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Sustainable and digital finance: taking stock of challenges and initiatives in the EU

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Ladies and Gentlemen, Good morning.

I thank Afore Consulting and ASIFMA for giving me the opportunity to address you today. I am truly delighted to be back in Hong Kong, a place that warmly welcomed me 24 years ago as seconded advisor to the Hong Kong SFC.

Already during my experience, it was noticeable how Hong Kong had long developed from a trade entrepot to a successful financial centre, ranking as the world's most economically free market[1] and playing a key role in the process of global financialisation. Certainly, at that time, the effects of the 1997 Asian Financial Crisis could still be felt. Fast forward to this decade, we can see the benefits of policies and initiatives that established Hong Kong as a centre of financial globalisation situated between East and West. Today, Hong Kong consistently features as the fourth most competitive financial centre in the world, according to the Global Financial Centres Index[2].

Notwithstanding these unique features, regulators in Hong Kong, just like in other jurisdictions, now have their agendas heavily dominated by discussions around two common topics: sustainability and digitalisation, very much in line with the main themes of today's conference. Much has been said about their risks and benefits. Yet, there are no signs that these will fade

[1] Fraser Institute (from 1970) and the Heritage Foundation (from 1995).
[2] The Global Financial Centres Index, GFCI 34 Rank, September 2023.

away anytime soon, or that the regulatory community will no longer be faced with new developments and challenges in these areas.

Today, I would like to give you an overview of the EU regulatory architecture, including ESMA's role, in general, and in the context of both sustainable and digital finance. I will then highlight key challenges that ESMA is facing in both areas. I truly hope that my remarks will provide a good introduction to today's discussions, and I look forward to further discussing these and other topics with fellow regulators and other public and private sector stakeholders here in Hong Kong.

Without further ado, let me first put ESMA's role into context.

The EU regulatory architecture and ESMA's role

In doing so, please allow me to make a few introductory comments on how the EU regulatory setting was designed and how it operates.

This European regulatory and supervisory architecture was created in the aftermath of the Global Financial Crisis when it became evident that further coordination and harmonisation of financial laws and supervision within the EU was needed. As a response, the EU developed a system consisting of a macro- and a micro-prudential pillar, which relies on the joint efforts of European authorities and the National Competent Authorities (NCAs) of the member states for local supervision.

Established in 2011, ESMA is at the heart of this system: one of the European Supervisory Authorities (ESAs) tasked to enhance investor protection, promote orderly financial markets and safeguard financial stability. Now, you might be wondering what this means in practice.

From a regulatory standpoint, our efforts involve complementing the EU laws on financial services with proposals for technical standards and ensuring their consistency and harmonisation across different EU countries.

From a supervisory standpoint, ESMA works as the sole supervisor in the EU of a small subset of financial infrastructures and service providers. In most areas, however, supervision of firms is conducted directly by the NCAs of the different EU countries, like in the case of investment funds or investment firms. In these cases, ESMA promotes convergent and coordinated supervisory practices throughout the EU. This is done through peer reviews, common supervisory actions, and common supervisory priorities, by way of example.

Finally, the monitoring and assessment of risks, in order to ensure financial stability in the EU, is also at the core of ESMA's responsibilities. In the span of slightly more than a decade, ESMA has weathered a wide range of challenges, including intense volatility caused by the COVID-19 pandemic in 2020, a subsequent crisis in energy derivatives markets in 2022 resulting from the invasion of Ukraine by Russia and, last year, the collapse of certain US banks and the failure of Credit Suisse in Europe.

Besides these, the EU – just like some Asian jurisdictions – is still feeling the effects of inflation and higher-for-longer interest rates.

Faced with these challenges, the EU and other global markets have proved resilient, in part thanks to the efforts of policymakers and regulators establishing the right tools and measures as a response to the Global Financial Crisis over a decade ago. However, we should not rest on our laurels: markets in the EU are still set to remain very sensitive and risks of market corrections continue to be high, owing to geopolitical and macro-financial uncertainty[3]. And this is certainly a shared concern of many jurisdictions worldwide. Therefore, important policy initiatives but also stringent and pro-active supervision are needed to ensure that markets remain resilient and open to cross-border capital flow that is so much needed to fund our ability to face global challenges.

This is why, for the next 4 years, and in line with our Strategy 2023-2028[4], ESMA will continue to work hard to improve the effectiveness of EU markets, their resilience and attractiveness, whilst facilitating the green and digital transitions. Our ambition is to do so in close cooperation with our counterparts in Asia and beyond.

I would like to turn to these two points now, starting with sustainable finance.

[3] ESMA Report on Trends, Risks and Vulnerabilities, No. 1,2024, 31 January 2024.
[4] ESMA Strategy 2023-2028, 10 October 2022.

Sustainable finance

In recent years, it became evident to policymakers worldwide that efforts to combat the effects of climate change can no longer wait, and that they must be supported by funding. In the EU, it is estimated that the implementation of the European Green Deal will require significant investments, around US $500 billion annually. In the Asia-Pacific region, a recent IMF study[5] has identified a need for at least US $1.1 trillion annually.

ESMA has been working to increase transparency in the EU sustainability framework. This is key, because investors need clear information on the environmental and social impacts of their investments, to make informed decisions. And in turn, sound information should increase investor confidence and effective capital allocation, including from retail investors.

At the heart of ESMA's efforts is corporate sustainability reporting. In this area, ESMA has closely supported the development of the Corporate Sustainability Reporting Directive (CSRD) by providing technical advice to the European Commission. This new Directive will strengthen the EU rules concerning the social and environmental information that companies must report and requires ESMA to develop guidelines for the supervision and enforcement of the new legislation.

All in all, the EU reporting requirements will not operate in a vacuum. They are informed by the ESG-reporting baseline established at the international level. This will only be possible thanks to the joint efforts of regulators across the globe and their contributions to the International Sustainability Standards Board (ISSB) and the International Organization of Securities Commissions (IOSCO) – and to a large degree to the Hong Kong SFC CEO, Julia Leung, for her leadership as one of the co-Chairs of the IOSCO corporate reporting workstream. I firmly believe that this coordination at international level will ensure regulatory consistency, to the benefit of global financial markets.

Connected to corporate reporting is the very topical discussion around transition finance and transition plans.

In the EU, the CSRD now requires companies to disclose their plans relating to their business models and strategies, and how these plans are compatible with the transition to a sustainable economy, with the objectives of limiting global warming, and achieving climate neutrality by 2050. To date, ESMA has already provided some recommendations on the quality of disclosures relating to transition plans as part of its 2022 European Common Enforcement Priorities.

In parallel, the international community of regulators are gearing up their efforts to examine the role of transition plan disclosures and clarify their relevance in supporting capital markets efficiency, integrity, and investor protection. This will be spearheaded by a new workstream developed by IOSCO. Furthermore, this topic will soon be examined from a financial stability angle by the Financial Stability Board (FSB) and ESMA will support the efforts of the international fora. Market participants should expect this matter to feature prominently on the agenda of financial regulators.

Now, let me turn to product disclosure – although without the intention of being comprehensive. This topic is particularly relevant in view of an important increase on both the demand and supply sides of investment products much needed to fund the green transition, alongside heightened risks of greenwashing.

ESMA has particularly focused on the funds sector, where the lack of labels or clarity around the current text of the EU Sustainable Finance Disclosure Regulation (SFDR) has fuelled the misuse of some of its provisions as marketing classifications. As a response, ESMA will soon issue guidelines on funds' names using ESG or sustainability-related terms.

More broadly, ESMA has been working with the EU banking and insurance authorities to establish a definition of greenwashing. A final report is due May this year, but already in our June 2023 progress report, the ESAs put forward a common understanding of this phenomenon, highlighting that greenwashing can occur either intentionally or unintentionally and in relation to entities and products that are either within or outside the EU regulatory perimeter.

Finally, another prominent topic in the regulatory agenda is the development of a framework to improve the transparency of ESG ratings characteristics and methodologies. I was pleased to see the unveiling of a proposal in the EU in June last year, following the work of IOSCO in this area. Indeed, ESMA has been supporting the development of such a framework since 2021 and led the work of IOSCO to deliver good practices for ESG rating and data providers. We are, therefore, happy to see that EU co-legislators reached a compromise deal on this bill earlier this month. We will monitor the next steps, contribute to implementation and eventually start supervising ESG ratings providers. I am also mindful that the interest in ESG-rated products is growing globally and leading to codes of conduct and associated regulatory initiatives, notably in Asia – with initiatives already undertaken in Japan, Singapore, India, Taiwan, and South Korea – and in Hong Kong.

Let me now turn from sustainable finance to the digital space.

Digital finance

The digitalisation of the financial sector has been taking place for years, with firms constantly seeking new technologies to reduce costs and gain efficiencies. But this trend was accentuated in various jurisdictions during the COVID-19 pandemic and interest of retail investors in accessing financial products in the palm of their hands, as found by a G20/OECD-INFE report published in 2021[6].

The benefits of technology in our sector are many, but it is the risks that keep regulators awake at night. After all, digitalisation may come with significant risks to investors and cybersecurity threats must not be overlooked.

This problem became evident when the failure of several crypto platforms, including the major exchange FTX, set off alarm bells and shed light on vulnerabilities in the crypto-asset markets. As valuations felt, over US $450 billion vanished during the market turmoil following the Terra/Luna collapse in May 2022 alone. Another US $200 billion was lost as a consequence of the FTX bankruptcy in November 2022[7], leaving many retail investors with significant losses that might have been prevented by adequate regulatory safeguards and supervision.

For these reasons, the introduction of an EU framework to regulate crypto-asset markets ("MiCA" Regulation) was a necessary step. For ESMA, this is the beginning of a new journey.

[6] G20/OECD-INFE Report on Supporting Financial Resilience and Transformation through Digital Financial Literacy, 27 October 2021.
[7] BIS Bulleting No. 69, Crypto shocks and retail losses, 20 February 2023.

The MiCA Regulation requires ESMA to prepare a number of technical standards and guidance on topics such as the authorisation of crypto-asset services providers, their governance, conduct of business, operational resilience, disclosure requirements, before the new regime becomes applicable in early 2025.

With crypto emerging as a transformative force into the global finance landscape, other jurisdictions too are starting to establish regulatory safeguards. International alignment and cooperation will be essential. Therefore, I strongly welcome the publication of respective recommendations by the FSB[8] and IOSCO[9] last year, which should serve as an anchoring point for policymakers globally when designing their policies and laws – in the same way that MiCA is aligned with these recommendations.

Looking beyond the crypto space, progress is also being observed in relation to operational resilience. In the EU, the establishment of the Digital Operational Resilience Act (DORA) in December 2022 means that ESMA will continue to work with the other ESAs to deliver technical standards on ICT risk management and consider the establishment of a single EU Hub for ICT-related incidents reporting. ESMA will also have to adapt to new practices and rules, as part of the integration of DORA oversight for critical third-party service providers into its existing supervisory processes.

Lastly, I could not conclude my remarks without touching on a very hot topic these days: Artificial Intelligence (AI). At ESMA, we have been observing financial sector firms gradually starting to use AI as a productivity-enhancing tool, whilst others have been making more use of this technology in portfolio optimisation and technical analysis. The key aspect for regulators is to understand the significant risks posed by AI, like those around the concentration of systems and models among a limited number of players; interconnectedness and systemic risks; algorithmic bias; and data quality, to name a few. At ESMA, we will keep a close eye on AI technologies to understand the risks that they may pose.

[8] FSB High-level recommendations for the regulation, supervision and oversight of crypto-asset activities and markets, 17 July 2023.
[9] IOSCO Final Report with Policy Recommendations for Crypto and Digital Asset Market, 16 November 2023.

Conclusion

Ladies and Gentlemen, let me conclude.

Today, I hope I provided an overview of some critical areas for policymakers, regulators and supervisors wishing to advance the transition to a green, digital economy.

In the EU, intense work is being undertaken to ensure that respective regulatory frameworks are in place to allow for capital allocation, whilst protecting investors from associated risks.

ESMA will continue this journey for the next years, but it will not be alone. We will be accompanied by other jurisdictions working to reap the benefits of sustainability and digitalisation. I sincerely believe that we must continue working together closely to provide investors with an efficient, aligned framework that allows us to tackle the common challenges in the EU, Asia and beyond.

Thank you very much indeed.