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Spotlight on Markets – January and February 2023

Artificial intelligence in EU securities markets

A widespread use of AI comes with risks. Increased uptake may lead to the concentration of systems and models among a few 'big players'.

- 2023 first Trends, Risks and Vulnerabilities Report
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AI in EU securities markets

A widespread use of artificial intelligence (AI) comes with risks. In particular, increased uptake may lead to the concentration of systems and models among a few 'big players'. These circumstances warrant further attention and monitoring to continue ensuring that AI developments and the related potential risks are well understood and taken into account. Check the Trends, Risks and Vulnerabilities article.

Key findings:

- **asset management**: increasing number of managers leverage AI in investment strategies, risk management and compliance
- **trading: traders**, brokers and financial institutions use AI to optimise trade execution and post-trade processes
- **elsewhere**: some credit rating agencies, proxy advisory firms and other financial market participants also use AI tools, mostly to enhance information sourcing and data analysis

2023 first Trends, Risk and Vulnerabilities Report

The European Securities and Markets Authority (ESMA) published the first Trends, Risks and Vulnerabilities (TRV) Report of 2023. Overall, risks in ESMA's remit remain high, and investors should be prepared for further market corrections.

Financial markets remained remarkably stable in 2H22, despite the general volatile environment. Although economic sentiment has become more positive in early 2023, there is no room for complacency. ESMA is keeping the overall risk assessment across its remit at the highest level.

The confluence of high risks across the ESMA remit and fragile market liquidity may test the resilience of the financial system against possible future shocks.

- Verena Ross, ESMA Chair

The second half of 2022 was dominated by the slowdown of economic activity, high inflation, global tightening of financial conditions, the geopolitical environment and the materialisation of peripheral risks linked to leverage and liquidity, together with growing concerns over business practices in the crypto space. These remain the defining drivers of risk in EU financial markets at the current juncture.

Main findings:

Overall risk assessment: Contagion and operational risks are considered very high, as are liquidity and market risks. Credit risk stays high and is expected to rise, reflecting the growing concerns over public and corporate indebtedness. Risks remain very high in securities markets and for asset management. Risks to infrastructures and to consumers both remain high, though now with a worsening outlook, while environmental risks remain elevated.

Market environment: The tightening of financial conditions globally has weighed on economic activity, while inflation remains very high. Volatility in energy markets stayed elevated despite a general decline in prices. Structural vulnerabilities expose markets and participants to the risk that shocks to markets could be amplified by liquidity supply and demand imbalances.

Securities markets: Equity prices were volatile in 2H22 with markets partially recovering 3Q22 losses based on news flow around relatively stable inflation and positive corporate earnings.

Asset management: The EU fund sector has seen outflows and low performance across most fund types in 2H22, as assets under management experienced their sharpest decline since the Global Financial Crisis. Maturity mismatches in Commercial Real Estate Funds persist, and the impact of the UK Gilt market turmoil on leveraged Liability-Driven Investment Funds in 2H22 confirmed existing concerns over fund liquidity risk management and excessive leverage, as well as contagion risks given strong systemic interconnections.

Consumers: Investor sentiment remains weak, against the backdrop of economic uncertainty. Inflation acts as a drag on real investment returns and contributes to falling household savings.

Infrastructures and services: Central clearing volumes grew further, as margins collected by EU CCPs for interest rate and commodity derivatives rose with rises in prices and volatility in underlying instruments, while some migration from ETD to OTC energy derivatives was observed.

Market-based finance: Capital market financing decreased sharply in 2022, turning negative for the first time since the Covid-19 related market stress in early 2020. The drop in activity is linked to high investor uncertainty, tighter credit standards for firms, high corporate debt levels and a rapid increase in the overall cost of external financing in the euro area.

Sustainable finance: Net-zero pledges have come under growing scrutiny, with the energy crisis jeopardising decarbonisation objectives. More broadly, the focus on greenwashing has increased while investors increasingly appear to differentiate between products based on their sustainability credentials, as reflected in steady net flows into SFDR Article 9 funds. Despite this, ESG markets continued to grow, with this trend showing resilience to broader market developments.

Crypto-assets and financial innovation: Crypto-asset valuations have now fallen by almost 70% year-on-year, driven by macro-economic factors and several high-level collapses in 2022. The recent failure of FTX, formerly one of the largest centralised crypto exchanges, triggered some large market corrections across crypto-assets. Contagion within the crypto sector has been substantial, reflected in further price drops of key crypto instruments and knock-on bankruptcies among service providers. Given low exposures by EU market participants, material spill-over effects of the crypto turmoil into the EU finance sector and the real economy have not been registered so far.

ESMA's first opinion on the draft ESRS

The European Securities and Markets Authority (ESMA) issued an opinion on the first set of draft European Sustainability Reporting Standards (ESRS Set 1) developed by the European Financial Reporting Advisory Group (EFRAG). ESMA finds that ESRS Set 1 broadly meets the objective of being conducive to investor protection and of not undermining financial stability.

To bring Set 1 from broadly capable to fully capable of meeting that objective, ESMA advises the European Commission to address selected technical issues set out in the opinion. Most notably, these issues relate to possible improvements of the level of consistency vis-à-vis the requirements of the Corporate Sustainability Reporting Directive and other pieces of EU legislation, important clarifications of definitions and terminology and further guidance on the materiality assessment process. The European Commission will consider ESMA's technical input as it finalises ESRS Set 1 and adopts it into delegated acts.

The development by EFRAG of the first draft set of ESRS is a major achievement. These standards will increase the consistency and quality of information flowing through the sustainable investment value chain. They will also enable broader accountability of European businesses for their sustainability commitments and impacts vis-à-vis retail investors."

"In line with the ESMA Strategy, we will continue to contribute actively to the sustainability reporting standard-setting process, with the aim of supporting the capital markets in financing the transition to a sustainable economy.

Verena Ross, ESMA Chair

Background

ESMA's opinion was drafted in response to a request from the Commission and in line with the mandate established by the Corporate Sustainability Reporting Directive. ESMA applied an assessment framework with four detailed criteria to prepare its opinion. These criteria relate to whether ESRS Set 1:

- promotes disclosure of material sustainability information of high quality;
- is conducive to consistent application in terms of both content and format;
- is consistent and interoperable with other relevant EU legislation within ESMA's remit; and
- promotes interoperability with global standard-setting initiatives for sustainability reporting to the greatest extent possible (and taking account of the EU's sustainability requirements and objectives).

The draft ESRS Set 1 was developed and submitted to the Commission by EFRAG in November 2022.

Next steps

The Commission will now consider ESMA's opinion alongside opinions submitted by the EBA, EIOPA and other public bodies and adopt ESRS Set 1 into delegated acts by 30 June 2023.

ESMA will continue to actively contribute to the development of the ESRS as an official observer in EFRAG's Sustainability Reporting Technical Experts Group and Board and plans to use its assessment framework also for its future opinions on the subsequent sets of ESRS.

EU Money Market Funds market 2023

The European Securities and Markets Authority (ESMA) published its inaugural market report on European Union (EU) Money Market Funds (MMF). With this report ESMA provides for the first time a comprehensive market-level view of EU MMFs, based on supervisory information collected by National Competent Authorities (NCAs) and ESMA.

"MMFs play a central role in the financial system, by bringing together the demand for and supply of short-term funding, and are closely interconnected with other parts of the financial sector. Recent periods of stress experienced by MMFs in the short-term funding markets (such as in March 2020) have shown the importance of monitoring trends and developments in the EU MMF sector.

The MMF Regulation introduced a reporting obligation for managers of MMFs to inform competent authorities' supervisory activity, allowing ESMA to publish today the first overview of this market using regulatory data."

Verena Ross, ESMA Chair

Main findings:

EU MMF sector:: The EU MMF sector had €1.44tn of assets in 2021, with 89% of the funds domiciled in France, Luxembourg and Ireland

Sector breakdown: Low-volatility NAV (LVNAV) MMFs account for 46% of the total assets, followed by Variable NAV (VNAV) MMFs (42%) and Constant NAV (CNAV) MMFs (12%). All MMFs domiciled in France are of the VNAV type and almost exclusively denominated in EUR. MMFs in Luxembourg and Ireland are mainly in non-EU currencies and set up mostly as CNAVs and LVNAVs. MMFs authorised in other EU jurisdictions are VNAVs denominated in other EU domestic currencies and account only for a small fraction of assets.

Asset allocation: The portfolio structure of EU MMFs remains relatively stable over time, and they are mainly exposed to the financial sector. Between March 2020 and June 2022, average exposures to credit institutions amount to 60% of total assets. Most of the EU MMFs' government debt exposure is towards non-EU sovereigns, and during March to December 2020 LVNAVs increased their share of government bonds before starting a slow readjustment back to the pre-COVID composition.

Liquid assets and risk sensibility: The share of daily and weekly liquid assets remained above the regulatory minimum, and increased for CNAVs at a regular pace starting in 3Q20. As of 3Q21, EU MMFs have significantly reduced the interest rate risk sensitivity of their portfolios, measured as the weighted average maturity of assets (WAM), to improve resilience to a rate rise.

Ownership and liabilities: Professional investors hold more than 90% of EU MMFs. Financial corporations are the main unitholders of MMF shares, with insurance firms, pension funds and banks accounting together for 25% of NAV and other financial institutions, including collective investment undertakings, for 45% of the NAV. Between December 2021 and March 2022 MMFs experienced substantial outflows, partially driven by investor expectations linked to the increase in interest rates and a turning investor sentiment away from fixed income instruments in general, a trend that reversed later in 2022.

In its opinion from February 2022, ESMA proposed that the European Commission should consider a number of changes to the MMF Regulation, intended to make MMFs more resilient. These reforms would help to improve the overall stability of financial markets, by reducing the risk of liquidity stress. Alongside key policy measures such as addressing the threshold effects for CNAV MMFs, and addressing liquidity related issues, ESMA suggested complementary reforms aimed at enhancing MMFs' preparedness for a crisis. These reforms would include enhancements of reporting requirements and the stress testing framework, as well as new disclosure requirements linked to the rating of MMFs. ESMA has also highlighted the importance of having these changes to the MMF Regulation implemented speedily.

ESMA assesses supervision of CSDs

Verena Ross, ESMA Chair, said:

The publication of this peer review marks an important juncture regarding the supervision of CSDs that make use of the freedom to provide services in other Member States.

The report sets out important recommendations for national authorities that aim at reinforcing their supervision of CSDs to ensure efficient securities settlement. An efficient, open internal market in securities settlement allows investors across the Union to invest in securities in another member state with the same ease, and using the same processes, as when they invest in their home country.

The European Securities and Markets Authority (ESMA) published its Peer Review Report on the national supervision of Central Securities Depositories (CSDs) providing cross-border services or participating in interoperable links.

The peer review assessed six National Competent Authorities (NCAs) in respect of how they supervise CSDs, which make use of the freedom to provide services in another Member State. The exercise included onsite visits to the CSSF (Luxembourg), FKTK (Latvia) and NBB (Belgium) to gain a deeper understanding of how these NCAs supervise the cross-border activities of CSDs.

Key findings:

NCAs **generally** have **satisfactory initial authorisation processes** using adequate tools and procedures to assess the cross-border links;

There is **room for improvement** in some NCAs' **approval processes during passporting procedures** when acting in their capacity as host authority;

NCAs should consider **improving cooperation** between them, notably with the home authorities of the CSDs which provide services in their jurisdiction;

Overall, NCAs conduct ongoing supervision of CSDs in a holistic way considering the entire organisation without distinguishing between domestic and cross-border services; and

NCAs supervisory approaches should follow a **risk-based approach** and rely on adequate tools to monitor risks.

Today's peer review is the first of a series of peer reviews mandated by the Central Securities Depositories Regulation, according to which ESMA should conduct at least every three years a peer review on the supervision of CSDs which make use of the freedom to provide services in another Member State.

Next steps

ESMA expects to carry out a follow-up assessment in two years to review the level of improvements achieved based on the findings and recommendations of this peer review.

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Publications

Click to read the news items

Date	
26 Jan	ESMA issues its first opinion on the draft European Sustainability Reporting Standards
27 Jan	ESMA publishes data for the quarterly liquidity assessment of bonds
31 Jan	ESMA consults on the review of the methodology on stress test scenarios for Money Market Funds
31 Jan	ESMA withdraws the CRA registration of Qivalio SAS
31 Jan	ESAs consult on draft Guidelines on the system for the exchange of information relevant to fit and proper assessments
1 Feb	ESMA reviews the scope of clearing and derivatives trading obligations
1 Feb	ESMA publishes data for the systematic internaliser calculations
2 Feb	ESMA issues Opinion on the trading venue perimeter
3 Feb	New Q&As available
6 Feb	The European Supervisory Authorities meet stakeholders from across the financial sector amid preparations for the Digital Operational Resilience Act
8 Feb	ESMA report finds EU MMF industry at close to €1.5tn
9 Feb	ESMA sees high risks amid fragile markets
15 Feb	ESMA assesses supervision of CSDs

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Speaking appearances

by ESMA Staff in March

Date	
2 Mar	Profilazione della clientela ai fini della valutazione di adeguatezza - Salvatore Gnoni, Head of Investor Protection and Intermediaries
7 Mar	11th Annual Conference Euronext - Verena Ross, ESMA Chair
9 Mar	FIX EMEA Trading Conference - Charlotte Sickermann, Team leader, Trading unit
15 Mar	Financial Times' Climate Capital Live 2023 - Dora Blanchet, Head of Sustainable Finance unit
21 Mar	ALFI European Asset Management Conference - Verena Ross, ESMA Chair
22 Mar	Trade and Transaction Reporting 2023 - Nikolay Arnaudov, Team leader, Data Reporting unit
23 Mar	Politico Finance Summit - Verena Ross, ESMA Chair
30 Mar	Thirteenth Annual EFR Stakeholder Round Table - Verena Ross, ESMA Chair
30 Mar	Luxembourg Sustainable Finance Forum 2023 - Fabrizio Planta, Head of Data Intelligence and Technology

Consultations

Click on the consultation

Closing date

9 Mar	Consultation on authorisation and registration of benchmark administrators
31 Mar	Consultation on the manual on post-trade transparency
28 Apr	Consultation on the review of the methodology included in the Guidelines on stress test scenarios under the MMF Regulation
2 May	Consultation on JC Guidelines on the system for the exchange of information relevant to fit and proper assessments

Hearings

Have you missed the latest hearings?

23 Jan	Open hearing on the consultation on ESG terms in funds' names recording presentation
6 Feb	Joint ESAs public event on DORA – Technical discussion presentations: ESAs | European Commission
16 Feb	Webinar on TRV report no.1 2023 presentation

Open vacancies

All open vacancies can be found on ESMA's recruitment portal

Deadline

28 Feb	**Head of Department Markets & Digital Innovation**
31 Dec	**Seconded National Experts (multiple profiles)**
31 Dec	**Traineeship Notice - Support functions profile**

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