

Transitions and challenges for European securities markets and their regulators

Keynote to ICMA Annual General Meeting and Conference – Stockholm

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Good afternoon Ladies and Gentlemen,

First, let me thank ICMA for inviting me to speak at its annual general meeting and conference today in Stockholm. I am delighted to address such a distinguished audience and, looking through the room, I am pleased to see that the interest in hearing the regulatory perspective seems to remain high.

European securities markets are currently undergoing an unprecedented transition linked to various factors, regulation only being one, that present challenges for both markets and regulators alike. I could speak for hours about the various transitions and challenges, but decided to concentrate – in light of the conference agenda and the key topics being discussed - on two important areas driving challenging transitions: sustainable finance and benchmarks. Thirdly, I will touch briefly on a couple of other key challenges that are occupying the EU securities markets, and us at ESMA, this year and beyond.

Sustainable Finance

Let me begin with sustainable finance, which is also at the top of the regulatory agenda. The transition to a low-carbon, more resource-efficient and sustainable economy can only be achieved by building a financial system that supports and finances sustainable growth.

Internationally, important steps have been taken with the 2016 Paris agreement on climate change and the United Nations 2030 Agenda for Sustainable Development. To achieve the ambitious targets for the EU, as agreed in Paris, which include a 40% cut in greenhouse gas emissions, Europe must fill an investment gap that the European Commission has estimated

at €180 billion per year. A transition to greener growth is about making an investment in our future – and €180 billion per year is a substantial investment indeed. To be able to achieve this we need to fundamentally review how the EU capital markets can support investment in sustainable growth.

To kick-start this tremendous transition, the Commission has initiated an ambitious ‘Action Plan on Financing Sustainable Growth’ for the Union, which you will all be well aware of. The plan intends to clarify fiduciary duties and to increase the transparency for both risks and investment opportunities related to sustainability. In May 2018, the Commission further detailed how this should be achieved. The package on sustainable finance included proposals, among other things, to establish:

1. a unified European classification system of sustainable economic activities – this will be a common “EU taxonomy” for sustainable products creating a common terminology for all actors in the financial system;
2. increased transparency on how institutional investors integrate environmental, social and governance (ESG) factors in their processes; and
3. the creation of a new category of benchmarks which will help investors compare the carbon footprint of their investments.

In addition, the Commission had asked ESMA for technical advice on integrating sustainability risks and factors in MiFID II and in the UCITS and AIFMD Directives. Following a public consultation, ESMA submitted its advice for amendments to the relevant rules applying to investment firms and investment funds on 30 April.

Let me give you a brief insight into what that advice contains.

Starting with investment funds, ESMA recommends changes to the UCITS and AIFMD Level 2 legislation with respect to organisational requirements, operating conditions, and risk management.

For example, on organisational requirements, ESMA recommends amending relevant requirements to ask all UCITS management companies and AIFMs to:

- consider sustainability risks in their internal processes, systems and controls;
- devote sufficient resources to the integration of sustainability risks; and
- ensure that senior management is responsible for the integration of sustainability risks.

In relation to operating conditions, we recommend that fund managers consider sustainability risks in their due diligence processes. In addition to due diligence requirements, ESMA also recommends that fund managers consider conflicts of interests that may arise in relation to the integration of sustainability risks.

Finally, regarding risk management, we propose to include sustainability risks in the list of material risks to be managed by UCITS Management Companies and AIFMs.

Turning to investment firms, ESMA's technical advice on MiFID II covers investment firms' general organisational requirements, risk management, and conflicts of interest policies. It also covers product governance. ESMA is, in addition, also working on updating its guidelines on product governance and suitability assessments.

As you may be aware, in March this year European co-legislators also agreed to a Regulation on ESG Disclosures. This Regulation sets out ESG disclosure requirements for a broad range of financial market participants (including UCITS management companies, AIFMs and MiFID investment firms) and financial products. The aim of this Regulation is to strengthen improve disclosures to end-investors.

Under the Disclosure Regulation, EBA, EIOPA and ESMA are asked to deliver a number of joint Technical Standards, relating to:

- Public disclosure of so-called "principal adverse impacts" of investment decisions on sustainability factors, such as environmental and social matters (this will apply to market participants on a comply or explain basis, except for companies with more than 500 employees for which the obligation is mandatory);
- product specific disclosure (at a pre-contractual, public and periodic reporting level), showing how products fulfil environmental or social characteristics or meet sustainable investment objectives; and
- how to market sustainable investments.

The ESAs will coordinate work with the other ESAs to produce the requested draft technical standards. The timeline is quite tight as the vast majority of them must be delivered within 12 months of entry into force of the Regulation, which is expected during or just after the summer.

Coming back to the theme of my speech today, as you can see, there are big transitions and substantial challenges ahead in the area of sustainability. However, I strongly believe all these

different aspects ultimately will drive greater transparency to, and assistance and clarity for, the end-investors on how to invest in a way that supports sustainability. It will be down to all of us, market participants and regulators, to ensure that we help the EU capital markets to meet the sustainable finance challenge and grasp the opportunities this transition presents.

Benchmarks

Let me now move on to benchmarks. I will first talk about low-carbon benchmarks (following on from my comments just now on sustainability) and then speak more generally about the transition to new benchmarks.

Benchmarks play an important role in guiding investors, pricing investment products and in directing investment flows. The creation of new benchmarks that consider the carbon footprint of underlying assets will certainly help to reassure investors looking to invest into sustainable finance products. As mentioned earlier, under the Commission's Action Plan on Financing Sustainable Growth, an important agreement was reached by EU co-legislators on low-carbon benchmarks in February. The agreement creates two new categories, or labels, of low-carbon benchmarks:

- **the EU climate transition benchmark** which brings the resulting benchmark portfolio on a decarbonisation trajectory; and
- **the EU Paris-aligned benchmark** which brings the resulting benchmark portfolio's carbon emissions in line with the Paris Climate Agreement goal to limit the global temperature rise to 1.5C° compared to pre-industrial levels.

For these two new benchmarks, the Commission has mandated an industry-led expert group to define certain requirements such as the methodology, weighting method of the underlying assets, and the criteria for the choice of the underlying assets. In addition, each benchmark will have to provide an explanation of how the methodology reflects ESG factors. This will facilitate investors' choices, limit greenwashing as well as hopefully assist in the proliferation of these new, green benchmarks.

However, following the agreement of the Low Carbon Benchmarks legislative package, the ESG disclosure will not be limited to these two new benchmarks. All benchmarks, within their benchmark statement, should disclose whether they pursue ESG objectives. As such, as of 31 December 2021, all benchmarks except for interest rate and currency benchmarks should include information on their degree of alignment with the Paris Agreement.

A wide variety of indices is currently grouped together as low-carbon indices. Those low carbon indices are used as underlying benchmarks for investment portfolios and products that are sold across borders. Many low carbon indices are also used as performance measures for investment portfolios with a carbon emissions related-strategy. In addition, portfolio and asset managers often hedge their carbon exposure risks by using benchmarks. There are already quite a few low-carbon benchmarks around, however, divergent approaches to benchmark methodologies currently result in fragmentation. Introducing a clear distinction between EU Climate Transition and EU Paris-aligned Benchmarks and developing minimum standards for each of them, will contribute to more consistency. In addition, having a common EU framework for these low carbon indices will allow asset managers and other users, when looking at benchmarks produced in other Member States, to be sure that these benchmarks use the same standards and approaches.

Let me now move on to benchmarks more broadly. The ESG angle aside, as I mentioned earlier benchmarks play an extremely important role in financial markets. Following the manipulation of important benchmarks in the past, the EU's Benchmark Regulation (BMR) therefore regulates indices used as benchmarks in financial instruments and financial contracts, as well as indices measuring the performance of investment funds. The Benchmarks Regulation has four aims:

- Improving governance and controls over the benchmark process, to ensure that administrators avoid conflicts of interest, or at least manage them adequately;
- Improving the quality of input data and methodologies used by benchmark administrators;
- Ensuring that contributors to benchmarks and the data they provide are subject to adequate controls, to avoid conflicts of interest; and
- Protecting consumers and investors through greater transparency and adequate rights of redress.

In order to achieve these objectives, all benchmarks used in the EU and their administrators are by the end of 2020, at the latest, required to fully comply with the BMR. However, as part of the political agreement on low carbon benchmarks, a longer transitional period of an additional two years has been granted for benchmarks provided outside the Union and for those benchmarks classified as critical in the EU.

This decision on extending the transitional period for critical benchmarks is important as a discontinuation of such a benchmark could impact market integrity, financial stability, consumers, the real economy and/or the financing of households and businesses in Member States. The transitional period introduced will ensure the availability of BMR compliant critical benchmarks by the end of the new transition period and anticipate any potential delay in implementation.

The most important euro-denominated interest rate benchmarks are EONIA and EURIBOR. Both EONIA and EURIBOR are classified as critical benchmarks as they are widely used in both cash and derivative products, representing underlying gross notional volumes exceeding €150 trillion. EONIA is widely used in derivatives, with maturity dates that can go beyond 30 years, and (to a lesser extent) also in cash products and instruments. However, EONIA in its current form will not become BMR compliant, given the lack of underlying transactions and high concentration of volumes by only a few contributors. Therefore, unless its methodology is improved, EONIA can no longer be used in new contracts as of the new end of the transition period, i.e. as of 1 January 2022.

EURIBOR in contrast could become BMR compliant by moving to the EURIBOR hybrid methodology. This new methodology would strengthen EURIBOR by bringing in transaction data and is currently under implementation, with a plan to finalise it in the second half of 2019. Moreover, the administrator of EURIBOR has applied for authorisation from the Belgian Financial Services and Markets Authority in May 2019.

An industry-led working group, with the task to identify and recommend alternative euro risk-free rates, is currently looking into alternatives for both EONIA and EURIBOR. This group is also tasked to work on a market adoption plan, to ensure a smooth transition to these alternative euro risk-free rates by all market participants. Over the last year, during the preparation phase, this working group on euro risk-free rates has worked hard on finding and ultimately recommending the replacement of EONIA with €STR. €STR, the new euro-short-term rate, will be published by the ECB starting this October. The group is also working on the transition path to move from EONIA to €STR, and on an €STR-based term structure that could function as a robust and resilient fall-back to EURIBOR.

The next phase for the working group is to ensure that these recommendations will be adopted by all market participants. Here the group is looking into mainly legal, financial accounting and risk management implications and how to remove potential barriers to adoption.

ESMA is directly involved in the working group on euro risk-free rates and cooperates closely with the ECB and the Commission, as well as the FSMA (the Belgian Regulator currently responsible for the supervision of EONIA and €STR as well as EURIBOR). I should note here, that in a few years time, ESMA itself will become the direct supervisor of critical benchmarks (as well as third country benchmarks) in the European Union and thus we will play an even more central role on this topic. Critical benchmarks and their transition into BMR compliance are a challenge for all of you as users of these essential providers, as well as for us on the regulatory and supervisory side.

Regulatory priorities 2019

Let me now finally move on my last topic of today. As promised earlier I wanted to use the opportunity of this speech to touch briefly on a couple of other key challenges that are occupying the EU securities markets, and us at ESMA, this year.

Brexit

The first topic on this list, not surprisingly, is Brexit. It is difficult these days not to talk about the UK leaving the EU, in one way or another. However, I do not want to comment on the political process but rather focus on practical issues we need to address to guarantee an orderly exit in terms of the financial markets. It is important to be well prepared when the biggest capital market leaves the EU's single market. Given London's many and close interlinkages to EU financial markets, which will continue to exist after Brexit, the UK will not just become a "normal" third country.

A lot of preparations have been done and are ongoing, on both sides of the Channel and by both private and public sector. As ESMA we have early on identified risks to our supervisory convergence objectives, particularly in the context of UK firms moving to create new entities within the EU27. In the summer of 2017, ESMA clarified what is expected from different market players, including asset managers, trading venues, and investment firms, in terms of for example substance and governance arrangements when setting up in the EU27. To ensure a true and fair level playing field across the EU, we decided that further supervisory convergence work was required, and therefore set up a Supervisory Coordination Network. This is a forum that allows senior authorisation and supervision experts from the national competent authorities to discuss cases that they are managing involving UK entities looking for authorisation in the EU27.



We are aware of the uncertainty which Brexit brings to the market. There are immediate consequences in case of a 'no-deal' Brexit scenario. ESMA has put a lot of effort into preparing for this scenario.

One key consequence that worried many parts of the market was the fact that delegation of investment and risk management activities to UK entities would not be permitted, unless there are cooperation agreements between the EU27 NCAs and the FCA in place. This is why we recently announced that ESMA and European securities regulators have agreed MoUs with the UK FCA. These MoUs would only take effect in the event of a no-deal Brexit scenario. The MoUs we put in place are essential so that regulators may exchange supervisory information and can guarantee investor protection, orderly markets, and stability. Given the potential significant impact on the current business models of the industry should there be no transitional arrangements in place, the MoUs have been an absolute priority for us.

Another key area of concern was the access of EU counterparties to UK post-trade infrastructure in the case of a 'no-deal' Brexit. Here ESMA also took action, in close alignment with the Commission, which issued temporary equivalence decisions, to ensure that UK CCPs and the UK CSD could be recognised and that the necessary MoUs with the Bank of England are in place. Even with these key issues having been tackled, I would like to remind everybody that sound contingency planning needs to remain high on your and our agendas. Given the significant levels of uncertainty remaining around the exact shape, timing and impact of Brexit, it is important to remain diligent to best manage the transition to a post-Brexit environment. Coming back to my theme of transitions and challenges, I am sure you agree that the topic of Brexit will continue to pre-occupy and impact on us for years to come.

MiFID II and Data

The second subject which you can hardly escape these days when speaking about Europe's securities markets is MiFID II. Even if MiFID II has been in place for nearly 1½ years now, it is only gradually that we can judge its impact on the markets. Overall, regulators and ESMA saw a smoother than expected transition to the new regime. On the markets side, the reporting – following a period of teething problems – for equity and many non-equity instruments is now functioning reasonably well, with an unprecedented amount of data being available to regulators and the public.

I believe this shows, together with the post-trading data on derivatives, data on investment funds and soon to come also on securities financing transactions, that we are starting to harvest the first fruits of this new data, together with other regulators and authorities at EU and national level, for our risk monitoring and market abuse analysis. ESMA has conducted its first analysis on the fund industry and the derivatives markets based on this data which, a decade ago before the crisis, was purely not available. However, we are also conscious that all this reporting has placed a heavy burden on you in the industry. It will be important to ensure that we build on the lessons learned from the implementation of the various reporting regimes and aim to find synergies and common standards that make reporting regimes smoother. We also need to continue our efforts on data standardisation – where we can at a global level - to drive forward data completeness and quality for the benefit of all data users.

The whole topic of MiFID II and MiFID data is another area where we are still in a transition period which places many challenges on all of us, but it also offers opportunities to further increase transparency and achieve better results in terms of investor protection across the Union.

Conclusion

To conclude, today I have focused on the transition and challenges for European securities markets stemming from sustainable finance and benchmarks, but also from Brexit and MiFID II. I have emphasised the importance of markets adapting to the challenges that these changing circumstances present. Hopefully we can also seize these transitions and changes as opportunities to further strengthen the European capital market. Looking at the next panel discussion which will focus on 10 years after the financial crisis, let me end by saying that I am pleased to see the tremendous transition EU financial markets have already accomplished and that I'm looking forward to experiencing the next chapter.

Thank you for your attention and thanks again to ICMA for inviting me to speak here today.