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ESMA Brief - 2021

The Impact and Evolution of ESG Scores in Financial Sector (governance)

The performance and influence of ESG (environmental, social, and governance) scores in the financial sector have been significant, yet present various challenges. Recent controversies surrounding governance practices have been increasing, affecting financial sector data and ESG-related controversies alike. While the ESG ratings cover three distinct pillars allowing customisation of different environmental, social, and governance scores; they are usually aggregated into a single ESG score. This system raises issues like anonymity, governance, and privacy. Factors like operational resilience, scalability, and governance present additional challenges. ESG leaders must meet high scoring requirements across all pillars, yet a lack of commonality in the definition of these components exists. While there is a growing focus on ESG factors in financial decision-making, issues like overvaluation and negative returns have been noticed due to higher dispersion in ESG ratings. The expansion of sustainable finance in Europe comes with concerns about interconnectedness, governance, and potential conflict of interest in the financial system.

ESMA Report Analysis on Market Trends, Risks, and Innovations (esg)

The European Securities and Markets Authority (ESMA) has released an analysis of market trends, risk and vulnerabilities, which focuses mainly on the impacts of the COVID-19 pandemic, Brexit-related uncertainty, and interest in environmental, social, and governance (ESG) equity benchmarks. The performance of ESG equities has been mixed due to the variable impacts of COVID-19 vaccine announcements on different sectors. These fluctuations highlight the growing importance of ESG ratings in sustainable investing. The report also notes a high level of net flows into ESG equity funds, showing interest among asset managers. The integration of AI and machine learning by financial institutions in designing ESG-based portfolios is also acknowledged. Lastly, the report provides insights into macroeconomic conditions, revealing that improvement was reflected by better GDP forecasts, despite high uncertainties linked to the future economic impact of the COVID-19 pandemic.

Shift and Implications of Decentralised and Digital Business Models in The Financial Sector (business model)

The financial sector is witnessing an increasing shift towards decentralized, digital platform models, also known as 'neo-brokers' or 'zero-commission brokers', which offer a range of services from trading to wealth management. These platforms, including cryptocurrency and various investment services, are attracting consumers due to their zero-commission business models and gamified features. However, this trend also raises investor protection concerns. The COVID-19 pandemic has accelerated the adoption of these business models, transforming capital allocation and risk management processes. Moreover, substantiating the growing interest in digital platforms, four digital investment platforms raised €100 million globally in Q1. Nevertheless, this data-based business model could potentially undermine competition by facilitating price discrimination and raising privacy concerns.

The Uneven Recovery and the Rise of Fintech (technology)

The post-COVID recovery across sectors and countries is inconsistent. Tech and consumer discretionary sectors show strong recovery, whereas financials and telecom sector lag behind. Meanwhile, significantly increased interest is noted in financial tech, or fintech, specifically green fintech targeting climate and social targets. Despite the energy-intensive reputation of distributed ledger technology (DLT), less resource-intensive versions have been developed, giving a boost to large tech companies. As technology continues to advance and integrate into finance, benefits such as improved consumer outcomes and risk reduction are anticipated. Concurrent with these benefits, the dominance of large tech companies continues to increase. Regulatory technology (Regtech) and supervisory technology (Suptech) adoption might further reduce risks. Decentralized Finance (Defi) also promises disintermediation, 24/7 availability, and censorship resistance. Investments in renewable energy technologies can trigger a temporary slowdown before revitalizing economic growth. The unequal recovery coupled with the rising influence of fintech and its potential implications are noteworthy.

Confidentiality and Compliance in Financial Market Practices (confidentiality)

High-frequency trading (HFT) techniques widely used in trading venues are expected to comply with national and union laws regarding the protection of information confidentiality, including undisclosed know-how, business information, and personal data processing. Customized private funds and portfolios, often protected by bilateral confidentiality agreements, are not recommended to be publicly disclosed. If necessary, such disclosures should be made in a password-protected section of the website. Concerns were raised about potential conflicts between pre-contractual and website disclosures with confidentiality duties. Insurance sector respondents pointed out that reporting top investments might conflict with confidentiality agreements making some data meaningful for end investors. ESMA emphasizes the need to enhance the quality and security of trade repository data, addressing breaches of confidentiality, and system's integrity failures. The ESMA staff vows commitment to confidentiality upon joining and annually declares any interest that can cause conflicts of interest. Emphasizing the ICT risk, the need for safeguarding network security, ensuring processes, data, and assets' integrity and confidentiality were noted. Appropriate procedures adhering to reported data's security and confidentiality were proposed. Lastly, any information exchange or cooperation must consider confidentiality, retaining the integrity and confidentiality of the shared information.

Prioritizing Business Sustainability: Environmental, Social and Governance Indicators (human rights)

There is increasing focus on acknowledging and addressing the principal adverse impacts of investment decisions on sustainability. These adverse impacts highlight significant negatives in areas such as environmental, social, and employee matters, human rights, anti-corruption, and anti-bribery. Key players are calling for the formulation of regulatory technical standards (RTS) that stipulate the content, methodologies, and presentation of this information. The majority of respondents show interest in developing indicators for social and employee matters, human rights, anti-corruption, and anti-bribery alongside environmental ones. There are concerns about the exclusion of OECD Principles for Multinational Enterprises and UN Guiding Principles on Business and Human Rights in the draft RTS, prompting suggestions for their inclusion in future iterations. However, one member proposed that adverse impacts for social considerations, except human rights and controversial weapons, remain voluntary during a transitional period.

Green Fintech and Market Trends Influenced by COVID-19 (innovation)

The ongoing drive for financial innovation is critical in achieving new climate and social goals. Having a focus on 'green fintech' can aid in directing investments towards sustainable areas. The COVID-19 pandemic has expedited the digitalization process, resulting in both positive outturns and risks such as cyber resilience issues. The European Securities and Markets Authority reports a recovery in EU financial markets from COVID-19 related stress due to factors such as the creation and distribution of vaccines and reduction of Brexit uncertainty. Green fintech is a key theme in the EU's innovation facilitation efforts, aiming to utilize digital technologies for sustainability, though potential unintended consequences such as crypto mining need regulatory attention. The European Commission has introduced a Digital Finance Package to boost digital innovation in finance, featuring objectives such as promoting a regulated, data-driven financial sector and enhancing the online services market. Yet, Proliferation of digitalisation necessities constant monitoring of technological innovation in the EU financial services sector for risks and opportunities.

The Significance and Challenges of ESG Ratings in Sustainable Investing (esg ratings)

The current context reveals that ESG (Environment, Social, and Governance) ratings are becoming crucial for investors and issuers as sustainable investing gains popularity. However, these ratings present challenges due to the lack of standardized methodologies, creating issues of comparability and consistency. Furthermore, various ESG rating providers have skewed correlations. Despite these difficulties, ESG ratings can still offer valuable insights for investors, helping them navigate through 'impact-washing' concerns. Utilizing ESG ratings for investment funds may also bring about the need for enhanced transparency, particularly in relation to exposure to climate-sensitive sectors. Nevertheless, there is skepticism regarding the readiness and reliability of ESG ratings, citing potential opacity and subjectiveness in rating methodologies. The market for ESG ratings is diverse, covering different aspects, being either backward or forward-looking, and applicable to both corporate issuers and local governments. While ESG ratings have unique characteristics that set them aside, they share some similarities with credit ratings, such as being data-driven assessments from third-party providers. Nonetheless, the current limitations of ESG data require qualitative input, blurring the distinction between ESG ratings and scores.

Analyzing Climate Risk in Investment Portfolios and the Impact of Green Finance (climate change)

The main topics people are interested in from this provided paragraph focus on the examination of investment portfolio measurement from a climate risk perspective, the effect of policy measures aimed at mitigating climate change impacts, the exploration of climate change financial risks by the Bank of England, and the growing attention toward the Paris Agreement's 'net-zero' carbon emissions objective in the corporate sector. It also discusses the efficiency of green finance, particularly green bonds, in reducing global greenhouse gas emissions and their potential role in climate change mitigation. Additionally, there's an emphasis on the time-frame of climate change risk scenarios, acknowledging their insufficiency in portraying long-term climate change risks due to ignoring energy transition risks.

Enhancing Transparency and Accountability in Algorithmic Trading and Market Speculation (accountability)

Multiple sources of global and local news unveil the proposed Digital Service Act's new regulations for online intermediary services, aimed at improving transparency and accountability of online platforms. Financial firms should systematically reassess their trading systems, governance structures, business continuity, and compliance with MiFID II, based on their business scope and complexity. ESMA's individual monitoring activities have pinpointed issues regarding limited business line accountability, information security control, and strategy independence. These observations call for stronger front-office accountability and more robust detection systems to identify and fix potential deficiencies. On another note, as of January 1, 2021, federal speculative position limits will apply to referenced contracts on some agricultural, metals, and energy commodities, and exchanges must establish or enforce speculative position limits or accountability levels for non-federal limited physical commodity contracts. The CME and ICE Futures Europe exchanges already have position management controls, including position limits and accountability levels, in place. The exchanges can demand information from position holders exceeding the set levels and instruct them not to increase it further or reduce the position if necessary.

Regulatory Framework and Supervisory Actions for High Speed Trading and Credit Rating Agencies (internal controls)

The FSA's regulations for High Speed Trading (HST) systems streamline the registration and monitoring process. ESMA's qualitative criteria is used to identify and handle significant weaknesses within the systems. The framework emphasizes on the importance of strict internal controls and oversight systems in order to mitigate potential risks.
The CRA regulation review by ESMA strives to provide a strong framework for internal controls and identifies critical areas such as business continuity, information technology (IT), and information security. In addition, issues such as conflicts of interest, transparency, and governance are also addressed under this regulatory framework.
The report highlights the need for competent authorities to evaluate if internal governance arrangements ensure the sound management of risks, especially in relation to potential threats from money laundering or terrorist financing. The document also insists on internal control systems' appropriateness and its importance in mitigating risks.
Finally, the information presented puts forth the idea of constant re-evaluation and reassessment of the internal control systems in differing situations and circumstances that potentially increases the risks associated with the financial institution. The oversight roles are highlighted for their importance in reviewing the performance and achievements of these systems.

Fintech and AI Growth Trends in the Financial Market (fintech)

The report details the recent and emerging trends in the financial market, focusing on fintech and AI. Notably, there are steady investment flows into AI and fintech, suggesting strong and sustained investor interest. Following the financial contraction induced by COVID-19 in Q1, fintech funding has rebounded in Q2 and Q3, resulting in the largest funding quarter on record in Q3. Innovative technologies like distributed ledger technology, AI, Machine Learning and

Internet of Things are enabling sustainability goals in financial products and services. There's been an increase in partnerships between established financial institutions and fintech firms to meet new tech-savvy investors' requirements. Additionally, green fintech, which leverages these technologies to achieve environmental goals, has been included as a key area of focus. Regulators' engagement with fintech through innovation hubs and regulatory sandboxes has also become mainstream across the EU. Despite the steady growth and promising performance, several promising fintech IPOs have underperformed the broader market so far.

Crowdfunding Fraud and ESG Controversies: Risks and Measures (fraud)

The document discusses the potential for fraud in crowdfunding investments due to their relative anonymity. It also highlights the increasing number of controversies surrounding environmental, social and governance (ESG) especially in financial services sector, with particular focus on tax fraud and business ethics. It also reveals a growing trend of corporate green bond issuances that despite having labels like 'human rights' and 'carbon emissions', could have underlying poor records in these areas. The document mentions anti-fraud measures and strategies ESMA has put in place, with a focus on promoting a culture of transparency and integrity within organizations. It also addresses guidelines for competent authorities to consider business strategies, outsourcing, legal issues, internal and external fraud risks in their assessments. It further details the technical and operational aspects related to data processing, IT infrastructures and outsourcing among firms.

The Impact of GDPR on Financial Product Disclosures and the Role of Big Data in Financial Institutions (gdpr)

The introduction of the General Data Protection Regulation (GDPR) has sparked a broad consensus on its potential to mitigate risks in financial product disclosures. Its implementation can reportedly bolster the framework for product governance and the development and monitoring of financial products. Big data techniques, enhanced by GDPR guidelines, could support institutions in creating products that cater to their target market's needs. The GDPR's principle of data portability mitigates 'lock-in' effects for consumers, and the non-biased approach of the GDPR provides an adequate framework for big data. However, further guidance is recommended to accommodate the financial industry and consumer needs and to increase legal certainty and trust in big data-based products and services. Finally, the enhanced data protection and accuracy standards as a result of the GDPR may decrease identified risks related to data protection and accuracy. Existing cyber risk management legislation, like the NIS Directive, in addition to the GDPR, addresses cyber security concerns. However, there's a belief that immediate legislative intervention would be premature as major legislations such as the GDPR, PSD, MIFID II, or IDD are either just entering into application or still awaiting implementation.

Financial Market Participants Disclosure and Adherence to Sustainability Standards (international standards)

Financial market participants have introduced disclosure measures which involve summary, policies, and plans to lessen the principal negative impacts. They comply with international standards, provide historical comparisons for at least five past reference durations, and share information about planned actions and targets for the upcoming reference period. The adverse sustainability impacts statement, made up of a summary, description of negative sustainability impacts, action plans, and engagement policies, is published as per the annex format. Their activities adhere to specific international standards, such as the International Finance Corporation's standard on biodiversity conservation. There's a strong emphasis on internal control effectiveness and alignment with high international standards set by the Committee of Sponsoring Organizations of the Treadway Commission (COSO) framework. Additionally, they align with the EU’s directive on prevention of money laundering and terrorist financing and follow FATF's international standards.

The Role and Impact of Information Gathering in Institutional Management and Regulation Compliance (interviews)

Firms often rely on information gathered directly from issuers, through questionnaires, interviews, and third-party data. Several firms have given data on the projected costs of integrating Environmental, Social, and Corporate Governance (ESG) considerations into their operations. Despite the challenges posed by COVID-19, regulators like the European Securities and Markets Authority (ESMA) continue to organize meetings and interviews with various stakeholders.

This information allows institutions to judge the suitability of individual members of their management bodies. They particularly examine the member's integrity and potential for Money Laundering/Terrorist Financing (ML/TF), as well as conflicts of interest, among other things. Information gathering is also crucial for the consistent supervision and evaluation of Central Counterparties (CCPs). Regulatory standards also exist to ensure the accuracy and objectivity of information presented to the public.

Additionally, this gathered information aids in risk assessment and the development of strategic processes. Institutions carry out these assessments through factors such as CCP self-assessment reviews and updates, evaluation of the CCP's risk models, ad-hoc meetings, and committee opinions.

Enhancing Sustainable Investing through ESG Disclosures (esg disclosure)

People are interested in the structured assessment of ESG ratings and their disclosure, with emphasis on its importance to move towards a more sustainable path within the European Union. They support sustainability objectives and push for increased transparency. However, they express concerns that new ESG related disclosure requirements could become barriers for small-sized players and want to avoid forcing them to rely on third party data providers. One proposed solution is to create a centralized, public EU ESG data register for standardized ESG data necessary for compliance. They also underline the importance of finding synergies between different legislations to enhance sustainability in the economy, expressing the need for alignment between various ESG disclosures related initiatives. Additionally, they suggest ESMA to provide guidance to asset managers on dealing with situations where issuers do not provide taxonomy-related disclosures.

Interest in Business Ethics and Anti-Fraud Measures in European Financial Sector (ethics)

People's interest spans across areas like business ethics, anti-competition, and tax fraud. These subjects are particularly important in the financial services sector, which dominates tax fraud controversies and holds a considerable share of business ethics-related issues.

The growing number of ESG controversies is another concern, particularly among STOXX

Europe index firms from the financial industry. The European Commission's plan to reduce greenhouse gas emissions is also a highlight.
The ESMA, on noticing the significance of these issues, has adopted measures like anti-fraud and ethics management, such as implementing a code of good administrative behaviour and appointing part-time ethics officers. This promotes ethical principles and organizational values amongst the staff while ensuring prompt response to ethical issues.
ESMA also recommends the role of an independent valuer, who maintains policies in compliance with ethical and professional standards. This individual identifies any potential conflicts of interest, ensuring that the valuation does not have any material interest that could lead to a conflict.
These interests imply a growing demand for organizational transparency, ethical business practices, and sustainable operations in the financial sector.

Cybersecurity Strategies and Risk Monitoring Amid Crisis Anomalies (cybersecurity)

Market participants proposed varying cybersecurity strategies indicating limited common vulnerabilities. Amidst Covid-19, ESMA monitored TRS operations, performance, and cybersecurity. Progress was made in consumer protection, sustainable finance, joint risk assessment, financial innovation, and cybersecurity. The new ESAs' coordination group aims to streamline cooperation and coordination of cross-sectoral issues such as technological innovation and cybersecurity. ESMA increased its cybersecurity response capacities to support the pandemic situation, setting up additional VPN capacity, migrating users to Microsoft Office, implementing digital signatures and online voting tools, and enhancing security operations.
The primary risks identified included the prolonged Covid-19 crisis, the potential effect of the UK's withdrawal on EU securities markets, the security of ESMA IT systems amidst increased cybersecurity threats, and uncertainties concerning implementation of new EU legislative and non-legislative proposals. Stakeholders expressed concern over double reporting, noting the need to avoid duplication with AML and cybersecurity reporting requirements.
The majority agreed that cyber risks should be a fundamental concern as the impact of breaches can have major consequences. In the EU cybersecurity strategy framework, the adoption of the NIS directive institutes that operators should take appropriate security measures. The ESAs expressed that the current legislation on data protection, cybersecurity, and consumer protection could address some identified risks, and thus highlighted key responses in their final report. ESMA plans to address TRS' concerns while maintaining its supervisory role over TRS.

Carbon Footprint and Investment Trends in Various Economic Sectors (carbon footprint)

The economic sectors with the heaviest carbon footprint include manufacturing of non-metallic mineral products and basic metals, utilities, air transport, and waste management. Some investment portfolios have high average emissions and large carbon footprints, making them a regulatory focus due to their potential capacity for climate impact. Key sectors relevant for analysis are energy and utilities, due to their substantial carbon footprints, and banking due to its large share in corporate borrowing. Despite the significance of carbon footprint metrics, the limitations must be noted and forward-looking climate scenarios are advisable for disclosure referencing the Paris Agreement. The Covid-19 pandemic has also impacted corporate carbon footprints by prompting a shift towards digitalization, reducing travel and the subsequent emissions associated.

Uncertainties and Explanations Associated with Entity's Going Concern Status (going concern)

The material deals with uncertainties and explanations revolving around an entity's ability to continue as a Going Concern. Mostly, it includes the disclosure of material uncertainties that may cast doubt on the entity's continuing capability, explanation regarding preparation of financial statements without adopting Going Concern basis, and reasons why the entity is not regarded as a Going Concern. In unfavorable scenarios, issues like increased cost, reduced income and adverse confidence effects due to the COVID-19 pandemic have been mentioned as challenges to the entity's sustainability. There's also a provision for the description of financial resources covering potential losses and operational costs over a minimum six-months period suggesting viability assessment. Finally, it highlights the importance of effective resolution regimes for Central Counterparties (CCPs) to ensure financial stability and continuity.

Greenhouse Gas Emissions: Corporate and Regulatory Implications (greenhouse gas emissions)

European Commission plans to cut down greenhouse gas emissions by at least % below 1990s levels by 2030 are driving numerous corporate initiatives targeting 'net zero' emissions. This is fueled by the Paris Agreement, which aims to balance greenhouse gas emissions with removals by the second half of the century. A concern for reputation and business impact is also at play. Specific guidance is provided for entities to calculate their GHG emissions. Investments, particularly in companies and real estate assets, are scrutinized for their indicators like greenhouse gas emissions, energy performance, biodiversity, among others. Preference is given to direct measures like GHG emissions over alternative quantifiable indicators in assessing adverse environmental impacts.

Understanding IFRS Accounting Estimates Disclosure (accounting estimates)

The provided content details the dynamics of accounting estimates under the International Financial Reporting Standards (IFRS) with a focus on reporting and documentation. It denotes the function of table axes in defining relationships and provides an illustrative identification of an 'accounting estimates' member. Further, the material unpacks the complexities arising from estimating changes in accounting estimates due to impracticability. It also describes the nature of changes in accounting estimates impacting current and future periods. Additionally, it emphasizes the disclosure process of changes in accounting estimates. Lastly, the text enumerates a list of notes related to various IFRS roles covering areas like cash flow statement, accounting policies, and diverse roles in other entities.

Transition in Energy Sector: Comparative Analysis of 'Green' and 'Brown' Firms (renewable energy)

The adoption of renewable energy, though causing a temporary slowdown due to the impacts on traditional industries, eventually supports a return to economic growth. A comparative study of 'green' and 'brown' firms (those focused on renewable energy and water versus those in the coal, oil, and gas sectors) indicates that the Return on Equity (ROE) typically tends to be lower for green sector firms. There has been no consistent data suggesting a significant outperformance of these green companies in comparison to brown companies. Despite this, the price-to-earnings ratios of green firms have exhibited a rising trend. The aim of the European Green Deal is to achieve carbon neutrality, increase renewable energy share and energy efficiency, protect biodiversity and water, and eliminate waste. Majority of private sector green bond issuances in Europe finance projects leading to lower emissions, like renewable energy projects, clean transportation, and green construction. The report underlines the globe's gradual transition toward renewable energy and its impact on the economy and investment environment.

Evolving Interest and Concerns in Cloud Services, AI, Data Analytics, and Digital Finance (data analytics)

Communities and firms are showing increased interest in cloud services, AI, machine learning, big data analytics, and digital finance. In Q1, there was a significant global expenditure on cloud services, a platform that supports activities like data analytics and AI, witnessing a year-on-year growth rate of %. Attracting most enquiries from firms were AI, big data, machine learning, open finance, and application programming interfaces. There's also a growing interest in financial service provision platforms, regtech, and customer due diligence technology. There is, however, an increased onus on firms to scrutinize valuation processes and maintain fair pricing for OTC products now that technology and data are readily available. Some concerns also exist, particularly among consumer organizations, over the intrusive nature of big data analytics in finance which could dictate personal behaviors. Despite the concerns, many still see the benefits of big data analytics, especially in risk mitigation and compliance. AI is also seen as improving the function and precision of big data analytics. Yet, there is a need to ensure these technologies do not contribute to consumer detriment.

Objectivity and Consistency in Remuneration and Business Policies in Investment Firms (objectivity)

The focus of the media on larger companies can introduce size bias, impacting objectivity. It is important for investment firms to maintain consistency in remuneration policy with the company's risk strategies, long-term interests, corporate culture and values. Firms need to avoid conflicts of interests and not encourage excessive risk-taking. It is also obligatory to identify staff whose work significantly impacts the company's risk profile. The remuneration should not compromise the company's capital base and should comply with certain legislative directives. The internal control functions need to be designed in a way to not link their remuneration with their performance to ensure objectivity. An independent internal review of the remuneration policy is recommended. Appropriate procedures should be in place for transactions with related parties. It is also essential to maintain transparency and objectivity in the appropriateness assessment. The valuation date should ideally be the last available public financial statement date for higher transparency. The management needs to have rules in place for handling complaints and participating requirements. Lastly, the design of remuneration policies should not compromise the objectivity and independence of management body and senior management.
