Opening Keynote Address

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First of all, good morning to everyone.

I would like to thank ISLA for inviting me to be here today. I take this opportunity also to congratulate ISLA on the occasion of its 30th annual conference, such a relevant number of annual conferences is, for sure, a very good proof of ISLA's work importance.

Before moving further, there is one special word I would like to express, and that word is of deep solidarity with the people of Ukraine. The war has been going on for too long and we cannot become indifferent to a conflict affecting so many people so close to us and which, depending on how it evolves, can make all we say in this conference seem irrelevant.

I must confess that when I was invited to deliver a keynote at this conference, I also felt some concern, because it would be very difficult to say something about securities lending, that the specialists on the topic, which are those in this audience do not already know or have not already thought about.

Fortunately, the organizing committee invited me to tackle any area that would potentially be of interest to the audience.

What I thought of sharing with you has a strong and direct link with the views which CMVM, the Portuguese Securities Markets' Commission, has been trying to convey in the pursuit of its mandate, which includes the promotion of the capital markets development, in addition of course, to investor protection and to ensuring financial stability as well as the orderly functioning of capital markets.

There is one statement we use very frequently which I would like to share with you today: "the capital market is not an end in itself but rather a means", and an extremely powerful means to address both citizens' and companies' challenges and objectives, and a means for which there is no direct substitute.

Based on what I've just said, what I'll try to do in the next minutes is to briefly cover two main topics. One consists of highlighting some of the main challenges we are collectively facing. The other is about why we need to increase market-based finance to handle the

[1] As prepared for delivery

challenges, and these two main topics will allow me also to mention other relevant issues, such as, for instance, the Capital Markets Union, or the so called “CMU”.

Before moving on to these topics, I would like to show you a picture. I’m showing it because of a lesson I learned as a university student. We tend to forget almost everything we are taught in classes, but the things we forget less, are those that are embedded in stories, so I hope this picture can somehow be the equivalent to a story.

The picture is from an unknown Flemish Painter and depicts downtown Lisbon, as seen from where it was painted (View of the “Rua Nova dos Mercadores” street in Lisbon, circa 1570-1619). The painting is currently in London, at the Kelmscott Manor Collection, The Society of Antiquaries of London and it was displayed at an exhibition entitled “Lisboa – Cidade Global” which means “Lisbon – Global City”. By analyzing the painting, we can say that the global world was announced at Rua Nova Street, displaying together, for the first time in the same place, exotic objects and materials from faraway places around the world such as India, China, Japan and the Americas.

In these vivid and detailed views, we can see some aspects of what was then, a very cosmopolitan city. Although almost 500 years have passed and some say the world is “deglobalizing”, I hope that Lisbon’s global DNA, captured in the painting, is still well present today and can positively influence the outcome of ISLA’s annual conference.

Let me now move into the two main topics I would like to cover.

The first topic, as I have already mentioned, is to take a quick look into our European and Portuguese context and relative position and share with you some of the main challenges we are collectively facing, at least as we see them from the CMVM’s vantage point.

As far as challenges are concerned, If I had to narrow it down to one single sentence, probably the best one would be: “The challenges we are facing are significant both in number and complexity”, which means that in order to handle them, we’ll need not just to use all the instruments currently available in the tool kit, but we’ll have to use them as best as we possibly can, and we’ll likely have to create new ones. I’ll come to that in the second topic.

Since it is not feasible to point out all challenges, what I’ll do is to focus on a selection of five which I think will require a strong response involving the capital markets.

Just a note to say that the order in which I’ll mention them does not reflect any hierarchy.

Let me start by the first challenge which is financial stability. Although financial stability seems to be one of those concerns which can cover many others, I believe we can limit the scope in order to better understand what is at stake. Financial stability is one of those things that economic agents only think about, when they feel it is missing. We’re talking about something which is crucial, for taking decisions on consumption, saving and investment.

The number of factors that can impact financial stability have not just expanded in recent times, but have also intensified, as is clearly reflected in the Global Financial Stability Report of the International Monetary Fund from April 2023 and in the Financial Stability Review of the European Central Bank published in May 2023. This relatively new context of high inflation and high interest rates are two key factors specially as they seem more persistent than initially anticipated.

Tighter financial and credit conditions are testing the resilience of companies, households and sovereigns. The non-banking financial sector has remained resilient during the recent banking sector stresses and market volatility, but liquidity and credit risks remain high.

The share of high-quality liquid assets held by the euro area investment fund sector, remained broadly stable in 2022, but at a level of **13%** of total holdings, which is well below the average of 17% observed between 2014 and 2020.

In an adverse scenario, relatively small cash buffers could lead investment funds to engage in procyclical selling behaviour, potentially amplifying market corrections. This means that financial stability vulnerabilities remain high.

The second challenge I would like to point out is climate and digital transition. Let me be a little bit more specific about each one of them.

Regarding the particular case of the climate transition, and the E arm of our ESG efforts, we should never lose sight of the key objective: carbon neutrality. As an economist, I subscribe to the view that the single most effective way to reach carbon neutrality is through carbon pricing.

The planet is sensitive to “Carbon” not to ESG complex rules, nor even to the E alone in such rules. I’m not saying all that is being done in the regulatory landscape is not important. What I’m saying is that, in order to achieve the so-called green transition, if the world in general and certain countries in particular, plan to act according to what is needed and according to what is said, then the number I would like to share with you, has to be factored in.

The number is **700 billion euros** and corresponds to the European Commission estimate of the increase, on annual investment needs over the next decade compared to the previous one in order to meet the Green Deal, RepowerEU and the Net Zero Industry Act. Such an increase, just to put it into perspective, is larger than the total Swedish GDP.

And we’re not just talking about investing in currently available technologies, we’ll need to come up with new technologies if we are to be successful in achieving a goal of such magnitude as changing the way the world economy works, and make it carbon neutral.

As far as the digital transition is concerned, I would like to just add one perspective related to this, in addition to the investment amounts required. The perspective is derived from economic theory. When we try to go against economic theory, it tends to show how painful and unsuccessful it can be.

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In the case of the digital transition, it is particularly important to keep in mind the rule which states that in a competitive market, the price of a product tends to converge to its marginal cost. In digital products as well as in the intangible component associated to the value of a product – which may be software or physical components with large software component attached – in such cases, the marginal cost of one more item is zero or close to it.

This means that although companies incur on a cost to develop the software or the product, the cost to replicate those components can be nonexistent or close to it.

If we take a close look at the products we buy, we will quickly realize that they have a growing digital component incorporated. This fact implies that scale is an increasingly critical factor for a company to be competitive, since only with an adequate scale it is possible to conveniently dilute costs associated to digitalization and to the intangible component of products and services.

Moving now to the third challenge, I’ve selected retaining and attracting talent as another important one. In relation to this, we have been witnessing the high mobility of skilled employees, which has been facilitated by this new world of remote work. This situation is likely to continue because, in a competitive context in which the intangible elements are increasingly decisive for companies’ success, being able to innovate and enlarge those intangibles requires capacity to attract and retain the right people, and this means hiring beyond domestic borders.

This might be a concern felt more in certain geographies than in others, but if not addressed adequately, it can generate imbalances which ultimately can also impact those who currently don’t recognize it as a problem.

We shouldn’t forget that the world is interconnected and that this is even more evident in certain parts of the world, such as Europe for instance and, within Europe, in certain regions or groups of countries more than others.

This means that if a certain area’s success is achieved by draining another area’s potential, it is probably not sustainable on a medium to long term.

The fourth challenge I would like to mention is the ageing population, something that is particularly visible in Europe.

Just a disclaimer to stress that I’m mentioning this challenge based on what are the current life expectancies. I’m not factoring in potential research breakthroughs leading to cracking the code of eternal life, but even if such breakthrough occurs (and there are many believing it will, and also investing to ensure it will) we’ll face other new and potentially even bigger challenges.

Coming back to life expectancies as we know it, I would like you to keep in mind the figure **56,7%**. It represents the dependency ratio (number of dependents to the total working-age population). The figure is estimated for 2050 in Europe. It means that for one person above 65 years old, there will be less than two persons of working-age (between 20 and 64 years old).

This number means also various things in the coming years. One is a potential substantial reduction of income for a growing part of the population, when they reach retirement age, particularly in countries where social security is based on a "pay as you go system". Another is a huge pressure on health systems and a third one is a decline of risk appetite by society as a whole.

I believe that the combination of all the effects I've just mentioned can be anything but a walk in the park.

Let me move to the 5th and last challenge, which is also the key to help solving many of the previous ones I've just mentioned. I'm talking about economic growth and development.

The latest figures based on the IMF's forecasts, drawing on from its World Economic Outlook published last April, indicate that growth will slow from 3.4 percent last year to 2.8 percent this year.

Although growth is expected to accelerate to 3 percent next year, the risks to the outlook are heavily skewed to the downside, including heightened chances of a hard landing. In a plausible alternative scenario, with further financial sector stress, global growth would decelerate to about 2.5 percent in 2023. Looking further ahead, growth is expected to remain around 3 percent over the next five years.

This baseline forecast of 3 percent five years ahead for 2028 makes it the lowest medium-term growth projection since 1990 and well below the average of 3.8 percent from the past two decades.

Although these aggregate figures might not seem as bad as one could expect, the truth is that they include very different realities once we look into its details, and Europe is not looking particularly well on the estimates.

European Union is expected to grow 0,7% and the Euro Area (countries who have the Euro as their currency) is expected to grow 0.8 percent. Just for comparison, the United States of America is expected to grow 1.6 percent.

As far as challenges are concerned I'll stop here, and I'll now move to the second topic I would like to cover which has to do with how to address the variety and complexity of challenges.

And one word of caution is needed here, because the solution of complex problems can't be narrowed down to a simple and single recipe.

It is important to keep in mind some basic old rules and principles which have been valid in the past, are valid in the present and will remain valid in the future.

One is the rule stating that in order to have higher returns, you need to take higher risks, which turns out to be the same as saying that if we are to face higher risks, we need to ensure higher returns to compensate for such risks. In other words, there is no sustainable way of obtaining return without being willing to handle risk.

The other principle is the one that states that, the riskier the activity, the more solid the financial structure should be.

If we combine these two basic rules, with another very important fact, we'll be in a position to draw some conclusions on an important part of the solution, for the five challenges I have mentioned previously. And the very important fact not contradicted until now, is that companies are the most important value creation tool that has ever been invented by mankind. This means that in order to overcome the challenges, we'll have to incentivize companies, either existing or new ones, to improve and deliver their potential.

If companies are the best value creation tool, it is also beyond dispute that society as a whole would benefit if as many as possible of its citizens, could have access to the rewards of such value creation even if, of course, they have to share some of the risks associated with that process.

By now it should be clear that combining all I've mentioned is not achievable if we discard the use of capital markets as the enabler for combining resources and sharing risks and rewards.

And this brings me spot on the second main topic I had mentioned at the beginning, about the need to increase market-based finance to handle the challenges. This necessity is particularly strong in Europe, and even more so within certain European countries, such as my own.

When we look into capital markets related figures, it's easy to recognize that a change in the European landscape is needed.

The U.S. equity markets are the largest in the world and continue to be among the deepest, most liquid, and most efficient, representing 41.1% of the $107 trillion global equity market cap in 2023, accounting for $44 trillion. This is 3.6 times the next largest market, China. Europe comes close to China, in 3rd position.

Within Europe there are also big differences among the various countries. If you consider another commonly applied indicator, which is total market capitalization as a percentage of GDP, Portugal is one of the countries in Europe where that percentage is the lowest, currently below 30%, and Sweden, a Country with roughly the same population, has one of the highest percentages, above 220%.

Capital markets alone do not explain the success of the United States' economy, but for sure they explain part of it. And for sure both market-based and bank-based finance contribute to economic growth, but there is strong evidence that the marginal contribution of capital markets increases with economic development, and that is because market-based finance contributes to the efficient allocation of capital towards innovative and productive companies.

It is also important to take into consideration the fact that, in spite of the process of European integration that has been taking place and with all that has been achieved with the Banking Union, the reality is that cross-border bank lending remains very low, so here too, market-based finance can strengthen financial integration, not just by facilitating cross-border funding, but also risk sharing throughout the entire euro area.

One other factor that is not so clearly perceived, and probably is even considered to be the opposite if we ask the opinion of common citizens, is that Capital Market infrastructures, particularly the ones supporting transparent public markets, are more resilient to systemic risk.

Even during the most recent difficult periods of the big financial crisis, transparent public markets never stopped functioning, which was not the case with other non-public and non-transparent parts of the market.

One last remark, about something which sometimes is also described as an existential threat. I'm talking about the need to accelerate the greening of the economy, which I've already mentioned at the beginning.

Although the carbon tax would be the most adequate way to accelerate the transition, even if such taxation is implemented, we'll still need a tremendous amount of investment to be done if we want to preserve our living standards. The ability to mobilize and allocate funding to achieve such a goal requires a substantial involvement of capital markets and market-based finance.

I could go on and on advocating on the importance of expanding market-based finance, but for the sake of time, I will use a couple more minutes to share some views on whether positive signs can be seen as regards moving in the right direction.

European institutions have been working towards improving market-based finance for many years and they have been doing so through a strategy that has involved different components, such as, for instance:

- Revising the regulatory environment to encourage market-based finance while ensuring investor protection and market stability;
- Technology, connectivity, and market infrastructure improvements to facilitate seamless trading and settlement processes;
- Encouraging institutional investors such as pension funds, insurance companies, and sovereign wealth funds, to participate in market-based finance, combined with developing a Retail Investor Strategy to attract retail investors;
- Fostering collaboration and integration with international financial markets;
- Creating supportive policies and mechanisms to facilitate access to capital for start-ups and SMEs.

In spite of all I've just mentioned, we have to be honest and conclude that until now European national capital markets are not responding in a way that can be considered compatible with these efforts. And probably that is why there is still an ongoing political push towards the idea of achieving what is known as the CMU, or Capital Markets Union.

I'm not sure whether we'll ever be able to achieve a complete CMU but, regardless of whether such political ambition is met, for sure the underlying goals behind it should be achieved, and the sooner the better.

Empirical research has shown that in financial systems with well-developed loan, corporate bond and equity markets, if one of these funding sources for non-financial corporations dries up, then one or both of the others can compensate for it, at least partially.

If investors and companies can diversify investments and funding sources, they'll be much better equipped to thrive and to withstand economic shocks.

At this point I wouldn't feel comfortable without a word related to the activity that has brought us together in this conference: securities lending, to emphasize the importance of the relationship between securities lending and capital markets.

Securities lending benefits lenders by generating additional income while borrowers gain access to securities for various trading purposes. It enhances market liquidity and efficiency, contributing to the better overall functioning of capital markets. Although it is not a common practice in Portugal, the CMVM has a positive view on it and will try to contribute to making market participants feel comfortable about it.

I'm about to conclude but before doing so I would like to emphasize that capital markets are a global reality from which we can all benefit.

Europe must be able to compete globally and, for that, its companies need strong and integrated capital markets able to facilitate an efficient allocation of savings and allowing for risk taking and sharing according to investors needs and profiles. These same European companies will have to give a major contribution in developing new technologies that will reshape our world in terms of energy production and use, water consumption and biodiversity preservation.

We depend on companies, alongside citizens and the public sector to achieve a sustainable economy worldwide. Thriving capital markets, including all its components, such as securities lending, are an indispensable support for this journey.

Allow me just one final remark to say that, despite all the challenges and difficulties we face, we must be able to put them into perspective. And as far as putting things in perspective is concerned, I couldn't think of a better example than reiterating the solidarity with the Ukrainian people.

I am sure that those living and fighting in Ukraine would gladly swap their situation for the opportunity of handling the problems I mentioned here today.

This means that our collective task, although difficult, is clearly achievable.

I thank you for your attention and wish you all an excellent working session.