timely insights on emerging risks and help organizations take proactive measures to prevent financial crime.

> **Good data is the starting point for the successful use of AI in AML.**

AI can also make it faster and easier to conduct repetitive screening tasks that help identify patterns of suspicious behavior and complete thorough risk assessments - for example in high-risk sectors and with high-risk entities. By analyzing patterns and anomalies in data, AI can flag outliers and alert risk and compliance professionals to investigate further. This proactive approach enhances AML/CFT efforts and makes consistent implementation of AI a powerful tool in an era of risk.

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Can AI and new technologies foster a quick and efficient implementation of AMLA?

The new European AML harmonized regime has created a lot of expectations in particular regarding the creation of AMLA tasked with the implementation of harmonized supervision.

A quick and efficient implementation of this new supervisory agency is therefore the main short-term priority and a crucial test for the credibility of the whole framework.

In that context AI and new digital technologies can significantly improve the efficiency of the AML/ CFT (Anti money laundering and counter financing of terrorism) framework with however some necessary safeguards regarding the use and the extend of data sharing. Regarding financial institutions, AI also offers huge opportunities and, in particular, by automating many of the labor-intensive aspects of AML compliance, it can significantly reduce its overall cost.

1) Enhancing data analysis and pattern recognition:

The main characteristic of AI and machine learning algorithms is that they can analyze a huge amount of data, quickly and accurately, identifying patterns and anomalies much more quickly than traditional methods. These technologies are particularly well suited at recognizing complex and subtle patterns that might indicate money laundering activities. In particular, Natural Language Processing (NPL) can be used to analyze even unstructured data, such as emails, news, articles, social media posts and gather intelligence on emerging money laundering threats.

2) Automating monitoring and screening:

AI can automate the monitoring of transactions and customer activities, flagging suspicious behaviors in real time. This reduces the manual workload for compliance officers and speeds up the detection process. Therefore, it is not only more efficient but also much more cost effective than the widespread manual processes.

3) Enhancing Fraud detection and behavioral analysis:

Machine learning algorithms can learn from past incidents of fraud and adapt to new tactics used by criminals. This continuous learning processes help in maintaining robust fraud detection mechanisms. It can also analyze customer behavior over time to detect deviations from normal patterns.

The use of AI can improve the effectiveness of the AML/CFT framework if implemented carefully.

4) Streamlining analysis of Regulatory reporting:

AI can streamline the process of generating reports for regulatory bodies, ensuring accuracy and compliance with various requirements.

As far as AMLA is concerned it can also streamline the analysis of these reporting. The use of automated processes also reduces the time and resources needed to fullfill these regulatory obligations.

5) Generating efficiency in investigations:

AI tools can help investigators by providing insights, linking related cases, helping to build comprehensive profiles of individuals and organizations and even predicting future criminal activities based on historical data. All these has the potential to enhance the efficiency and effectiveness of investigations which will be very important for the future work of AMLA.

6) Allowing regulatory compliance cost reduction:

For financial institutions it is a huge win. By automating many of the labor-intensive aspects of AML compliance, AI and digital technologies can reduce the cost of compliance for financial institutions without compromising on the qualities of controls and deliveries. In particular, for those credit institutions, it has the potential to greatly improve both KYC processes and risk assessment by automating the collection and verification of customer information and by evaluating the risk profiles of both customers and transactions more effectively in considering a broader range of factors and data points.

However, the use of AI and digital technologies must also integrate some necessary safeguards in particular regarding data sharing. Even if the use of those techniques allows for enhanced collaboration by facilitating secure and transparent data sharing between financial institutions and regulators, and therefore should be of great help for the new system; it needs to be balanced against the needs of data protection and the related regulations. Both regulators (and in particular the future AMLA) and financial institutions should carefully look at implementation considerations. Regulatory compliance needs to be achieved, and AI systems must be designed to comply with relevant regulations and standards.

Data quality is another pressure point: ensuring high quality, clean data is crucial for the effectiveness of AI models as well as the necessity to maintain transparency and explainability. All models should be transparent and provide explainable outputs to ensure trust and compliance. Finally, those models must be integrated with existing systems for maximizing its benefits.

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On the eve of a technological revolution, AML comes under European supervision

The AMLA will be deploying new standards to ensure uniform supervision at European level and to develop cross-border knowledge of risks. Private sector reporting bodies will have to harmonize their organizations beyond the perimeter of each Member State and adapt the architecture of their databases and control systems.

At present, AML processes generate a huge operational workload at every stage of the production chain: recording and updating knowledge of customers (KYC) and suppliers (KYS), filtering third parties before entering a relationship, and then monitoring transactions. Harmonizing these processes as they stand at European level would be a colossal task. Some players have attempted it and have chosen to relocate to India to limit costs.

Digitalization has already made certain processes lighter and more secure: OCR (Optical Character Recognition, that recognizes text within a digital image) to read identity documents, or RPA (Robotic process automation, that is based on software robots) to automate the preparation of investigations, for example. But the industry still spends a lot of energy dealing with false positives that add no value. The reason for this is the paucity of customer knowledge, the weakness of detection algorithms that produce 150 alerts for a real suspicion of financial crime, and the still highly manual nature of investigations.

Artificial Intelligence should bring considerable productivity gains through the holistic consolidation of internal information and the use of external databases of unstructured information.

To enhance customer knowledge (KYC), artificial intelligence could take the place of physical networks in ChatGPT-type conversation mode and analyze the links between natural persons (PP) and/or legal entities (PM). Fraudulent documents could be unmasked by cross-referencing with available internal and external data. Lastly, external data extractions could be used to enrich documents and customer files, under the control of Personal Data Protection (RGPD) of course.

Generative AI can extract relevant information from unstructured free text, enabling algorithms to assess matches much more accurately and maximize the effectiveness of investigators by automatically identifying many false positives while highlighting matches representing a real risk, and prioritizing them.

Synthetic data generators can be used to optimize the effectiveness of detection models, through impact studies and calibration tests.

Artificial intelligence enables a combinatorial and dynamic approach to financial crime.

AI can automatically generate analysis reports on detections, citing its sources, including in multiple languages.

To investigate alerts, AI can help analysts by producing a holistic view of customer behavior, a report that analyses and summarizes the data, thus limiting laborious manual searches in disconnected systems.

Finally, a conversational engine can assist analysts.

In addition to efficiency gains through more precise targeting of alerts and effective assistance with their processing, artificial intelligence enables a combinatorial and dynamic approach to financial crime through the simultaneous processing of a very large amount of data, which captures the evolving patterns of money laundering much better than a static threshold-based detection system. We can therefore expect a significant improvement in the prevention, management, and assessment of the risk of financial crime.

But the deployment of high-performance Artificial Intelligence faces several challenges:

- Effective models require reliable data. Detection systems based on simple rules remain necessary, as these solutions exploit “traditional” data and produce a first level of qualified information, upstream of artificial intelligence solutions which can refine this raw material using less secure data.
- The processing of personal data is a challenge, given the many obligations to protect it and the stringent regulations governing its use. Organizations are in various stages of developing and implementing comprehensive AI governance models that include cross-functional coordination, using both existing frameworks and newly established guidelines specific to managing AI risks and ensuring compliance, especially with upcoming regulations like the EU AI Act.

Finally, Artificial Intelligence engines are subject to biases that need to be monitored and controlled.

An artificial intelligence white paper dedicated to financial security, resulting from a consensus between the AMLA and AI solution providers, would make it possible to define market standards that would secure the construction of future LCB-FT systems.

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ABOUT EUROFI

The European think tank dedicated to financial services

- **A platform for exchanges between the financial services industry and the public authorities**
- **Topics addressed include the latest developments in financial policy and the macroeconomic and industry trends affecting the financial sector**
- **A process organised around 2 major international yearly events, supported by extensive research and consultation among the public and private sectors**

OUR OBJECTIVES

Eurofi was created in 2000 with the aim to contribute to the strengthening and integration of European financial markets.

Our objective is to improve the common understanding among the public and private sectors of the trends and risks affecting the financial sector and facilitate the identification of areas of improvement that may be addressed through regulatory or market-led actions.

OUR APPROACH

We work in a general interest perspective for the improvement of the overall financial market, using an analytical and fact-based approach that considers the impacts of regulations and trends for all concerned stakeholders. We also endeavour to approach issues in a holistic perspective including all relevant implications from a macro-economic, risk, efficiency and user standpoint.

We organise our work mainly around two-yearly international events gathering the main stakeholders concerned by policy work in the financial sector and macro-economic issues for informal debates. Research conducted by the Eurofi team and contributions from a wide range of private and public sector participants allow us to structure effective debates and offer extensive input. The result of discussions, once analysed and summarized, provides a comprehensive account of the latest thinking on financial regulation and helps to identify pending issues that merit further action or assessment.

This process combining analytical rigour, diverse inputs and informal interaction has proved over time to be an effective way of moving the regulatory debate forward in an objective and open manner.

OUR ORGANISATION AND MEMBERSHIP

Eurofi works on a membership basis and comprises a diverse range of more than 70 European and international firms, covering all sectors of the financial services industry and all steps of the value chain: banks, insurance companies, asset managers, stock exchanges, market infrastructures, service providers... The members support the activities of Eurofi both financially and in terms of content.

The association is chaired by David Wright who succeeded Jacques de Larosière, Honorary Chairman, in 2016. Its day-to-day activities are conducted by Didier Cahen (Secretary General), Jean-Marie Andres and Marc Truchet (Senior Fellows).

OUR EVENTS AND MEETINGS

Eurofi organizes annually two major international events (the High Level Seminar in April and the Financial Forum in September) for open and in-depth discussions about the latest policy developments impacting the financial sector and the possible implications of on-going macro-economic and industry trends. These events assemble a wide range of private sector representatives, EU and international public decision makers and representatives of the civil society.

More than 900 participants on average have attended these events over the last few years, with a balanced representation between the public and private sectors. All European countries are represented as well as several other G20 countries (US, Japan, China...) and international organisations. The logistics of these events are handled by Virginie Denis and her team. These events take place just before the informal meetings of the Ministers of Finance of the EU (Ecofin) in the country of the EU Council Presidency. Eurofi has also organized similar events in parallel with G20 Presidency meetings.

In addition, Eurofi organizes on an ad hoc basis some meetings and workshops on specific topics depending on the regulatory agenda.

OUR RESEARCH ACTIVITIES AND PUBLICATIONS

Eurofi conducts extensive research on the main topics on the European and global regulatory agenda, recent macro-economic and monetary developments affecting the financial sector and significant industry trends (digitalisation, sustainable finance...). Three main documents are published every 6 months on the occasion of the annual events, as well as a number of research notes on key topics such as the post-Covid recovery, vulnerabilities in the financial sector, enhancements to the EU financial policy framework, sustainable finance, digitalisation trends and policies.... These documents are widely distributed in the market and to the public authorities and are also publicly available on our website www.eurofi.net :

- **Regulatory update:** background notes and policy papers on the latest developments in financial policy
- **Views Magazine:** over 190 contributions on current regulatory topics and trends from a wide and diversified group of European and international public and private sector representatives
- **Summary of discussions:** report providing a detailed and structured account of the different views expressed by public and private sector representatives during the sessions of each conference on on-going trends, regulatory initiatives underway and how to improve the functioning of the EU financial market.

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