ViewPoint

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Regulatory Developments in Europe: Midyear 2023 Outlook

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Introduction

Europe started 2023 facing multiple and interlinked challenges. Writing in the second quarter of the year, what we had thought would be a period of relative calm was interrupted in mid-March by episodes of bank stress on both sides of the Atlantic. Although European policymakers provided assurances that no immediate action was necessary to avoid banks in distress in the European Union (EU), ultimately the recent bank stress has reinvigorated the political willingness in the EU to speed up the completion of the Banking Union and to create stronger and deeper European capital markets (the EU's Capital Markets Union and efforts in the UK to boost "productive finance"). These events proved once again how macro-economic events can snap back abruptly, in turn shaping the contours of policy decisions that define the investment and regulatory environment.

From a macro perspective, 2022 was defined by Russia's invasion of Ukraine, an energy crisis combined with advancing climate change, prospects of economic stagflation with pressures on the cost of living, the continued impact of the Covid pandemic, and the growing challenge of the West's complex relationship with China.

Many of these developments have continued into 2023. But, this has galvanised the policy maker response, including at the EU level given its historic capacity to make some of its greatest advances in crisis.

In contrast to the post-Global Financial Crisis (GFC) period, the policy challenge for the financial services sector will stem not from being at the centre of politician's preoccupations, but the extent to which it is impacted by Governments' other objectives, such as boosting competitiveness, tackling climate change, and promoting economic resilience.

There are many ways in which this macro backdrop cascades into the financial services regulatory agenda in the months and years ahead. For instance:

- The conflict in Ukraine has led to new financial and economic sanctions and further de-risking of the global economy.
- In Europe, economic de-risking stemming from a growing deglobalisation trend could morph into political fragmentation. Therefore, accelerating the EU's agenda of open strategic autonomy and the UK's drive to develop its own frameworks - although the Windsor Agreement earlier this year has had the effect of warming post-Brexit relations.
- Fiscal constraints mean Governments are looking to the private sector to invest more in growth industries.
- Popular attitudes to technological innovation, data, and "big tech" could translate into concrete regulatory measures for financial stability, competition, and national sovereignty.

The opinions expressed are as of May 2023 and may change as subsequent conditions vary.

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- Meanwhile, the geopolitics of energy spills into the sustainable finance agenda shaping diverse issues such as taxonomy, disclosures, stewardship, product labels, and a revised State aid framework in the EU.

The upcoming six months will see a continuation of this turbulence and uncertainty. Yet as attention turns to parliamentary elections in both the EU and UK, we will also see new momentum to consolidate responses to these challenges and move the policy agenda forward.

In doing so, **there needs to be a balance between business-as-usual policy reform and ensuring its relevance and involvement in this much broader macro-level era of geopolitical and socio-economic change.**

European Union

Boosting competitiveness and addressing climate change remain two major topics for the European Union (EU). The most significant policy development in recent months has been the EU's response to the US Inflation Reduction Act (IRA), the so-called Green Deal Industrial Plan (GDIP). This proposal could be critical to creating investment opportunities in sectors that are key to reaching Europe's climate goals.

It will be a very busy period for policymakers as they try to push out new policy initiatives and seek conclusion of different files ahead of the European Parliament elections and the new Commission mandate in June 2024. Expect the energy transition and broader EU resilience to be carried forward into the next mandate as overarching themes shaping policy for investment and investors. More concretely, **in financial services, we expect this year to bring to a close to critical files on market structure and retail investment, as well as a reinvigorated willingness to further complete the European Banking Union**.

United Kingdom

Following a period of instability in the six years following the Brexit referendum, the UK is entering a period of political stability. The forthcoming Comprehensive and Progressive Trans-Pacific Partnership (CPTPP) accession and the Windsor Framework stabilise arguments about the UK's future relationship with Europe, and the end of the Sturgeon era in Scotland means that while not settled, the debate about UK's own future is less pertinent than it has been in recent years.

On the transition, the UK government has disavowed a subsidy-led approach to driving investment in clean energy infrastructure and technology, preferring an approach that aims to crowd-in private capital with limited taxpayer support and a supportive regulatory regime.

In financial services, 2023 is the year Brexit really begins to impact policy development. Not only is the UK Government in the process of introducing a new regulatory framework for financial services – conferring considerable autonomy on the UK regulators – but it has launched far-ranging reviews across the body of financial regulation. Many of the changes under consideration, such as the Listings framework, were possible before Brexit, but it has nevertheless been the occasion for them. Overall, **we see an approach focused on rightsizing, eschewing change for change's sake, and aimed at making sensible reforms where it makes sense for the UK's domestic objectives.**

About this ViewPoint

BlackRock advocates for public policies that we believe are in our clients' long-term economic interests. We support the development of regulatory regimes that increase financial market transparency, protect investors, and facilitate the responsible growth of capital markets. In this outlook, we set out the developments in financial services policy impacting retail investors, institutional investors, and distributors across Europe that we expect to be top of mind for policymakers in the upcoming months across five focus areas.

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If you want to know more about our positions on European policy files read our ViewPoints **here**, for views on global and international issues visit our **Global Public Policy page.** More on the UK **here**.

Policy developments

Retail, funds & retirement

Policymakers across the EU and UK have prioritised facilitating investments and increasing participation of retail investors in capital markets in recent months and are expected to maintain this as a core focus of their agendas as markets continue to recover.

Retail investor participation

In the EU, 2023 will be an important year for retail investment as in May the European Commission published its long-awaited Retail Investment Strategy (RIS). While much focus is being put on the suggestion for a retrocession ban for execution-only products and the possibility of this being extended by the co-legislative process to a full ban – a divisive element due to its contrasting role in various distribution models across Europe – the proposal is wide-ranging. It aims to reduce costs for retail investors, improve disclosures, enhance the digital experience, and boost financial literacy through the introduction of new rules as well as amendments to existing files. Any changes in the retail investment environment are likely to take at least three years (if not more) until implementation. **We believe successful measures in this area should look at increasing trust, simplifying choice, and encouraging digital users**.

In the UK, retail participation is also high on the agenda after the introduction of the proposals for Consumer Duty in 2022. The new Consumer Principle introduced by the Financial Conduct Authority (FCA) requires firms "to act to deliver good outcomes for retail customers", a requirement the EU is closely looking at as part of the RIS. The FCA has been clear that the Consumer Duty will form the cornerstone of its three-year strategy and that there will be a "paradigm shift" in its expectations of firms. The Duty will impact all regulated firms that serve retail consumers, even if there is no relationship with the end consumer. Prioritising good consumer outcomes will now become a business objective and should receive board attention in the same way that financial performance would. Following an extension of the implementation period, the measures will come into effect on 31 July 2023 (closed book products will have an additional 12-month implementation period), although there remain significant challenges for some firms to overcome in terms of implementation timeline.

Saving for retirement

On pensions, **the UK's introduction of auto-enrolment has brought millions more people into workplace pension schemes. The focus now needs to be on ensuring their savings can generate adequate retirement income.** In addition to increasing contribution rates, this can be achieved by improving overall investment performance.

The UK Government has long seen a confluence of interests between pension savers seeking higher returns and projects and companies seeking long-term financing. Several positive steps have been taken towards facilitating this – including the creation of a 'Long-term Asset Fund' (LTAF) structure suited to Defined Contribution (DC) schemes seeking less liquid investments; and from April excluding well-designed performance-based fees from the overall 'charges cap' applied to default investment options[1]. While these developments are important and necessary to increase the flow of capital from pension schemes to longer-term 'productive' investments, alone they are not sufficient. The correct incentives must also be in place.

One aspect of this is the UK Government's recently-announced 'Long-term Investment for Technology and Science (LIFTS)' initiative, which proposed to catalyse investment into venture capital, growth equity, and UK science and technology 'scale-up' companies, with an initial support of £250mn in government investment.

This and similar ideas to attract and incentivise pensions investment in the UK can help boost the economy whilst also delivering better retirement outcomes for end investors.

However, it is essential that any calls for further investment in the UK are balanced against the need for pension schemes to make investment decisions based on the interests of their members. **We continue to advocate for client choice and believe asset owners in all jurisdictions should be free to invest in accordance with their objectives, and not be required or feel pressured into making particular asset allocations.**

Linked to this, the UK Government used its Edinburgh Reforms package to call for increased consolidation of the pensions market to help drive economies of scale and spur further investment in the longer-term assets referenced above. For DC, this included the Value for Money framework proposed jointly by the Department for Work and Pensions (DWP), the Pensions Regulator (TPR), and the Financial Conduct Authority (FCA), which will help assess whether a scheme is providing value and encourage further consolidation of pension schemes where necessary. For Local Government Pension Schemes (LGPS), the Government has committed to two consultations, the first on increasing the pace of asset pooling and the second on requiring LGPS funds to ensure they are considering investment opportunities in illiquid assets.

Finally, the UK is expected to implement the Overseas Funds Regime, regularising the inward marketing of funds from overseas, which in the case of EU-domiciled funds, have been subject to the 'Temporary Permissions Regime' since Brexit. Doing so will ensure UK investors continue to benefit from the economies of scale, wide range of choice and access to innovative products that access to European-wide fund ranges offer.

Overall, **as we navigate an uncertain economic situation marked by fears of a recession, we can see how generating long-term savings and wealth for European citizens are now more relevant than ever**.

What else can we expect in the retail space?

In the EU, files such as UCITS and AIFMD, are approaching the end of their review; a targeted selection of changes aimed at facilitating stronger European capital markets through increased efficiency and access for investors, while balancing the need to maintain stability in the financial system through enhanced supervision and reporting arrangements. The review has introduced a product framework for loan-originating funds, a welcome recognition of the value these can have as a source of funding for European businesses, given the reduced availability of traditional forms of financing – some of the proposed measures lean more strongly into a product-focused perspective than AIFMD's existing manager-focused regime and could benefit from some flexibility to ensure the intrinsic value of these funds is not constrained by an overly prescriptive product framework. It also expands the availability of a broad range of Liquidity Management Tools (LMTs) to all Member States, a measure we have long supported[2], and continues to preserve the benefit of delegation arrangements through enhancements to the rulebook, empowering investors with enhanced choice, cost efficiency and access to high quality expertise. We expect negotiations on the final text to potentially conclude in the summer of this year, with measures likely to be implemented by mid-2025 at the earliest.

Similarly, to the EU, the FCA is also expected to kick-off a review of the current AIFMD and UCITS framework and to repeal PRIIPs all as part of the recently announced UK asset management review.

Sustainability, stewardship and corporate governance

Since the launch of the first EU Sustainable Finance Action Plan five year's ago and with this years' update to the UK's Green Finance Strategy, the subject of sustainable finance remains high on the EU regulatory agenda.

Disclosure frameworks

In the EU, while some of the building blocks of the framework with regard to products and transparency are now in place, complexities in the implementation and data gaps remain impacting the experience of the end investor. EU policymakers and regulators are assessing the functioning of the framework, focusing on the Sustainable Finance Disclosure Regulation (SFDR), which is likely to lead to improvements to the framework under the next Commission. Although the process to review the RTS and the whole Regulation more broadly has already kicked off, we expect this to pick up fully in the autumn. To fill in the gaps, the EC has also released additional elements of the EU Taxonomy which we expect to be further developed under the next mandate.

In parallel, the FCA has outlined proposals for its own Sustainable Disclosure Requirements (SDR), with final details of the framework expected in Q3 this year. In March, the FCA announced that it would push back the timeline for publishing this final set of rules in order to consider fully feedback on the consultation paper. We anticipate the FCA will review the proposed marketing restrictions, refine the criteria for product label eligibility and clarify how different products, asset classes and strategies can qualify for a label, including multi-asset and blended strategies. The need for coherence with international product disclosure regimes is acknowledged, it remains to be seen, however, if differences could lead to frictions in the cross-border distribution of funds, potentially disadvantaging UK investors if access to competitive product ranges were to be restricted.

Reporting standards

Since product disclosure frameworks need to be underpinned by high-quality sustainability data on the

BlackRock high-level recommendations

- Upcoming proposals in the retail space should focus on empowering retail investors by increasing trust in the financial services system, improving the level of financial education and facilitating digital engagement.
- The new UCITS and AIFMD frameworks should aim at improving efficiency and access for investors.
- Pension market reforms should preserve the freedom of trustees to prioritise their fiduciary duties.
- The new UK framework with the repealing of rules such as PRIIPS and UCITS KID and implementation of the Overseas Funds Regime should work for the end investor.

underlying investee companies, reporting standards are under development at global, regional, and national level.

The UK recently committed to continue to support the development of baseline sustainability disclosure standards by the International Sustainability Standards Board (ISSB) – and will set up a framework to assess these standards for adoption in the UK after the summer, when the ISSB's first set of standards are expected to be finalised.

In the EU, the Corporate Sustainability Reporting Directive (CSRD) was adopted in 2022 and defines the scope of listed and unlisted companies required to report against the European sustainability reporting standards (ESRS) under development by European Financial Reporting Advisory Group (EFRAG) - first phased reports are due in 2025. EFRAG is also working closely with the ISSB, to try to achieve interoperability between the two standards. To help companies fulfil the requirements of these sustainability reporting regimes, policymakers and industry are also looking at developing standards for net-zero transition plans – including the UK's Transition Plan Taskforce (TPT), is currently developing best practices for company transition plans, which will also be extended to financial institutions.

Alongside product frameworks and corporate sustainability disclosures, the European sustainable finance regulatory agenda is also focused on other parts of the financial ecosystem. **Among other topics, ESG ratings and ESG benchmarks providers will potentially be brought into the regulatory perimeter in both the EU and the UK later this year**. In this context, we also expect EU institutions to reach an agreement in the upcoming months on the Corporate Sustainability Due Diligence Directive (CSDDD), which will introduce new human rights and environmental due diligence requirements for EU and non-EU companies.

Lastly, we are also seeing policymakers moving forward with the green agenda beyond traditional financial regulation by announcing further prudential regulation work on ESG and climate risks in the context of the EU transition plans. The UK is preparing to review its approaches to stewardship and pension scheme fiduciary duties as part of the updated Green Finance Strategy.

BlackRock high-level recommendations

- All initiatives emerging or being reviewed in the area of product classification need to ensure consistency and workability for end investors.
- Any reporting frameworks across jurisdictions need a high-level of consistency and alignment.
- Due diligence requirements need to acknowledge the differences between asset managers investing on behalf of clients and the companies themselves particularly when determining the scope of the value chain.

Technology

Technology has long been an important tool for asset management, supporting the investment process, risk management and operational efficiency by providing structure and intelligibility to large amounts of data.

Artificial Intelligence

2023 is increasingly being defined in the press as "the year of AI", as phenomena such as Generative Artificial Intelligence (AI) - technologies that can automate the creation of human-like content, such as texts, graphics, and video – showcase the new capabilities and solutions to support business and society.

In the year ahead, significant regulations for AI are expected to be finalised. The European Union's Artificial Intelligence Act (the "AI Act") will prioritise compliance with fundamental rights through categorising AI systems based on the risks they can potentially pose. Additionally, the AI Liability Directive ("AILD") and updated Product Liability Directive ("PLD") aim to establish guidelines for civil claims involving AI systems. The Council of Europe is also focusing on the topic, aiming at contributing to the legal framework for AI.

On the other hand, the UK government has opted for a less prescriptive, principles-led AI strategy, encouraging individual sector regulatory bodies to issue tailored guidance. In 2022 the FCA published a discussion paper to gather inputs from the financial services industry on its current use of AI / Machine Learning (ML). In his 2023 Budget speech, the Chancellor also set out government investments aimed at supporting innovation in the AI space.

These regulatory developments reflect a growing recognition of the need to balance innovation with accountability in the rapidly evolving digital landscape.

Tokenisation

In this context of growing importance of digital tools for investors, digital assets including tokenised assets are becoming more and more relevant attracting the interest of media and politicians. **Established crypto currencies currently dominate the debate, but the tokenisation of existing asset classes and the use of tokenised assets in capital market transactions will be significantly more relevant for the future of financial markets.**

Market participants are exploring ways in which the tokenisation of existing assets or the issuance of assets on a blockchain could increase their mobility and allow for a swift and secure transfer of these assets in an agreed environment. Tokenised shares of Money Market Funds, for example, could help tremendously in reducing frictions associated with posting cash collateral to meet margin calls. Here, the tokenisation of fund shares, which can more easily be transferred directly from one holder to another, could reduce the need for redemptions from a fund to post cash margin calls, thus reducing potential outflow pressure during times of market stress and volatility. Tokenisation could also open up new distribution models and reduce certain frictions and counterparty risk related to any transfer of ownership.

Being digital alone does not make assets automatically more attractive or useful, but as the underlying blockchain verification and distributed ledger technology is able to solve specific problems, these are the expected to be growth areas for digital assets.

Regulation in the field of digital assets has so far mainly addressed the significant risks and failures in the field of transactional tokens and publicly accessible ecosystems. Capital market transactions would mostly benefit from permissioned blockchains where terms and access are agreed by the participants with legislation that recognises the different risk profiles.

Fragmentation of markets and a lack of interoperability between different ecosystems could lead to trapped liquidity and discourage the use of digital assets. At the same time, links between systems have proven to be vulnerable to attacks and operational risk. Future harmonisation and regulation with a focus on enabling market participants to interact in a safe and transparent way will benefit investors, markets, and issuers of digital assets alike.

BlackRock high-level recommendations

- Upcoming legislation in the field of AI needs to strike the right balance between innovation and accountability.
- Raise awareness of the potential advantages of the tokenisation of assets and the role technology is beginning to play for asset managers.

Market Structure

Throughout 2023 the EU and the UK have been reviewing the introduction **of important reforms to improve the functioning of their respective capital markets**. Whilst both aim to boost transparency and access to capital, the UK will also begin reforming some retained EU rules for financial services and replacing them with a framework tailored to the post-Brexit environment.

Consolidated Tape

When it comes to market structure and data availability, one of the most notable and awaited developments we expect this year in both jurisdictions, is the introduction of a real-time consolidated tape. Although at different stages in the process, with the EU close to finalising what has proven to be extremely difficult and political negotiations - the level of ambition is very similar in the UK. While the final scope of the tape is still to be determined, everything indicates that **at a minimum, it will provide some pre-trade and post-trade information regarding transactions in shares and ETFs, and post-trade information for all transactions in other financial instruments**.

Listings Act

Regarding access to capital, **this year has been marked by efforts to increase the number of companies going public both in the UK and in the EU, by reducing the legislative burden and introducing different tools**, such as dual-class or multiple voting shares. The FCA is consulting on measures to implement the Hill Review, aiming to boost the attractiveness of UK listings for issuers. In doing so, we have argued in favour of striking a balance that ensures shareholder's interests are protected whilst expanding their range of investment opportunities[3]. In parallel with developments, the EU, as part of the EU Listing Act, is looking at ways to increase the amount of research - covering particularly SMEs- in sectors like technology or healthcare. The UK has also launched its own review. These two workstreams could influence the way in which research is currently produced and sold, including renewed debates on the future of the unbundling rule.

Clearing Rules

2023 will also be a year of renewed conversations around Clearing – especially in Europe with the start of the legislative negotiations on the European Commission "EMIR 3" proposal. Of particular note is the proposed introduction of an "active account" provision, which would mandate EU clearing participants to open and maintain a liquid account at an EU Central Counterparty (CCP), with the view to decrease perceived overreliance on UK clearing houses.

Settlement Cycle

Finally, this is also a year where shortened settlement cycles will be introduced. In addition to discussing and mitigating the impacts of the US move to T+1 – due to take place in May 2024 – we expect debates to pick up, in the EU as well as in the UK, where an industry taskforce has been launched to explore a similar move[4].

BlackRock high-level recommendations

- A consolidated tape should include pre- and post-trade real time data to improve market transparency and ensure best execution for retail investors.
- Listing rules should be simplified to encourage more companies to list in European venues. However, the reforms need to balance carefully to achieve both current levels of investor protection and enhances investment opportunities.
- Clearing rules should allow for greater choice of what and where to clear by taking a market-driven approach and avoiding mandatory relocation.

Financial Stability

The COVID-induced 'dash for cash' during March 2020 prompted policymakers, led by the Financial Stability Board (FSB), to examine the demand and supply of liquidity for core financial markets.

In 2023, this phase of policymaking will draw to a close: having published recommendations to enhance Money Market Fund (MMF) resilience in October 2021, the FSB will this year produce recommendations on liquidity risk management for open-ended funds (OEFs) and look more broadly at the functioning of core funding markets. Recommendations for OEFs are likely to focus on ways to improve standards in the application of the liquidity risk management toolkit and ensure that OEF subscription and redemption terms are appropriate for the assets they hold.

From now on, policymaker attention is likely to shift elsewhere. Recent turbulence in the banking sector will likely result in a review of how (macro)prudential policies are being applied in the 'non-bank' sector. The FSB has signaled its intention to address perceived vulnerabilities linked to the use of leverage; and the impact margin and collateralisation processes have on financial markets more broadly. In recent years, this work programme has been prompted in part by several instances where the use of leverage by market participants has interacted with the post-Global Financial Crisis move towards central clearing and collateralisation of trades.

In the first instance, we expect policymakers to focus on ways to enhance transparency around leveraged investment strategies. However, we believe addressing liquidity stress in the financial system will require a holistic perspective on the interaction between all market participants, and the role of regulation in shaping market dynamics.

BlackRock high-level recommendations

Any legislative proposal addressing liquidity stress in the financial system should take a holistic approach that enhances market dynamics.

If you want to know more about our positions on European policy files read our ViewPoints here, for views on global and international issues visit our Global Public Policy page. More on the UK **here**.

Endnotes

1. https://www.gov.uk/government/consultations/broadening-the-investment-opportunities-of-defined-contribution-pension-schemes/outcome/statutory-guidance-disclose-and-explain-asset-allocation-reporting-and-performance-based-fees-and-the-charge-cap#performance-based-fees-and-the-charge-cap
2. https://www.blackrock.com/corporate/literature/whitepaper/a-european-perspective-on-managing-liquidity-risk-in-investment-funds-070822.pdf
3. BlackRock's response to the Hill Review https://www.blackrock.com/corporate/literature/publication/hmt-uk-listings-regime-review-020821.pdf
4. Accelerated Settlement Taskforce - GOV.UK (www.gov.uk)

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