Aim for green

A NEW REGULATORY REFORM AHEAD FOR FINANCIAL MARKETS

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Currently financial markets are in the aftermath of implementing regulations which were initiated between 2007-2010 after earlier crises. The regulatory environment is settling down in relation to the aims of these regulations. Enhanced consumer protection measures as well as improved transparency, risk mitigation, central clearing, transaction reporting and many others are now embedded in financial institutions policies, procedures and systems. Limited time however is given since the go-live of MiFID II (2018), EMIR Refit (2019) and SFTR (2020) to evaluate these implementations, while the next new strategic theme on the regulatory calendar has been introduced: Sustainability.

The elements of Environmental, Social and Governance (ESG) will dominate the strategy and implementation calendar of the entire financial sector throughout the years to come. Within this concept, multiple regulatory initiatives already have been launched and this is only the beginning. With the first regulatory deadline already behind us (SFDR per 10 March 2021) time to evaluate previous implementations is limited. We do think some reflections are useful, given the previous regulatory overhaul, avoiding pitfalls when shifting focus on this important topic of sustainability.

What lessons can be learned in terms of implementation efficiency? How can we as a sector be more efficient while implementing new sustainability regulations and learn from the past? This article aims to answer these questions. We start with a regulatory reflection and move into practical implementation lessons to be taken into account when moving towards the implementation of sustainability regulations in the years to come.

At the G20 summit in Pittsburgh in September 2009 it was concluded that the credit crises demonstrated the urge of reforms of the OTC-derivatives markets. These reforms included reporting of derivatives transactions to foster transparency, central clearing of derivatives, obligatory trading of derivatives on trading venues and exchange of margin for OTC-derivatives. Together these measures aimed to decrease global systemic risks.

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In Europe these reforms were implemented via the European derivatives regulation (also known as EMIR), and (parts of) the Markets in Financials Instruments Regulation (MiFIR). Multiple other regulations were introduced by the European Commission (EC) such as:

- alternative investment fund managers were regulated by the AIFMD;
- investor protection rules and market infrastructure rules were worked out and detailed in MiFID II/ MIFIR;
- regulation on securities settlement and central securities depositories (CSD) can be found in the CSDR;
- pre contractual information to retail clients in PRIIPs;
- information disclosure and reporting requirements with regard to securities finance transactions in the SFTR.

Not only the number of regulations, but also the amount and complexity of requirements within these regulations make it safe to state that the financial markets faced an avalanche of regulatory initiatives. MiFID II/ MIFIR alone already includes over 30.000 pages of rules. What makes it even more complex, is that all financial markets regulators across the globe took action and introduced new financial markets regulations in their own approach, timeframe and not always in a coordinated way. For example, in the United States the reforms were implemented via the Dodd Frank Act (DFA) and with an extraterritorial scope. Despite the overlap in requirements with European regulations mutual recognition of each other's requirements is not equally available for all the requirements in these regulations. This resulted in European institutions having to implement both European as well as US requirements which among others impacted derivatives transactions between US and European counterparties.

DESPITE THE ACHIEVEMENTS MADE THERE ARE CHALLENGES AHEAD AND IMPROVEMENTS ARE REQUIRED

Having implemented all the measures derived from these regulations over the last decade, various positive impacts can be identified, including:

- the financial markets have become more transparent for regulators due to transaction reporting requirements from various regulations in relation to financial products;
- counterparty risks in the derivatives markets have been reduced by central clearing and mandatory exchange of both variation and initial margin;
- investor protection has been further enhanced, for instance by ensuring that only products are being distributed that have an identified target market for their clients.

Next to the positive effects of these new regulations, also some concerns are identified. This includes the central clearing obligation of EMIR, which resulted in additional risks on derivatives increasingly concentrated on a few central counter parties (CCP's). With the liquidity now being concentrated on these CCP's, this triggered a new systemic risk. To mitigate these new systemic risks, EMIR has now been reviewed to give supervisory authorities (in particular ESMA) more powers to supervise systematically important CCP's. Because of the relevance of these systematically important CCP's, they also became politically important as we learned from Brexit and the discussion on UK CCP's. The continuation after Brexit of the use of UK CCP's by EU financial institutions is therefore still highly debated.

Also derived from the new regulations, investors were confronted with higher costs of services and products resulting especially in smaller retail investors concluding that certain services/ products are less accessible for them. E.g. investment services to retail investors became focussed on standardized portfolio management, investment funds or execution only services and less on (bespoke) investment advice. Due to the disclosure requirements, clients are now confronted with an overload of information which doesn't necessarily imply that they are better informed.[1]

VARIOUS INSIGHTS AND SIDE-EFFECTS LED REGULATORS TO PARTIALLY REVISE THE REGULATIONS AND INTRODUCE REGULATORY RELIEFS, OR NOT…

The EC started to alleviate the regulatory burden over the last years. Various publications on these introduced financial markets regulations stipulated the need to review, acknowledging the feedback from the various market participants. When looking at EMIR refit, which was published on 17 June 2019, some deregulations are introduced. This included that smaller financial counterparties do not have to comply with the clearing obligation anymore and smaller non-financial counterparty do not have to report their derivatives transactions themselves.

> OVER THE LAST TEN YEARS, REFORMS HAVE SIGNIFICANTLY IMPACTED FINANCIAL MARKETS THROUGH VARIOUS REGULATIONS SUCH AS MIFID II, AIFMD, EMIR AND PRIIPS

On 15 February 2021, a MiFID II quick fix has been announced, including less stringent cost disclosure rules in the wholesale market. A more fundamental review of MiFID II is expected at a later stage and will also deal with the infrastructure in the financial markets.

When looking at these regulations from a market-wide perspective, these regulatory reviews and refinements definitely provide some relief for certain parties. This relief however also entails that – among others – internal processes, systems, procedures, risk policies are to be amended again. When looking ahead, both regulators, financial institutions as well as investors could benefit from a "first time right" design and implementation of financial markets regulations.

IMPLEMENTING REGULATIONS AND REMAINING COMPLIANT COMES AT A PRICE

In order to become and stay compliant, financial parties had to set up large projects and developed various instruments in order to keep oversight. Examples in this regard are baseline documents including all the relevant requirements to facilitate implementation in policies, procedures, systems as well as audit trails to demonstrate how all these requirements were implemented. Such extensive implementations would typically be supported by or outsourced to law and consultancy firms with accompanying costs. Once implemented, risk and control frameworks have to be established, maintained and enhanced in order to continuously monitor if the organization is still compliant in the business as usual situation. Identification of potential deficiencies and remediation would trigger the continuous improvement of these regulatory implementations and increase the cost of control at the same time. Hence, both the implementation of new regulatory requirements and the maintenance of such frameworks going forward are a costly burden for the supervised financial institutions. One can imagine that especially for smaller firms it has become more and more challenging to keep afloat.

> NEW REGULATIONS CHANGE THE FINANCIAL MARKETS LANDSCAPE AND INTRODUCE VARIOUS NEW PLAYERS – SUCH AS DATA SERVICES PROVIDERS – WHICH AIM FOR A PIECE OF THE PIE

To give an impression of the costs involved, the EC provided an estimate for MiFID II in 2011.[2] It was estimated to generate one-off compliance costs of between € 512 and € 732 million and ongoing costs of between € 312 and € 586 million. This represents one-off and ongoing cost impacts of respectively 0.10% to 0.15% and 0.06% to 0.12% of total operating spending of the EU banking sector. Consequently these costs shall be borne by the financial markets participants in scope of MiFID. These expenditures are additional to the already imposed costs at the time of the introduction of MiFID in 2007. These were estimated at 0.56% (retail and savings banks) and 0.68% (investment banks) of total operating spending while ongoing compliance costs were estimated at 0.11% (retail and savings banks) to 0.17% (investment banks) of total operating expenditure.
These figures are the estimations made by the EC and are considered to be on the low side when looking at the actual expenditures after implementing MiFID II and its further revisions.

The introduction of the various (revised) regulations also led to much new data to be produced and transmitted which created an earning model for new players. An example in this regard are so called "trade repositories" to which counterparties should report their transactions and from which the reporting to various regulators is performed. These trade repositories (e.g. DTCC, Univista and RegisTR) were introduced to facilitate the reporting requirements under EMIR and SFTR. Another example are the "data reporting services providers" introduced to facilitate the reporting and transparency requirements under MIFIR. In the data providing area, to demonstrate compliance with the best execution rules of MiFID II, firms have to get data from third party suppliers which often is taken up by the trading venues. Next to the facilitation of the execution of transactions, collection and selling data has become a new important commercial activity for trading venues.

These new players and new functions in the financial markets infrastructure came at a price as well as additional dependencies on a limited number of providers in the market. The costs are paid by firms providing investment services/ investment activities, leading to higher prices and/ or less profit. At the same time these institutions are very much dependent on these trade repositories/ data reporting services providers performing the actual reporting to the regulators for them.

WITH ALL THIS DATA BEING REPORTED AND MADE AVAILABLE CENTRALLY, WHO'S REALLY BENEFITTING?

So far, the institutions in scope of these additional requirements have invested significant amounts to get these processes up and running. They however did not yet benefit from – for instance – using the market wide reported data in aggregated form or otherwise. Subsequently, only regulators are currently able to use this data where even they are not yet able to do so on a wider scale.
Because of the fragmented data streams created, the EC is likely to aim to establish a European public consolidated tape provider. This will probably be the European Securities and Markets Authority (ESMA) or linked to ESMA. This consolidated tape provider will consolidate data on transactions collected because of all the regulatory reporting requirements and made available to regulators and a wider audience for transparency reasons. It is expected that a public consolidated tape provider will result in lower prices on data with regard to financial instruments traded in the financial markets. Details have to be worked out in the framework of the review of MiFID II which will take place in 2021.

THE NEW STRATEGIC TOPIC: SUSTAINABILITY

While still in the middle of the regulatory reviews of financial markets regulations, the new strategic topic on the European calendar has already been introduced: Sustainability. For financial markets the impact relating to sustainability will primarily focus on Environmental, Social and Governance (ESG) factors that have to be taken into account for investments and economic activities.

Under the sustainability-umbrella various new regulatory initiatives are already being launched. The major triggers are in particular the 2015 UN 2030 and sustainable development goals, the Paris climate agreement, the Green deal of

11 December 2019 and the European Green Deal investment plan of 14 January 2020.The latter intending to mobilize at least 1 trillion euro (!) of investments for sustainability goals over the next decade. This can only be ensured by a massive redirection of investments to which financial institutions, investors and the real economy will have to contribute.
Major new regulations (proposed or already final) are among others:

- the Sustainable Finance Disclosure Regulation (SFDR) which seeks to increase transparency on how financial market participants integrate sustainability risks and opportunities into their investment decisions and recommendations;
- the taxonomy regulation which establishes the criteria for determining the level of contribution to environmental objectives for specific economic activities;
- the EU green bond standard supporting the green bond market growth and promoting its transparency and integrity;
- regulation on sustainable benchmarks systematically evaluating the sustainability performance of various elements used while implementing sustainability measures;
- MiFID II ESG to implement ESG in risk management, product governance and suitability;
- amendments of the Non-Financial Reporting Directive (NFRD) to include information on sustainability to be disclosed by companies.

This is just an overview of what is already known to be implemented over the coming years and it is just a tip of the sustainability iceberg.

THE FINANCIAL SECTOR SHOULDN'T UNDERESTIMATE THE QUANTITY AND THE COMPLEXITY OF THE SUSTAINABILITY REGULATIONS

Next to the quantity and complexity, there is also a strong political pressure to implement these regulations as soon as possible. Because of the high-speed pace, the regulations are not always carefully drafted in full alignment with other regulations. A good example is the SFDR of 27 November 2019, which had a first date of application on 10 March 2021. It was clear that the level II regulation with all the relevant details would not be finalized and officially published before that date. Even though the European Supervisory Authorities (ESA's) encouraged the EC to reconsider[3] the application date of the SFDR, the EC chose not to postpone. This creates a lot of uncertainty as proper implementation can only be done when the more detailed guidance in Level II regulation is final and sufficient time is given to implement these. On the first application date of 10 March 2021 only implementation on high level could be done based on the level I regulation. The level I regulation is also awaiting further clarification on certain important elements. The ESA's sent a letter to the EC on 7 January 2021 with a list of quite fundamental but not exhaustive lacks of clarity with regard to SFDR level I.[4] One could wonder why the EC insisted on implementation on 10 March 2021 while there were so many lacks of clarity and only level I regulation was available for implementation.

WHAT LESSONS CAN BE LEARNED WHEN STARTING THE CHALLENGE OF IMPLEMENTING THE SUSTAINABILITY REQUIREMENTS?

The size, complexity, lack of clarity and political pressure on quick implementation are a given. But with the extensive experience in the market place being available at both the level of regulators as well as within the financial institutions, there is much to gain from the lessons learned while implementing previous regulations. The key question is *"how will we jointly be able to do so, and be more (cost)efficient in implementing the upcoming sustainability regulations while realizing the ambitions as set forth in these regulations?"*.

We believe that there are three main pillars of interest to focus on:

1. joint efforts and market wide baseline setting;
2. spend costs for the right purpose and focus on profitability;
3. better use of data output as generated by market participants.

1. JOINT EFFORTS AND MARKET WIDE BASELINE SETTING

Sustainability regulations rather seem to focus on effective measures to instigate the market to move towards sustainability goals especially by redirecting investments.

For example, the SFDR is meant to disclose sustainability information to investors. One could expect these disclosures to be focussed on sustainable products in order to make transparent to investors whether these products are really "green" (in line with the aim and definitions following the SFDR). However next to disclosures on green products, the SFDR requires financial market participants and financial advisors to gather detailed information and to provide disclosures on entity level. These disclosures should inform investors on principal adverse impact of investment decisions and financial advice on sustainability factors (article 4 of the SFDR)[5] When the level II SFDR regulation is final, detailed qualitative and quantitative disclosures will have to be made based on various indicators.[6] This includes financial market products and advice without any sustainable goals. In order to prevent to issue negative principal adverse impact statements, market participants/ financial advisers could be stimulated to focus more on green investments.
It is also good to mention that the regulators request financial market participants to describe their actions taken and which aim to avoid or reduce principal adverse sustainable impact in their investments.[7]

Next to discussion of the SFDR on how to interpret, the Dutch Association of Banks went a step further. The complexities and lack of clarity of the SFDR required a different approach.

Subsequently, on behalf of a large group of Dutch banks, a law firm was involved and instructed to extract the requirements out of the SFDR in so called baselines and give guidance as much as possible. As the SFDR level I and II and the interpretations will evolve over time, these baselines will have to be updated at a later stage.
Looking at this specific example the first lesson learned has already been put into practice, saving a significant amount of money for institutions; jointly set the legal baseline for the regulatory implementations. This joint effort helps to:

- get grip and joint understanding on this complex regulation;
- create an overview of the detailed requirements and an understanding in the market of these requirements;
- can serve as a verified basis for an audit trail proving implementation of the regulation;
- create a solid basis for a joint approach and implementation of the legal baselines without affecting the necessary commercial freedom of parties in the market;
- be cost efficient as well as consistent throughout the market;
- facilitate discussions with regulators on the implementation.

Not only for the sustainability regulations can this be seen as a best practice but also for other regulations in the sector. This approach is already quite often used in the US and with success.

2. SPEND COSTS FOR THE RIGHT PURPOSE AND FOCUS ON PROFITABILITY

The ESG regulations seem to have similarities with the EU financial market regulations issued after the credit crisis 2008 and the Euro crisis 2010 and which have an impact on the costs involved with implementation. For the coming years, the costs of implementation itself will be significant and is expected to be at least equivalent to the implemented regulations over the last ten years. The similarities are related to for instance:

- the ESG regulations form an avalanche of regulations with high complexity;
- financial market participant will become more dependent on third parties to get the necessary data to comply with ESG regulations;
- the regulations are shifting into an area which is greenfield for the majority of market participants;
- investments in new (technological) structures will be required,
- support of law firms and consultants will likely to be required,
- internal capacity working on the change will again be significant.

Markets participants stressed in several occasions that – when drafting regulation and especially the more detailed level II regulation – cost efficiency should be taken into account by the (European) regulators.[8]

These additional costs for doing business could interfere with another strategic and essential element dominating the agendas of market participants; the focus on improving the cost-income ratio. Especially in current market circumstances where among others low interest rates are putting the cost-income ratios under pressure, investing in regulatory implementations does not immediately contribute to these ambitions. Having to invest a significant amount of money to adhere to the new ESG-standards comes at a price and will lead to further pressure on the feasibility of cost-benefit ambitions. Subsequently, it is to be decided by institutions whether or not these costs are well spent or if discontinuation of products and/or services is the better option.

Unfortunately these are not the main elements of impact in relation to costs and profitability. A more fundamental shift is being triggered. One has to face the facts that if the product and services portfolio is to be gradually transferred to new characteristics (more or only green), other products or services might become (partially) obsolete due to misalignment with ESG-standards. Also clients and social pressure could demand shifting towards the characteristics of services rather than profitability. In that case it becomes a challenge to keep a balance between improving the sustainability character of the product portfolio and return on investments for clients. For instance investing in regions outside Europe could be profitable but do not meet the European sustainability standards.

3. BETTER USE OF DATA OUTPUT AS GENERATED BY MARKET PARTICIPANTS

The collection and dissemination of sustainable, but also financial data is fragmented. Stakeholders encounter significant difficulties in accessing, comparing and using financial and sustainability related information published pursuant to the relevant EU legislation. The EC stated that a European single access point of data (ESAP) is needed[9] and has started a consultation to get general and technical views how to establish this ESAP.[10] This seems a similar approach as for the consolidated tape provider as single access point for transaction data.

Given the joint interest and investments in creating a more ESG-friendly environment, one could consider to make the overload of ESG-data which will be reported available in an aggregated and secure way. This would enable market participants to assess in an efficient way how investments meet the sustainability levels and to comply with ESG disclosure requirements. It will facilitate an adequate provision of sustainability information to investors and the markets which of course should also be done in an understandable way.[11]
Installing the ESAP is therefore considered pivotal to really facilitate the access of market participants to sustainability data.

FINAL REMARKS

To make regulations on sustainability a success, it is of paramount importance that with the further development and implementation of these regulations, both the EC, other regulators and the market participants;

- focus on their costs benefits analyses and cost efficient implementation;
- facilitate easy access to relevant sustainability data to comply with the regulations;

- keep the practical feasibility in mind;
- avoid unnecessary complexities;
- have a focus on the needs of investors and the markets.

We've highlighted the lessons learned from the previous regulatory implementations in financial markets and added some further suggestions to put these into practice. One could hope that such lessons learned and suggestions will be taken into account in the framework of the further drafting and the implementation of new sustainability regulations.

When looking ahead, the next new strategic theme on the regulatory calendar – sustainability – will dominate our regulatory change for the years to come. With the higher goals of sustainability at stake, we're all in this together.

"COMING TOGETHER IS A BEGINNING; KEEPING TOGETHER IS PROGRESS; WORKING TOGETHER IS SUCCESS."
– HENRY FORD –

Notes

1 MiFID II/MiFIR/PRIIPs Regulation Impact Study: Effectiveness and Efficiency of New Regulations in the Context of Investor and Consumer Protection, Prof. Dr Stephan Paul Nicola Schröder, M.Sc. Simon Schumacher, M.Sc. Ruhr-Universität Bochum.
2 Results of consultations with the interested parties and impact assessment as provided in the "Proposal for the DIRECTIVE OF THE EUROPEAN PARLIAMENT AND OF THE COUNCIL on markets in financial instruments repealing Directive 2004/39/EC of the European Parliament and of the Council (Recast)" on 20.10.2011. (COM 2011 656 final, 2011/0298 (COD)).
3 Letter of the joint committee of European Supervisory Authorities (EBA, ESMA and EIOPA) to the European Commission of 28 April 2020, ref. Submission of regulatory technical standards of ESG disclosures under Regulation (EU) 2019/2088.
4 Letter of the joint committee of European Supervisory Authorities (EBA, ESMA and EIOPA) to the European Commission of 7 January 2021, ref. Priority issues with regard to SFDR application.
5 Financial market participants with an average number 500 employees or less and financial adviser can publish a statement that they do not consider principal adverse impact. This statement should include clear reasons why they do not do so.
6 The ESA's published a final report on 2 February 2021 containing proposed level II regulation, including further elaborated requirements to comply with article 4 SFDR. A principle adverse impact statement on entity level has to be disclosed. The disclosures are focused on a set of indicators for both climate and other environment-related adverse impacts, adverse impacts in the field of social and employee matters, respect for human rights, anti-corruption and anti-bribery matters.
7 We refer to article 6, paragraph 2 of the new level II regulation as proposed by the ESA's in the final report of 2 February 2021.
8 In the feedback statement of the EC of 24 May 2018 following a consultation on sustainability, one stakeholder gave the following example. In case costs increase by 0.5% of assets under management (AUM), this could impact net returns to investors by 5 % if these costs are fully passed on to these investors.
9 A Capital Market Union for people and businesses-a new action plan, 24 September 2020, action point 1.
10 Targeted consultation document establishment of a European single access point (ESAP) for financial and non-financial information publicly disclosed by companies, first action of the capital markets union action plan, responses could be sent until 3 March 2021.
11 The first indications are not hopeful. The AFM did a consumer testing of SFDR disclosures. The consumer panel consisted of highly motivated consumers engaged in financial products. The disclosures were assessed as complicated, hard to read and not easy to understand. AFM 20 October 2020, consumer testing pre- contractual and periodic ESG financial product information.