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Solvency 2 News, May 2022

Dear members and friends,

On 27 July 2021, EIOPA received a request from the European Commission, as part of its Retail Investment Strategy, to provide technical advice on a number of specific areas in the field of retail investor protection such as enhancing consumer disclosures, tackling damaging conflicts of interest in the sales process and assessing the impact of product complexity in the retail investment market.

EIOPA was given until 30 April 2022 to provide its advice to the Commission. Given this short timeframe, EIOPA was not able to carry out the level of detailed work and impact assessment it would have preferred to do, but nevertheless sought to gather evidence and consult as widely as possible.

For example, EIOPA ran an informal evidence-gathering exercise with its Insurance and Reinsurance Stakeholder Group (IRSG) in August / September 2021, then a public consultation on its draft advice from 27

January to 25 February 2022 (for which it received responses from 37 stakeholders) and held a public hearing on 18 February 2022.

EIOPA appreciates the input provided by stakeholders within an unusually short timeframe, which helped EIOPA to shape its policy recommendations further.

EIOPA would like to stress that the following high-level goals/objectives have been a strong basis for it developing this technical advice:

- Seeking to increase retail participation in capital markets;

- At the same time, creating a safe environment for consumers that enables them to make the right choices, and ensure products are suited for the proposed target market;

- Promoting further the principle that IBIPs should offer "value for money";

- Aiming for a regulatory framework that will enable a risk-based approach to conduct of business supervision.

The following is a summary of EIOPA's advice on the following five areas covered in the Call for Advice. EIOPA would like to emphasise that, in developing its technical advice, it has sought at all stages to ensure close co-ordination with ESMA and the Joint Committee, given that separate Calls for Advice were sent to ESMA on MiFID II and to the Joint Committee of the ESA on the review of the PRIIPs Regulation.

Addressing and enhancing investor engagement with disclosures and Drawing out the benefits of digital disclosures

EIOPA recommends that existing duplications between Solvency II and PRIIPs KID disclosure requirements could be addressed by disapplying non-personalised Solvency II pre-contractual disclosures.

The personalised disclosures from Solvency II, as well as the generic disclosures from Solvency II that are not included in the PRIIPs KID, should be transferred to the IDD. However, the transfer of specific disclosure requirements to the IDD, should also ensure a clear separation of responsibilities in terms of disclosures between the product manufacturer and distributor.

To enhance existing periodic disclosures at EU level with regard to IBIPs, EIOPA recommends the idea of developing an "annual statement" in the

IDD which could include information, for example, on paid premiums, past performance and current value of the savings.

This “annual statement” should be based on a simple list of high-level topics at Level 1, which would be supplemented by more detail, including consumer testing and impact assessment, at Level 2.

Although EIOPA also proposes to include adjusted individualised projections in this list of high-level topics as their inclusion is important from an investor protection perspective, further assessment would be needed as to the feasibility of such projections for different types of IBIPs, as well as the methodology to be used.

EIOPA sees the need for a shift towards truly consumer-focused disclosures, built upon an enhanced supervisory framework, that fits the digital age:

- The starting point when designing consumer disclosures should be behavioural research and enabling sufficient time and resources for consumer testing;

- Consumer information needs to be radically simpler to achieve the objective of allowing consumers to make sensible decisions. It should be understandable, but crucially shorter and visual in order to be engaging, also to a non-financially literate audience; and

- Future disclosures need to be designed as a comprehensive solution from the perspective of the consumer, replacing existing documents and not simply being added on top of the existing disclosure documents.

EIOPA notes that a number of provisions in the IDD relating specifically to the distribution of IBIPs are already subject to disclosures in the format of a “durable medium”.

Notwithstanding this, although EIOPA can see some benefits in inverting the current approach in the IDD regarding the format of disclosures completely from a “paper by default” to a "digital by default" approach to take account of the ongoing digital transformation, it would be important that the IDD keeps the option for consumers to ask for information both pre-contractually or periodically, on paper or in a printable format if they wish, considering that some segments of the population may still prefer to receive the information on paper.

With increasing digitalisation, EIOPA considers it important that national competent authorities have the ability to anticipate misleading and aggressive marketing communications in relation to the sale of IBIPs in the future.

EIOPA, therefore, recommends including in the new legislative framework, a provision that national competent authorities have the power to take timely and effective action against misleading marketing practices.

Assessing the risks and opportunities presented by new digital tools & channels

At present, the market for digital tools and platforms selling IBIPs is limited to specific national markets, but EIOPA sees scope for a market for digital platforms selling IBIPs and for open insurance to develop further in the future in EU Member States, but only under the appropriate regulatory framework & conditions.

Certain risks to consumers will need to be borne in mind, should such a market further develop, such as the risks of insufficient consumer disclosures, information asymmetry and misuse of client data.

In order to make the legal framework future-proof, the Commission should address the impact the “choice architecture” or “choice environment” has on consumer decision making and ensure that firms use behavioural finance insights in the best interests of the customer.

Tackling damaging conflicts of interest in the sales process

EIOPA would like to emphasise the heterogeneous nature of the insurance distribution market in Europe and that this heterogeneity can present challenges in ensuring that any harmonised approaches apply evenly across all national markets and consumers are treated in a consistent manner across different markets.

EIOPA also notes that the commission-based distribution model is currently the prevalent distribution model in the majority of national markets.

In analysing the impact of differences in the regulation of the payment/receipt of inducements between MiFID II and the IDD, EIOPA has noted that there are some important differences particularly at the level of disclosure of inducements and stronger language restricting the payment / receipt of inducements in MiFID II as compared to IDD, where there could be benefits in aligning legislation.

Nevertheless, national authorities also noted the practicalities of applying different concepts in national supervision and the fact that there is little evidence of material differences in terms of supervisory outcomes.

EIOPA sees, from its own consumer trends and oversight work, the need for more to be done to tackle damaging conflicts of interest arising throughout the product lifecycle of an insurance-based investment product, to address the risk of inducements leading to product bias and materially impacting the cost-efficiency and "value for money" of IBIPs.

EIOPA has set out the pros and cons of a number of different policy options to more strictly regulating the payment/receipt of inducements.

Although, based on its recent consumer trends and conduct oversight work, EIOPA does consider improvements to the existing rules on inducements under the IDD to be necessary, EIOPA sees no single all-encompassing solution in this area as it has identified pros and cons with all options, and varying market impacts. A combination of different options could also bring specific benefits.

To read more:
https://www.eiopa.europa.eu/sites/default/files/publications/advice/final_report_-_technical_advice_on_retail_investor_protection.pdf

https://www.eiopa.europa.eu/sites/default/files/publications/advice/annexes_-_technical_advice_on_retail_investor_protection.pdf

Joint ESA Supervisory Statement on expectations regarding the 'What is this product?' section of the key information document for packaged retail and insurance based investment products

2. CONTEXT AND OBJECTIVE

2.1. The objective of this Supervisory Statement is to achieve a high, effective and consistent level of regulation and national supervision promoting a level playing field and the protection of retail investors.

2.2. The 'What is this product?' section is the first descriptive section of the KID and is an essential part of the document to enable retail investors to understand the key features of the product.

It is also a largely "free text" section within the KID template, where it is the responsibility of the PRIIP manufacturer to use appropriate text or language and there are not pre-defined narrative explanations.

2.3. The answer to the question 'What is this product?' must be provided according to five elements:

- the type of the PRIIP ('Type');
- its objectives and the means for achieving them, including by means of direct or indirect exposure to the underlying assets ('Objectives');
- the description of the type of retail investor to whom the PRIIP is intended to be marketed ('Intended retail investor');
- where applicable, details of the insurance benefits; and
- the term of the PRIIP ('Term').

2.4. Taking into account different approaches taken by certain PRIIP manufacturers to describe the main features of the product, including approaches which are considered to go against the aims of the KID to provide retail investors with information that is accurate, fair, clear and not misleading, the ESAs consider it important to clarify their expectations regarding the 'What is this product?' section of the KID.

2.5. In particular, as highlighted in recitals 13 and 14 of the PRIIPs Regulation, given difficulties many retail investors have in understanding specialist financial terminology, particular attention should be paid to the vocabulary and style of writing used in the document.

It is, therefore, necessary to ensure that clear and understandable language is used, which is accessible to retail investors and that the description of how the investment objectives are achieved, including the description of the financial instruments used, avoids financial jargon and terminology which is not clear to retail investors.

The ESAs' supervisory experience since the implementation of the KID has shown that these standards relating to the use of clear and understandable language, are often not adhered to by PRIIPs manufacturers.

2.6. This Supervisory Statement applies to all types of PRIIPs. However, a number of the issues identified so far during the supervision of the KID concern product features that are not relevant to all types of PRIIPs, and in particular are only relevant for certain types of structured products or derivatives.

These features include, for example, autocallability, the possibility for early termination, and the payment of coupons or leverage. Products with these features are usually offered directly, but in some jurisdictions might also be offered as underlying investment options in a PRIIP offering a range of options for investment.

In this context, in most cases, the issues are only applicable to the specific information on relevant underlying investment options, rather than the generic key information document.

2.7. At this stage, the ESAs have considered those elements of the 'What is this product?' section that apply to all types of PRIIPs, including the 'Type', 'Objectives' and 'Intended retail investor' and 'Term'.

This does not mean that there are not issues relating to current practices for the part of this section on the insurance benefits, or indeed regarding other "free text" sections of the KID.

The ESAs may, in a next step, set out their views and expectations regarding these other parts of the KID.

2.8. For each of the issues identified, a description is provided of some of the current practices observed, with reference to specific examples drawn from KIDsthat are included in an Annex, followed by the ESAs expectations regarding how to improve the clarity and comparability of KIDs.

To read more: https://www.eiopa.europa.eu/document-library/supervisory-statement/joint-esa-supervisory-statement-expectations-regarding-what_en

The impact of digitalisation on the financial system

Burkhard Balz, Member of the Executive Board of the Deutsche Bundesbank, speech delivered at the FGV-Ebape in Rio de Janeiro

1 Introduction

Ladies and gentlemen, FGV students and faculty members, Professor Norden,

Thank you very much for inviting me here today. It is a great pleasure for me to be at the FGV-Ebape in Rio de Janeiro. Given the restrictions imposed by the coronavirus pandemic over the last two years, I do not take this opportunity for granted and am very thankful for the chance to exchange views with you today.

One thing is for sure; you can`t go to Brazil and not go to Rio de Janeiro. When you think about Brazil, it is Rio that first comes to mind. Rio is one of the most sought-after destinations in Brazil and has more citizens than some European countries in total.

However, Rio de Janeiro is not just known for its carnival and sunny beaches, but also for its unique fintech climate and its role as an economic powerhouse. The city of Rio de Janeiro is home to the headquarters of many private, national, multinational, and state corporations. Needless to say, the rise of digitalisation in society and business will also affect the future of this city.

I am not only delighted to be in Rio de Janeiro, but, more importantly, to be able to discuss the impact of digitalisation on the financial system with you here at the FGV-Ebape today. Digitalisation is picking up speed.

This affects universities, as well as you as students. Not just as consumers, but also as future employees and managers in business, digitalisation will accompany you throughout your lives. Digitalisation is pertinent to the entire financial sector.

As my colleague Roberto Campos Neto, President of the Banco Central do Brasil, once so aptly put it: “There can be no more difference between a large bank or a fintech. All financial institutions must be digital.”

Digitalisation is also very evident in payments: it fundamentally changes the way we pay. This brings me straight to the subject of my speech. As the Deutsche Bundesbank Executive Board member responsible for the area of payments, I have been monitoring changes in this sector since September 2018.

It is clear to me that the pick-up in the pace of digitalisation is caused by demand as well as supply factors. So I'll begin my remarks by discussing changes in user and payment behaviour. Afterwards, I'll address the challenge posed by new players in the payments space.

I would then like to outline my thoughts on how we should react to the new challenges. These thoughts can be summarised under one key heading: updating existing payment systems, for example via instant payments, and also central bank digital currency (CBDC). In the context of the latter, I will also give a brief overview of the ongoing project on a digital euro.

2 Challenge 1: Changes in user and payment behaviours

When it comes to payment habits, cash remains the number one means of payment at the point of sale in Germany. The general public still delve into their wallets for coins and notes to settle around 60% of payments when they're out shopping.

That is one of the key findings from the payment behaviour study which the Bundesbank conducts regularly, most recently in 2020. As a means of payment in the German retail sector, cash still has a high standing.

However, it is losing significance – the share of cash was 74% in the preceding study from 2017, thus decreasing by an impressive 14 percentage points within only three years. Certainly, the coronavirus pandemic gave non-cash payments an extra boost here.

In my view, Brazil and Germany are not that different from each other in this respect – in Brazil, too, cash still is the preferred means of payment for many people, but non-cash payments are experiencing strong growth, helped along by the coronavirus pandemic: to my knowledge, between 2019 and 2020, cash use at the point-of-sale fell by almost 25% in Brazil.

However, the Brazilian market differs from that of Germany in one major aspect: while there are more than 110 million bank accounts in Germany (for 83 million inhabitants), a significant proportion of the Brazilian population has no access to banking services in a traditional sense. Digital technologies could therefore present an opportunity to further bridge the financial inclusion gap.

We can observe this evolution here in Brazil already, as the pandemic produced strong growth in the number of digital bank accounts and significantly increased the access of citizens to banking services.

At this juncture, I would like to praise the Brazilian central bank for being an active driver of developments in the booming fintech market and for fostering competition and innovation in the banking sector. The most prominent example might be the new – and already very successful – instant payment system Pix.

The central bank's efforts have resulted in a considerable increase in competition – according to one study, more than 100 Brazilian fintech companies are now active in the field of payments.

This means that usage patterns are evolving. Digital financial and payment services are gaining ground. Just a year and a half after Pix was launched, more than half of the Brazilian population have already used it, underlining just how quickly the adoption of digital payments can spread.

The situation is changing in Germany, too, where contactless payments based on NFC technology are particularly popular. For instance, at the end of 2021, three out of four (73%) payments of the debit card[6] common in Germany were contactless.

In Germany, there are more than 100 million cards in circulation. The system is operated by the German banking sector and is independent of international credit card companies like Visa and Mastercard.

In Germany, more and more customers are reaching for their smartphone instead of cash or card when paying for goods. Here, mobile payments are gaining more momentum by the day.

Something similar is happening in Brazil. The average citizen here owns 1.6 smartphones and payments with digital and mobile wallet are growing. Brazil's instant payment system Pix contributes to this, offering various overlaying services including QR code and NFC payments.

In Germany, savings banks and cooperative banks also run a successful peer-to-peer (P2P) mobile payment service. Thus, in Germany, the topic of smartphone payments is being pushed by both bigtech firms and banks.

3 Challenge 2: New actors in the payments markets

This brings us to an important driver of digitalisation in the financial industry in both Brazil and Germany: New players, namely fintech and bigtech firms.

Fintech players – that is, fledgling start-ups offering innovative technology-enabled financial services – also feel very much at home in the payments market. These newcomers are starting out on greenfield sites and are able to build their systems from the ground up in a way that lets them leverage the opportunities offered by the platform economy and digitalisation. One example of this is smartphone banks such as Revolut in the United Kingdom or N26 in Germany and also here in Brazil.

A key element of the new digital banking world are the much-discussed application programming interfaces – APIs. So-called open interfaces that allow for the seamless interlinking of different services – like bank account management and payments. Many fintech firms are basing their business models on these interfaces.

And yet even the traditional banking industry in Europe recognises the importance and urgency of refining its own business model in times of open banking and open interfaces.

More and more credit institutions are therefore deliberately positioning themselves as platform providers. The idea is to create one's own API ecosystem which allows bridges to service providers across Europe to easily be built. This development is also covered and supported by European law and a corresponding legal framework – most prominently the revised Payment Services Directive (PSD2).

In Brazil, too, new players are stirring up the financial industry. Nubank, for example, reminds me of Germany's N26 since it also focuses on smartphone banking: account and payment services as well as all communications take place via the customer's mobile device.

After being publicly listed at the New York Stock Exchange, Nubank is one of the largest and most valuable digital banks worldwide. Interestingly, Nubank also runs an office in Berlin so as to benefit from the German IT developer scene.

From Germany, I can report that fintech firms definitely have a big impact, because we are seeing more and more cooperative ventures between credit institutions and fintech players. These allow the former – the banks – to provide their customers with convenient, innovative services within a short space of time.

The latter – the fintech businesses – get to tap into a large customer base and benefit from the confidence shown in them and from regulatory expertise, amongst other things. Between them, fintech players and traditional banks are often forming quite a symbiosis.

By contrast, bigtech players are transforming the European financial sector and particularly the world of payments far more radically than the up-and-coming fintech firms ever could. Bigtech firms are the heavyweight global tech businesses and platforms such as Apple, Amazon, Google and Meta, formerly known as Facebook from the United States, Alibaba and Tencent from China or MercadoLibre in Latin America.

Bigtech players can leverage a large, existing customer base, technological expertise and sizeable financial resources to conquer new markets. For instance, the dominant force in e-commerce in Germany has, for a long time now, been the US group Amazon – which also offers a payment service of its own. Google Pay and Apple Pay are two other bigtech players that offer their payment services in a wide range of countries, including, of course, Germany and Brazil.

China offers a very vivid example of how far bigtech services can penetrate people's day-to-day lives: there, WeChat and Alipay, which is affiliated with the e-commerce giant Alibaba, can be used not only as a payment method, but also to directly order food, buy cinema tickets or call taxis – all services united on a single platform.

This development is, however, not without its problems from the point of view of the consumer, nor from the perspective of regulators and established banks.

If bigtech firms expand into an increasing number of business areas, there is a risk that monopolies will be formed. Moreover, if the data generated are analysed and consumers are offered matching products and services, they will lose sight of the alternatives. In the marketplace of the internet economy, the winner usually takes it all.

From the consumer's perspective, we should remind ourselves of the business logic of many bigtech firms: many of the services they offer – such as payments – might be provided as a way of obtaining data, the key raw material for their business model. Hence, many services are only ostensibly free for consumers, since they are paying for them with their personal data – and an increasing dependency on the services offered by one big commercial supplier.

For established banks, meanwhile, there is the danger of losing the battle for the customer in payments, which would leave the banks merely as interchangeable settlement agents in the background.

For now, the bigtech firms still rely on cooperation with banks for the settlement of payments in Europe. There, a payment made using Apple Pay or Google Pay is mostly settled via the credit card stored in the account, which is issued by a bank. The next step could be to create closed payment systems that no longer are based on established payment instruments. The most prominent example of such a concept was probably the Diem initiative (formerly known as Libra) launched by Facebook – or nowadays Meta, to be precise.

Diem was intended to be a “stablecoin”. These often peg their value to an existing currency or a currency basket. Furthermore, their value is backed by suitable collateral. However, Meta will not pursue this project – at least not in this form and as things stand today.

Nevertheless, the idea of bigtech stablecoins remains relevant. Meta recently launched a pilot project with Paxos to enable payments with stablecoins in its dedicated Novi app in the context of remittances. For the purpose of money transfers between the United States and Guatemala, various design options are to be tested on a small scale.

PayPal is also planning to issue its own stablecoin. Thus, discussions on the handling and regulation of these new means of payment will continue. In this context Europe is currently being working at full speed, by creating the Markets in Crypto Assets Regulation – MiCA.

With MiCA, the European Union would create a single European regulatory framework for crypto assets. This would be an important contribution to the stability of the markets for crypto assets in particular, but also of the financial markets in Europe in general.

4 Possible answers and conclusions

How should we be responding to the challenges posed by digitalisation in payments?

Despite having lost momentum, initiatives like Diem reveal that there is room for improvement in payments, and that this also applies to cross-border payments, or, in short, global payments. With this in mind, I would like to take a closer look at two key concepts: updating existing payment systems, for example via instant payments and also central bank digital currency (CBDC).

4.1 Updating existing payment systems / Instant payments

I believe that it is vital to think about how we can further develop our traditional payment systems in order to correct deficits in global payments and master new requirements.

European law stipulates that transfers must be credited to the recipient's account within one working day. However, if we think about the availability of information, communications and media content, then "real time" is now already the norm. Against this backdrop, central banks in the euro area launched TARGET Instant Payment Settlement system – or TIPS for short – at the end of 2018.

TIPS is able to ensure the availability of almost all institutions active in payments throughout Europe. The goal must be for instant payments to become the new normal in the long term. We are still a fair number of steps away from reaching that point in Europe. Therefore, the European Commission is evaluating potential regulatory interventions to push the market further in that direction.

Here in Brazil, the Banco Central do Brasil is further improving real-time payments. With the BCB's instant payments system Pix, which is available around the clock, instant payments in Brazil are becoming more attractive and are already in broad use nationwide. Brazil can surely be counted among the pioneers of instant payments in Latin America.

In my view, instant payments can also help to improve the deficits in traditional payment systems that have been made increasingly clear by offerings from bigtech companies. In order to achieve this, real-time processing has to be combined with attractive and customer-friendly products for end users.

If we look at global payments systems, the most important aspect is to make transactions faster, cheaper and more transparent. There are already plenty of initiatives, such as SWIFT's global payment initiative. However, it is also crucial to better link traditional interbank payment systems, especially in industrialised countries, with the smartphone-based payment systems in emerging economies.

An interesting approach could be, for example, the linkage and interoperability of different instant payment systems. Given that new and innovative instant payment systems are already being set up in many parts of the world, we should think about linking them up or using them for cross-border payments.

4.2 Central bank digitial currencies (CBDC) and the digital euro

In the last couple of years, there have been increased calls for central bank digital currency, or CBDC. This means that CBDC is currently one of the hottest topics in the world of central banking. A stocktaking by the Bank of International Settlements (BIS) in mid-2021 counted at least 56 initiatives on CBDC around the globe. More than ten have either completed the initial pilot phases or, like Sweden's for example, are in the midst of doing so.

More initiatives are constantly being added, and existing ones continue to mature into fully fledged concepts or pilots. One example would certainly be the Chinese central bank – the People's Bank of China – which has already decided to introduce a digital alternative to cash. Or the Bahamas, where the Sand Dollar was launched in October 2020.

With digitalisation changing our payment habits and the accelerating decline of cash usage, it is possible that banknotes could lose their role as reference value, undermining the integrity of the monetary system. In this new age, CBDCs would ensure that citizens have free access to a simple, universally accepted, secure and reliable means of payment.

The central bank would issue it and, depending on the actual design, private individuals as well as retailers and other companies could pay with it. Speaking for the euro area, it would under no circumstances replace cash, but rather supplement it.

A CBDC would expand the existing choice of payment methods. It could contribute to financial inclusion and ensure that less digitally savvy groups of the population also have access to digital payments. In addition, depending on the design choices, it could offer the opportunity to exploit technical innovations like DLT and thus enable, for example, payments embedded into programmable applications.

In Europe, when it comes to CBDC we aim to be "ahead of the curve" as ECB president Christine Lagarde put it, while, at the same time, taking the utmost care to evaluate the design options for a digital euro. Its development is a balancing act between two key risks.

The first risk is that being too ambitious could lead to a crowding out of private payment solutions and a potential disintermediation of the banking sector. The second is the risk of creating an unattractive product that would not be accepted by consumers and enterprises.

In October 2021, the ECB launched what it refers to as the investigation phase of the project. This is designed to ensure that the Eurosystem stands ready to offer a functioning digital euro, should the decision be made to introduce it. Until then, we will carefully investigate the risks, the functional and technical design options, monetary policy independencies as well as financial stability implications.

Last but not least, we are holding lively discussions with all relevant stakeholders to identify key features that would add value for the potential users of a digital euro. The primary goal is to maintain the accessibility of central bank money in a digitalised economy. To fulfil this function, the digital euro must be accepted throughout the European Union and adopted by its citizens.

We are therefore fostering a dialogue with European businesses and citizens. The EBC recently published the findings of the responses by focus groups. These give us additional insights on the payment needs of consumers and merchants and specific use cases of a potential digital euro. Most importantly, participants in the focus groups preferred payment methods with pan-European reach, speed, high convenience and universal acceptance in physical shops and online.

In addition, privacy protection is of high importance. Participants also valued the possibility of instant and contactless person-to-person payments. Here, Brazil's instant payment system Pix can serve as an example, showing that consumers have a demand for such services and quickly adopt them.

As you can see, there is a great deal to do and central banks, governments and other public institutions play a major role here, because the past has shown that without their input no major and sustainable improvements can be achieved.

Let me draw to a close here. Payments and payment systems, although often remaining unnoticed, inevitably affect everyone. They will always be driven by innovation and despite huge geographical distance, we face similar challenges when it comes to digitalisation in the financial sector. Ultimately, the same holds true for both Brazil and Germany: a digital economy needs efficient, quick and competitive digital payment methods.

Thank you for your attention.

To read more: https://www.bundesbank.de/en/press/speeches/the-impact-of-digitalisation-on-the-financial-system-889922

Joint Committee, Annual Report 2021

In 2021, the Joint Committee under the chairmanship of the ESMA, continued to have a central role for the coordination and exchange of information between the European Supervisory Authorities (ESAs), the European Commission (EC) and the European Systemic Risk Board (ESRB).

The main areas of cross-sectoral focus continued to be joint risk assessment, enhancement of consumer protection, development of the regulatory and supervisory frameworks for sustainable finance and securitisation as well as monitoring and contributing to the development in digital finance, supporting scale up of FinTech through innovation hubs and sandboxes and cyber security.

Joint risk assessment

The Joint Committee issued two Joint Risk Assessment Reports on Risks and Vulnerabilities in the EU Financial System.

The 2021 Spring Joint Risk Report highlighted how the COVID-19 pandemic continued to weigh heavily on short-term recovery prospects, focused on a number of vulnerabilities in the financial markets, and warned of possible further market corrections.

The ESAs also warned of a possible deterioration of asset quality and recommended policy actions for supervisors and regulated institutions, including for banks to ensure sound lending practices and adequate pricing of risks, and to adjust provisioning models to adequately address the impact of the economic shock of the pandemic.

The ESAs also called on competent authorities, financial institutions, and market participants to continue to develop further actions to accommodate a "low-for-long" interest rate environment and its risks.

The 2021 Autumn Joint Risk Report highlighted increasing vulnerabilities in the financial sector, not least because of side effects of the COVID-19 crisis measures, such as increasing debt levels and upward pressure on asset prices.

The Report noted that expectations of inflation and yield growth, as well as increased investor risk-taking, might put additional pressure on the financial system.

Against this context, the ESAs warned of the continued risk of possible asset quality deterioration, potential disorderly increases in yields and sudden reversals of risk premia.

In addition to these economic vulnerabilities, the Joint Risk Report highlighted the increased exposure of the financial sector to cyber risk and information and communication technology (ICT) related vulnerabilities.

The ESAs highlighted the need that appropriate technologies and adequate control frameworks are in place to address threats to information security and business continuity in the financial sector.

Consumer protection and financial education In 2021, consumer protection continued to be a key element in the work of the Joint Committee.

Following the submission of the draft RTS with the proposed amendments to the PRIIPs Delegated Regulation to the European Commission in January 2021 and as part of a wider initiative of the European Commission to develop a new retail investment strategy for the EU, the Joint Committee received in July 2021 from the Commission a Call for Advice on the review of the PRIIPs Regulation.

The scope of the mandate from the European Commission follows the areas referred to in Article 33 of the PRIIPs Regulation, as well as additionally including issues related to the use of digital media.

In order to gather evidence, the Joint Committee published a Call for evidence for a public consultation until 16 December 2021 and is working to deliver its Joint Advice by the end of April 2022.

During 2021, in total 13 administrative sanctions or measures under the PRIIPs Regulation were reported to the ESAs by the competent authorities in 3 Member states (Croatia, Czech Republic and Hungary).

These measures were fines and orders to the PRIIP manufacturer or person advising on, or selling, the PRIIP to remedy specified breaches of the PRIIPs Regulation or the PRIIPs Delegated Regulation.

Furthermore, the Joint Committee finalised its review of the application of the Joint ESAs' Guidelines on complaints-handling that the three ESAs had issued in 2014.

The review concluded that the Joint Guidelines have contributed to a consistent approach to complaints-handling across the banking, insurance and securities sectors and have resulted in better outcomes for consumers.

This review examined how the ESAs Guidelines on complaints-handling have been applied since they came into force.

In particular, the Final Report of the review describes the extent to which the objectives of the Guidelines have been achieved, the supervisory actions that NCAs have undertaken as a result of their national implementation, including the steps taken to identify good/poor practices by firms, as well as the remaining challenges faced.

Finally, the Joint Committee started a new work stream on Financial Education with the aim to fulfil the ESAs' mandate to review and coordinate national financial education initiatives.

The main focus of the Joint Committee work in this area in 2021 was the preparation of a joint high-level conference on financial education and the development of a Joint ESAs repository of national education initiatives focused on fraud, scams and cybersecurity, both of which are scheduled for February 2022.

Sustainability-related disclosures

A very significant part of the work of the Joint Committee in 2021 focused on development of the regulatory and supervisory framework for sustainability-related disclosures.

The Sustainable Finance Disclosure Regulation (SFDR), which has been amended by Article 25 of the Taxonomy Regulation mandated the ESAs to develop through the Joint Committee a number of

Regulatory Technical Standards (RTS). In 2021, the Joint Committee have developed two sets of draft RTS, containing a total of 13 RTS.

Firstly, the ESAs published on 4 February 2021 draft RTS on the content, methodologies and presentation of disclosures under SFDR that aim to strengthen protection for end-investors by providing sustainability disclosures on the principal adverse impacts of investment decisions and on the sustainability features of a wide range of financial products.

This will help to respond to investor demands for sustainable products and reduce the risk of greenwashing.

In addition, the draft RTS contain proposals under Taxonomy Regulation on the do not significantly harm (DNSH) principle.

Secondly, the ESAs have also published on 22 October 2021 draft RTS regarding disclosures under SFDR that relate to financial products investing in economic activities that contribute to environmental objectives.

The draft RTS provide disclosures to end-investors regarding the investments of financial products in environmentally sustainable activities, providing them with comparable information to make informed investment choices and enable a single rulebook for sustainability disclosures under the SFDR and the Taxonomy Regulation.

The draft RTS include pre-contractual and periodic disclosures for products referred to in Articles 5 and 6 of the Taxonomy Regulation that identify the environmental objectives to which the product contributes and show how and to what extent the product's investments are aligned with the EU Taxonomy.

The ESAs have also addressed emerging implementation and supervisory issues. In a letter to the European Commission on 7 January 2021 the ESAs highlighted the priority issues relating to the draft RTS under SFDR.

The European Commission responded in July 2021 and provided interpretative guidance to a number of the questions highlighted in the letter in its response.

In addition, the Joint Committee published on 25 February 2021 a Joint ESAs Supervisory Statement to mitigate the risk of divergent application of SFDR within the period from 10 March 2021 (SFDR application date) to the application date of the SFDR RTS.

The overall objective of the joint supervisory statement is to achieve an effective and consistent application and national supervision of the SFDR, promoting a level playing field and the protection of investors.

The Commission informed the European Parliament and Council in November 2021 that due to the technical complexity of the RTS and the timing of the submission, the bundled February and October RTS would become applicable by 1 January 2023.

Apart from the SFDR related work, through the Joint Committee, the ESAs coordinated their approach with regards to the membership and governance of the new Sustainability Reporting Pillar of European Financial Reporting Advisory Group (EFRAG).

In the letter in July 2021 the ESAs reiterated their strong commitment to contribute to the development of high-quality sustainability reporting standards, and expressed their preference to remain active observers in the EFRAG governance framework.

The ESAs considered that such an observer status is in line with the proposal for a Corporate Sustainability Reporting Directive (CSRD) to require ESMA, and invite the other ESAs, to provide an opinion on EFRAG's draft sustainability reporting standards.

Securitisation

With a view to support the development of the EU securitisation market, the Joint Committee continued its work to address obstacles in the implementation of the Securitisation Framework and to suggest improvements to the regulatory and supervisory regime to the National Competent Authorities (NCAs) and the European Commission.

In particular, the Joint Committee considered the difficulties to ascertain the jurisdictional scope of application of certain provisions in the Securitisation Regulation in case one or more of the securitisation parties are located in a third country.

In the Joint Opinion issued in March 2021, the ESAs examined the EU securitisation requirements which may be applicable to third-country parties, as well as related compliance aspects of a transaction under the Securitisation Regulation.

The ESAs also set out their common view on the practical difficulties faced by market participants and recommended that these difficulties should be addressed through interpretative guidance from the European Commission.

Furthermore, in the report prepared according to Article 44 of the Securitisation Regulation, the ESAs assessed the implementation and the functioning of the Securitisation Regulation, and provided recommendations on how to address initial inconsistencies and challenges which may affect the overall efficiency of the current securitisation regime.

In particular, the report highlighted specific issues related to transparency and due diligence requirements, criteria for simple, transparent and standardised (STS) securitisation and requirements related to supervision of securitisation. The report was meant to provide guidance to the European Commission in the context of its review of the functioning of the Securitisation Regulation.

It also includes an analysis of the efficiency of the STS securitisation framework, considering in particular the role that securitisation could play in the economic recovery post the Covid-19 pandemic.

In addition, the Joint Committee provided further guidance on the application of the Securitisation Regulation through Q&As.

These Q&As clarify in particular:

(i) the content and the format of the information of a securitisation transaction that should be disclosed by the originator, sponsor and securitisation special purpose entity (SSPE);

(ii) the transaction documentation of a STS securitisation that should be made publicly available to facilitate investors' compliance with its due diligence requirements; and

(iii) the type of STS certification services that can be provided by Third-party Verifiers to the securitisation parties.

These Q&As were subsequently updated to clarify whether a "vendor financing" structure can be considered a synthetic securitisation.

Finally, the Joint Committee has initiated work to address the Call for Advice from the European Commission in October 2021.

This Call for Advice seeks the Joint Committee's assistance to assess the recent performance of the rules on capital requirements (for banks, and insurance and reinsurance undertakings) and liquidity requirements (for banks) relative to the framework's original objective of contributing to the sound revival of the EU securitisation market on a prudent basis.

The Joint Committee report is scheduled for submission to the European Commission by 1 September 2022.

Digital finance

In 2021 the Joint Committee stepped up its digital finance-related work, including in the context of the European Commission's Digital Finance Strategy, with extensive technical discussions on topics such as crypto-assets and digital operational resilience.

Moreover, the ESAs prepared a comprehensive response to the Call for advice from the European Commission's February 2021 Call for Advice on Digital Finance on value chains, platformisation and new mixed activity groups.

The ESAs have been actively involved in the discussions on the legislative proposals for a regulation on markets in crypto-assets (MiCA) and the regulation on digital operational resilience for the financial sector (DORA).

In particular, apart from considering technical and resource elements relating to operational preparations for the proposed supervision and oversight tasks, the Chairs of the ESAs sent a letter to colegislators, where the ESAs set out their views on how to take forward most efficiently important aspects of the governance and operational processes of the oversight framework for critical third-party service providers and the application of the proportionality principle in the proposed DORA.

Among other things the ESAs stated that the proposal raised challenges on the practical functioning of the oversight framework, especially the complexity of the governance and decision-making process between the Joint Committee of the ESAs, the Boards of Supervisors of the ESAs and the Oversight Forum.

The report: https://www.eiopa.europa.eu/document-library/annual-report/joint-committee-annual-report-2021_en

Proposal for a Directive on measures for a high common level of cybersecurity across the European Union

EUROPEAN COMMISSION

Reasons for and objectives of the proposal

This proposal is part of a package of measures to improve further the resilience and incident response capacities of public and private entities, competent authorities and the Union as a whole in the field of cybersecurity and critical infrastructure protection.

It is in line with the Commission's priorities to make Europe fit for the digital age and to build a future-ready economy that works for the people. Cybersecurity is a priority in the Commission's response to the COVID-19 crisis.

The package includes a new Strategy on Cybersecurity with the aim of strengthening the Union's strategic autonomy to improve its resilience and collective response and to build an open and global internet.

Finally, the package contains a proposal for a directive on the resilience of critical operators of essential services, which aims to mitigate physical threats against such operators.

This proposal builds on and repeals Directive (EU) 2016/1148 on security of network and information systems (NIS Directive), which is the first piece of EU-wide legislation on cybersecurity and provides legal measures to boost the overall level of cybersecurity in the Union. The NIS Directive has:

(1) contributed to improving cybersecurity capabilities at national level by requiring Member States to adopt national cybersecurity strategies and to appoint cybersecurity authorities;

(2) increased cooperation between Member States at Union level by setting up various fora facilitating the exchange of strategic and operational information; and

(3) improved the cyber resilience of public and private entities in seven specific sectors (energy, transport, banking, financial market infrastructures, healthcare, drinking water supply and distribution, and digital infrastructures) and across three digital services (online marketplaces, online search engines and cloud computing services) by requiring Member States to ensure that operators of essential services and digital service providers put in place cybersecurity requirements and report incidents.

The proposal modernises the existing legal framework taking account of the increased digitisation of the internal market in recent years and an evolving cybersecurity threat landscape.

Both developments have been further amplified since the onset of the COVID-19 crisis. The proposal also addresses several weaknesses that prevented the NIS Directive from unlocking its full potential.

Notwithstanding its notable achievements, the NIS Directive, which paved the way for a significant change in mind-set, in relation to the institutional and regulatory approach to cybersecurity in many Member States, has also proven its limitations.

The digital transformation of society (intensified by the COVID-19 crisis) has expanded the threat landscape and is bringing about new challenges which require adapted and innovative responses. The number of cyber attacks continues to rise, with increasingly sophisticated attacks coming from a wide range of sources inside and outside the EU.

The evaluation on the functioning of the NIS Directive, conducted for the purposes of the Impact Assessment, identified the following issues:

(1) the low level of cyber resilience of businesses operating in the EU;

(2) the inconsistent resilience across Member States and sectors; and

(3) the low level of joint situational awareness and lack of joint crisis response.

For example, certain major hospitals in a Member State do not fall within the scope of the NIS Directive and hence are not required to implement the resulting security measures, while in another Member State almost every single healthcare provider in the country is covered by the NIS security requirements.

Being an initiative within the Regulatory Fitness Programme (REFIT), the proposal aims at reducing the regulatory burden for competent authorities and compliance costs for public and private entities.

Most notably, this is achieved by abolishing the obligation of competent authorities to identify operators of essential services and by increasing the level of harmonisation of security and reporting requirements to facilitate regulatory compliance for entities providing cross-border services. At the same time, competent authorities will also be given a number of new tasks, including the supervision of entities in sectors so far not covered by the NIS Directive.

Article 1, Subject matter

1. This Directive lays down measures with a view to ensuring a high common level of cybersecurity within the Union.

2. To that end, this Directive:

(a) lays down obligations on Member States to adopt national cybersecurity strategies, designate competent national authorities, single points of contact and computer security incident response teams (CSIRTs);

(b) lays down cybersecurity risk management and reporting obligations for entities of a type referred to as essential entities in Annex I and important entities in Annex II;

(c) lays down obligations on cybersecurity information sharing.

Article 2, Scope

1. This Directive applies to public and private entities of a type referred to as essential entities in Annex I and as important entities in Annex II. This Directive does not apply to entities that qualify as micro and small enterprises within the meaning of Commission Recommendation 2003/361/EC. 28

2. However, regardless of their size, this Directive also applies to entities referred to in Annexes I and II, where:

(a) the services are provided by one of the following entities:

(i) public electronic communications networks or publicly available electronic communications services referred to in point 8 of Annex I;

(ii) trust service providers referred to point 8 of Annex I;

(iii) top–level domain name registries and domain name system (DNS) service providers referred to in point 8 of Annex I;

(b) the entity is a public administration entity as defined in point 23 of Article 4;

(c) the entity is the sole provider of a service in a Member State;

(d) a potential disruption of the service provided by the entity could have an impact on public safety, public security or public health;

(e) a potential disruption of the service provided by the entity could induce systemic risks, in particular for the sectors where such disruption could have a cross-border impact;

(f) the entity is critical because of its specific importance at regional or national level for the particular sector or type of service, or for other interdependent sectors in the Member State;

(g) the entity is identified as a critical entity pursuant to Directive (EU) X/Y of the European Parliament and of the Council 29 [Resilience of Critical Entities Directive], or as an entity equivalent to a critical entity pursuant to Article 7 of that Directive.

Member States shall establish a list of entities identified pursuant to points (b) to (f) and submit it to the Commission by [6 months after the transposition deadline]. Member States shall review the list, on a regular basis, and at least every two years thereafter and, where appropriate, update it.

3. This Directive is without prejudice to the competences of Member States concerning the maintenance of public security, defence and national security in compliance with Union law.

4. This Directive applies without prejudice to Council Directive 2008/114/EC 30 and Directives 2011/93/EU 31 and 2013/40/EU 32 of the European Parliament and of the Council.

5. Without prejudice to Article 346 TFEU, information that is confidential pursuant to Union and national rules, such as rules on business confidentiality, shall be exchanged with the Commission and other relevant authorities only where that exchange is necessary for the application of this Directive. The information exchanged shall be limited to that which is relevant and proportionate to the purpose of that exchange. The exchange of information shall preserve the confidentiality of that information and protect the security and commercial interests of essential or important entities.

6. Where provisions of sector–specific acts of Union law require essential or important entities either to adopt cybersecurity risk management measures or to notify incidents or significant cyber threats, and where those requirements are at least equivalent in effect to the obligations laid down in this Directive, the relevant provisions of this Directive, including the provision on supervision and enforcement laid down in Chapter VI, shall not apply.

Article 3, Minimum harmonisation

Without prejudice to their other obligations under Union law, Member States may, in accordance with this Directive, adopt or maintain provisions ensuring a higher level of cybersecurity.

To read more: https://eur-lex.europa.eu/legal-content/EN/TXT/HTML/?uri=CELEX:52020PC0823&from=EN

Macropru – fit for the future?

Sarah Breeden, Executive Director for Financial Stability Strategy and Risk and a member of the Financial Policy Committee (FPC), the United Kingdom's macroprudential authority.

When the financial system is in poor condition – when there is financial instability – it can be damaging to us all.

I like to compare the importance of financial stability to our collective prosperity with the importance of health to an individual. Good health may not be the only thing that matters for an individual's happiness. But it is essential. Because poor health comes with undesirable consequences.

We need only remind ourselves of the global financial crisis, more than a decade ago, to appreciate the undesirable consequences of financial instability.

UK GDP shrank by more than 6% during the first five quarters of the crisis, staying below its pre-recession size for a further five years. Unemployment increased, with an additional 1 million jobs lost by its peak at the end of 2011. And labour productivity, the best way to measure living standards in the long-run, fell sharply in 2008 and has barely recovered since.

The poor health of the global financial system was exposed in the most dramatic of fashions. We might liken it to a heart attack. And in response the authorities co-operated across borders and across institutions to design a radical 'healthcare plan' – to improve resilience, both at the micro-prudential individual institution and the economy-wide macro-prudential levels.

It is this macro-prudential perspective that I want to discuss today – specifically, to consider how macro-prudential policy will need to adapt, just as our health-care plans adapt, to be fit for the challenges of the future.

Since the global financial crisis, the financial system has not been a cause of sustained economic instability. But this is no reason for complacency. The financial system is ever changing. And experience suggests our job may not yet be complete.

So today, I will begin by setting out why financial stability is important and the role of macro-prudential policy in delivering it. In so doing I hope to set out why it's as important for the financial system to observe macro-prudential policies as it is for patients to stick to their health-care plans.

I will then briefly set out some principles on which good macro-prudential policymaking is based. The rules of thumb that underlie our prescriptions if you like.

And I will conclude by raising some challenges that macro-prudential policy is facing now, including my thoughts on the road ahead. Through that, I hope to set out how we need constantly to adapt macro-prudential policies, as we do with our health-care plans as lifestyles evolve.

Interactions between financial stability and sustainable growth and the role for macro-prudential policy

Why is financial stability important?

To understand why we place so much emphasis on a well-grounded macro-prudential framework, it's important to understand why we care about financial stability in the first place. In brief, it is because we believe that financial stability is a precondition for sustainable economic growth.

A stable and well-functioning financial system exists to serve us all. It enables the efficient allocation of resources, so that businesses can exploit productive opportunities and households can meet their needs. And it allows the risks incurred in the course of generating economic growth to be shared.

The banking system supplies credit to households, to buy homes or spend more than they currently earn; and to businesses, so that they can hire more workers, invest in capital, and innovate and expand.

Non-bank financial firms further transform long-term savings into new investments via bond and stock purchases; and they enable both households and businesses to insure themselves against risks that could prove costly were they to crystallise.

The financial system also facilitates payments, so that households and businesses can pay safely for the goods and services they choose to receive.

A stable financial system is one that is resilient to shocks and so is able reliably to support households and businesses through the consistent supply of the vital services that they demand. Financial stability thus supports growth and prosperity, just as good health supports us in our daily lives.

The role of macro-prudential policy

Historically, there was a view among policymakers that as long as monetary policy guaranteed low and stable inflation, and micro-prudential regulation was successful in ensuring the balance sheets of individual institutions were robust to shocks, the financial system could take care of itself, and financial stability would follow.

However, the global financial crisis revealed the flaws in this view: while monetary policy sets the benchmark interest rate for financial transactions and “gets into all the cracks” in the financial system, it isn’t sufficient to ensure that those transactions are undertaken efficiently and effectively.

Similarly, micro-prudential policy ensures the safety and soundness of individual institutions, but does not take a sufficiently bird’s eye view to identify possible risks affecting the financial system as a whole.

The financial crisis highlighted quite how much the whole is greater than the sum of its parts. And that ensuring the parts are healthy does not guarantee that the whole is.

Macro-prudential interventions typically fill two gaps:

1. Individual agents don’t necessarily take into account the bigger picture. Individual financial institutions and borrowers face private incentives which do not take into account the wider social impact of their actions. In such cases, macro-prudential policymakers can seek to better align private costs and benefits with social costs and benefits.

One example is the Financial Policy Committee’s (FPC) mortgage tools, which seek to limit the number of mortgages banks can extend for loans that are high relative to income.

Individual borrowers may be keen to stretch themselves financially to buy a bigger house, expecting their earnings to grow or house prices to rise.

And individual lenders may be happy to provide a larger loan to receive more income. But should a recession hit, not only will we see defaults, but overstretched borrowers will reduce their spending as they struggle to pay their mortgages. And this reduction would ultimately spillover to the rest of the economy, making the downturn worse.

Macro-prudential policy takes these spillovers into account. By ensuring borrowers in aggregate are not overstretching themselves and financial institutions in general are lending responsibly, macro-prudential regulators can ensure that the whole system is more resilient to shocks.

2. Markets are not necessarily efficient or complete. Market prices may not reflect the real value of assets, not every market is perfectly liquid and risks may not be as well-dispersed as they might seem. These imperfections can lead to two types of risk to financial stability: cyclical and structural.

Cyclical risks arise because financial conditions can suddenly reverse. The simplest example is of financial institutions taking on too much risk in booms, in the expectation that the assets they purchase will always be in demand. When the cycle turns, asset prices can fall rapidly, leaving institutions with losses. This is why we have countercyclical tools - to ensure the system can build up resilience in good times, and use it in bad times.

Structural risks refer to fault-lines within the financial system, such as high concentrations of risk, complex interconnections, promises made that cannot necessarily be honoured, and uninsurable – or tail – risks. These risks can trigger sharp reversals in financial conditions, or amplify cyclical risks when they crystallise. As with cyclical risks, macro-prudential policy looks to build resilience to these risks, as well as eliminating fault-lines where appropriate.

The cost-benefit calculus

In seeking to fill these two gaps, it is important to acknowledge that there are two sides to the ledger – that a build-up in financial stability risk is often accompanied by higher growth.

When the financial system under-prices risks, households, companies and the economy at large may appear to benefit. As asset prices rise, perceptions of wealth become inflated and risks appear smaller. Households and companies feel more comfortable taking on debt, banks and investors feel more comfortable lending to them. We can consume more, invest more, grow the economy more and feel more prosperous.

The problem is that it cannot last. We cannot continue consuming more than we ever hope to earn; we cannot invest more than we ever intend to save; risks cannot be under-priced forever. This time it probably isn't different.

And when it all goes into reverse, when risks are found to be under-priced and not well-dispersed, when shocks arise and are amplified by the financial system, the cost in terms of lost growth can far outweigh the benefit of higher growth enjoyed while the risks were building.

It is this cost-benefit calculus that both motivates a role for macro-prudential policy, and helps us define precisely what we mean by it.

In short, macro-prudential policy aims to improve the trade-off between the financial system's contribution to the rewards expected in a growing economy and the degree of risk that we will face in the bad times.

To return to my analogy, we might liken it to the NHS and to health insurance where we pay a bit in the good times to protect ourselves should our health take a turn for the worse.

Principles of good policy making

Macro-prudential authorities, like the UK's FPC, work to ensure that financial systems are resilient to, and prepared for, the wide range of possible shocks they could face. Their aim is to ensure that when shocks occur, the financial system is able to absorb those shocks, rather than to amplify their impact on the economy.

We ground what we do in two elements of good macro-prudential policymaking:

- Macro-prudential policy should be targeted to provide a net benefit to the overall economy. Where interventions incur costs, these should only be imposed when they are outweighed by the benefits over the full cycle. This is perhaps equivalent to starting a course of new medication, where a good doctor must be aware of potential side effects as well as intended benefits.

  We must also recognise that there will be occasions when interventions are not yet needed, as emerging risks are not yet systemic in nature. To return to our analogy, a good doctor might decide not to start medication, but instead simply monitor a patient's general health to judge better how to improve it.

- Macro-prudential policy should be ready to adapt to change, allowing the economy to expand and innovate safely. Change always brings with it opportunities and risks and so our macro-prudential framework will need to evolve. To overuse the health analogy once more, doctors need to adapt. A doctor in the 1960s, for example, would never have had to think about the health effects of vaping.

Challenges that lie ahead

Ten years after establishing the FPC, we have reached the point where we have both made the case for macro-prudential policy, and built a macro-prudential framework designed to ensure the sector is resilient to stress. In other words, we have pulled together the skeleton for a healthcare plan and convinced the patient that they need it and that it needs to be updated regularly.

These are important achievements. Indeed we need to make sure we hang on to them even as memories of the global financial crisis fade.

But we need to decide the plan for the coming months and years too. Recent shocks – the Covid pandemic, and more recently, Russia's invasion of Ukraine – and structural changes to the financial system have reaffirmed that our work is not yet done.

Let me briefly mention a few of the lessons from our experience in Covid-19.

First the capital framework does not in practice support use of bank capital buffers in a stress as we intended. And that would have mattered a lot in the absence of the substantial government support for the corporate sector.

Second, we need to change our approach to stress testing in a stress if we are to avoid those stress tests further amplifying any downturn.

And third, in a shock of roughly half the size of the global financial crisis, it was only large-scale use of central bank balance sheets that calmed dysfunction in the system of market-based finance.

We are continuing to learn through the Russia-Ukraine crisis too. We are exploring concentrations in, and interconnections across, energy and other commodity markets, the financial system, and the real economy, as well as the potential for feedback loops between them. And we have observed too that commodity markets are relatively opaque.

We must now develop the macro-prudential framework to reflect the lessons from these recent stresses.

Looking beyond recent events, neither the financial system nor the economy stands still: there are clear structural changes that macro-prudential policy must confront.

1.The rise of market-based finance: vulnerabilities that are as much global as domestic

One key challenge is that many vulnerabilities are as much global as they are domestic. That includes non-bank, or market-based, finance.

Non-bank financial institutions currently represent around 50% of global (and UK) financial sector assets. They are increasingly a source of finance for UK businesses. However, the ‘dash for cash’ in March 2020 led to a rapid deterioration in the functioning even of advanced-economies’ government bond markets and created market dynamics significant enough to raise the cost of lending. The episode clearly demonstrated the need to build resilience in market-based finance.

Given the global nature of market-based finance, the effectiveness of any policies in the UK will depend in part on policies implemented in other major jurisdictions.

We are therefore working with international counterparts in the Financial Stability Board to take coordinated action to address these issues - including on open-ended funds, margins, the liquidity structure and resilience of core markets, to name a few.

In the meantime, the FPC (and other UK authorities) need to continue monitoring them, starting by ensuring there is reliable data to do so.

2.The growth of cryptoassets and decentralised finance: regulatory frameworks need to evolve

Another important challenge is seen in cryptoassets and decentralised finance (DeFi) which in recent years have grown to represent around 1% of global financial assets.

Cryptoasset technology is creating new financial assets, and new means of intermediation. Many services now facilitated by this technology mirror those available in the traditional financial sector, including lending, trading and exchange, investment management and insurance.

While that activity is currently small, if the pace of growth seen in recent years continues, interlinkages with the traditional financial sector are likely to increase.

In addition, the new technology has the potential to reshape activity currently taking place in the traditional financial sector, either through the migration of that activity or the widespread adoption of the technology.

Crypto technology has the potential to bring significant benefits, for example by reducing the cost and increasing the speed of cross-border transactions, and encouraging competition in the financial system.

But those benefits can only be realised and innovation be sustainable if it is undertaken safely and accompanied by effective public policy frameworks that mitigate risks and maintain broader trust and integrity in the financial system.

In this way, the growth of cryptoassets and DeFi has highlighted another of the key challenges for policymakers: the need for regulatory frameworks to adapt.

3.The transition to net zero: structural change requires coordinated action from all sectors

And finally, we face the continued need to support the orderly transition to a net zero economy. Climate change creates risks to financial stability through two channels: physical risks and transition risks. And the financial system will play a key role in financing the significant structural economic changes needed to deliver the transition to a net zero economy.

The unique challenge here is that the orderly transition to net zero will require coordinated action across private and public sector institutions, and across all sectors of finance and the real economy.

The Bank's role is focussed on tackling the consequences (not the causes) of climate change. Indeed the transition to net zero is likely to be a bumpy one, particularly in light of recent events, and macro-prudential regulators have an important role to play in helping manage those bumps.

In support of this work, we are running a stress test of the UK's largest banks and insurers that will extend the time horizons over which we, and they, view climate risks.

This is a good start in understanding the implications of climate change and transition for the financial system. But more work is needed to build the green market infrastructure that will support an orderly transition to net zero, and this will be an important area of focus for macro-prudential regulation over the coming years.

Conclusion: The road ahead

Where does all this leave us?

It's clear that we macro-prudential policymakers need to look forwards as well as backwards as we do our risk assessment. And we must also ground our analysis in the impact of shocks to the financial system on businesses, households and so the economy, and not just their impact on financial players.

The source of shocks and the mechanisms through which the financial system could amplify those shocks is wide – covering climate, Covid, crypto, cyber, and conflict as well as the credit cycle and the core banking system. But our understanding of many of these is still developing, reflecting differences in the maturity across our framework.

The consequence is that like any health check the list of what we need to review is long. And so the key is how we prioritise our work and what prescriptions we write on the back of it. That's a daunting task. But helpfully while for some issues only the macro-prudential policymaker can do the job, for other issues just like a GP we can call on the help of specialists.

I'm not proposing to write any prescriptions in this speech today. But the Bank and FPC are working hard on their diagnoses and will aim to communicate further on issues that they wish to prioritise later this year, through the Bank's Financial Stability Strategy and the FPC's medium-term priorities.

And I hope that today has given you a flavour of the importance of building a macro-prudential framework that's as fit for the risks and opportunities of the future as it is for those we have faced in the past.

The views expressed here are not necessarily those of the Financial Policy Committee. I am grateful to Nicola Anderson, Kristina Bluwstein, Giovanni Covi, Tom Daniels, Emma Moriarty, Nicholas Vause, Danny Walker and Gabija Zemaityte for their assistance in drafting these remarks. I would like to thank Jon Cunliffe, Alina Barnett, Geoff Coppins, Lee Foulger, Grellan McGrath, Jon Relleen and Matt Waldron for their helpful comments.

Fake WhatsApp 'voice message' emails are spreading malware

National Cyber Security Centre

A phishing campaign which impersonates WhatsApp's voice message feature has been spreading information-stealing malware.

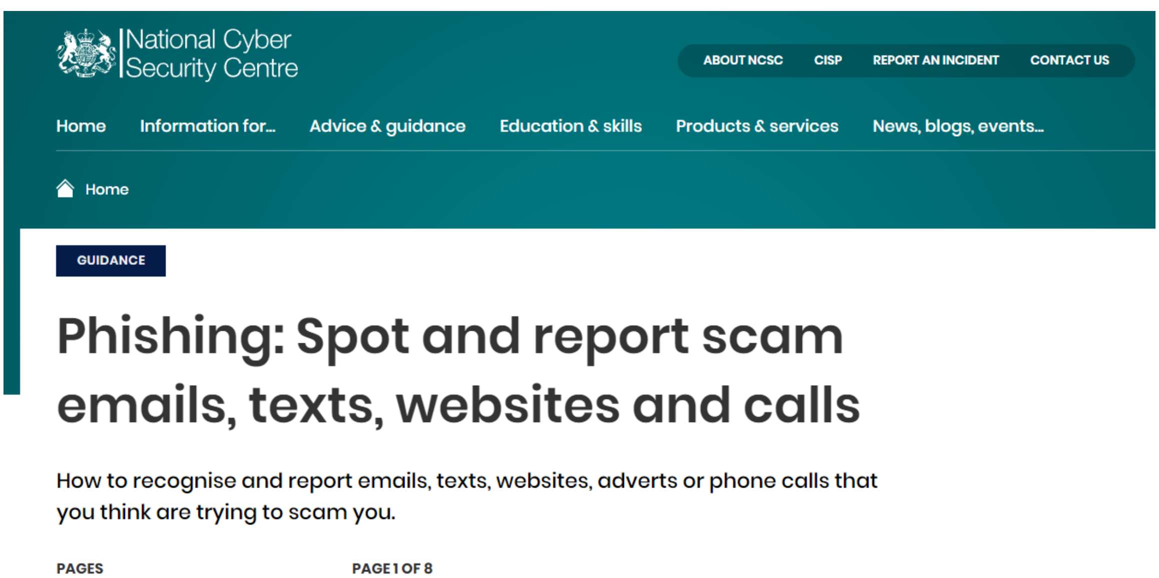
The attack starts with an email claiming to be a notification from WhatsApp of a new private voice message. The email contains a creation date and clip duration for the supposed message, and a 'Play' button.

The identity 'Whatsapp Notifier' masks a real email address belonging to a Russian road safety organisation. As the address and organisation are real, the messages aren't flagged as spam or blocked by email security tools. Armorblox, who discovered the scam, believe the Russian organisation is playing a role without realising.

The 'Play' button will take the email recipient to a website which then asks them to click 'Allow' in an allow/block prompt to 'confirm you are not a robot'. Once 'allow' is clicked, the browser will prompt to install software that turns out to be information-stealing malware.

While there are numerous 'tells' that this is a scam, these attacks rely on people missing the signs – perhaps because they are waiting for urgent or exciting news that could well be delivered by a voice message.

The NCSC has published guidance on how to spot and report scams, including those delivered by email and messaging. You may visit: https://www.ncsc.gov.uk/collection/phishing-scams



Our top tips for staying secure online will help you keep your devices and information secure even if you do click on a scam, and you can also learn how to recover a hacked account.

You may visit: https://www.ncsc.gov.uk/collection/top-tips-for-staying-secure-online

https://www.ncsc.gov.uk/guidance/recovering-a-hacked-account

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